Changes to US Treasury Market Structure and Request for Comments

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The dramatically changing market for US Treasury securities raises questions and concerns for the public and regulators alike.[1] For example, as with the equities markets, high-frequency trading has entered the US Treasury markets. The Treasury markets are also evolving with respect to new trading technology, increased automated trading, evolving market making roles, reduced risk tolerance among financial institutions, different business models, and shifts in buy and sell-side participation. In addition, as regulatory reforms have increased capital requirements and generally tightened financing requirements, there has been an ongoing debate about whether such reforms enhance or degrade the quality and depth of markets, especially in the fixed income context. These developments take on great urgency with the Treasury markets because these markets finance the US debt and provide the benchmark for the risk-free rate of return on investments.

In response to these market changes, the US Department of Treasury (Treasury) published a request for public comment regarding:

- the implications of these changes for market structure and liquidity;
- the efficacy of risk management practices in the Treasury markets;
- the need to update current regulatory requirements applicable to the government securities markets;
- the need to provide comprehensive market data about the Treasury markets to the official sector; and
- the possibilities of increasing public disclosure of Treasury market activity available to the public.[2]

Responses to this request for comment will provide important information to the staff of the Treasury, the Board of Governors of the Federal Reserve System (Board), the Federal Reserve Bank of New York, the US Securities and Exchange Commission (SEC), and the US Commodity Futures Trading Commission (collectively, the Joint Staff) in their continuing study of the Treasury markets in the wake of the Joint Staff's report regarding the events in the Treasury markets on October 15, 2014.[3]

Treasury has requested comment regarding these issues from a diverse group of stakeholders, including the general public, buy and sell-side market participants, academics, and industry groups, by March 22, 2016.

Effect of the Evolution of the US Treasury Markets on Market Structure and Liquidity

Treasury is interested in the various factors driving the evolution of the Treasury markets, and their implications for liquidity provision, market functioning and financing using Treasury securities. For example, Treasury asked for comment on whether there have been changes in the nature of liquidity provision, or demand for liquidity, in the Treasury markets, and, if so, whether these trends differ for different sectors, different types of Treasury securities, or in the futures, dealer-to-customer, or interdealer broker markets. Treasury also requested input on the current market structure, how participants believe the Treasury market structure will evolve in the coming years, and whether any changes to the Treasury market structure—whether through public or private sector initiatives—might be advisable given the recent and expected future evolution. Furthermore, Treasury asked to what extent changes in the Treasury financing markets affected liquidity in the cash Treasury markets.[4]

Risk Management Practices

Treasury is interested in public comment on what steps the public and private sectors can take to address any outstanding risks in the Treasury markets, including operational risks to market functioning and risks to market integrity. For example, Treasury asked for input on the risk management controls currently in place at the US Treasury cash and futures markets, as well as at firms transacting in those venues, and the internal risk controls employed by firms using algorithmic and other automated trading strategies in the Treasury markets. Public comment also was requested regarding the benefits and risks associated with the current structure for clearing and settling Treasury securities transactions in the dealer-to-customer market and on interdealer broker platforms. Treasury also inquired how best practices (e.g., the best practices published by the Treasury Markets Practices Group[5]) are used in evaluating and updating risk management systems at firms.

Regulatory Requirements Applicable to the Government Securities Markets

Many of the standards applicable to US securities, commodities and derivatives markets are not applicable to the Treasury cash market. As a result, Treasury requested comment on whether any of these differences should be aligned.[6] For example, Treasury inquired whether firms that conduct certain types of automated trading, or a certain volume of trading, in the US Treasury markets should be subject to registration, capital requirements, examinations, supervision, conduct rules, and other standards. If such changes should be implemented, Treasury asked whether any such changes would affect the cost of accessing or participating in the Treasury markets, and whether there would be any implications for the US federal government borrowing costs.

Data Available to the Official Sector

Because the official sector (which, although undefined in the release, presumably includes Treasury, the SEC and the Board) does not currently receive any regular reporting of Treasury cash market transactions, Treasury states that the need for more comprehensive official sector access to such market data is “clear.”[7] Accordingly, Treasury requested comment regarding the Treasury market data that should be made available to the official sector on a regular and ongoing basis.[8] For example, Treasury sought comment on what transactions should be reported, who should have the reporting obligations, whether the reporting should include identifiers for categories of end users, whether quotes/orders should be reported, and whether reported transactions, quotes and orders should include a time stamp with a certain clock precision. Treasury also inquired whether the reporting requirements should vary for different types of transactions or instruments.

