May 27, 2022

<u>Via Electronic Submission: rule-comments@sec.gov</u>

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Release No. 34-94524; File No. S7-12-22; Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer

Dear Ms. Countryman:

The Independent Dealer and Trader Association ("IDTA")[1] appreciates the opportunity to respond to the U.S. Securities and Exchange Commission ("Commission" or "SEC") proposed rule to further define the phrase "as part of regular business" for purposes of registering under with the SEC. (the "Proposed Rule").[2] Under the proposed rule, certain market participants who engage in specified levels of buying and selling government securities would be required to register as registered broker-dealers with the SEC. The IDTA shares the SEC's goals and concern for ensuring integrity, transparency and liquidity in capital markets. However, we are concerned that this proposal will be adverse to competition in the Treasury market and, most specifically be problematic to members of the IDTA, who are non-bank, middle market institutional and registered Treasury and Repo broker-dealers. Requiring any major "liquidity provider," whether or not engaged in broker-dealer activities, to register as a broker-dealer will fundamentally change the market structure and the price discovery process. The IDTA believes that the proposal fails to adequately analyze the effects such a change would have on liquidity in the market. Furthermore, on its face, the failure to also adequately review and analyze the effect of the proposal on

[1] The IDTA was formed to create a forum for independent dealers and traders to discuss and consider the impact of market operational issues on their industry sector and to advocate for constructive solutions that promote the liquidity and efficiency of capital markets. The objective of the IDTA is to form an interactive line of communication with regulators and other relevant policy makers, with particular emphasis on the Securities and Exchange Commission, the Treasury Department, and the Federal Reserve Bank of New York. The IDTA is composed of six organizations registered as broker-dealers or futures commission merchants (or affiliates of such organizations) that are not affiliated with a bank holding company. For additional information, visit IDTA's web site: www.idtassoc.com/.

[2] Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 FR 23054 (April 18, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-04-18/pdf/2022-06960.pdf (hereinafter "Proposed Rule").

competitiveness in the government securities is not only ill advised but appears to be in direct contradiction of President Biden's Executive Order on Competition ("Executive Order") which requires regulators, including the SEC, to ensure that current and proposed rules enhance, not hinder competition in the markets they oversee.[3]

While superficially, it may appear that bringing more trading firms within the Commission's regulatory oversight creates more players and therefore more competition, the opposite is likely to be true because the proposed rule redefines certain trading activity as being part and parcel to the regulated activities of a registered broker-dealers. By definition broker-dealers create liquidity by serving as an intermediary or market maker for both sides of a trade. Requiring some of those counterparties to now register as a government securities dealer will materially alter the role of those new "broker-dealers" in the market, resulting in uncertain effects on the price discovery process. Furthermore, the timing of this proposal is troubling and unfortunate, because there has been well publicized growing concern about liquidity in the government securities market – concern that pre-dated the current rising interest rate environment and the planned reduction of the Federal Reserve's balance sheet.[4] In the current market conditions, it is absolutely critical to fully understand the effect any regulatory proposal will have on liquidity and competition in the affected markets.

SEC rules should not harm competition in markets.

The proposal does not sufficiently account for the increasing concerns surrounding competitiveness and liquidity in the marketplace. In his prepared statement, Chairman Gary Gensler expressed, "Requiring all firms that regularly make markets, or otherwise perform important liquidity-providing roles, to register as dealers or government securities dealers also could help level the playing field among firms and enhance the resiliency of our markets."[5] The IDTA agrees that leveling the playing field among broker-dealers is paramount. But that does not mean "one size fits all" solutions. Leveling the playing field requires policies that achieve their public purpose in a manner that does not favor or penalize entities by virtue of their size, organizational structure or location. However, over the last several years, policies approved by the SEC have done the opposite. For example, middle-market dealers have had to shrink their businesses models to comply with the Capped Contingent Liquidity Facility ("CCLF")[6] that was implemented by the Fixed Income Clearing Corporation and approved by the SEC. Such "one size fits all" solutions have disproportionately penalized non-bank middle market broker-dealers resulting in less, not more, competition in the markets, which materially manifests itself in reduced liquidity in markets during time of high market volatility and stress. Furthermore, these policies disproportionately advantage the largest systemically significant banks.

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[3] Exec. Order No. 14036, 86 Fed. Reg. 36987 (July 14, 2021).

[4] Press Release, Federal Reserve Board, Plans for Reducing the Size of the Federal Reserve's Balance Sheet (May 4, 2022), https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504b.htm.

[5] Chairman Gary Gensler, Statement on Further Definition of a Dealer-Trader (Mar. 28,2022), *available at* https://www.sec.gov/news/statement/gensler-statement-further-definition-dealer-trader-032822.

[6] *See* Independent Dealer & Trader Association White Paper on the Repo Market Affecting U.S. Treasury and Agency MBS (Dec. 6, 2019) discussing the importance of middle-market participation in FICC and the wholesale liquidity market, *available* at https://static1.squarespace.com/static/5ad0d0abda02bc52f0ad4922/t/5dea7fb6af08dd44e68f48cc/1575649207172/IDTA+-+White+Paper+%2812.6.19%29-c2.pdf.

The IDTA has communicated regularly with the SEC on the CCLF, as well as other policies including: amendments to the FICC Mortgage-Backed Securities Division Rulebook ("MBSD Rules") that introduced a new "Minimum Margin Amount" charge against clearing members,[7] changes to the method by which the FICC Government Securities Division ("GSD") calculates members' margin,[8] and changes to the GSD's Required Fund Deposit Calculation.[9]

Attached to this letter are comment letters and white papers that the IDTA has prepared on these issues underscoring the concern that these actions would limit competition and diversity in the affected markets and likely result in further consolidation among middle market firms and greater concentration of market share and market risk among the largest firms. This result is not only inconsistent with the letter and spirit of the President's Executive Order on Competition, but now, nearly 13 years since the passage of Dodd Frank, contradicts one of its tenets to achieve fiscal stability and ensure that the financial markets are not overly concentrated in the largest systemically significant banks.

As mentioned above, the IDTA notes that President Biden signed an Executive Order on July 9, 2021 in which he articulated his Administration's policy of promoting competition, not consolidation, of American industry. The Executive Order creates a new inter-agency White House Competition Council and calls for a "whole-of-government approach" to address excessive concentration, abuses of market power, unfair competition, and the effects of monopoly.[10] The Executive Order specifically identified the SEC as one of the agencies whose rules must seek to resist consolidation and promote competition, "including the market entry of new competitors."[11] The IDTA is concerned about the impact that the proposed rule could have on smaller independent broker-dealers in the government securities market and urges the Commission to review the mandate in the Executive Order and consider the impact on middle-market firms.

So, while this proposed rule is of a different nature than some of the aforementioned clearinghouse rules, it is clear to the IDTA that the market structure change in the US Government securities market facilitated by this proposed rule brings with it uncertainty and risk that must be better understood.

The Proposed Rule would require firms that satisfy certain qualitative and quantitative standards to register as a dealer pursuant to Sections 15(b) or 15C(a) of the Securities Exchange Act of 1934. The Proposed Rule exempts any person that has or controls total assets of less than $50 million, is a registered investment company, or falls within an existing exemption to the dealer registration requirements.

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[7] Independent Dealer and Trader Association, Comment Letter on Proposed Rule Change to Modify the Calculation of the MBSD VaR Floor to Incorporate a Minimum Margin Amount (Feb. 23, 2021), https://www.sec.gov/comments/sr-ficc-2020-017/srficc2020017-8411794-229480.pdf.

[8] Independent Dealer and Trader Association, Comment Letter on Proposed Rule Change to Expand Sponsoring Member Eligibility in the Government Securities Division Rulebook and Make Other Changes (Jan. 22, 2019), https://www.sec.gov/comments/sr-ficc-2018-013/srficc2018013-4844303-177209.pdf.

