Remarks at U.S. Treasury Market Conference

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Good Morning. Thank you Brian [Smith] for that kind introduction. I am pleased to join you again this year to continue our discussion on ways to enhance the structure of the U.S. Treasury market. Thank you to the Department of the Treasury, the Federal Reserve Bank of New York, the Board of Governors of the Federal Reserve System and the Commodity Futures Trading Commission as well as to their staffs and the staff of the SEC for tirelessly working to improve this critically important market. Thank you in particular to Nate Wuerffel, Rania Perry, and the staff at the New York Fed; to Brian Smith and the staff at the Treasury Department; and to David Saltiel, Patrick Norton, and the staff at the SEC for your work on this conference and more broadly for your work in this market. Next year, we will all hopefully be able to meet together in person.

At this point, let me deliver the usual disclaimer that my views are my own and do not reflect those of the Commission or any of the other Commissioners.

When I spoke with you last year I shared my belief that the Commission should consider applying Regulation Alternative Trading System, or "Reg ATS" and Regulation Systems Compliance and Integrity, or "Reg SCI" to alternative trading systems, or ATSs, that trade Treasury securities.[1] Because ATSs are critical to the structure of the Treasury market, I believe that it is worth considering whether applying these rule-sets to Treasury ATSs will strengthen the public market for Treasury securities.

The events of this past March underscore the importance of pursuing sound enhancements to the Treasury market. As many of you are likely aware, yesterday the Commission took an important step in this regard when it proposed to apply Reg ATS to alternative trading systems that trade U.S. government securities and to apply Reg SCI to certain of these government securities ATSs.[2] Today, I will discuss the contours of that proposal as well as the following three other ways that I believe we could consider strengthening the market for U.S. Treasury securities:

1. Ensuring that regulators have full view of secondary market trading;
2. Improving our understanding and, to the extent insufficient, oversight of key treasury market participants; and
3. Broadening access to central clearing in the cash market.

I believe that prioritizing these three improvements would help optimize regulators' oversight capabilities and support the market's efficient functioning.

Proposal to Apply Reg ATS and Reg SCI to Government Securities ATSs

But first, let's discuss the Commission's proposal to apply Reg ATS and Reg SCI to government securities ATSs.

An ATS is a trading venue that meets the definition of an "exchange" but is not required to register as one if it complies with the terms of an exemption under Reg ATS.[3] Currently, however, Reg ATS includes an exemption for trading venues that only trade government securities such that these ATSs are both exempt from exchange registration and are not required to comply with Reg ATS.[4]

In recognition of the important role ATSs play in the government securities market, the Commission proposed to eliminate the Reg ATS exemption for ATSs that only trade government securities. Eliminating the exemption would require these trading venues to (1) register as broker-dealers, (2) become members of FINRA, and (3) comply with the investor protection and Commission oversight provisions of Reg ATS.[5]

In addition, the proposal would require Government Securities ATSs to file a new form, Form ATS-G, which would be subject to Commission review and made publicly available on the SEC website after becoming effective. The proposed form would solicit key information from the ATS on the activities of its operator and the manner of its operations, including order entry methods, available order types and execution protocols, trade error policies, segmentation of trading interest and counterparty restrictions, market data, the display of trading interest, and clearing and settling trades.[6]

The Commission also proposed to subject ATSs that represent significant markets for government securities to Reg ATS's fair access rule.[7] With respect to Treasury securities, ATSs that represent five percent or more of the average weekly dollar volume traded during at least four of the preceding six months would be subject to fair access.[8] These ATSs would be required to maintain reasonable written standards for granting access to trading and to apply those standards in a fair and non-discriminatory manner.[9] We have proposed using the aggregated weekly volume statistics made available on FINRA's website to determine whether an ATS has met the fair access threshold.

