

22 April 2016

Office of the Undersecretary for Domestic Finance
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Response to the Department of the Treasury notice seeking public comment on the U.S. Treasury Market.

Dear Sir or Madam:

Daiwa Capital Markets (“DCM”), a Primary Dealer, will focus its comments on the various liquidity characteristics of the Treasury Market. We reference our association’s (“SIFMA”) response which covers other queries with specific recommendations and observations.

By many metrics, the Treasury market has never been more liquid and tradable. The developments over the past 10 years have been and most likely will be a net positive for the efficacy of the Treasury Market. But the evolution of technology, the implementation of corrective regulations and a push towards transparency has created some idiosyncratic trading characteristics. There are warning signs that benefits will be tempered by some negative consequences and future intrusions and decisions need to be carefully analyzed.

The discussion about the efficiency of this market must begin with the auction process. Funding the deficit is the reason for official tinkering intended to protect the Government’s borrowing ability. By any measure, the Treasury’s success in funding a deficit which has been astoundingly large and volatile is amazing. The change from competitive to Dutch bids and opening of Direct bidding to non-Primary Dealers has had a great beneficial effect on the cost of Debt to the tax payer and the depth of the auction process. The Treasury’s commitment to a stable auction calendar and the expectations of the Primary Dealers support has been critical in fostering confidence in this process. But auctions reveal what is a common theme in today’s market: the diminution of the Primary Dealer’s influence, the increasing reliance on other active money funds and an increase in the probability of higher dispersions.

The last 10 years has seen Central Banks flood the system with liquidity through interest rate reductions and quantitative easing against a back drop of falling inflation and slow growth and this has undoubtedly aided in the smooth digestion of government paper. The question is whether this current system is as robust as it will need to be when the Federal Reserve policy is conflicted between its two mandates of stable growth and inflation.

One of the most consequential developments to the Treasury Market has been the implementation of electronic market platforms and the expanded, tradable hours Treasuries are open. Combined with the CME platforms, U.S. exposure can be initiated or hedged almost 24hours a day. Live electronic trading has opened this market to a multitude of new traders and investors, improved liquidity, reduced trading costs through falling commissions and narrower bid/ask spreads and enhanced risk taking and hedging. The biggest risk right now is a systemic failure of access to live electronic trading. October 15th

was a day to celebrate because in the face of high volatility and uncertain catalysts, trades were executed in record volume and there was not one report of a problem at the CME or Broker Tec etc. No regulation needed on access since they have a large incentive to keep the machines running even with volumes we haven't even contemplated yet.

The request for quotes ("RFQ") platforms have been the biggest influence on public transparency and another driver of the bid/ask spread collapse. They have certainly created expectations on transaction levels but they often do not reflect an individual Dealer's ability to execute at those levels because of wrong algorithmic produced prices or the pockets of illiquidity found in the Treasury Market. Yes liquidity can be defined by how tight bid ask prices are and their depth and how fast they recover from nonstandard volume but they can also impose costs on market makers by pulling resources away from the difficult, balance sheet clogging businesses to the risks which can be more accurately estimated with regard to time and profit/loss.

Balance sheet regulations have added to the difficulty in achieving a reasonable return on investment providing liquidity in some areas of the Treasury Market: Bills, TIPs, Off-the-run Long Bonds, and Strips all have periods and issues which are difficult. One reaction to regulations, transparency and easy access is this market has great liquidity in current issues and even for the majority of the curve but you can see the transformation in the market from the influence of dedicated market makers to firms more concerned about using Treasuries as one leg of an arbitrage.

As commoditization marches on, knowledge is dispersed, correlations are effected and expertise in multiple facets devolves into a focus on prices of the most liquid areas. Given the complexity and the national and monetary importance of the U.S. Treasury Market, any initiatives which accelerate and exacerbate some of the cracks appearing underneath the $\frac{1}{4}$ 32nd spreads should be fully vetted. Some, such as the proposal to publicly release block trade information to the public, should be rejected as being clearly an assault on liquidity with little offsetting benefits. On the other hand, a way to share information with the official class in order to make informed mutual decisions is welcome.

Daiwa Capital Markets America