[9] Independent Dealer and Trader Association, Comment Letter on Proposed Rule Changes to the Required Fund Deposit Calculation in the Government Securities Division Rulebook (Mar. 29, 2018), https://www.sec.gov/comments/sr-ficc-2018-001/ficc2018001-3361899-162097.pdf.

[10] *Supra* note 3.

[11] *Id.* at 36989.

The Commission explains that even if conditions are not met, a person "may nonetheless be a dealer if it is otherwise engaged in a regular business of buying and selling securities for its own account by, for example, acting as an underwriter."[12] The IDTA believes that the Proposed Rule is overly broad and could fundamentally change the current market structure and price discovery process. The Commission is attempting to address "unregulated" liquidity providers. While such traders, including Principal Trade Firms (PTFs), are not regulated by Financial Industry Regulatory Authority or Office of the Comptroller of the Currency, these firms are trading through regulated entities, such as broker-dealers, interdealer brokers and ATSs. This means that the trades are still subject to reporting requirements, as well and other regulations governing the government securities market. This includes antifraud provisions and regulation by the Office of Foreign Asset Control when cleared through a bank or a broker. The change in market structure to redefine certain "traders" into "broker-dealers" will result in uncertainty and risk. The IDTA believes that this is a high price to pay.

Furthermore, IDTA members are market-makers, bringing together buyers and sellers to effectuate trades. The existence of buyers and sellers as customers with the broker-dealers creates an efficient price discovery environment. Hence, by function, the members of the IDTA and other broker-dealers make up the "'sell-side" of the markets, and it is their clients (i.e. financial institutions, investors (including investors who trade regularly)) that provide or take liquidity by serving as the "buy-side" of the market. Middle-market dealers and their clients comprise an important and necessary tier of liquidity, which only grows in importance with the increasing financing needs of the U.S. government and the consumer housing market. The disintermediation of the traditional market-maker role of a broker-dealer in these institutional markets will disproportionately affect middle-market institutional broker-dealers who exist to provide and give institutional and other investors the ability to choose to trade through the broker-dealer that best meets their needs whether that is a large SIFI bank or a specialized middle market broker-dealer.

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The IDTA urges the SEC to consider how the Proposed Rule will shift the current market structure and further inhibit competition.

The IDTA thanks the Commission for considering our comments. Should you have any questions, please contact the undersigned.

Sincerely,

James Tabacchi
Chairman
Independent Dealer and Trader Association

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[12] *Id*. at 23077.

Independent Dealer & Trader Association ("IDTA")
White Paper on the Repo Market Affecting U.S. Treasury and Agency MBS
December 6, 2019

I. Overview and Introduction.

The goal of this White Paper is to foster a greater understanding of the unique role and perspective of independent, middle-market government securities dealers in the distribution and financing of U.S. Treasury and Agency mortgage-backed securities ("MBS"). As the nation's financing needs increase – now approaching $1 trillion in net new issuances annually – diverse, deep and liquid markets for U.S. Treasury and Agency MBS are even more critical for the economy. During the drafting of this White Paper, the Federal Reserve Bank of New York ("FRBNY") was forced to begin, for the first time in roughly eight years, injecting tens of billions of dollars of liquidity into the U.S. repurchase agreement funding market ("repo market") to ensure sufficient liquidity for normal repo operations.[1] This temporary fix, though, is just that – temporary – and there needs to be a greater sense of urgency in addressing the breadth, depth and diversity of repo market liquidity.

While this White Paper focuses primarily on the wholesale repo market, it is important to recognize that the repo market and the primary market are closely connected. As stated in the October 2017 U.S. Department of the Treasury market report on the capital markets:

> Treasury repo plays a central role in U.S. securities financing markets. Repo transactions are used by market intermediaries to finance long positions in Treasury securities. Long-only investors use repo to invest cash with safe collateral. Some investors use repo to implement short positions in Treasury securities. All of this activity contributes to the Treasury market being the deepest and most liquid government securities market in the world.[2]

Despite repeated claims that the U.S. Treasury market is the deepest and most liquid government securities market in the world, there is a paucity of public data by which to understand the makeup and continuous reliability of market liquidity. Even the U.S. Treasury Department could only estimate the size of the repo market at $5 trillion[3] – a level that has grown since the 2008 financial crisis, but is still believed to be significantly lower than prior to the crisis. The decrease in the size of the repo market is attributed, in part, to the fact that primary dealer financing

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[1] Nick Timiraos and Paul Kiernan, *Fed Will Purchase Treasury Bills at Least Into Second Quarter of 2020*, WALL ST. J. (Oct. 11, 2019), https://www.wsj.com/articles/fed-will-purchase-treasury-bills-at-least-into-second-quarter-of-2020-11570806265.

[2] U.S. DEP'T OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: CAPITAL MARKETS 75 (Oct. 2017) [hereinafter TREASURY MARKET REPORT].

[3] *Id.* at 76 (citing Viktoria Baklanova, Adam Copeland, and Rebecca McCaughrin, *Reference Guide to U.S. Repo and Securities Lending Markets*, Federal Reserve Bank of New York Staff Report No. 740 (Sept. 2015 and revised Dec. 2015)).

activity – seen as a large component of repo outstanding – is approximately two-thirds of the size it was prior to the financial crisis.[4]

The repo market is an over-the-counter ("OTC") market that depends on primary dealers and middle-market dealers to provide liquidity and efficient price discovery. It provides immediate and fully collateralized funding for the purchase of U.S. Treasury and other securities in the market by broker-dealers and institutional investors. The collateral used in a repo transaction is ordinarily U.S. government securities. At their core, the transactions are an agreement between two institutions where the institution requiring cash sells a government security to another institution with an agreement to buy it back at a set date, typically one day. This generates immediate cash for the seller for redeployment in the market without needing to liquidate its holdings. The agreed upon "repurchase" price is the cost of the transaction, which is usually consistent with well-collateralized, short-term borrowing rates.

Repo transactions are either tri-party or bilateral. Tri-party repo transactions use a settlement bank, such as The Bank of New York Mellon ("BNY Mellon"), but are not cleared through a central counterparty ("CCP"). Bilateral repo, on the other hand, can be cleared through a CCP, such as the Fixed Income Clearing Corporation ("FICC"), or can be settled directly between counterparties. The main participants in the repo market are central banks, commercial banks, broker-dealers (bank-affiliated and non-bank-affiliated), insurance companies, industrial companies, municipalities, mutual funds, pension funds and hedge funds.

The Independent Dealer and Trader Association ("IDTA") was formed in 2017 to represent middle-market dealers that commit their capital to provide liquidity in the U.S. Treasury, Agency MBS and repo markets. IDTA members are not owned by or affiliated with a U.S. bank holding company, and thus do not have access to the Federal Reserve Board of Governors' ("Federal Reserve") discount window or unsecured borrowing in the Federal funds market. IDTA members also are not systemically important financial institutions ("SIFIs"), as designated by the Financial Stability Oversight Council ("FSOC"). However, IDTA members provide significant liquidity to market participants.

The grey line in the chart below represents the daily volume of transactions that comprise the Secured Overnight Financing Rate ("SOFR"), which is replacing the London Interbank Offered Rate ("LIBOR") as the reference point for overnight funding rates. The dark blue line represents that portion of the SOFR volume that is transacted by IDTA members, but it excludes any forward-starting transactions, a growing portion of IDTA member activity (further discussed below). The light blue line represents IDTA transaction volumes, including these forward-starting transactions.