In addition, the Commission proposed to utilize the same threshold to apply Reg SCI to large Treasury ATSs.[10] Currently, Reg SCI applies to certain key market participants such as exchanges, clearing agencies, FINRA and the MSRB, securities information processors, and certain equity ATSs.[11] Among other things, Reg SCI imposes requirements designed to reduce the occurrence of systems issues, improve resiliency when systems problems do occur, and enhance the Commission's oversight by requiring SCI entities to provide notice of systems issues.[12]

Through these requirements, Reg SCI has strengthened the infrastructure of our equity and options markets. As trade volumes, volatility, and message traffic rose to unprecedented levels earlier this year, the "pipes and plumbing" that power the U.S. equity markets held up remarkably well. In an active, automated market, system capacity, security, and resiliency are critically important. Because of the increasing use of automated systems to trade Treasuries, we proposed to require large Treasury ATSs to comply with Reg SCI to enhance the market's resiliency.[13]

The electronification of the Treasury market, like all markets, is continuing apace. In the six month period between July and December 2019, ATSs accounted for approximately 57 percent of total trading volume and approximately 67 percent of total interdealer trading volume in on-the-run U.S. Treasury securities.[14] It is important that the regulatory regime for a market as interconnected as the cash Treasury market meets the challenges presented by this reality. Fair, orderly, and efficient markets are those that are operationally transparent and maintain reasonable safeguards related to cybersecurity and system integrity. I look forward to receiving feedback in response to our proposal and my door is always open to all who want to engage with me on these issues.

Transaction Reporting

As I move on to discuss additional areas for improvement, I'll start by noting that the Commission's ATS proposal was very much informed by the Treasury transaction data that broker-dealers have been reporting to FINRA's TRACE system. Since July 2017, SEC-registered broker-dealers that are FINRA members have reported their Treasury transactions to TRACE.[15] Beginning this past March, FINRA took the important step of posting on their website aggregated weekly Treasury trading volumes.

Over the last three years, the TRACE data has contributed to a greater understanding of Treasury market dynamics and yielded more effective regulatory analysis and oversight. The data has been critical to timely assessments of market events, including those of this past March. And at the Commission, the data has contributed to more informed policymaking, including by allowing us to calibrate our ATS proposal. In short, the TRACE data is truly the foundation upon which we can pursue smart and effective initiatives to enhance the oversight of the Treasury market.

However, work in this area is far from done. While trading by broker-dealers represents a significant portion of the cash Treasury market, banks are active participants in this market too. To that end, in 2016, the Federal Reserve Board announced that it intends to collect Treasury security transaction data from banks.[16] In 2017, Governor, and now Chairman, Powell acknowledged that it was important that the same trading activity done with a broker-dealer is not treated differently from that done with a bank.[17] And at this conference in 2018, Governor Brainard stated that the Board was close to finalizing an agreement with FINRA to collect trade data from banks.[18]

I commend the Board for their continued commitment to collect trade data from banks. Given the importance of the TRACE data to regulators, it is essential that it provide a complete picture of secondary cash trading. Including trade data from banks will improve Treasury market transparency, address a potential competitive disparity, and allow regulators to pursue tailored policy initiatives to enhance market oversight.

Improving Market Participant Oversight

Another key focus for regulators should be ensuring that regulations treat similarly situated entities in a similar manner, taking into account among other things, differences in markets and oversight regimes. The SEC has established frameworks for regulating certain market intermediaries such as trading venues and dealers. I believe it is worth considering whether the application of these specific frameworks in the cash Treasury market continues to be appropriate.

For example, while our ATS proposal is an important step in strengthening the oversight of certain Treasury trading venues, this oversight framework may not extend to all trading venues that utilize request-for-quote ("RFQ") or streaming quote protocols.[19] This is obviously a gap. Additionally, most principal trading firms ("PTFs") which are large players in the cash Treasury market are not SEC-registered dealers. This may be appropriate, for example, when other regulators oversee such entities, but disparate treatment exposes a market to potential risk and can lead to unfair burdens on competition. I want to share a few thoughts on the potential benefits of extending our ATS and dealer rules to some market participants that are not currently subject to these rules or other protective regulations, since they play critical roles in today's Treasury marketplace. I want to be clear that I do not advocate for a one-size fits all regime, where we simply impose current SEC equity market requirements on the cash Treasury market, but I do think discussing the benefits and costs of applying certain requirements is worthwhile.

