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Treasury Market Alert

Regulators Implement Enhanced Oversight and Propose Transparency for the Treasury Market

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Introduction

On October 24, 2016, the Federal Reserve Bank of New York (FRBNY) held a conference on "The Evolving Structure of the US Treasury Market" (Conference). The Conference was a sequel to the first annual such event where oversight agencies pledged to work together to better understand and regulate the market for US Treasury securities. The Conference included the Department of the Treasury (Treasury), the Board of Governors of the Federal Reserve System (FRB), the FRBNY, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) (collectively, Agencies). Presenters included the Honorable Mary Jo White (chair of the SEC), the Honorable Timothy Massad (chair of the CFTC), Antonio Weiss (counselor to the secretary of the Treasury) and the Honorable Jerome H. Powell (governor, FRB). The Conference also included several panels where representatives of the Financial Industry Regulatory Authority (FINRA), the CFTC, the FRB and the industry spoke about the effect of new and potential regulatory initiatives.[1]

The Conference speakers emphasized the critical role of the Treasury market, and regulators were especially careful to note that there is a collective responsibility to protect the special nature of the market. Speakers reiterated the fact that the Treasury market is the deepest, most liquid securities market in the world. They acknowledged that Treasury securities are the world's risk-free benchmark that facilitate the implementation of US monetary policy, offer a reliable store of value for savers around the world, help businesses manage their risks and finance the federal government. Nevertheless, the volatility of trading on October 15, 2014,[2] prompted the Agencies to set up a collaborative working group that reexamined the rules and infrastructure of the Treasury market. The report of the interagency working group (Joint Staff Report), available here, has highlighted several potential sources of risk in the market. This alert summarizes the various proposals to reform the Treasury market over the next 18 to 36 months.

[1] Industry participants included NASDAQ, ICAP, DTCC, Global Trading Systems, Bank of New York Mellon, UBS, Morgan Stanley, Credit Suisse, BlackRock, Citadel, Hudson River Trading, AQR Capital Management and the Pacific Investment Management Company (PIMCO).

[2] On October 15, 2014, the yield on the benchmark 10-year Treasury security, a useful gauge for the price moves in other, related instruments that day, experienced a 37-basis-point trading range, only to close 6 basis points below its opening level.

Enhanced Data Collection and Interagency Collaboration

The Conference highlighted the Agencies' commitment to collecting and analyzing information about the Treasury market, but not necessarily to changing the market's operation or structure. Chair White noted the "convergence" of regulatory regimes governing equity markets and the Treasury market. Her priorities now include promoting enhanced oversight and reporting of Treasury market trading, working closely with FINRA as it considers the application of its rules to the Treasury market, and "strengthening the foundational regulatory regime" for platform operators and broker-dealers involved in the Treasury market.[3] Counselor Weiss also stated that in response to a request for information published in January, the Treasury received a significant number of public comments expressing support for comprehensive data collection and greater oversight of the Treasury market. The Treasury has therefore started working on a plan (to be completed by the end of the year) for comprehensive collection of trading data for cash Treasuries. He emphasized that the guiding principal of regulatory agencies is to "do no harm" to the market. [4]

Data Gathering | FINRA's Efforts

On October 19, 2016, the SEC approved FINRA's new reporting requirements, which require that all Treasury security trades (with the exception of savings bonds) be reported to FINRA through its Trade Reporting and Compliance Engine (TRACE).[5] Consequently, trading involving all marketable Treasuries, including Treasury bills, notes, bonds and inflation-protected securities (TIPS), will have to be reported to FINRA by July 10, 2017. Additionally, the new reporting requirement applies to the separate principal and interest components of Separate Trading of Registered Interest and Principal of Securities (Treasury STRIPS).[6] Purchases of Treasury securities from the Treasury as part of an auction are not reportable, but "when-issued transactions," which can take place after the