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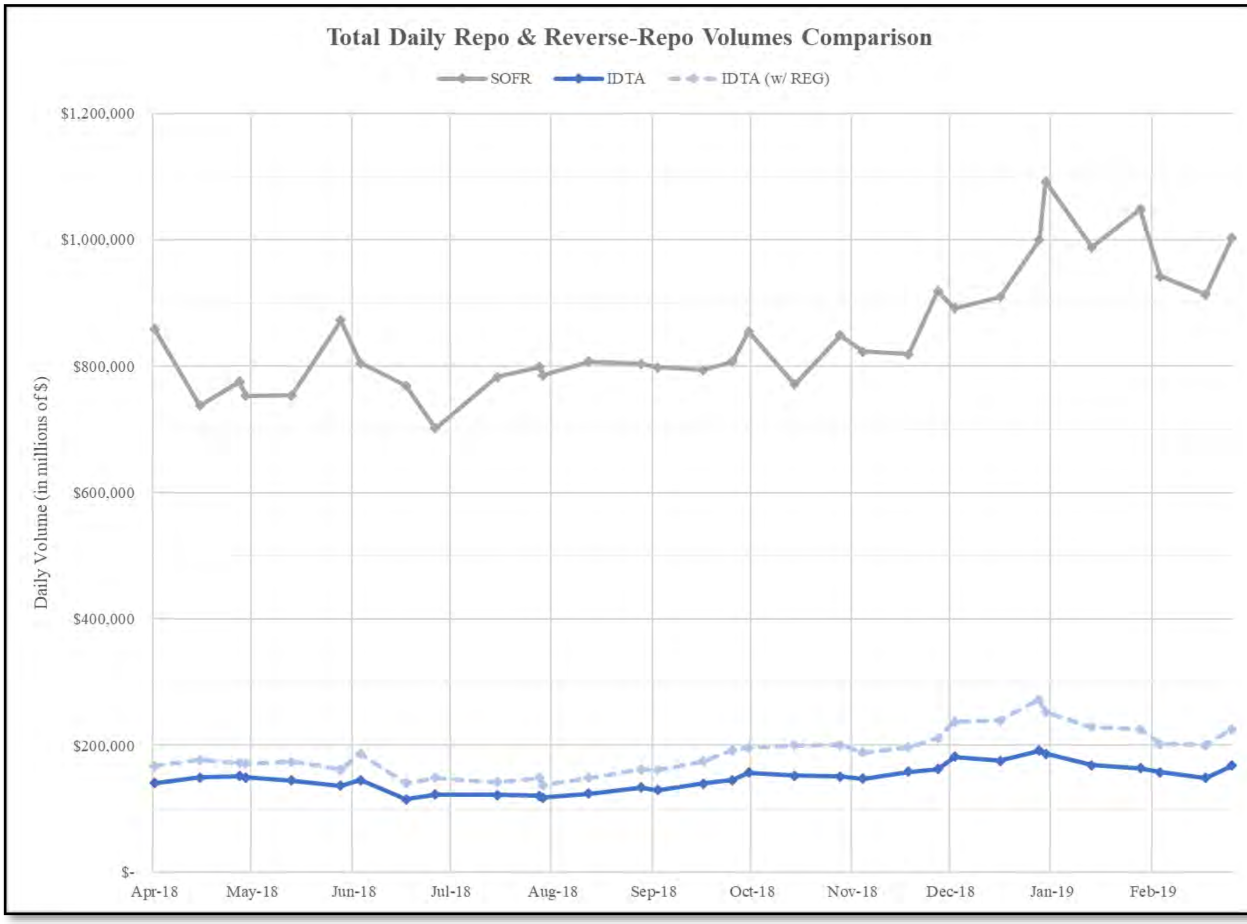
[4] *Id.*



IDTA members' buy-side clients include U.S. Treasury hedge funds, Agency real estate investment trusts ("REITs"), insurance companies, pension funds, municipalities and mutual funds, all of which are essential to providing liquidity and support to the continued underwriting of U.S. debt and the U.S. housing market. Middle-market dealers and their clients comprise an important and necessary tier of liquidity, which only grows in importance with the increasing financing needs of the U.S. government and the consumer housing market.

The need for diversity of market liquidity and, in turn, middle-market dealers is often accentuated during year-end, quarter-end, month-end and other peak-volume days, when balance sheet constraints of the major U.S. bank holding companies cause these large institutions to withdraw from the market.[5] This has led to significant and unnatural funding price volatility, such as seen on December 31, 2018,[6] and more recently on September 16 and 17, 2019. These more recent funding price spikes led to intervention by the FRBNY.[7] Furthermore, the FRBNY's

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[5] *See* Paul J. Davies and Sam Goldfarb, *Fed Injects More Into Money Markets After Banks Bid Heavily for Funds*, WALL ST. J. (Sep. 18, 2019), https://www.wsj.com/articles/short-term-funding-spike-raises-hopes-for-fed-cuts-11568807648 (noting the difficulties in determining how much reserves banks want to hold).

[6] Robert Mackenzie Smith, *Repo Rate Hits 7.25% on Year-End Volatility*, RISK.NET (Jan. 2, 2019), https://www.risk.net/derivatives/6263606/repo-rate-hits-725-on-year-end-volatility.

[7] *See supra* text accompanying note 1.

continued involvement in stabilizing the repo market via a ladder of term liquidity injections as part of temporary, open market operations has underscored the fragility of the repo market. In short, the repo market has become dependent on FRBNY activity, which will continue at least into the second quarter of 2020 without a clear path for when such activities will cease.

This White Paper seeks to illustrate how market trends since the financial crisis have led to an increase in concentration, and a decrease in the diversity and depth, of the repo market. Symptoms of this shift in concentration include rate volatility and higher funding costs, as recently witnessed in mid-September 2019. This combination of volatility and higher funding costs can have significant repercussions for the primary market, as key, buy-side market participants could find it too costly and even unprofitable to finance purchases of U.S. Treasury and Agency MBS. If these market participants retreat from the market, only central banks and the Federal Reserve will be available to provide support for the primary and secondary markets. Allowed to continue unabated, these trends could challenge the government's ability to efficiently underwrite the national debt.

II. The Repo Markets Depend on a Diverse Group of Participants.

If one asks those within the "C-suite" of the top U.S. bank holding companies if they are proponents of a large and fully diversified repo market, they would all respond in the affirmative. Yet, today, we find signs that the market is under stress and has been for some time.

These developments have been documented by studies that utilize a combination of publicly available data, as well as confidential information held by the Federal Reserve and the U.S. Treasury's Office of Financial Research ("OFR"). One OFR report, which analyzed the activities of United States, Japanese and European banks, concludes that the Japanese and European institutions significantly reduced their cash lending relative to their U.S. counterparts around key reporting dates.[8] The report suggests that this may be attributed, in part, to reporting conventions that require the U.S.-based institutions to report *averages* of their balance sheet components, which is not required in either Japanese or European filings.[9] The report also notes that levels of lending rise quickly in the days following the reporting deadline and normalize within a week thereafter.[10] Such acute periodic shocks contribute to the propensity for the system to sustain extreme disruptions.

In a robust funding market, there should be ample, alternate sources of cash from multiple sources participating in that market. The equilibrium quantity and cost of borrowing would fluctuate as the supply of cash diminishes. Recent episodes suggest that institutions that would normally provide liquidity have significant pricing power. In these circumstances, it is natural to ask what role acute decreases in cash supply have played in disrupting the functioning of repo markets. This phenomenon is particularly worrisome given the short duration of secured lending and the quality of the collateral in question.

