December 23, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 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 (File No. S7-23-22, RIN 3235-AN09); 87 Fed. Reg. 64,610 (Oct. 25, 2022)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release").[2] The Proposal, if adopted, would modernize the clearance and settlement of trades in the U.S. Treasury securities markets by requiring more transactions to be centrally cleared through a clearing agency. Specifically, it would amend Rule 17Ad-22(e)(18) to require central clearing agencies providing clearing and settlement services in U.S. Treasury securities transactions, including cash and repurchase ("repo") transactions, to have policies and procedures that require their members or direct participants to submit all eligible secondary market transactions in U.S. Treasury securities for clearing.

If adopted, the Proposal would substantially increase the number of transactions in U.S. Treasury securities markets that are centrally cleared as Congress intended when it passed the Government Securities Act of 1986, thereby reducing risk in financial markets that have experienced several periods of financial instability in recent years.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 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, 87 Fed. Reg. 64,610 (Oct. 25, 2022).

1825 K Street, NW, Suite 1080, Washington, DC 20006
TELEPHONE (1) 202.618-6464
FAX (1) 202.618.6465
WEBSITE bettermarkets.com

In this comment letter, we trace the history and need for the Proposal and voice our support for this important reform. We also issue a general caution insofar as increasing the volume of U.S. Treasury securities transactions that are centrally cleared highlights the need to ensure vigilant oversight of the clearing agencies that represent centralized concentrations of risk. Finally, we provide context for the Proposal and briefly review a number of the other important SEC reforms now underway to increase the transparency and stability of the U.S. Treasury markets.

## BACKGROUND

"He touched the dead corpse of the public credit and it sprang upon its feet." These are the words etched in stone at the base of the statue of Alexander Hamilton that lay outside the U.S. Department of Treasury building in Washington, D.C. As the nation's first Secretary of the Treasury, Secretary Hamilton helped to create the U.S. Treasury securities market with his carefully crafted plan to assume states' debts and fund the debts of the national government at par, as set forth in his Report on Public Credit.[3] Since U.S. securities first traded in the public markets in 1790, much has changed.

Since the sale of the first U.S. Treasury securities in 1790, the U.S. Treasury securities market has developed into the largest and most liquid bond market in the world that serves as the benchmark of the global financial system. U.S. Treasury securities have become broadly viewed as the primary global "risk free" asset, and so the yields of U.S. Treasury securities are utilized as the benchmark for determining the prices of virtually all other financial assets. Because they are a cash-like asset that provides a financial return, they are highly desirable as an investment and as support for other financial transactions. As an investment, they represent the deepest and most liquid market in the world and are held in significant quantities by foreign governments, banks, and large investment management firms. Of the $18.1 trillion of Treasury debt privately held as of March of this year, $7.8 trillion was held by foreign governments, $4.6 trillion by mutual and pension funds, and $1.8 trillion by depository institutions.[4] Hedge funds in particular hold them as part of a more complicated investment strategy to profit from the basis between the cash and futures market. Additionally, because they are seen as a "safe haven" asset, they are used by investors as a hedge against market stress because their value typically rises under stress as investors seek safer assets. Treasuries also are used more functionally to meet margin requirements for derivative agreements and as collateral in funding transactions, particularly repos.

Robust federal regulation of the U.S. Treasury markets was not put in place until the 1980s. Following the collapse of several firms that traded in government securities, in 1986 the Government Securities Act was passed and signed into law. The bill focused on bringing activities related to Treasuries into the regulatory fold to give the government more oversight and transparency in the markets. Brokers and dealers of government securities were required to register

[3] *See* Alexander Hamilton, *Report Relative to a Provision for the Support of Public Credit* (Jan. 9, 1790), https://founders.archives.gov/documents/Hamilton/01-06-02-0076-0002-0001#ARHN-01-06-02-0076-0002-fn-0098.