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[3] *See* Mary Jo White, Prioritizing Regulatory Enhancements for the US Treasury Market (October 24, 2016), https://www.sec.gov/news/speech/white-keynote-us-treasury-market-conference-102416.html (last visited November 10, 2016) (Chair White's Keynote Speech).
[4] *See* Antonio Weiss, Treasury Markets: Data, Oversight and Transparency (October 24, 2016), https://www.treasury.gov/press-center/press-releases/Pages/jl0591.aspx (last visited November 10, 2016) (Counselor Weiss's Speech).
[5] *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Relating to the Reporting of Transactions in US Treasury Securities to TRACE, SEC Release No. 34-79116 (October 18, 2016), https://www.sec.gov/rules/sro/finra/2016/34-79116.pdf (last visited November 10, 2016).
[6] Treasury STRIPS are zero-coupon bonds—the coupons are "stripped" from the bond or note. Return is determined by the difference between the purchase price and the bond's trading value, or face value if held to maturity. These bonds and notes offer minimal risk and tax benefits in some states.

Treasury Department's announcement of an auction but before the auction and issuance of the securities, are reportable. The rules now include a new trade indicator for these "when-issued transactions."[7]

FINRA also announced two new trade modifiers that will be used to indicate Treasury security trades that are priced away from the current market for *bona fide* reasons. However, FINRA members will not have to implement these modifiers by the current implementation date of July 10, 2017—it is still debating the appropriate implementation timeline for these modifiers.[8] Steven Joachim (executive vice president, Transparency Services, FINRA) stated that FINRA recognizes the implementation of the new reporting requirements will take time and technological adaptation, and that participants may make mistakes in implementation or may have interpretive questions. Joachim suggested that FINRA is sensitive to these concerns and is trying to be responsive by implementing real-time filters in reporting tools and by directly answering questions from members. He also stated that the organization understands that different firms have different abilities to adapt to new reporting requirements. Therefore, FINRA is providing machine-to-machine interfaces, setting up phone lines with service bureaus for participants and providing web browser access for small firms, all to facilitate adherence to the new rules. While large member firms with access to sophisticated technology will find it easier to implement these rules, Joachim said that FINRA hopes it can create and effectuate a reporting regime that is relatively fair and equitable to all.

Data Gathering | The Remaining 10%

In his speech, Counselor Weiss noted that FINRA's efforts to collect Treasury trade information through TRACE will capture 90% of Treasury market transactions. He stated that TRACE will cover trades of FINRA members, including the trades of FINRA members with non-FINRA member counterparties, and also capture trading on major platforms, such as BrokerTec and eSpeed. Nevertheless, 10% of Treasury trades occur between banks and other entities that are not FINRA members. To help close this gap, Counselor Weiss said that the FRB plans to collect Treasury market transaction data from banks and use FINRA as its collection agent. He characterized the FRB's plans as consistent with the Agencies'

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[7] *See* FINRA, Reporting Transactions in US Treasury Securities, Regulatory Notice 16-39 (October 2016), https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-16-39.pdf (last visited November 10, 2016).
[8] *Id.*

collective desire to ensure that there is "full coverage, no exceptions" of trading data and a level playing field for entities subject to reporting requirements.[9]

Platform Oversight | Regulation ATS and Regulation SCI

Chair White noted that the equities market has a regime for the registration and oversight of alternative trading systems (ATSs) that does not extend to activities in the Treasury market. When the SEC originally adopted this regulatory structure in 1998, it decided to exclude platforms that solely trade government securities in deference to the joint regulatory responsibilities of the SEC, the Treasury and federal banking regulators regarding the Treasury market. Increases in the trading of Treasury securities, electronic platforms and the exponential growth in high-speed trading have prompted regulators to reconsider their relatively hands-off approach to electronic systems trading these securities. Accordingly, Chair White asked the SEC staff to recommend ways of extending the regulatory regime attendant to the equities market platforms to the Treasury market platforms.[10]

Chair White mentioned that in the market for on-the-run US Treasury securities, ATSs bring buyers and sellers together for a large portion of daily trading volume. Even so, the operational integrity standards of Regulation SCI—Systems, Compliance and Integrity—do not apply to these ATSs. They are also exempt from Regulation ATS, which requires, among other things, registration as a broker-dealer, regulatory disclosures about operations, and the provision of efficient and fair use of primary trading venues to participants. Chair White expressed her belief that the SEC staff will recommend extending various provisions of Regulation ATS and Regulation SCI to platforms that currently trade government securities.[11] Counselor Weiss also emphasized that the Treasury supported the SEC's expansion of its oversight of the Treasury market through the elimination of exceptions in Regulation ATS. Counselor Weiss called the application of Regulation ATS to Treasury platforms "inevitable and necessary."[12]