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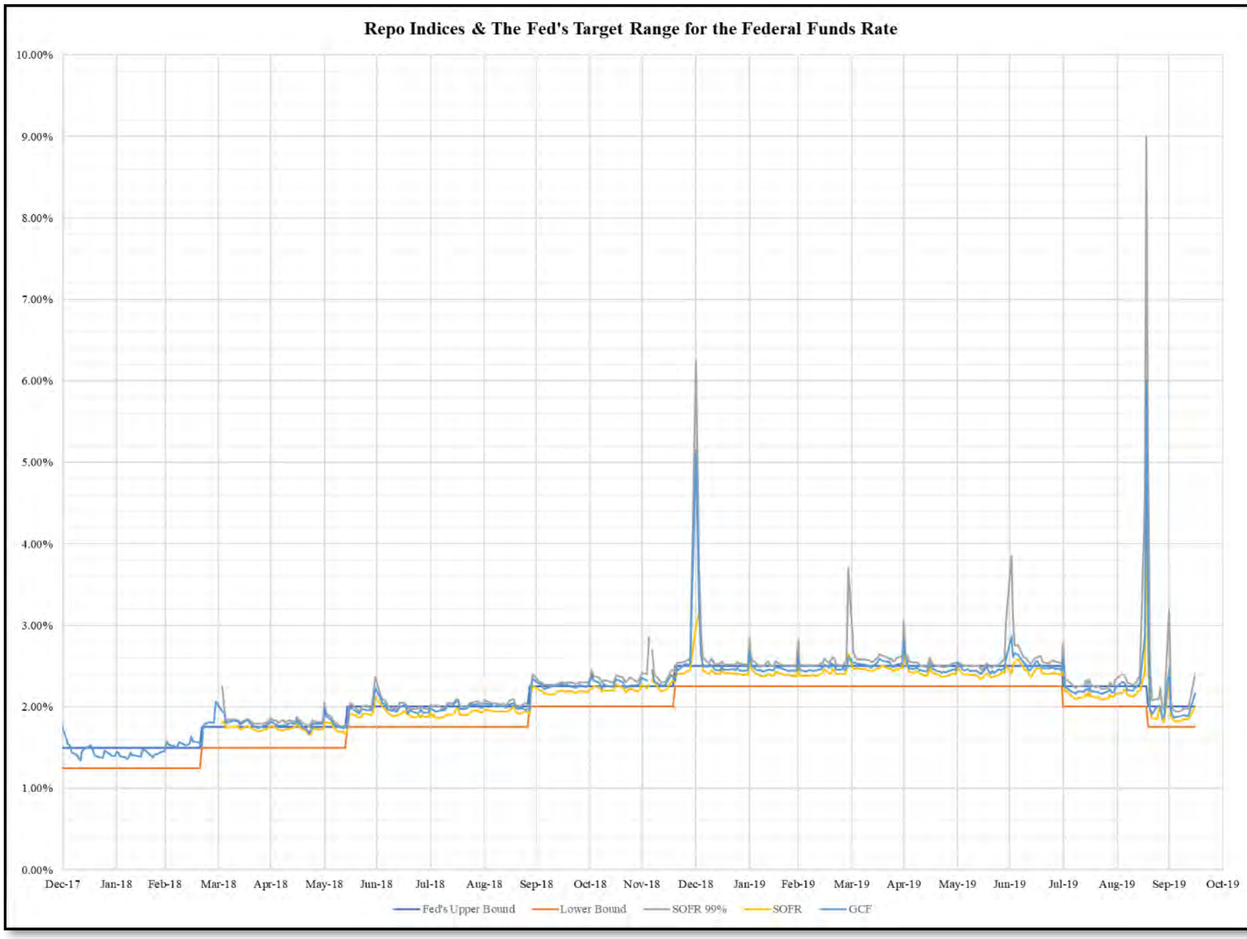
[8] BENJAMIN MUNYAN, REGULATORY ARBITRAGE IN REPO MARKETS (WORKING PAPER NO. 15-22), OFFICE OF FIN. RESEARCH (June 1, 2017).

[9] *Id.* at 2.

[10] *Id.* at 5.

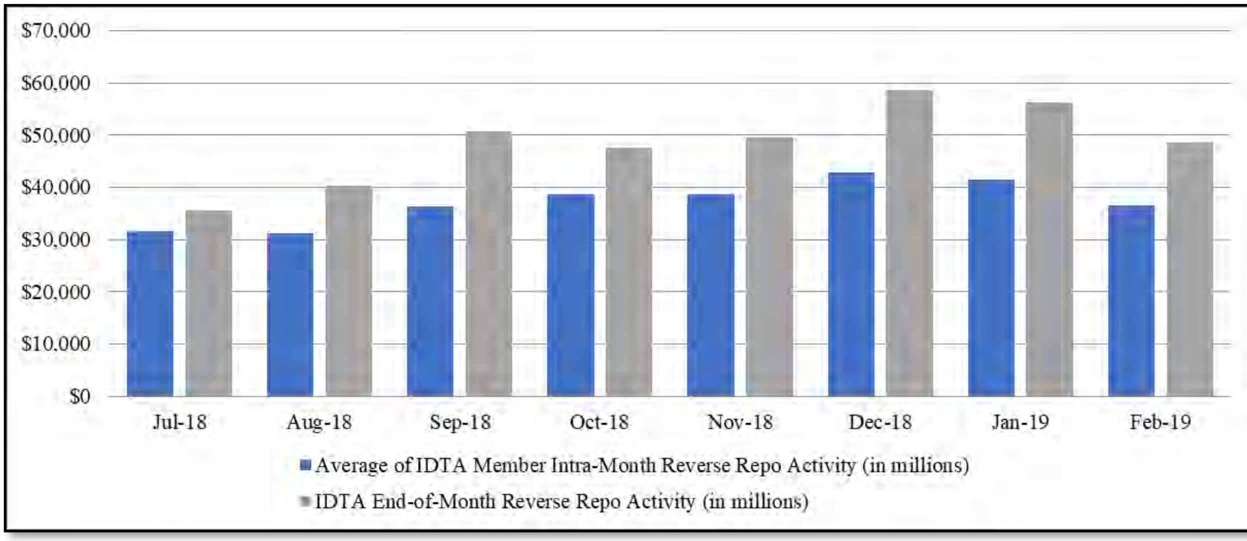
Furthermore, the volatility in overnight funding rates has been elevated since the second quarter of 2018 and throughout the third quarter of 2019. There were particularly exaggerated volatility and unnatural interest rates in the repo market at year-end 2018 and during the third week of September 2019. As shown in the chart below, overnight funding frequently traded above the top end of the Federal Reserve's range, and even did so away from key reporting dates when elevated levels might be anticipated.