[4] Data obtained from United States Treasury, *Treasury Bulletin* (September 2022), https://fiscal.treasury.gov/reports-statements/treasury-bulletin/.

with the appropriate regulatory agency, with non-bank dealers being required to register with the Commission, and clearinghouses for government securities were put under the Commission's regulatory authority. By 2000, all interdealer broker ("IDB") platform users were members of a central clearinghouse, and their trades were therefore centrally cleared.[5]

However, over time—as with markets for other assets—technological advancements provided a faster, simpler means of trading government securities and at the same time led to dealer fragmentation within the U.S. Treasury securities markets. Inevitably, there has been a significant rise in algorithmic trading and so-called principal trading firms ("PTFs") or high-frequency trading firms. These firms are able to trade without registering with the Commission as dealers or trading through a clearing counterparty. They account for more than 20 percent of the overall volume of U.S. Treasury cash market trading and more than 60 percent of the volume reported on IDB platforms.[6] Similarly, central clearing in the repo markets is equally split among non-centrally cleared bilateral repo transactions and centrally cleared repo transactions.[7] That is a significant portion of trading in the U.S. Treasury securities markets into which regulators and other market participants have no visibility. As a result, investors, other market participants, and even regulators have little insight into a majority of these transactions because these firms, although functioning as de facto dealers, are not required to report their transaction data or clear their trades through a central clearinghouse.

This lack of transparency in the U.S. Treasury securities markets has hamstrung the ability of regulators to maintain fair, orderly, and efficient markets and to ensure adequate liquidity, specifically in periods of exceptional market stress. Several important market events that occurred in the last few years in the U.S. Treasury securities markets in particular highlight how any disruption in those markets can lead to or exacerbate financial instability. For example, in October 2014, the 10-year Treasury bond experienced a mini flash crash with a volatile round trip in price. During that episode, the bond instrument experienced unusual volatility and dropped and recovered an extraordinary 1.6% in a matter of 12 minutes. While other electronically traded markets have experienced similar moments of volatility throughout their own histories, this move in the U.S. Treasury securities market was swift and unprecedented. A joint staff report published by the Inter-Agency Working Group for Treasury Market Surveillance ("IAWG") stated "[b]efore 2014, many did not believe that an event of this type was likely to occur in the Treasury market."[8]

In identifying the exact causes of the flash crash, the report went on to highlight the lack of transparency and regulatory access to data:

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5 Treasury Market Practices Group, *White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities*, Federal Reserve Bank of New York 2 (2018).

6 James Collin Harkrader & Michael Puglia, *FEDS Notes: Principal Trading Firm Activity in Treasury Cash Markets* (Aug. 04, 2020), https://www.federalreserve.gov/econres/notes/feds-notes/principal-trading-firm-activity-in-treasury-cash-markets-20200804.html.

7 Inter-Agency Working Group for Treasury Market Surveillance, *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report* 4 (Nov. 8, 2021).

8 *Id.* at 18.

> Following the October 2014 disruption, analysis found that diversity in trading venues and participants and fragmented and incomplete data reporting had left market participants and individual regulatory agencies with only a very limited view of Treasury risk transfer and price discovery. These gaps posed challenges to understanding the causes of the flash rally.[9]

More recently, the economic and financial market uncertainty surrounding the outbreak of the COVID-19 pandemic in March 2020 led to a massive demand for liquidity, putting pressure on the U.S. Treasury securities markets from large-scale sales of U.S. Treasury securities for cash and also exerting pressure on the repo market as many firms sought short-term funding. The IAWG report details the moves in prices on the 10-year Treasury bond over the period of several days in March 2020:

> The benchmark 10-year yield fell from 1.46 percent on February 21 to 0.54 percent on March 9, rebounded to 1.18 percent by March 18, then fell again to close the month at 0.70 percent. Intraday yields varied over an even wider range.[10]

In response to this crisis and in order to help bring stability to the U.S. Treasury markets, the federal government needed to intervene. The Federal Reserve announced and executed a plan to purchase trillions of dollars of U.S. Treasury securities and set up special repo facilities to facilitate transactions in the repo markets in order to bring stability to the fragile markets.