Trading Venue Regulation

I will start with electronic trading venues that utilize RFQ or streaming quote protocols. These protocols provide for the interaction of actionable trading interest from multiple buyers and sellers and some would argue that trading venues that use these protocols should be subject to our ATS framework.

Trading venues that use RFQs or streaming quotes are significant centers of risk transfer and are increasingly embracing automation to execute trades. Recent reports suggest that perhaps as a result of work-from-home requirements, over 70 percent of Treasury trading is now done electronically.[20] This means that today, a significant percentage of trading occurs on RFQ and streaming quote venues.

It is important that our collective oversight framework keeps pace with this evolution. The same concerns motivating our ATS proposal, namely operational transparency, system resiliency, and fair access also apply to RFQ and streaming quote venues. It seems prudent to have transparency into these venues' operations and for them to maintain reasonable safeguards regarding cybersecurity and system resiliency, while accounting for the diversity of trading venues operating in the Treasury market.

Dealer Regulation

The second area I think merits further consideration is clarifying whether to designate PTFs as dealers for purposes of SEC rules. PTFs appear to buy and sell securities for their own account as part of a regular business. While some may be subject to our dealer rules, some are potentially subject to other regulatory regimes. It is important for us to understand this regulatory structure and ask whether it is sufficient given the current state of market intermediation.

Recent analysis has shown that PTFs account for over 61 percent of trading in the interdealer market.[21] This is not surprising. As use of electronic venues and automated technology have become more commonplace, PTFs are increasingly well situated to compete with dealers for order flow. However, this reinforces concerns regarding the disparate regulatory treatment of PTFs and dealers. Because it seems that most PTFs are not SEC-registered dealers, the regulatory framework for this market is uneven. Other market participants may often bear the risks of certain PTF trading activity.

Capital Requirements

For example, PTFs that are not SEC-registered dealers are not necessarily subject to capital requirements and thus can trade intraday in amounts that could significantly exceed the firm's capital. ATS operators and trading counterparties are put in the position of managing this risk and mitigating the potential that PTF trading activity could have systemic consequences. Sensible, tailored capital requirements could address this inequity.

Market Access Requirements

In addition, ATS operators, and not PTFs themselves, are currently responsible for maintaining controls under the SEC's market access rule with respect to non-dealer PTF activity.[22] The market access rule is particularly important because it is designed to mitigate the risk that an algorithm may malfunction and lead to broader market effects and to also enhance surveillances for manipulative trading, such as wash sales.[23] Placing the burden on ATSs to maintain these controls for PTFs that are not SEC-registered dealers is concerning for two reasons. First, ATSs have limited insight into the breadth of a PTF's trading activity, so they may not be well situated to implement sufficiently robust controls. Second, it is fair to question the incentives we are creating for certain market participants to be able to develop and implement highly complex trading strategies yet shift the accountability for managing the risk associated with those strategies to a third party. To me, it seems that the responsibility for maintaining market access controls should lie with the entity that developed and best understands its trading strategies.

Market Making Obligations

Finally, while new sources of liquidity have the potential to beneficially affect markets, trading that is premised on retaining small net overnight positions could result in a negative correlation between liquidity and volatility. In other words, this liquidity may not be there when investors most need it. Over the last few months, I have been considering more broadly the current regulatory approach to liquidity providers in all our securities markets. Historically, market-makers have received certain benefits in exchange for complying with certain obligations. Market efficiency depends on getting the balance between benefits and obligations right. While we should never expect someone to catch a falling knife, I question whether we have the right set of obligations for those making markets in various securities, including cash Treasuries. If the Commission were to consider affirmative or negative obligations for those making markets in Treasury securities, it is important that those obligations apply consistently to all similarly situated market participants.

