

April 21, 2016

Office of the Under Secretary for Domestic Finance
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Notice Seeking Public Comment on the Evolution of the U.S. Treasury Market Structure
Docket ID: TRES-DO-2015-0013

Ladies and Gentlemen:

On behalf of Wells Fargo & Company and its subsidiaries (collectively, "Wells Fargo"), including its institutional broker-dealer subsidiary, Wells Fargo Securities, LLC ("WFS"), we appreciate the opportunity to provide comments to the U.S. Treasury Department ("Treasury") regarding its Request for Information ("RFI") on the Evolution of the U.S. Treasury Market Structure. Wells Fargo is one of the world's leading financial services companies participating meaningfully in the U.S. Treasury market as both a significant end-user of U.S. Treasury securities ("UST") and Treasury-based products and as a significant U.S. securities market maker on behalf of clients via WFS, a registered U.S. broker-dealer. This was highlighted by the recent announcement on April 18, 2016 that WFS will become a primary dealer of USTs. In addition to our own comments, Wells Fargo has assisted in developing the comment letter submitted by the Securities Industry and Financial Markets Association ("SIFMA") and generally supports the positions therein.

Maintaining a stable, liquid U.S. Treasury market is a vital U.S. economic interest and we support Treasury's effort to study the evolution of this market including its Joint Staff Report dated October 15, 2014 (the "JSR"). We also appreciate Treasury's willingness to gather further information from interested parties through this RFI process and its focus on trading and risk management practices, reviewing the current regulatory requirements applicable to the market, and assessing the information available from the official and private sectors. We file this comment letter to address from Wells Fargo's perspective several of the issues and questions raised in the RFI. In particular, Wells Fargo seeks to comment on (1) the importance and evolution of the UST market, (2) how Dealer to Client execution protocols have continually evolved and are effective in price transparency as well as risk transfer, (3) the need to reduce settlement risk through centralized clearing platform ("CCP") enhancements, (4) the value of trade reporting for regulatory purposes, (5) unintended consequences and/or the inadvertent impact of certain regulatory action, and (6) the need for a consistent regulatory regime for all market makers and liquidity providers.

The Importance and Evolution of the U.S. Treasury Market

A properly functioning U.S. Treasury market is critically important to the United States and market participants worldwide. The UST market is the base for almost every fixed income product playing a significant role in commercial banking markets from setting mortgage and savings rates to acting as the basis for spread based products (e.g. Corporate Bonds, Mortgage Back Securities ("MBS") products

Interest Rate Swaps, etc.). In the global market place, USTs continue to be a safe haven and the US Treasury is the largest borrower in the world's debt markets thus aiding the US Dollar in its role as the dominant world currency.

As stated in the RFI, the structure of the UST market has evolved over the past two decades with technological advancements that have facilitated the growth of high speed electronic trading. This, along with other developments including changes to the regulatory landscape, has led to increased participation from Principal Trading Firms ("PTF"s) many of whom employ High Frequency Trading ("HFT") strategies. The reliance on these HFT strategies has resulted in a race to develop and utilize more sophisticated technology and a resulting increased priority on speed. According to a Risk Magazine article dated Sep 23, 2015¹, eight out of the ten most active trading firms on BrokerTec's Central Limit Order Book ("CLOB") for UST on-the-runs were PTFs ("on-the-runs" refers to trading of the six most recently issued UST notes or bonds for a given maturity, while "off-the-runs" refers to a prior issued security of such maturity).

Risk transfer mechanisms relating to UST have changed over time, particularly as auction protocols and regulatory rules evolved causing existing UST dealers (i.e. Primary Dealers and Bank non-Primary Dealers) to evaluate their business model, capital allocation and return on investment. Further, as stated above, the emergence of electronic trading brought new players to the market changing the landscape predominantly in the on-the-runs securities. The on-the-run market is now flush with these new market participants who employ HFT strategies; and while they can be a valuable source of liquidity, the consistency and depth of the liquidity they add to the market, at times, is questionable. Their trading is often associated with low fill rates compared with the number of orders placed. These attributes might be one of the main drivers of increased intraday volatility. These HFT strategies may have brought "an improvement in average liquidity conditions at the cost of rare, but severe bouts of volatility that coincide with significant strains of liquidity".² As it relates to market stability, it is important to note in contrast to the traditional dealers the majority of PTFs take little overnight risk and carry limited balance sheet which potentially adds to intraday volatility.