As recent episodes of market disruption have made clear, the technological innovations and evolution of the types of market participants in the U.S. Treasury securities markets have identified the emergence of regulatory gaps in these markets that pose a substantive threat to the financial stability of the U.S. financial system. In fact, in a recent research report, Bank of America cautioned that "the Treasury market arguably poses one of the greatest threats to global financial stability today, potentially worse than the housing bubble of 2004-2007."[11] The Proposal is part of a worthwhile regulatory effort to create a more durable solution to the lack of transparency and the risk of instability associated with the U.S. Treasury market so that dramatic interventions in moments of crisis are no longer necessary.

## OVERVIEW OF THE PROPOSAL

### *Increasing central clearing of trades in U.S. Treasury securities*

The Commission has proposed amendments under the Securities Exchange Act of 1934 to expand central clearing in the U.S. Treasury securities markets. The Proposal makes several amendments to existing Commission rules that address the policies and procedures of covered clearing agencies that provide central counterparty services for U.S. Treasury securities.

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9 *Id.*

10 *Id.* at 8.

11 *Alarm Bell Sounds on Treasury Market Trading Conditions*, WALL ST. J. (Sept. 7, 2022), https://www.wsj.com/articles/alarm-bell-sounds-on-treasury-market-trading-conditions-11662578202.

Specifically, the Proposal would amend Exchange Act Rule 17Ad-22(e)(18) to require covered clearing agencies to have policies and procedures in place to require their direct participants to submit all eligible secondary market transactions in U.S. Treasury securities for clearing, including:

- Repo and reverse repo agreements where one of the counterparties is a direct participant;
- Any purchases and sales by a direct participant if they bring together buyers and sellers through use of a trading facility and if they serve as a counterparty to both the buyer and seller in separate transactions; and
- Any purchase and sale between a direct participant and a counterparty that is, or has an account at, a registered broker-dealer, a government securities dealer or broker, or a hedge-fund.

Importantly, transactions between a direct participant and a central bank, sovereign entity, international financial institution, or natural person would be ***excluded*** from these amended requirements.

Additionally, the Proposal would require covered clearing agencies that provide central counterparty services for transactions in U.S. Treasury securities to have written policies and procedures to facilitate access to clearing and settlement services for all eligible secondary market transactions, including by indirect participants, which shall be reviewed by the covered clearing agencies' boards of directors annually.

*Increasing margin requirements for trades in U.S. Treasury securities*

The Proposal would require covered clearing agencies that provide central counterparty services for transactions in U.S. Treasury securities to establish, implement, maintain, and enforce written policies and procedures requiring them to calculate, collect, and hold margin for direct participants' proprietary transactions separate and apart from margin calculated and collected in connection with U.S. Treasury securities transactions submitted on behalf of indirect participants that rely on services provided by direct participants to access covered clearing agencies services.

*Allowing margin to be treated as a debit in the customer reserve formula applicable to covered clearing agencies*

Finally, the Proposal would amend Rule 15c3-3a to permit margin required and on deposit at covered clearing agencies that provide central counterparty services for U.S. Treasury securities to be included as a debit item in the customer reserve formula. As a result of the increase in margin requirements for central clearing in the Proposal, the Proposal also includes changes that require covered clearing agencies to segregate customer margin used for customer trades from other broker-dealer activities. This enables broker-dealers to use customer funds to meet margin

requirements generated by the customer's trading activity. This debit item in the customer reserve formula would be limited to customer position margin that is required and on deposit at the covered clearing agency.

## COMMENTS

### I. The Proposal would result in more central clearing of transactions in the U.S. Treasury securities markets as Congress intended when it passed the Government Securities Act of 1986.

The Proposal would substantially increase the number of transactions in the U.S. Treasury securities markets that are centrally cleared, a primary goal Congress sought to achieve when it passed the Government Securities Act of 1986. Congress acted in 1986 to respond to repeated failures in the U.S. Treasury securities markets when it passed the Government Securities Act and mandated that regulators, including the Commission, enhance their oversight of the secondary trading of these markets. However, after decades of technological innovation, increased electronic trading, and the evolution of the types of participants in these markets, a majority of transactions escape adequate regulatory oversight in today's markets. The Proposal seeks to modernize the regulation of these markets in part by requiring more central clearing of transactions in the U.S. Treasury securities markets, as Congress intended when it subjected this market to enhanced regulatory scrutiny.