Broadening Access to Central Clearing

Lastly, the market conditions in March raise the question of whether we should consider broadening the universe of cash Treasury trades that are subject to central clearing.

As the percentage of Treasury trades executed by registered broker-dealers has decreased, there has been a corresponding decrease in the percentage of trades that are centrally cleared. And since almost all trades in the dealer-to-client segment are cleared bilaterally, the vast majority of cash Treasury trades do not benefit from central clearing.[24]

Trades cleared bilaterally are subject to bespoke risk management and may be settled on a gross, as opposed to net, basis. This means that credit risk, both intraday and overnight, remains with the original trade counterparties, including ATS operators. Furthermore, should a market participant with unsettled trades fail, contagion could spread through the market without a central counterparty to manage and potentially mutualize losses.

The increased assumption of credit risk by intermediaries inhibits the Treasury market's resiliency. Electronic trading has the potential to reap great benefits for investors, but if there is not an efficient mechanism to guarantee the financial performance of trading, the risks may exceed the rewards. The more transactions that can benefit from novation, netting, and guaranteed settlement, the more resilient the market could be.

I wonder if expanding access to central clearing could also have positive effects on market breadth and depth. In my conversations with market participants about the conditions in March they shared with me that they had trouble receiving bids on their bonds because dealers, overwhelmed by a large amount of one-way trading flows, lacked balance sheet capacity or hit internal risk limits. If a larger portion of trades were centrally cleared, dealers may be better able to net their buys and sells across market segments. This could free up capacity to continue to make markets during volatile periods, be they persistent or transitory in nature.

Finally, I continue to question whether it is optimal for ATS operators to assume counterparty credit risk arising from the trading activity of their participants. In today's environment, ATS operators face enough risks in trying to manage complex, automated markets. Operating trading venues in a fair and orderly manner should arguably be their main focus.

The Treasury market possesses a solid clearing foundation. The T+1 settlement cycle limits many of the risks motivating the old adage, "nothing good happens between trade date and settlement date." As we seek to enhance the efficiency and resiliency of the Treasury market, we should consider building on this foundation. However, in doing so, we should carefully consider whether we have adequate safeguards for ensuring that we do not further entrench entities as systemically important and that these entities have appropriate controls and resolution contingencies.

Conclusion

The U.S. Treasury market is the deepest, most liquid market in the world. I am committed to pursuing sound, targeted policies designed to enhance the market's functioning. I encourage you all to reach out and share your thoughts with me on these initiatives. I look forward to continuing to learn from your experiences.

With that, I'll turn it back over to Rania [Perry].

[1] *See* Commissioner Elad L. Roisman, Remarks at the U.S. Treasury Market Conference (Sept. 23, 2019) *available at* https://www.sec.gov/news/speech/roisman-2019-09-23.

[2] *See* Regulation ATS for ATSs that Trade U.S. Government Securities, NMS Stock, and Other Securities; Regulation SCI for ATSs that Trade U.S. Treasury Securities and Agency Securities; and Electronic Corporate Bond and Municipal Securities Markets, Exchange Act Release No. 90019 (Sept. 28, 2020) *available at* https://www.sec.gov/rules/proposed/2020/34-90019.pdf (hereinafter "ATS-G Proposal").

[3] *See* Exchange Act Section 3(a)(1) and 17 CFR 240.3b-16. *See also* 17 CFR 240.3a1-1(a).

[4] *See* 17 CFR 242.301(a)(4). However, ATSs that trade government securities and other types of securities, such as corporate bonds or foreign sovereign bonds, are required to comply with Reg ATS, although certain provisions of Reg ATS are not applicable to government securities. *See*, *e.g.*, 17 CFR 242.301(b)(5), (b)(6).

[5] *See* 17 CFR 242.301(b) (requiring, among other things, the maintenance of certain books and records, the filing of periodic confidential volume reports with the Commission, and adopting written safeguards and procedures to protect confidential subscriber information).