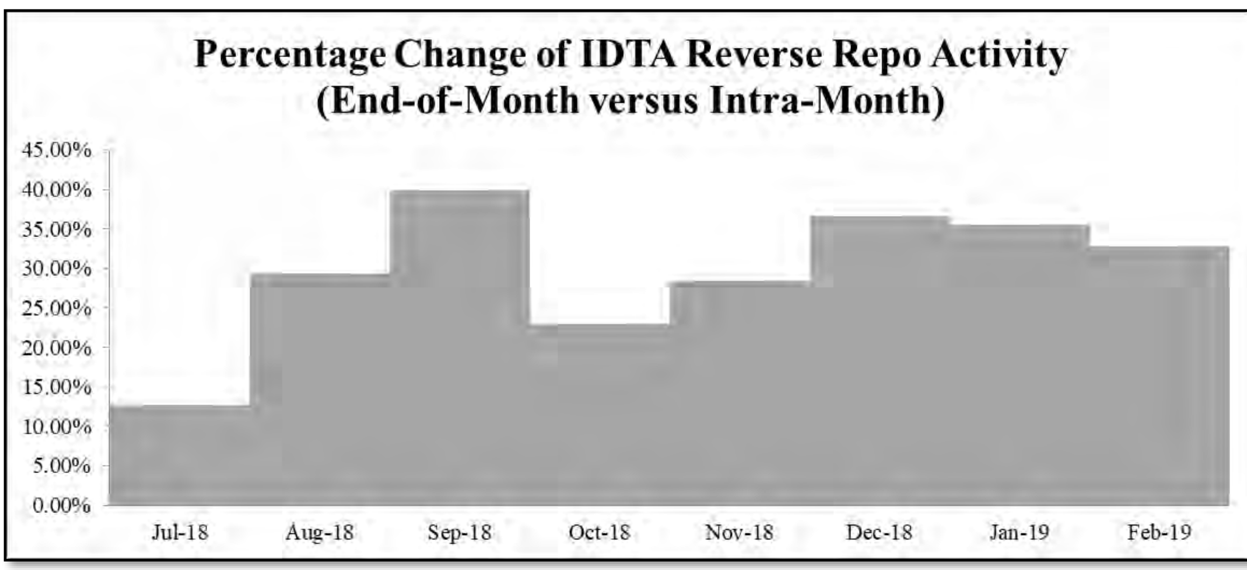


Where wholesale sources of funds are concentrated within a handful of extremely large SIFI banks, the market becomes more fragile and susceptible to rate spikes. For example, an unexpected, large client transaction within a bank or geopolitical event that causes one or more institutions to temporarily withdraw their normal allocation of funds will likely lead to a spike in rates. Moreover, these risks have intensified as excess reserves were withdrawn over the past year, leading to higher levels of concentration of funds. In short, the market has lost its ability to withstand any significant loss of funds.

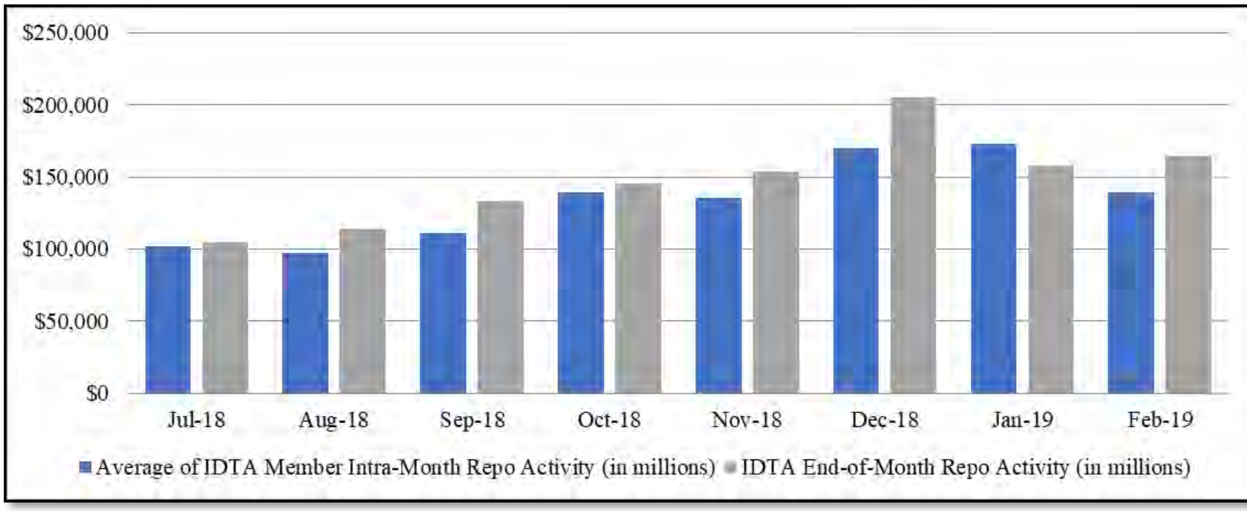
The fragility of the repo market is particularly worrisome given the quality of the underlying collateral and significant volume of issuances of U.S. government securities (exceeding $80 billion of new issues every month), all of which underscores the need for further inquiry. Recently, credit repo has been insulated from financing rate spikes, which is the reverse of historical norms. Riskier "business purpose" and non-Qualified Mortgage loans were being financed at significantly better levels than the Government-Sponsored Enterprise ("GSE")-issued Agency MBS pools that consist entirely of conforming home loans.

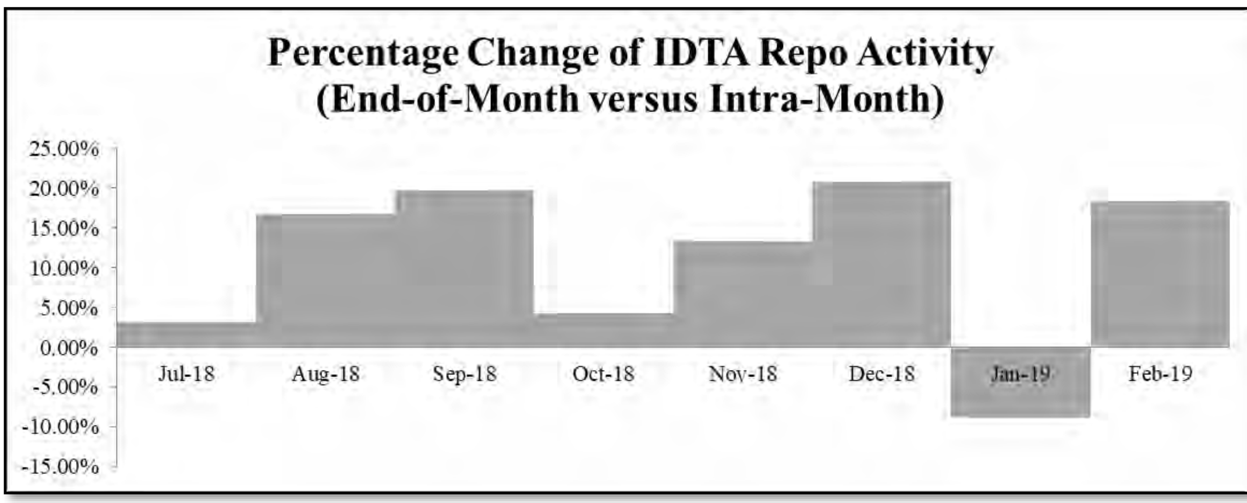
During recent events, middle-market dealers and their clients have provided the market with much needed liquidity. Additionally, middle-market dealers are significant providers of liquidity at month-end, when FSOC-designated SIFIs tend to withdraw from the market. For example, in the second half of 2018 and the first two months of 2019, IDTA members' cleared reverse repo activity was approximately 30% higher at month-end than on sample dates earlier in the same month.





Similarly, IDTA members' cleared repo activity was on average approximately 11% higher at month-end than on sample dates earlier in the same month.[11]





Middle-market dealers have been providing liquidity at times when SIFIs have been unable to do so, in part because of constraints imposed upon SIFIs by virtue of their systemic risk. Again, as noted in the October 2017 U.S. Treasury market report on the capital markets, "It is generally acknowledged that the interaction of the U.S. banking regulators Basel III capital requirement's supplementary and enhanced supplementary leverage ratios (SLR, eSLR) and other rules enacted following the financial crisis have discouraged some banking functions."[12] Amidst this regulatory backdrop, it is critical to ensure that the regulatory environment does not drive away other providers of liquidity.

[11] The January 2019 data may have been skewed by incorporating data from January 2, 2019, as part of the intra-month calculation. If the January 2019 data is excluded, the month-end average increase over the sample period rises to 14%.

[12] TREASURY MARKET REPORT, *supra* note 2, at 82.

Recent efforts by FICC to address its liquidity needs have both intensified pressure on the middle-market dealers and correspondingly affected the ability of those dealers to fill liquidity voids during times of market stress. FICC, an operating subsidiary of the Depository Trust and Clearing Corporation ("DTCC"), provides CCP services for major segments of the U.S. Treasury market with the aim of reducing operational, settlement, market, legal and default risks for its members. As a CCP, FICC stands between each buyer and seller, and guarantees the trade should one counterparty default.