Section 17A of the Securities Exchange Act of 1934 provides for the Commission's regulatory authority over clearing agencies that provide clearance and settlement services for certain securities transactions.[12] It includes a range of requirements, such as registration, the duty to provide prompt and accurate clearing and settlement, the safeguarding of funds, and fair access. However, the Commission's authority in this section did not extend to clearing agencies providing clearance and settlement services for government securities until the Government Securities Act of 1986 was passed into law. The Government Securities Act of 1986, among other things, amended Section 3(a) of the Securities Exchange Act to ensure that clearing agencies that provided clearance and settlement services for government securities transactions would not be exempt from the requirements in Section 17A of the Exchange Act.[13] This change was made, in part, due to several failures in the marketplace that had material impacts on the U.S. Treasury securities markets.

In the years prior to passage of the Government Securities Act, the U.S. Treasury markets experienced several incidents of market disruptions which led to losses for investors and raised the cost of borrowing. These incidents were documented in a speech on the House floor by the bill's sponsor and Chairman of the Energy and Commerce Committee when he said:

[12] 15 U.S.C. § 78q-1.
[13] Government Securities Act of 1986, Section 102(a) P.L. 99-571.

> Between July 1975 and April 1985, several unregulated government securities dealers failed – Financial Corp. of Kansas City, MO. 1975; Winters Government Securities, 1977; Drysdale Government Securities, 1982; Lombard-Wall, 1982; Comark, 1982; Lion Capital Group, Inc., 1984; and most recently E.S.M. Government Securities, Inc. and Bevill, Bresler & Schulman Asset Management Corp., 1985 – with estimated losses to investors of about $1 billion. E.S.M.'s failure alone resulted in losses of over $300 million to local governments and savings and loan associations, which triggered a depositor's run on thrift institutions in Ohio and the temporary closing of 71 Ohio thrifts. Similar events occurred in Maryland, followed by a sharp rise in the price of gold in European markets and a corresponding drop in the value of the dollar.[14]

In fact, news reports of the times reported these market failures as the primary reason for the passage of the bill and enhancing Commission regulatory oversight over the secondary trading of U.S. Treasury securities markets, saying:

> [S]ome 200 smaller dealers have been almost totally unregulated. And the collapse of several such dealers in recent years – such as the 1985 failure of the Bevil Bresler group of companies and E.S.M. Government Securities – which created hundreds of millions of dollars in losses ***was the primary impetus for passage of the regulatory legislation***.[15]

The legislative history and news report makes clear that passage of the Government Securities Act of 1986 was a direct response to the failures in the U.S. Treasury securities markets.[16] Congress explicitly directed the Commission to regulate these markets and exercise regulatory oversight over clearing agencies that provided clearance and settlement services in this market. The result was that up until the mid-2000s, central clearing agencies cleared most interdealer trading of U.S. Treasury securities because the trading occurred between primary dealers who were required to be members of the clearing agency.[17] However, as we know, the

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[14] Cong. Record, Volume 132, Part 20, Page 28,808 (Oct. 6, 1986) (Statement by Rep. John Dingell).

[15] *House Passes Bill on Dealers in U.S. Debt*, N.Y. TIMES (Oct. 7, 1986) at D5.

[16] *See* U.S. Government Securities: More Transaction Information and Investor Protection Measures are Needed, Government Accountability Office, GAO-90-114 34 (Sept. 14, 1990) ("The legislative history of the act as set forth in committee reports and floor debates shows that Congress sought to improve the safety of the market by ensuring that all broker/dealer participants were subject to a basic regulatory scheme and assure that the repurchase agreement market not be a source of loss to investors").