Interagency Collaboration

The volatile trading environment on October 15, 2014, and the more recent "flash crash" in the price of the pound during after-hours trading on October 6-7, 2016, have led regulators

[9] *See* Counselor Weiss's Speech, *supra* note 4.
[10] *See* Chair White's Keynote Speech, *supra* note 3.
[11] *Id.*
[12] *See* Counselor Weiss's Speech, *supra* note 4.

to believe that they each have an incomplete picture of Treasury market activity. In order to illustrate this point, Chair Massad described how the CFTC collected and analyzed data from the currency futures markets during the two events. He concluded that during these events, some market participants were executing strategies in the futures market that were tied to their positions or strategies in the cash market. Because the cash market is much larger, activity is spread across a multitude of platforms and the CFTC does not have regular access to data from the cash market, the CFTC could not, on its own, make a definitive statement on the causes of either event.[13] But the Treasury, the FRB, the FRBNY, the SEC and the CFTC later established a joint working group to analyze what happened on October 15, 2014. The group published its report on July 13, 2015,[14] nearly nine months after the triggering event.

Today the Agencies are creating a more robust framework for enhanced coordination and collaboration. For example, William Dudley (president and chief executive officer of FRBNY) noted that the Agencies have signed a memorandum of understanding to share information. They also have set up an "Interagency Working Group" that will enable the Agencies to collaborate on effective and comprehensive data collection and monitor market activity and liquidity. President Dudley also noted that earlier this year, the Agencies engaged in joint meetings with market participants and groups such as the Treasury Markets Practices Group.[15]

The SEC and FINRA also have increased coordination regarding the Treasury market. The SEC asked FINRA to undertake a comprehensive review of its rulebook to identify FINRA rules that exclude Treasury securities and submit a schedule for how and when FINRA will address any identified gaps where warranted.[16] FINRA has already made a preliminary response and expects to present a proposal on a range of these issues to its board of

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[13] *See* Timothy Massad, Remarks of Chairman Timothy Massad before the Conference on the Evolving Structure of the US Treasury Market (October 24, 2016), http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-50 (last visited November 10, 2016).

[14] *See* US Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, US Securities and Exchange Commission, and US Commodity Futures Trading Commission, Joint Staff Report: The US Treasury Market on October 15, 2014 (July 13, 2015), https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf (last visited November 10, 2016) (Joint Staff Report).

[15] *See* William Dudley, Remarks at The Evolving Structure of the US Treasury Market: Second Annual Conference (October 24, 2016), https://www.newyorkfed.org/newsevents/speeches/2016/dud161024 (last visited November 10, 2016). President Dudley emphasized that engagement between the official and private sectors can "facilitate the development of timely solutions to important issues in the industry. Such efforts include the best practices the [Treasury Markets Practices Group] has produced for the Treasury, agency debt and agency MBS markets, and the Group of 30's recommendations on banking culture and conduct."

[16] *See* Chair White's Keynote Speech, *supra* note 3.

governors in the first quarter of 2017.[17] The proposal may include extending the rules that control front running of block transactions, prohibiting trades ahead of customer orders, trading ahead of research reports and applying certain conflict-of-interest provisions to the Treasury market. In 2015, FINRA already extended its markup and commission rules to transactions in government securities.[18]

Post-Trade Transparency

Treasury sees "compelling benefits" in providing post-trade transparency. During his speech, Counselor Weiss cited the corporate bond market, where post-trade transparency was introduced in July 2002. According to Counselor Weiss, there has been about a 50% compression of variation in mark-to-market valuations of bond holdings by mutual funds. Transaction costs also were reduced by half, saving investors approximately $1 billion annually, and there is evidence of improved competition through new entrants and reduced market share concentration. Additionally, because several key fixed income markets that are priced and traded relative to cash Treasuries—such as Treasury futures, agency debt, agency mortgage-backed securities and other securitized products, corporate bonds, and interest rate swaps—already have instituted post-trade transparency, this approach would be consistent with prevailing trends.[19]