Even with the PTFs increased market participant rates and the enhanced competition that they add; traditional Bank dealers remain the backstop for the vast majority of UST trades when asset managers or Central Banks want to move large positions. These dealers are able to leverage their large balance sheet capabilities and broad distribution networks to hold and then distribute these positions to their vast network of customers. Further regulatory arbitrage between market participants (e.g. Banks and PTFs) through the addition of regulation and/or additional changes in market structure could cause material changes to the world's most trusted asset. We believe this has caused certain traditional market participants (mostly dealers) to exit the marketplace leading to higher realized volatility and less liquidity.

Dealer to Client Execution Protocols Have Evolved and Are Effective In Price Transparency As Well As Risk Transfer

We believe Dealer to Client ("D2C") execution protocols have evolved positively and as a result are very effective in creating improved price transparency and enhanced liquidity. Operational risk has also improved through the advent and prevalence of straight through processing ("STP") for electronically

¹ <http://www.risk.net/risk-magazine/news/2426923/client-list-reveals-hft-dominance-on-brokertec>

² JSR pg. 6

executed trades. Electronic trading of USTs has evolved in a way very consistent with how USTs are executed in the traditional voice markets. There is bifurcation in the UST marketplace between where risk is transferred from the clients to the dealers and where dealers offset this risk amongst themselves. We are supportive of that bifurcated structure and the existence of two disparate liquidity pools. This historical bifurcation between Dealer-to-Dealer (Risk Mitigation & Hedging) and Dealer-to-Client (Customer Facilitation) liquidity pools drove electronic trading protocols to also split into two formats. On one hand, the Dealer-to-Client market utilized a Request-for-Quote ("RFQ") or Request-for-Streams ("RFS") format. Significant elements of these formats included: Protocols of choice to satisfy Best Execution requirements; Tradeweb introduced the multi-dealer RFQ model of trading US Treasuries in 1998; Bloomberg originally supported single dealer RFQ and eventually evolved to multi-dealer RFQ in the early 2000s; and Single Dealer Platforms were built and rolled out throughout the 2000s by multiple Dealers. On the other hand, the Dealer-to-Dealer ("D2D") liquidity pools have transitioned to Electronic Central Limit Order Books (CLOBs). The two primary CLOBs are: eSpeed launched by Cantor Fitzgerald in 1998 and BrokerTec launched by a consortium of dealers in 2000.

This execution protocol split contributed toward a further shift between trading in on-the-runs vs off-the-runs, TIPS, STRIPs and Bills. With this differentiation, these two liquidity pools grew over time with the bulk of on-the-run UST trading shifting to electronic execution by the mid-2000s.

The growth of CME UST Futures vs UST cash instruments has increased correlation trading between the two sets of instruments along with accessibility to the CLOB markets via trading Application Programming Interfaces (API) having also led to significant changes in the past 10 years including: Increased number of participants trading via automated strategies; faster trading between venues; increased dealer internalization to offset costs; development of trading APIs to facilitate more direct private trading between counterparty's; and launch of multiple new trading venues within a very short timeframe.

The single most significant impact these changes might have is the potential obsolescence of the RFQ protocol for on-the-run USTs. RFQ was born out of the need for clients to demonstrate best-execution by putting dealers in competition with each other to win a particular trade. However, given all of the changes to the liquidity of and the behavior on CLOB markets, the RFQ protocol is becoming less feasible as an execution method. We see the market trending toward more direct, "point-to-point" trading driven by executable pricing streams being made available by multiple liquidity providers. The benefits of this new protocol are:

- Better pre-trade price transparency for clients due to live executable prices for the security and size needed by a client
- More direct trading between clients and market makers with less information leakage to other market makers and participants
- Lower transaction costs due to more competition to facilitate this style of trading

Overall, the changes to electronic trading of USTs demonstrate the natural evolution of a marketplace that has had little regulatory intervention. We are supportive of the D2C liquidity pool segment and believe that there has been a natural evolution of automation and corresponding electronic execution protocols: We do not believe this segment needs additional regulation or oversight.

On the other hand, the risk transfer and hedging of risk between dealers in the D2D liquidity pool has had a tremendous amount of change, primarily through automation and this is where we feel there

should be further industry examination. We feel that speed of execution has become paramount and may not be aiding the process by which large amounts of risk are being transferred.