[17] Release at 64,615 (*citing* Group of Thirty Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience* 9 (July 2021), https://group30.org/publications/detail/4950; Inter-Agency Working Group for Treasury Market Surveillance, *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report* 5-6 (Nov. 8, 2021), https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf; TMPG, *White Paper on Clearing and Settlement in the Secondary Market for U.S.*

increase in electronic trading and the evolution in the types of market participants that are active in the U.S. Treasury securities markets has dramatically reduced the number of trades centrally clearing through a central clearing agency. These changes have raised new issues, specifically in times of market stress. The Proposal accurately highlights these disruptions in the U.S. Treasury securities markets that have led to periods of increased volatility and/or decreased liquidity, including episodes in 2014, 2019, and 2020.[18]

Just as Congress mandated the Commission to establish regulatory oversight of the secondary market trading of the U.S. Treasury securities markets in the aftermath of repeated market failures in 1986, the Proposal seeks to modernize this mandate to right-size regulatory oversight of these markets in light of recent market evolutions and disruptions. We are now at the point where a majority of transactions in U.S. Treasury securities markets are conducted bilaterally, with no central clearing and limited regulatory oversight. Indeed, "[e]stimates from the first half of 2017 further suggest that only 13 percent of the cash transactions in the U.S. Treasury securities market are centrally cleared."[19] The Proposal is an important and necessary step, not only to lower risk within the U.S. Treasury securities markets and increase regulators' insights into these markets, but also to fulfill Congress' intent when it passed the Government Securities Act in 1986.

## II. The Proposal will reduce risks to the U.S. Treasury securities markets, but it must be followed by robust regulatory oversight over covered clearing agencies to guard against risks to financial stability.

The Proposal will reduce risks in the U.S. Treasury securities markets, but only if the Commission maintains robust regulatory oversight over covered clearing agencies. By increasing the number of transactions in U.S. Treasury securities centrally cleared by covered clearing agencies, the Proposal will reduce counterparty risks for market participants, reduce external risks for covered clearing agencies from failures of non-centrally cleared transactions between members of the clearing agency and non-members, and reduce operational and liquidity risks.

But as a result of these requirements, the covered clearing agencies charged with providing clearance and settlement services for U.S. Treasury securities will see a large influx of clearing and settlement activity and likely more entities seeking to become members of the clearinghouse. That will call for vigilance to ensure that the clearinghouse itself remains stable. The only covered clearing agency in this market is already a Financial Market Utility, otherwise known as a "too-big-too-fail" financial institution. Therefore, robust regulatory oversight over covered clearing agencies in U.S. Treasury securities markets is necessary to realize any reduction of risk in the U.S. Treasury securities markets as the Proposal contemplates.

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*Treasury Securities* 6 (July 2019), https:// www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_FinalPaper_071119.pdf.

18 *See* Release at 64,653-64,655.
19 *Id.* at 64,649.

In a statement released with the Proposal, Commissioner Pierce stated "[s]ome people assume that regulatory oversight will ensure that the clearing agency manages risk appropriately, but regulators do not always get it right either."[20] This is one way of noting the special importance of making sure that oversight of such critical market utilities is not only in place but done right.

The Proposal, if implemented as proposed, will be a net positive for reducing risks in the U.S. Treasury securities markets. Increased clearing of transactions within both the cash and repo Treasury markets will naturally enhance the level of transparency for both regulatory agencies and market participants. That is because in central clearing, the clearinghouse serves as the counterparty to each transaction and therefore centrally manages all trades, the data associated with them, and related risk management. When contrasted with the alternative – bilateral, non-centrally cleared trading – it would appear that central clearing is the far more preferred system. Former Commissioner Roisman rightly noted the risks arising from the absence of central clearing:

> 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.
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> 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.[21]

In addition, the Treasury Markets Practice Group at the Federal Reserve Board of New York also has identified the current risks involved with bilateral clearing when it said the practice "involves varying risk management practices that are less uniform and less transparent…and may be less efficient with regard to netting exposures and use of collateral as compared to central clearing."[22]

We certainly agree that central clearing in the U.S. Treasury securities markets is far preferable to bilateral clearing because it reduces overall risk in the system. The Proposal would enhance transparency among market participants and provide regulatory agencies with the data necessary to manage and help to mitigate risks to financial stability. It would also support the smooth and efficient functioning of the markets by increasing visibility and more efficiently

[20] Commissioner Hester Pierce, Treasury Clearing Standards for Membership Requirement and Risk Management (Sept. 12, 2022), https://www.sec.gov/news/statement/peirce-statement-treasury-clearing-09142022.