The panel discussions involving market participants highlight some of the issues regarding post-trade transparency. Michael Fleming (vice president of the Capital Markets Function, FRBNY) summarized studies showing that transparency had a positive impact on the bond market. He concluded that the research suggests greater transparency may improve liquidity generally (and lower transaction costs) but also may reduce liquidity during times of stress. Representatives of buy-side firms were enthusiastic about post-trade transparency. Representatives of broker-dealers were more cautious. They warned that in the corporate bond market, transparency has had positive results—such as reduced price dispersion—but has also resulted in reduced trading or a change in the style of trading. In another panel on the future of the Treasury market, panelists expressed a belief that liquidity may improve as a consequence of post-trade transparency. Panelists also thought that there would be more "flash crashes" and volatility in the market as a consequence of increased transparency, but

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[17] *See* Robert Cook (FINRA), Letter to the SEC Regarding Regulation of US Treasury Securities (October 17, 2016), https://www.sec.gov/divisions/marketreg/letter-from-finra-regulation-of-us-treasury-securities.pdf (last visited November 10, 2016).
[18] *Id.,* n 8.
[19] *See* Counselor Weiss's Speech, *supra* note 4.

that such volatility would not necessarily be a bad thing if it was accompanied by the attendant benefits of transparency.[20]

Developing a post-trade transparency regime for the Treasury market is a work in progress. Counselor Weiss noted some of the risks and counterbalancing policy proposals involved in public dissemination of trading data. The Treasury is considering three strategies to mitigate these risks: first, appropriate time delays (allowing parties to hedge or to find other sides of trades involving less liquid products); second, limitations on disclosure of size for large trades (to prevent excessive market movements or revelation of strategies—a policy that already has been implemented for corporate bonds); and third, a phased-in, gradual approach over time (to allow for consultation with participants). Additionally, these three strategies likely will be applied to different segments of the Treasury market based on characteristics such as their liquidity and current level of transparency. For example, on-the-run and off-the-run Treasury securities reasonably would require different time delays, primarily because off-the-run securities need to be inventoried by market makers for longer periods of time (days or weeks rather than minutes or seconds). TIPS likely would need lower size limits for reporting than nominal coupon securities. Likewise, securities with high duration, such as the 30-year bond, may require different post trade transparency treatment than a 2-year note. The Treasury recognizes that the nuances of any post-trade transparency regime are likely to affect the behavior of market participants, and so careful monitoring will be necessary after the implementation of the regime.[21]

Registration of Principal Trading Firms

One of the key concerns for the SEC and the Treasury is the significant presence of unregistered principal trading firms (PTFs) in the Treasury market. Indeed, Chair White noted that PTFs engaged in the business of buying and selling securities for their own account may be functioning like dealers. She cited the Joint Staff Report, which notes that the 10 most active PTFs represent more than 50% of volume on the trading platforms for Treasury securities. They trade more frequently and, on average, in smaller size per trade

[20] Of course, the new administration in 2017 will have its own views on the way forward. However, the concern about increased volatility and transparency in the Treasury market is likely to remain. This concern was echoed by Federal Reserve Vice Chair Stanley Fischer on November 15, 2016, while speaking at the Brookings Institution. Vice Chair Fischer stated that while liquidity is adequate today, it is uncertain whether it will be sufficient in times of market volatility. He also stated that "flash events may be more frequent today, and the dynamics of a system with frequent flash events are likely to become complicated." Stanley Fischer, Is There a Liquidity Problem Post-Crisis? (November 15, 2016), https://www.federalreserve.gov/newsevents/speech/fischer20161115a.htm (last visited November 16, 2016).