FICC and its predecessor, the Government Securities Clearing Corporation, have operated in this manner for decades. It has successfully managed the orderly unwind of defaulting firms several times without any loss to its cooperative members. However, based on available data, it appears that the transactions cleared through FICC have become more concentrated within a handful of SIFIs since the financial crisis. This concentration of activity can threaten the viability of a CCP, which is designed to mutualize risk across a wide range of market participants.

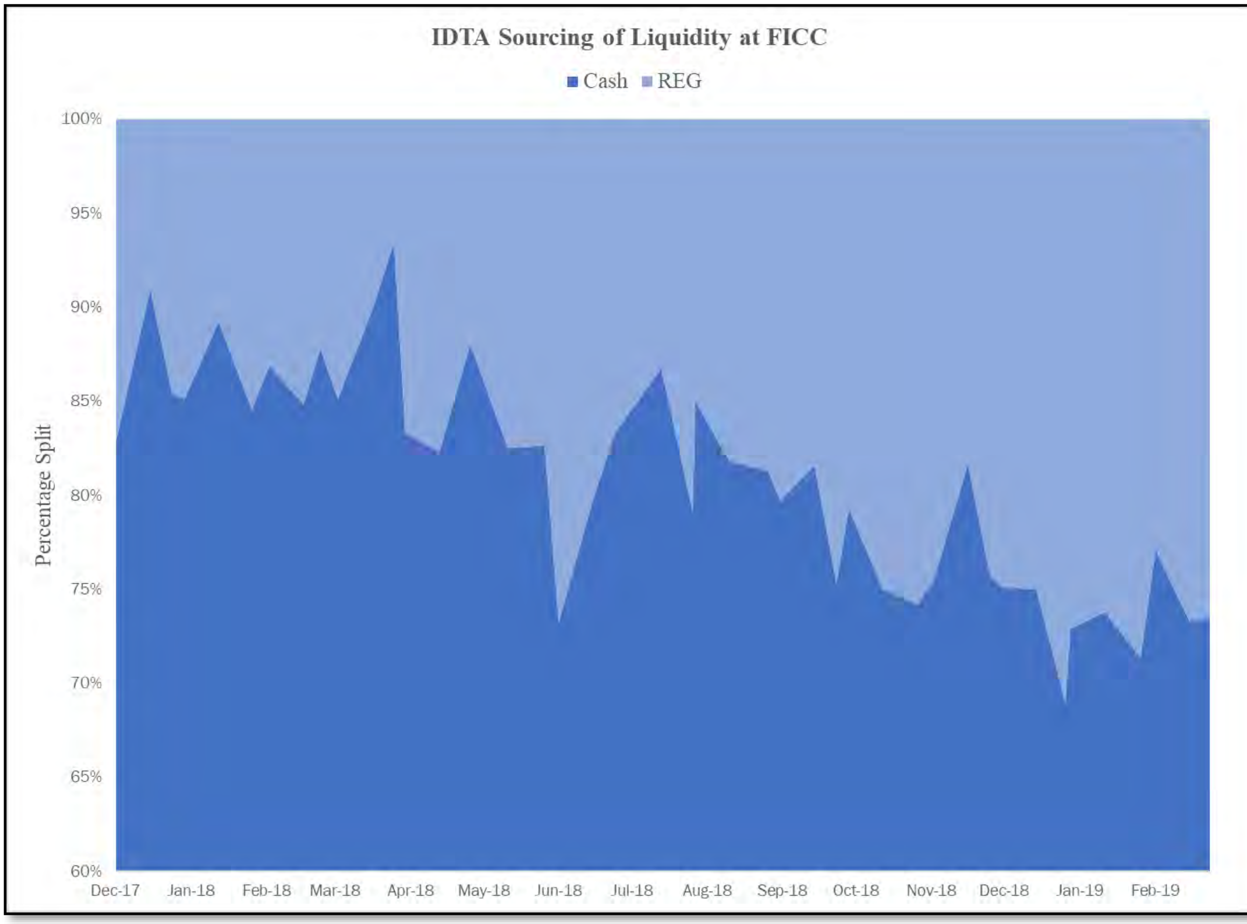
In part, because of this increased concentration, FICC implemented a Capped Contingent Liquidity Facility ("CCLF") to provide it with temporary financing to avoid "fire-sale" liquidations resulting from a SIFI default.[13] The CCLF requires all Tier 1 netting member firms to have in place a liquidity plan to provide FICC with financing options should a SIFI default. The size and cost of a firm's liquidity plan is tied, not only to its own exposure at FICC, but also to the maximum exposure of the largest SIFI bank (which could potentially default). This has caused IDTA members to reduce their portfolios as part of their CCLF liquidity plans. At the same time, SIFIs have increased the size of their portfolios, and correspondingly the very risk that the CCLF was designed to reduce.

Put simply, the CCLF was designed to reduce moral hazard and have all participants in the repo market (i.e., FICC members) create a liquidity backstop should a SIFI fail and leave FICC with a portfolio of the failed institution's U.S. Treasury and Agency MBS inventory to finance. One assumption of this stressed scenario was that the wholesale repo market would be frozen or unable to accommodate the portfolio of the defaulting FICC member.

In light of the fact that a significant component of a firm's CCLF obligation is based on its overnight liquidity exposures at FICC, middle-market dealers immediately took to reducing their reliance on overnight liquidity. Some middle-market dealers reduced the size of their portfolio and extended liquidity terms in place of overnight funding, adding to both financing and opportunity costs. Others have incorporated liquidity plans for which commitment and administration fees materially added to the cost of doing business.

The chart below shows the split between the sourcing of funds on a cash vs. REG (next day) basis, and illustrates a shift as certain IDTA members have changed their behavior in response to the implementation of the CCLF.

[13] Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change To Implement the Capped Contingency Liquidity Facility in the Government Securities Division Rulebook, Exchange Release No. 34-82090 (Nov. 15, 2017), 82 Fed. Reg. 55427 (Nov. 21, 2017).



In contrast, large SIFIs have had an easier time putting liquidity plans in place. SIFIs, which are all affiliated with federally-regulated and FDIC-insured banks, have access to large balances of internal deposits and money market funds and, as stated earlier, access to the Federal Reserve discount window. The relative lack of constraints imposed by the CCLF on SIFIs has led to unintended and counterintuitive results. Almost as soon as the CCLF was implemented, FICC's peak systemic liquidity risk *increased*. Within the first six months, peak liquidity risk had increased to almost twice what was expected, $115 billion as compared to the expected $60 billion.[14]

A more detailed analysis of FICC's daily report card of member firms shows that middle-market dealers (using IDTA members as a proxy) decreased their overnight exposures at FICC (one of the stated objectives of the CCLF), while systemic overnight liquidity risk almost doubled. If middle-market dealers reduced their risk while the overall market risk went up, the only plausible explanation is that one or more of the largest institutions significantly increased their exposures to FICC.