[21] Commissioner Elad L. Roisman, Remarks at U.S. Treasury Market Conference (Sept. 29, 2020), https://www.sec.gov/news/speech/roisman-us-treasury-conference-2020-09-29.

[22] Treasury Market Practices Group, *White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities* 3 (July 13, 2018), https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS-DraftPaper-071218.pdf.

matching buyers/lenders with sellers/borrowers. For these reasons, the Proposal will reduce the overall risk that currently lurks in our U.S. Treasury securities markets and more than offset the countervailing risks that might arise from increasing the size and complexity of the clearinghouse—provided regulators maintain robust oversight of this "too-big-too-fail" institution.

## III. The Proposal marks another step in enhancing much needed regulatory oversight and transparency in the U.S. Treasury securities markets.

The Proposal marks another important step the Commission is taking to enhance regulatory oversight of the U.S. Treasury securities markets, which is desperately needed. As explained above, the troubling disruptions in the U.S. Treasury securities markets that occurred in 2014, 2019, and 2020 have highlighted significant weaknesses in the current structure of the U.S. Treasury securities markets during times of market stress. Financial regulators across the federal government must take the necessary steps to increase transparency, enhance oversight of market participants, and steer these markets back to central clearing. This Proposal, coupled with other recent proposals from the Commission and elsewhere will help facilitate stronger, more resilient U.S. Treasury securities markets.

### *a. Advancements in FINRA's TRACE Reporting System for U.S. Treasuries*

In response to the unprecedented gyrations in the market for U.S. Treasuries that occurred in October 2014 and public comments submitted to the U.S. Treasury Department in response to a Request for Information on structural changes to the U.S. Treasury markets, FINRA finalized a rule requiring its members to report U.S. Treasury transactions to the Trade Reporting and Compliance Engine (TRACE) reporting system.[23] Requiring reporting to the TRACE reporting system was one way for regulators to gain more insight into the U.S. Treasury market that they did not have during or after the events of October 2014. Regulators across the federal government continue to make important improvements to increase the number of U.S. Treasury transactions that are reported to the TRACE reporting system and the frequency with which those transactions are reported.

Building on actions to require Treasuries transaction reporting to the TRACE reporting system by FINRA members, the Federal Reserve adopted a rule in October 2021 to require certain other financial institutions to report Treasuries transactions to the TRACE reporting system.[24] Specifically, the rule requires "[e]very national bank, state member bank, state non-member bank, savings association, or U.S. branch and agency of a foreign bank filing a Notice of Government Securities Broker or Government Dealer Activities Form…with average daily transaction volumes of over $100 million for U.S. Treasury securities" to report transactions to the TRACE reporting system. While this action would not result in all U.S. Treasury securities transaction data being

[23] Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change to Amend FINRA Rule 6730 To Enhance TRACE Reporting Obligations for U.S. Treasury Securities, 81 Fed. Reg. 73,167 (Oct. 24, 2016).

[24] Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB, 86 Fed. Reg. 59,716 (Oct. 28, 2021).

captured by TRACE, it is a significant step. This rule will help to enhance transparency in the Treasury markets by increasing the percentage of transactions being reported to the TRACE reporting system.

Similarly, FINRA has recently proposed further changes to the TRACE reporting system in an effort to "enhance the regulatory audit trail" and to ensure that data is reported "in a more timely manner."[25] Specifically, FINRA's proposed rule would require Members to report U.S. Treasury transaction data in the smallest increment available to the Member and as soon as practicable, but no later than 60 minutes following a transaction.[26] These changes would provide more granular and rapid transaction data that benefits regulators and market participants alike. This is another example of an important step regulators are taking to enhance transparency in our U.S. Treasury markets.