[21] *See* Counselor Weiss's Speech, *supra* note 4.

than bank-dealers. Their median end-of-day positions are much smaller than those of bank-dealers, both in absolute terms and especially relative to trading volume, demonstrating a significant intraday position turnover.[22] Chair White therefore expressed concern that in the absence of registration requirements and regulation of PTFs, the Treasury market and its investors are exposed to significant risk from the operations of PTFs.[23]

Chair White also noted that SEC-registered brokers and dealers are required to abide by the SEC's market access rule, which the SEC views as a critical safeguard for modern electronic markets against the harmful instability caused by the operational mistakes at a single firm. She stated that dealers with direct market access—or those that provide such access to others—must implement robust controls to manage the financial, regulatory and operational risks of such access. These controls should address, for example, the risk of high-speed algorithms malfunctioning and disrupting the market. Trading by PTFs, by contrast, is covered by this rule only if a PTF obtains its market access either through a broker, a dealer or an ATS that is itself obliged to comply with the market access rule. Chair White likewise noted that dealers are subject to net capital requirements, examinations of their books and records, and specific anti-manipulation and anti-fraud provisions. Those that are FINRA members also must comply with a number of important market conduct and other FINRA rules. Therefore, Chair White has asked the SEC staff to consider clarifying if, how and when the conduct of PTFs may trigger dealer registration requirements for such firms.[24] Counselor Weiss backed up Chair White's comments by saying that the "Treasury strongly supports registration of all PTF entities that transact in the nation's debt."[25]

Clearing and Settlement

The Conference included two panel discussions on clearing and settlement of Treasury market trades, respectively. There was much discussion about the role of PTFs in the market. Frank Keane (assistant vice president of FRBNY) noted that secondary trading in the Treasury market is split between inter-dealer platforms (IDBs) and dealer-to-customer trading. Trades on IDBs currently clear through the Fixed Income Clearing Corporation (FICC). As PTFs have gained increased access, they have remained outside the ambit of FICC. Instead, they clear bilaterally or through prime brokers for trades executed with FICC

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[22] *See* Chair White's Keynote Speech, *supra* note 3. *See also* Joint Staff Report, *supra* note 14, pp. 4 and 51.
[23] *Id.*
[24] *Id.*
[25] *See* Counselor Weiss's Speech, *supra* note 4.

members, and may not have the settlement risk management techniques offered by FICC clearing, such as margin collection, disciplined clearing fund balance requirements and predefined loss sharing. Panelists, especially regulators and those that provide clearing services, thought that there ought to be some mechanism to improve risk management associated with clearing for PTFs.

Conclusion

The rules governing the Treasury market have not kept up with the advent of electronic and high-speed, algorithmic trading. Some of the inertia can be attributed to the fact that Treasury securities hold a special position in the global economy and any regulatory changes must be carefully calibrated. As some panelists pointed out, the cost of a mistake in the Treasury market is far greater than the cost of a mistake in any other market. Therefore, the Treasury, the SEC, the CFTC and the FRB will have to work together if they want to design a regulatory regime that is both responsive to contemporary risks and increases (or at least does not decrease) liquidity.

We can expect that the next few years will witness several instances of SEC, CFTC and FINRA rulemaking addressing the Treasury market. FINRA already has put in place a framework to collect trading data from the market and will likely expand the scope of its efforts to cover banks transacting in Treasury securities. Some form of Regulations ATS and SCI probably will be applied to platforms trading Treasury securities, though the exact contours of the application are still unknown. Regulation AT, which is being developed by the CFTC, will have an effect on Treasury futures and indirectly, the cash market. Finally, we may see other FINRA and equities market rules being applied to Treasury market participants.

The new rules will alter the operational aspects of trading, but may also affect trading strategies, the volume of trading, price dispersion and risk management. Enhanced registration requirements for PTFs may result in more information becoming obtainable than ever before. We still do not know what post-trade transparency in the Treasury market will look like, but we can assume it will resemble post-trade transparency for the corporate bond market with some variations that will be based on the kind of Treasury security traded. The availability of pricing information, the depth of such information and the speed with which it is posted online are all new factors to be considered by traders and other market participants. During this time of change, it is important for Treasury market participants to

respond to proposed rulemaking individually or through industry groups. Only then will the SEC, FINRA and other regulatory agencies have the information necessary to make sound decisions.

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