In addition, Treasury sought comment regarding the manner in which such data would be reported. For example, Treasury inquired about what additional infrastructure would be necessary for market participants to begin reporting comprehensive Treasury market transaction data, especially given the diversity of trading venues in Treasury cash markets. In addition, Treasury requested comment on different methods for receiving transaction data from the Treasury markets (e.g., an existing reporting regime or a new alternative reporting regime).

Treasury also is interested in views regarding potential additional coordination across futures and cash markets, as well as interest rate swaps and options. For example, Treasury asked whether it is necessary for regulators to have visibility across all Treasury cash and derivatives markets in order to more effectively monitor and oversee trading behavior in any one market.

Data Available to the Public

Treasury also requested comment on the appropriate level and form of data about Treasury market activity that should be made available to the public. The extent of the publicly available information for Treasury markets, including that related to market prices, trading volumes, market participant inventories, and trends in market risk and liquidity, is substantially more limited than for many other major asset classes. Accordingly, Treasury recognizes greater price and operational transparency could provide a variety of benefits to the Treasury markets. For example, increased price transparency could improve efficiency, reduce transaction costs, enhance fairness, improve risk management practices, and encourage new entrants to the markets. Greater operational transparency (e.g., visibility into order types, access rules, and rulebooks) may encourage increased competition and a more level playing field. Nevertheless, Treasury also notes that the Treasury markets are not uniform, and that any such increased transparency must make appropriate accommodations for such differences. For example, more limited transparency may be necessary for larger trades, so as to avoid moving prices or revealing positions.

Accordingly, Treasury inquires whether increased public transparency is recommended for the Treasury markets, and, if so, what additional information should be made available to the public. With regard to price transparency, Treasury requested comment on what quotes/orders and characteristics (e.g., participant types, aggressor side, volume, price) should be reported, and whether these requirements should vary based on the age of the security, size of the transaction, or other characteristics of the security or transaction. With regard to operational transparency, Treasury requested comment regarding what additional information should be made available regarding the operation of trading platforms or trade execution algorithms on trading platforms.[9]

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[1] During a recent speech, SEC Chair White outlined a number of potential areas for reform regarding the regulation of the US Treasury markets, including operational integrity, volatility moderators, intermediary registration and regulation, public price transparency, and regulators' access to data and cooperation. Mary Jo White, Chair, Sec. Exch. Comm'n, Keynote Address at the Evolving Structure of the US Treasury Market Conference, Federal Reserve Bank of New York (Oct. 20, 2015).

[2] Notice Seeking Public Comment on the Evolution of Treasury Market Structure, 81 Fed. Reg. 3928 (Jan. 22, 2016) (Treasury Market Structure Request for Comments).

[3] Joint Staff Report: The U.S. Treasury Market on October 15, 2014 (July 13, 2015).

[4] The Bank for International Settlements Committee recently released two reports addressing similar issues in the fixed income markets. One report examines liquidity in the fixed income markets, and the other report focuses on electronic trading and its impacts on price discovery and market structure. See, respectively, Committee on the Global Financial System, Bank for International Settlements, Fixed income market liquidity, CGFS Papers No. 55 (Jan. 2016), and Markets Committee, Bank for International Settlements, Electronic trading in fixed income markets (Jan. 2016).

[5] Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets, Treasury Markets Practice Group (revised June 2015).

[6] Similarly, the SEC recently requested comment on whether Regulation ATS should be revised to apply to alternative trading systems that trade government securities. See the WilmerHale alert, SEC Proposes Significant Regulatory Changes for Alternative Trading Systems (Jan. 4. 2016) (WilmerHale ATS Alert).

[7] Treasury Market Structure Request for Comments, *supra* note 2, at 3931.

[8] The SEC recently adopted Rule 613 to require the establishment of a consolidated audit trail, which would capture customer and order event information for orders in national market system securities, across all markets, from the time of order inception through routing, cancellation, modification and execution. See, the WilmerHale alert, SEC Adopts the Consolidated Audit Trail Rule (Oct. 1, 2012). Rule 613 does not apply to government securities.

[9] The SEC recently proposed new rules that would require alternative trading systems that trade national market system securities to provide detailed information regarding their operation. The SEC's proposal, however, would not apply to alternative trading systems that trade government securities. See, WilmerHale ATS Alert, *supra* note 6.

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