*b. Treating PTFs as "Dealers" and "Government Securities Dealers"*

As mentioned previously, practically all users of interdealer broker platforms were members of a central counterparty, meaning nearly all trades of Government securities were centrally cleared through 2000.[27] The rise of electronic trading strategies by PTFs in the past two decades has materially reduced the percentage of U.S. Treasury securities transactions that are centrally cleared. These PTFs have become so prevalent in the Treasury markets that they represent nearly half of all trading on interdealer broker platforms.[28] Despite the outsized role PTFs perform in the Treasury markets, they are not currently required to be registered with the Commission as a dealer or government securities dealer, and therefore they are not required to be members of a self-regulatory organization ("SRO") such as FINRA and report their transactions to FINRA's TRACE system.[29]

A dealer is defined by the Securities Exchange Act as "any person engaged in the business of buying and selling securities for such person's own account," excluding "a person that buys or sells securities…for such person's own account…but not as a part of a regular business."[30] The second part of the definition is generally referred to as the "trader" exception and is meant to draw a distinction between a dealer, as defined in the Securities Exchange Act, and an ordinary investor

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25 Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of a Proposed Rule Change To Amend FINRA Rule 6730 To Enhance TRACE Reporting Obligations for U.S. Treasury Securities, 87 Fed. Reg. 33,844; 33,845 (June 3, 2022).

26 87 Fed. Reg. 33,844.

27 Inter-Agency Working Group for Treasury Market Surveillance, *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report* 6 (Nov. 8, 2021); Treasury Market Practices Group, *White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities,* Federal Reserve Board of New York 2 (2018).

28 Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23,054, 23,072 (Apr. 18, 2022).

29 FINRA Rule 6730(a)(1) requires members of FINRA to report TRACE-Eligible Securities, including Treasury securities.

30 Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)5.

that trades regularly for their own account but not as a part of a regular business.[31] The distinction between dealer and trader has existed since Louis Loss published his treatise on securities law in 1951, entitled "Securities Regulation." However, the rise in algorithmic, electronic trading by PTFs has blurred the line between dealer and trader in recent years. In general, PTFs have relied on the trader exception to avoid having to register with the Commission as "dealers" or "government securities dealers." However, PTFs have become such a source of liquidity by providing a majority of the trading volume in these markets that they have become de facto market makers. The Commission and the courts have concluded that there is a point beyond which trading in one's own account transitions out of the realm of the trader's exception and into the realm of the dealer. The Commission has identified "acting as a 'market maker' or a 'de factor market maker whereby market professionals or the public look to the firm for liquidity,' as a factor that indicates 'dealer' status."[32]

Better Markets supports efforts to treat market participants performing similar market activities similarly, and the Commission's proposed rule to expand the definition of government securities dealer to incorporate PTFs stands as a cardinal example.[33] Regulation of these firms as dealers will confer numerous benefits in terms of transparency, market stability, investor protection, and fair competition. As explained in the proposed rule,[34] dealers are required to register with the Commission, join an SRO, and adhere to a comprehensive regulatory regime. That framework includes provisions that limit risk and promote financial responsibility through net capital requirements; promote transparency through reporting and disclosure requirements; facilitate regulatory oversight through books and records requirements and the examination process; and curb abusive conduct through dealer-specific anti-manipulation and anti-fraud rules. Moreover, registered dealers are subject to the rules and enforcement authorities of the SROs, including reporting TRACE-Eligible Securities, such as Treasury securities, to FINRA's TRACE system. Government securities dealers, in particular, are further subject to rules issued by the Treasury that concern financial responsibility, capital requirements, recordkeeping, reports and audits, and large position reporting. Additionally, bringing PTFs within the scope of the dealer definition will promote fairness and competition among registered and unregistered dealers by applying similar rules to all dealer activities that meet the proposed standard. In short, this reform

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[31] Louis Loss, *Securities Regulation* 722 (1st ed. 1951) ("One aspect of the 'business' concept is the matter of drawing the line between a 'dealer' and a trader—an ordinary investor who buys and sells for his own account with some frequency").

[32] Definition of Terms in and Specific Exemption for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 46745 (Oct. 30, 2002), 67 Fed. Reg. 67496; 67498–67500 (Nov. 5, 2002) (stating that a person generally may satisfy the definition, and therefore, be acting as a dealer in the securities markets by conducting various activities, including "acting as a market maker or specialist on an organized exchange or trading system").

[33] *See* Better Markets Comment Letter, Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, https://bettermarkets.org/wp-content/uploads/2022/05/Better_Markets_Comment_Letter_Definition_of_Dealer__Government_Securities_Dealer.pdf.