[6] *See* ATS-G Proposal at 405-423.

[7] *See id*. at 47.

[8] With respect to agency securities, the Commission proposed that ATSs that represent five percent or more of the average daily dollar volume traded during at least four of the preceding six months would be subject to fair access. *See id*. at 49.

[9] *See* 17 CFR 242.301(b)(5) and ATS-G Proposal at 161 (proposing to amend Rule 301(b)(5) to add "reasonable").

[10] *See* ATS-G Proposal at 182. With respect to agency securities, the Commission proposed that ATSs that represent five percent or more of the average daily dollar volume traded during at least four of the preceding six months would be subject to Reg SCI. *See id*. at 183.

[11] *See* Securities Exchange Act Release No. 73639 (Nov. 19, 2014), 79 FR 72252 (Dec. 5, 2014).

[12] *See* 17 CFR 242.1001-1004.

[13] Reg ATS also includes a rule designed to enhance the capacity, integrity, and security of ATSs. *See* 17 CFR 242.301(b)(6). However, we chose not to apply this rule to Government Securities ATSs and instead to track the

approach we took with equity ATSs. Thus, while certain Treasury ATSs would be subject to Reg SCI, those that are not would not be subject to Reg ATS's requirements regarding operational, technological, or cyber risks. We have requested comment on this approach. *See* ATS-G Proposal at 194.

[14] *See* ATS-G Proposal at 271-272.

[15] In addition, since 2019, certain treasury trading venues that are currently regulated as ATSs are required to identify non-FINRA members in their trade reports. *See* FINRA Rule 6730.07.

[16] *See* Federal Reserve Board Press Release (Oct. 21, 2016) *available at* https://www.federalreserve.gov/newsevents/pressreleases/other20161021a.htm. *See also* A Financial System That Creates Economic Opportunities: Capital Markets, (Oct. 2017) at 71, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.

[17] *See* Governor Jerome H. Powell, Treasury Markets and the TMPG, (Oct. 5, 2017) *available at* https://www.federalreserve.gov/newsevents/speech/powell20171005a.htm.

[18] *See* Governor Lael Brainard, The Structure of the Treasury Market: What are We Learning?, (Dec. 3, 2018) *available at* https://www.federalreserve.gov/newsevents/speech/brainard20181203a.htm.

[19] In our ATS proposal, the Commission included a concept release on the electronic corporate bond and municipal securities markets. The Commission issued the concept release in light of a recommendation from the Fixed Income Market Structure Advisory Committee to review the oversight framework for fixed income electronic trading platforms. *See* Recommendation to Review the Oversight Framework for Electronic Trading Platforms (Jul. 16, 2018) *available at* https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-electronic-trading-platforms-recommendation.pdf. Among other things, the concept release solicited public feedback on matters concerning disparate regulatory treatment of electronic trading platforms based on trading protocols or business models. *See* ATS-G Proposal at 199-209.

[20] *See* JPMorgan Report Reveals 'Dramatic' Covid Shift to Electronic Bond Trading, FT (Aug. 9, 2020) *available at* https://www.ft.com/content/c3fd08b8-5690-42f6-be0e-5b6ff334ac64.

[21] *See* James Collin Harkrader, Michael Puglia, FEDS Notes, Principal Trading Firm Activity in Cash Treasury Markets (Aug. 4, 2020) *available at* https://www.federalreserve.gov/econres/notes/feds-notes/principal-trading-firm-activity-in-treasury-cash-markets-20200804.htm.

[22] *See* 17 CFR 240.15c3-5.

[23] *See, e.g.*, FEDS Notes, supra note 21 (identifying that 5.4% of average daily volume, or $10.2 billion per day, in the electronic interdealer market is the result of self-trading, which represents transactions in which the same entity takes both sides of the trade so that no change in beneficial ownership results).

[24] *See* Treasury Market Practices Group, White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities, (Jul. 11, 2019), at 12 *available at* https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_FinalPaper_071119.pdf.