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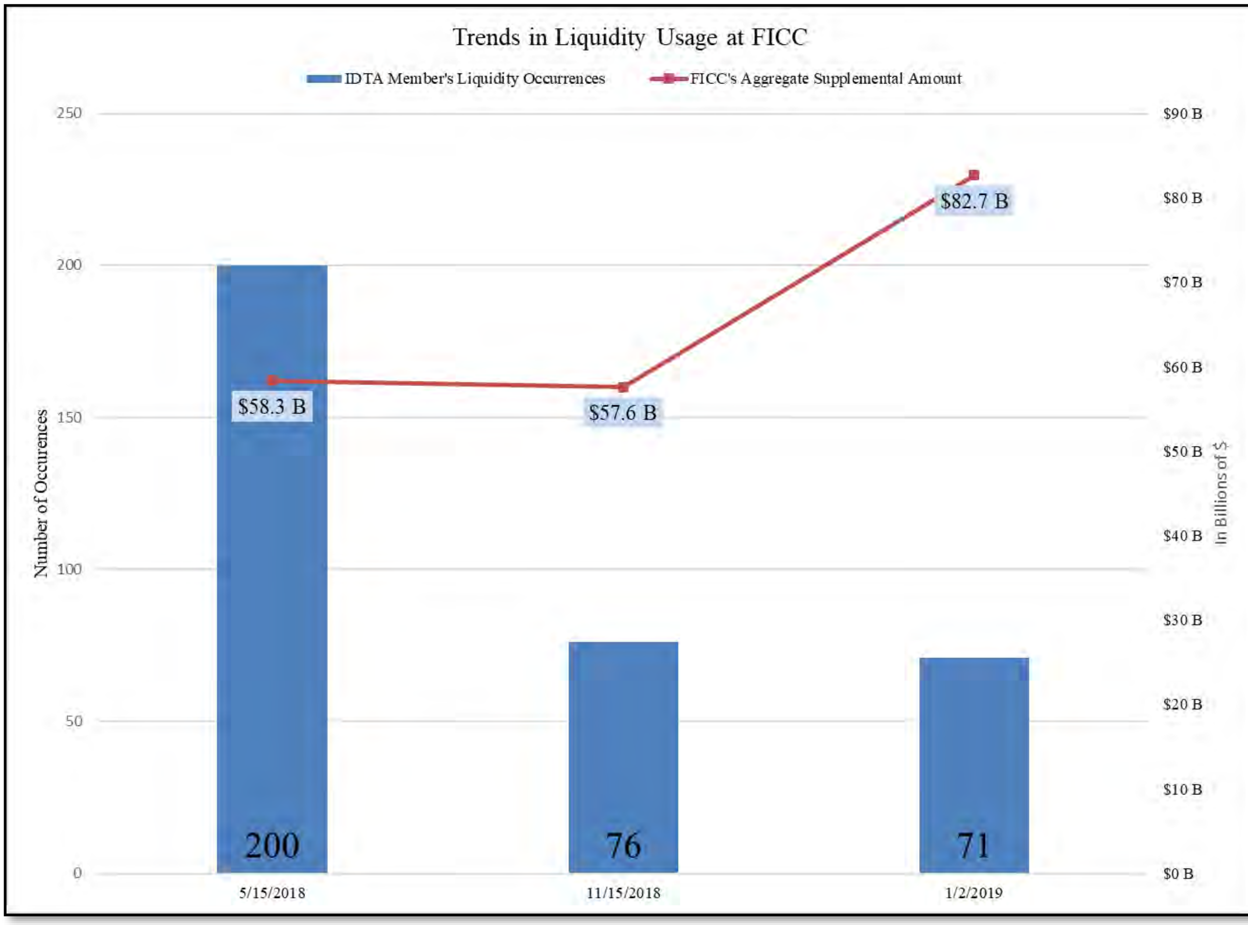
[14] It has since receded to approximately $75 billion, in part because FICC decided to net bank holding company subsidiaries. This practice is not transparent to the market and still leaves all the liquidity with the "netted" bank holding company.



III. Causes and Consequences of Concentration Risks.

In the midst of the 2008 credit crisis, the top five banks held 22% of U.S. domestic deposits, and today that number is more than 40%. In addition, the SIFI designation essentially decrees them "too big to fail" and enhances their counterparty credit, furthering their reach and ability to accept deposits from money market firms rated by a nationally recognized statistical rating organization ("NRSRO"). They also have added significantly to their capital base to remain compliant with new banking regulations. The largest banks have grown considerably larger and, while more broadly and deeply regulated and better capitalized, arguably pose even greater risks to the stability of the financial system. It is more important now than ever for non-SIFIs, such as middle-market dealers, to provide the bond and funding markets with liquidity in times of volatility when SIFIs have regulatory constraints.[15]

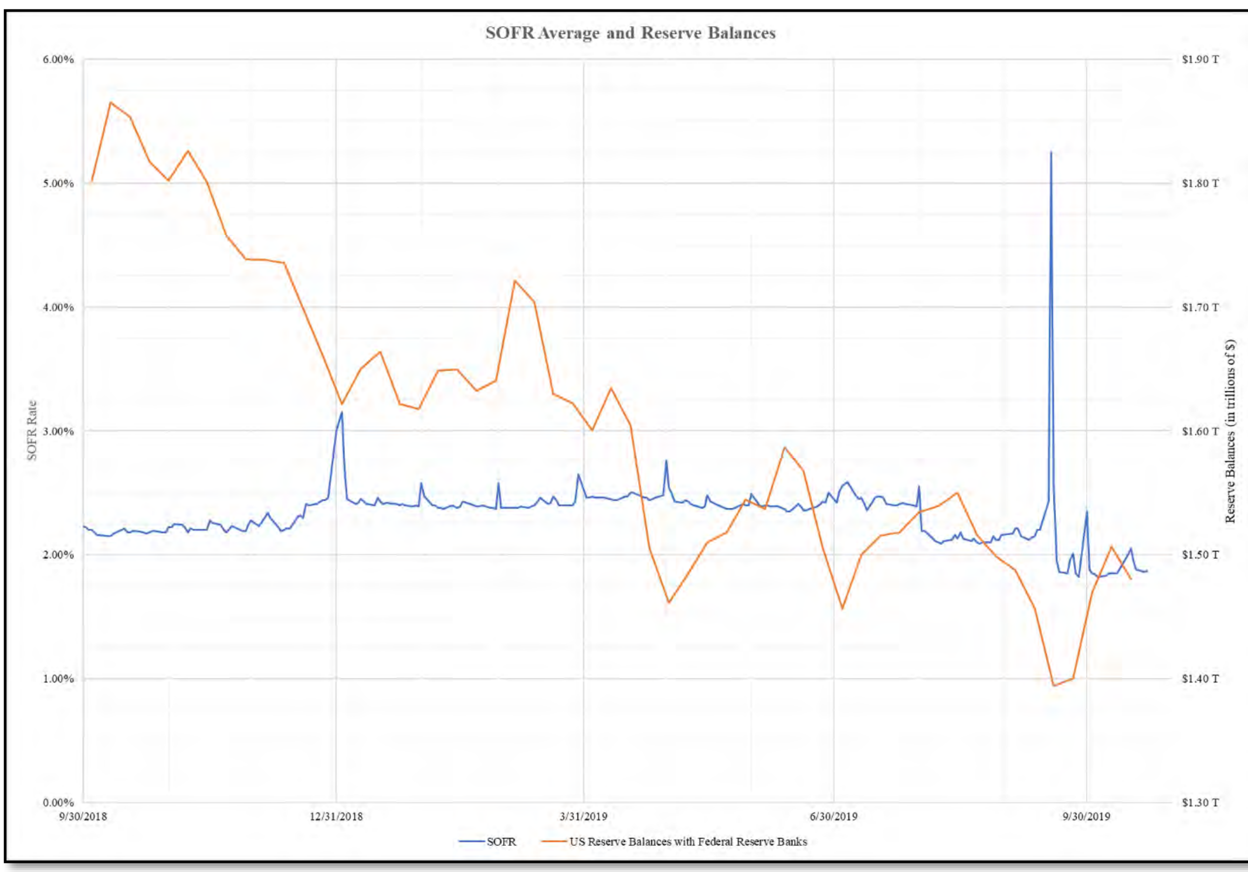
One impact of this increased concentration is that the repo market appears to be reliant on a few select SIFIs for day-to-day liquidity. If one of those institutions is unavailable to provide liquidity due to, for example, an unexpected large client transaction or geopolitical event, funding rates spike. As highly publicized at year-end 2018, U.S. Treasury financing costs peaked at 7.15% and averaged 5.14% for the day, significantly above the Federal Reserve's target range of 2.25%

[15] Alessandro Aimone, *Six US banks Grow Systemic Footprints*, RISK.NET (Aug. 27, 2019), https://www.risk.net/risk-quantum/6944186/six-us-banks-grow-systemic-footprints.

to 2.50%, and also significantly above where corporate bonds, high yield bonds and emerging market bonds were financed that day. An even higher peak occurred on September 17, 2019, when financing rates peaked at 10%.