[34] 87 Fed. Reg. 23,054; 23,078-79.

will greatly enhance the transparency of U.S. Treasury securities markets for market participants and regulators by requiring PTFs, who perform a majority of the trading in Treasury markets, to report their transaction data to the FINRA TRACE reporting system. It will not, of course, enhance central clearing of Treasury securities specifically, and that's why the Proposal is so important as one element of the group of reforms necessary in the Treasuries markets.

*c. Regulatory Oversight of Government Securities Alternative Trading Systems*

On a related front, the Commission has proposed a rule to eliminate the exemption for Government Securities Alternative Trading Systems ("ATS") from compliance with Regulation ATS and to require that Communication Protocol Systems, namely Request-for-Quote ("RFQ") protocols, must register as an exchange or under Regulation ATS.[35] These reforms will enhance transparency, bring more fair competition, and above all, result in stronger investor protections in the government securities markets. The disclosures that will be required of Government Securities ATSs via Regulation ATS will result in greater insight for investors into Government Securities ATS trading services, fees, conflicts of interest, market data, order types, and trading algorithms. Moreover, requiring Government Securities ATSs that trade a sufficient volume of securities to comply with the Fair Access Rule and Reg SCI is an appropriately tailored reform to help ensure fair and orderly markets and system integrity.

Better Markets supports the proposed rule because it will undoubtedly be useful to investors who seek to learn more about the potential conflicts of interest that can arise when the business interests of a broker-dealer operator or its affiliates clash with the interests of market participants that trade on Government Securities ATSs.[36] Such conflicts represent a significant and growing area of concern for investors. The Commission is to be commended for requiring disclosure of these conflicts. As a result, market participants will be better equipped to assess whether they are trading on a level playing field with other subscribers or instead are likely to fall victim to abusive and unfair practices. By eliminating the exemption from securities regulation that Government Securities ATSs have enjoyed for far too long, investors, market participants, and regulators will gain additional insight into the trading platforms used to trade government securities, such as Treasuries. These reforms will help address the overarching and compelling need for greater transparency, fairness, and stability in our markets, most notably the Treasury markets.

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[35] *See* Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, 87 Fed. Reg. 15,496 (Mar. 18, 2022).

[36] *See* Better Markets Comment Letter, Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange"; Regulation ATS for ATSs That Trade U.S. Government Securities, NMS Stocks, and Other Securities; Regulation SCI for ATSs That Trade U.S. Treasury Securities and Agency Securities, https://bettermarkets.org/wp-content/uploads/2022/04/Better_Markets_Comment_Letter_Reg_ATS.pdf.

*d. Exemption for Certain Exchange Members*

The Commission took yet another important step in enhancing the market transparency of the U.S. Treasury securities markets by closing a loophole in FINRA registration requirements for broker-dealers, specifically for PTFs.[37] By modernizing Rule 15b9-1 – in conjunction with other proposed rules to subject Government securities ATSs to Reg ATS and further define the definition of a dealer and government securities dealer – regulators across the federal government will have more real-time and historical data to adequately assess gyrations in the U.S. Treasury securities and repo markets that they did not have in 2014, 2019, or 2020. By in effect requiring more high-frequency trading firms to become members of FINRA, the Proposal will help mitigate the lack of transparency in the U.S. Treasury securities and repo markets.[38] It will ensure greater reporting of dealer trading activities by high-frequency trading firms that dominate those markets.

All of the foregoing reforms, acting in conjunction with the current Proposal, will substantially improve the transparency, fairness, and stability of the U.S. Treasury markets.

**CONCLUSION**

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

Stephen W. Hall
Legal Director and Securities Specialist

Scott Farnin
Legal Counsel

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

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[37] *See* Exemption for Certain Exchange Members, 87 Fed. Reg. 49,930 (Aug. 12, 2022).

[38] *See* Better Markets Comment Letter, Exemption for Certain Exchange Members, https://bettermarkets.org/wp-content/uploads/2022/09/Better_Markets_Comment_Letter_Exemptions_for_Certain_Exchange_Members.pdf.

shall@bettermarkets.org
sfarnin@bettermarkets.org

http://www.bettermarkets.org