GTS
Building Better Markets

Via E-mail

January 6, 2023

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

RE: Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities (Release No. 34-95763; File No. S7-23-22) ("Proposed Rule")

Dear Ms. Countryman:

GTS Securities, LLC ("GTS") appreciates the opportunity to provide comments in response to the Proposed Rule published by the U.S. Securities and Exchange Commission ("SEC"). GTS is a global electronic market making firm that provides liquidity across multiple asset classes, including equities, equity options, government debt, futures, and foreign exchange. Our fixed income business spans futures and cash bonds for trading activities on public exchanges and direct bilateral dealing with the financial community. GTS is also represented on the New York Federal Reserve's Treasury Market Practices Group ("TMPG") and we were pleased to see TMPG's work cited in the Proposed Rule.

GTS appreciates the opportunity to provide comments in response to the Proposed Rule issued by the SEC. The Treasury market is often described as the most important market in the world and is a worthy area of focus for the SEC. According to SIFMA, in 2021, Treasury securities issuance reached $5.1 trillion, a year-over-year increase of 31.9 percent, and average daily trading volume reached $624.1 billion, a year-over-year increase of 3.5 percent.[1] However, there have been notable recent dislocations in the Treasury market such as the March 2020 funding problem for off-the-run Treasury securities. In that event leveraged players, primarily hedge funds, were suffering losses in the rest of their investment portfolios and in response liquidated the instrument that was the easiest to raise cash—U.S. Treasuries. The size and speed of this selloff turned an event in the equities market that would normally lead to positive price performance of Treasury bonds into a stress event for off-the-run Treasuries.

[1] *See* SIFMA, 2022 Capital Markets Fact Book, https://www.sifma.org/wp-content/uploads/2022/07/CM-Fact-Book-2022-SIFMA.pdf, at 8, 56.

This March 2020 market volatility highlighted the fact that various external factors can influence the Treasury market, while also showing the resiliency of this market under stress. At the same time, it underscored the need to address potential vulnerabilities in the Treasury market to strengthen it for what may come next. In that vein we note that the Group of Thirty has observed that liquidity risks remain relatively large for Treasury securities because of large daily settlement volumes for purchases, sales, and repos.[2]

Against this backdrop, GTS is broadly supportive of the SEC's focus on risk management through central clearing in the Treasury market. We believe that central clearing is particularly important in the cash Treasury market, where it would generally result in reduced risk exposure, including counterparty risk and systemic risk, and increased transparency around Treasury market risks. In these ways we expect that central clearing will lead to more efficient, resilient and liquid Treasury markets for the benefit of all investors.

I. SEC's Proposed Approach

The Proposed Rule would apply to "direct participants" of the Fixed Income Clearing Corporation ("FICC"), which is the only existing central counterparty for Treasuries. Covered transactions by direct participants would include only those types of secondary market transactions that are currently accepted for clearing at FICC. In the cash market, eligible secondary market transactions would include (i) transactions of inter-dealer brokers ("IDBs") that are direct participants and stand as counterparties to both sides of each trade on their platforms; (ii) transactions between a direct participant and a broker-dealer, government securities broker, or government securities dealer; (iii) transactions between a direct participant and a hedge fund; and (iv) transactions between a direct participant and an account at a broker-dealer, government securities broker, or government securities dealer that can take on significant leverage. The Proposed Rule would not include certain cash transactions by direct participants' customers or other market participants, such as mutual funds and money market funds—even though dealer-to-customer trading is the largest sector of the Treasury securities secondary market, with daily trading volume estimated in 2018 to be $290 billion[3]—and would also have limited carve-outs for transactions with a central bank, a sovereign entity, an international financial institution, or a natural person.

[2] Group of Thirty Working Group on Treasury Market Liquidity, U.S. Treasury Markets: Steps Toward Increased Resilience (2021), https://group30.org/publications/detail/4950, at 10 ("Group of Thirty Working Group Report").
[3] *See* TMPG, White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities, July 12, 2018, https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS-DraftPaper-071218.pdf, at 5 ("TMPG White Paper").

II. Central Clearing in the Swaps Market is Instructive

When analyzing the Proposed Rule we believe that it is useful to consider the experience of the Commodity Futures Trading Commission ("CFTC") when implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act's central clearing mandate for swaps. In that context, the CFTC subjected certain swaps to the central clearing mandate and applied margin requirements to non-centrally-cleared swaps, which had a result of reducing arbitrage incentives. The CFTC's rules also featured a phased implementation and exemptions for certain end users and small financial institutions.

In response to the CFTC's rules some market participants predicted that central clearing of swaps would result in a variety of negative outcomes for that market, including that rising costs would force dealers out of the market and that clearing would result in illiquid and inefficient markets. Yet despite these claims, no major participant has dropped out of the swaps market as a result of the clearing mandate. At the same time academic research in certain swaps markets has shown that centralized clearing improves liquidity and reduces credit risk.[4] We believe that the CFTC's experience in the central clearing of swaps provides valuable insights for the SEC's Proposed Rule in a variety of areas, including by rebutting potential criticism of the proposal, supporting its likely benefits, and encouraging a broadly applicable mandate.