SOFR is essentially the risk-free borrowing rate in the wholesale institutional financial market, or the rate where banks and dealers can borrow when collateralized by U.S. Treasury collateral. It is compiled to include overnight tri-party, general collateral funding ("GCF") and delivered versus payment ("DVP") transactions. As the lowest risk-free rate, it would become the benchmark for indexing many corporate and consumer loans, replacing the LIBOR index that has been the most used benchmark for over 30 years. Put simply, if the major source of funds for tri-party, GCF and DVP financing trades are concentrated in a small number of large banks, the potential for higher funding rates to the majority of market participants are to be expected. In any market, highly concentrated sources of supply can and will lead to higher prices. For SOFR to become the standard benchmark rate for indexing both corporate and consumer borrowings, it must be insulated from the extent of the concentration risk noted above. Thus, SOFR works best when it depends on a diverse, deep and liquid repo market – a condition which appears threatened today.

The chart below shows the excess reserve balances versus SOFR. As reserve levels drop, spikes and volatility increase.



FICC members are generally banks and broker-dealers. Regional banks, even the largest regional banks, are normally represented in the FICC membership through their smaller, institutional broker-dealers. Regional banks often use FICC to facilitate their purchase and sale of U.S. Treasury securities.

The current market structure has made the Open Market Operations of the FRBNY an active and regular market participant – something it has not done for roughly eight years. As a result, the FRBNY must now consider its repo market activities in the broader context of managing monetary policy, insofar as adding liquidity to the repo market can be seen as loosening monetary policy, whereas subtracting liquidity (or not adding liquidity where a market is dependent on such liquidity) can be seen as tightening monetary policy.

Absent other changes, the FRBNY may be required to intervene on a more regular basis to keep the Federal funds target in the range it targets and publicizes. A repo rate that exceeds the Federal Reserve target by over 300%, like that which occurred on December 31, 2018, and by 500% on September 17, 2019, is antithetical to efficient market functionality.

The IDTA believes that a diversified market, where many sellers and many buyers compete, is best positioned to maintain rates within published ranges. Even then, the Federal Reserve must remain vigilant to add or subtract liquidity as needed.

IV. Recommendations.

The financial regulatory environment has undergone significant change since the 2008 financial crisis. The composition of the largest banks' balance sheets now includes more capital, less leverage and less risk. These are critical factors for a healthy banking system, and a healthy economy on which it is based. However, these changes are not without some unintended consequences. The largest banks have become larger, while other financial firms have struggled. Indeed, since the beginning of 2014, six mid-sized, independent dealers with significant U.S. Treasury and Agency MBS presence have either merged, were acquired, or completely shuttered their doors.[16] In the banking sector, Congress and Federal regulators recognized the unintended consequences of certain aspects of the post-credit crisis regulatory reform. In 2018, Congress passed the Regulatory Relief and Consumer Protection Act to give some regulatory relief to regional banks that represent little risk to the financial system, while providing important services to their customers.[17] Likewise, middle-market dealers bring essential private capital into the market to provide liquidity to the U.S. Treasury and Agency MBS market, yet present little – if any – risk to the financial system.

IDTA Recommendation #1

Concentration risks were less noticeable when excess reserves were higher. As the Federal Reserve reduced its balance sheet, these risks have become more apparent with rate spikes and volatility. It will take some time to find a balanced answer to the issue of highly concentrated sources of funds in the wholesale repo market. The Federal Reserve can "buy" time to fully analyze concentration risk by raising reserve levels to calm the repo market and facilitate this

[16] Cortview Capital Securities, Amherst Securities, and Pierpont Securities were consolidated into one, CRT Group was liquidated, and KGS-Alpha Capital Markets and Rosenthal Collins Group were acquired.

[17] Pub. L. 115–174.

analysis. Federal Reserve Chairman Jerome Powell, in an October 8, 2019, speech to the National Association of Business Economics, announced that the Federal Reserve would resume balance sheet growth in an effort to calm the liquidity market.[18] This is an important first step and the IDTA applauds the Chairman's decisive decision.

IDTA Recommendation #2

A positive item on the Federal Reserve's agenda is the much talked about "Repo Facility." The more concentrated the liquidity markets are, the more important a Federal Reserve Repo Facility becomes. However, a Repo Facility must be offered to a wider network that includes middle-market dealers. If restricted to primary dealers, its effects may be limited or negligible.

It should be noted that both Recommendations #1 and #2 could, if made permanent, provide a long-term solution. However, that does not need to be the case. While wholesale liquidity markets are stable only with a vigilant regulator that has the tools to counteract the unexpected, the issue of concentration risk can be addressed to reduce the market's reliance on the Federal Reserve.

IDTA Recommendation #3

To ensure diverse, deep and liquid markets, firms representing all key segments should participate on a level playing field. Middle-market dealers and regional banks should be encouraged to increase their participation in FICC and the wholesale liquidity market. Today, they are discouraged from doing so. Large, SIFI banks have unlimited authority to sponsor clients directly into FICC. Middle-market firms have formulaic limits based on their capital and risk. Limits should apply to both large and small institutions, and incentives should be established for middle-market, non-SIFI entities similar to the relief given to regional banks in the Regulatory Relief and Consumer Protection Act of 2018.

Middle-market dealers also have had to shrink their business models to comply with the CCLF, while large banks can easily meet their CCLF obligation and have grown larger as a result, increasing system funding risk. If the goal is to have a competitive and diverse liquidity market, then no institution should have an unlimited ability to further dominate. If the CCLF incentivizes only middle-market dealers to closely monitor and control their peak liquidity requirements, the incentives need to change.

IDTA Recommendation #4

Much of the data to do a proper review of the sources and uses of funds in the wholesale repo market is restricted by legal and confidentiality standards. This lack of public data is one of the reasons that the CCLF data made available to all FICC members has been so revelatory. As noted above, it was the CCLF data that disclosed the alarming increase in peak liquidity risk, while middle-market dealers, in the aggregate, reduced their peak liquidity exposures. While it is understandable for much of this data to be confidential, industry-wide data should be made more

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[18] Rich Miller and Steve Matthews, *Powell Sees Fed Resuming Balance-Sheet Growth, But It's Not QE*, BLOOMBERG (Oct. 8, 2019), https://www.bloomberg.com/news/articles/2019-10-08/powell-says-fed-to-resume-balance-sheet-growth-but-it-s-not-qe.

available. Transparency in wholesale public markets has always been rewarded. Regulatory reporting should have no such confidentiality, and regulators must be diligent in measuring concentration risk.

V. Conclusion.

Lawmakers and regulators must understand how the repo market is changing and the risks it presents. They should work with market participants – including with the buy-side, sell-side and clearinghouses – to ensure that public policy fosters market efficiency, integrity and fairness. The leaders of our industry, in combination with our regulatory counterparts, must solve this problem together. To expect the traders on the desk of these institutions to deal with this on an ad hoc basis, with the glut of funds in one place and the scarcity of funds in another, is unfair and unfathomable. If left unchecked, this increased concentration will make the market even more susceptible to shocks.

All market participants must come together to ensure the safety and soundness of the U.S. financial system.

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The IDTA is a forum for independent dealers and traders to discuss and consider the impact of market operational issues on their industry sector and to advocate for constructive solutions that promote the liquidity and efficiency of capital markets. More information about the IDTA can be found at https://www.idtassoc.com.

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