III. Central Clearing Mandates Should Be Comprehensive

Central clearing reduces counterparty credit risk and operational risk on trades that exist between the time a trade is executed and settlement of the trade.[5] However, because moving to central clearing would incur costs on individual market participants, and there are no participants that would singularly benefit, regulatory clearing mandates generally are required to achieve the overall benefits to the market. We believe that any central clearing mandate can and should be as comprehensive as is practical and, ultimately, cover almost all Treasury cash market participants.

First, as the SEC stated, we agree that the benefits of central clearing are scale-dependent, so that a more comprehensive clearing mandate results in lower contagion risk, less complexity, and larger economies of scale.[6] In particular, a comprehensive mandate mitigates arbitrage risk. For example, if mandated central clearing were limited to one set of market participants, it would

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[4] *See, e.g.*, Yee Cheng Loon & Zhaodong (Ken) Zhong, Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports (2016); Yee Cheng Loon & Zhaodong Ken Zhong, The impact of central clearing on counterparty risk, liquidity, and trading: Evidence from the credit default swap market (2014).

[5] *See, e.g.*, Group of Thirty Working Group Report; Darrell Duffie, Still the World's Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis, May 2020, https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_updated.pdf.

[6] *See* Proposed Rule, 87 Fed. Reg. 64610 (Oct. 25, 2022), at 64673.

create perverse incentives, such as incentives to conduct more trading activity out of market segments that are not subject to the mandate. It would also allow counterparty risks to persist in pockets of the Treasury market, limiting the broad-based systemic risk mitigation that is a core feature of market-wide central clearing. Without an appropriately comprehensive central clearing mandate (provided firms are not independently incentivized to centrally clear), market forces may result in a large amount of risk residing outside of the central clearing framework.

Second, a comprehensive clearing requirement is an important step to successfully fostering an all-to-all market for Treasury securities.[7] The market for Treasuries is too large, and too vital to the U.S.'s interests and the global financial system, to be forced to squeeze through the balance sheet of a small number of select market participants. This is particularly the case given that the growth of the amount of outstanding Treasury debt has outpaced the liquidity supplied by bank dealers.[8] A robust all-to-all market for Treasury securities would provide a variety of benefits to this market, but the lack of universal central clearing is one reason why end buyers and sellers cannot transact with each other in an open and fair market. The current market structure hinders competition, leads to inefficiencies, and has detrimental effects on the liquidity and resiliency of the Treasury market. The SEC could take positive steps to address these issues by applying the Treasury clearing mandate in a comprehensive fashion.

IV. GTS Supports a Pragmatic Approach to Central Clearing in the Cash Markets

Nevertheless, given the complexities involved in shifting market activity to a central clearing agency, GTS acknowledges the concerns of some market participants about the potential impact of a central clearing mandate for cash Treasuries transactions and appreciates the need for a pragmatic approach. This may justify a staggered or phased implementation akin to the CFTC's approach to implementing a clearing mandate for swaps, which might be designed to account for certain market infrastructure and operational realities, such as the time and resources required to shift FICC non-members to central clearing, or based on the liquidity characteristics of various products. The SEC could also undertake a phased implementation by first requiring central clearing for on-the-run securities for all market participants, then systematically applying the mandate to the most recent olds, the cheapest-to-deliver basket for the futures contracts, the remaining nominal coupons, bills, TIPS, and remaining products. In addition to phased implementation, the SEC could also consider a limited set of carve-outs from the mandate, either based on trading volume and a risk assessment, or by following the approach taken by the CFTC in exempting a narrow set of market participants from central clearing in the swaps market.

[7] *See, e.g.*, Nellie Liang & Pat Parkinson, Enhancing Liquidity of the U.S. Treasury Market Under Stress, Dec. 16, 2020, https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf; Federal Reserve Bank of New York Staff Report, All-to-All Trading in the U.S. Treasury Market, Oct. 2022, https://www.newyorkfed.org/research/staff_reports/sr1036.
[8] *See* Group of Thirty Working Group Report, at 1.

While we believe central clearing can and should eventually be expanded to cover almost all Treasury cash market participants, we generally believe the SEC's proposed requirements and exceptions provide a reasonable foundation to begin mandatory central clearing in this market. We would encourage the SEC to perform empirical analysis of the market impact of central clearing requirements after adoption of its Proposed Rule, and to continue to consider expanding central clearing requirements for cash transactions, including all transactions between dealers and customers, to reap the full benefits of market-wide clearing and avoid regulatory arbitrage.

V. Conclusion

In closing, we note that there are three markets for hedging interest rate risk: cash Treasuries, bond futures, and interest rate swaps. Cash Treasuries are currently the only one of these markets that is not centrally cleared and we encourage the SEC resolve that discrepancy. We strongly believe that the market-wide benefits of central clearing, combined with a thoughtful approach and phased implementation, would result in significant improvements in risk management and more transparent, liquid, and healthier Treasury markets. As a result, we support adoption of the Proposed Rule and urge the SEC to continue to work toward a comprehensive clearing mandate for cash transactions as soon as practicable.

GTS would welcome the opportunity to further discuss our comment letter and these issues with SEC staff.

Sincerely yours,

/s/ Ryan Sheftel

Ryan Sheftel
Global Head of Fixed Income
GTS Securities, LLC