Necessity to Reduce Settlement Risk through Centralized Clearing Platforms (“CCP”) Enhancements

We believe that under the current CCP framework there is increased settlement risk in the UST marketplace as pointed out by the JSR³:

“Clearing and settlement risks: Traditionally, firms trading on the interdealer platforms have cleared through the Fixed Income Clearing Corporation (FICC), which offers central clearing services for cash Treasury securities. However, as PTFs have gained access to the platforms, they have remained outside the FICC membership and clear with each other either bilaterally, or through a prime broker for trades executed with a FICC member. The significance of trading volume of firms outside the FICC membership—now larger in aggregate than that of FICC netting members—raises the question of whether trades cleared for non-CCP members are processed as prudently as those for firms inside the CCP. Trades cleared outside the CCP may not be subject to the same level of settlement risk mitigation techniques such as margin collection, disciplined clearing fund balance requirements, and predefined loss sharing arrangements”⁴

Examination of the US interest rate derivatives market reveals the impact that centralized clearing has on financial markets. The introduction of mandatory clearing for Interest Rate Swaps (“IRS”) is one of the most important regulatory changes that the Dodd-Frank 2010 legislation introduced. It is ironic that while the “riskier” US interest rate derivatives market was taking steps for more centralized clearing, the “safer” underlying UST cash market is taking steps to move away from this model.

We believe the evolution of this paradigm in shifting volume away from FICC presents risk, not only to the UST marketplace, but potentially to other parts of the financial ecosystem. CCPs provide a number of beneficial functions that don’t exist in a bilateral marketplace. These benefits include greater transparency and reduced operational risk as well as risk mutualization amongst the members. It is this risk mutualization and the ability to manage member defaults in an orderly fashion that are pillars to a CCP framework.

Allowing certain market participants the ability to avoid clearing directly through a CCP gives those market participants a potential cost advantage versus market participants that are required to clear directly through a CCP. This settlement bifurcation could be very detrimental to the UST market place and potentially result in unintended asymmetrical risk. Finally, CCPs provide an additional benefit through standardization of data which could enable regulators to more efficiently and effectively analyze market events. We are supportive of one CCP being empowered to clear all USTs and that all Dealer-to-Dealer market participants be mandated to clear USTs under the same circumstances, rules and cost structures.

³ https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf

⁴ See JSR, page 59

Further Analysis is necessary on Trade Reporting

We believe there is a distinct difference between trades reported for regulatory purposes and trades reported in the public domain. Regulatory reporting should exist for secondary market transactions in both on-the-run and off-the-run UST benchmark issues. Real-time market, public dissemination of this data, however, requires further examination. To that end, it may not be appropriate and in fact may be harmful to most market participants if the regulators were to require real time trade dissemination to the public. Issues around public dissemination of transaction data become exacerbated when discussing less liquid securities such as off-the-run USTs. Such reporting of large less liquid positions may give other market participants unwarranted insight into an investors position which can lead into dislocations in those positions. Ultimately, it is important to distinguish between transparency and too much information that could impact market pricing. Real-time public reporting is not designed for the UST off-the-run market given the frequency and volume of trades in this segment.

In conversations with our large end-user customer base, they have made it clear they do not want their activity in specific issues to be known because it hinders their ability to manage interest rate risk. Similarly, dealers do not want other market participants aware of their newly acquired customer facilitated positions (longs or shorts) in off-the-runs because other market participants would have the ability to use this information against the dealer who just accepted the risk transfer from the client. If transactions were mandated to be publicly reported we believe that dealers would have to widen their prices accordingly to offset predatory post trade information risk that would lead to inferior prices to customers. We are in favor of tape reporting for regulatory purposes, but believe careful examination should be given if public reporting were to be proposed to insure there are no unintended consequences.

Trade reporting tools such as TRACE⁵ provide valuable price discovery for a number of fixed-income markets such as the Agencies, investment grade corporate and high-yield debt markets. Such a tool, however, would not provide similar benefits to the UST market. UST prices are already widely available in the marketplace. Many UST rates are available to the public on free websites including Bloomberg, Yahoo Finance and CNBC. Trade reporting would add costs to participants and can also provide the inappropriate access to end-user positions and strategies without buying additional benefits. We therefore believe no such public reporting requirement is warranted.

The Potential for Unintended Consequences to due to Impacts of Regulation

Changes in the global regulatory environment have made balance sheets more expensive and off-the-run liquidity more challenging. This is particularly prevalent at month- and quarter-end. We believe that the increased scrutiny on banks' balance sheets, the overall reduction in system-wide leverage, and the reduction in extension of hedge fund credit has caused deterioration in liquidity for both on-the-run and off-the-run securities. These regulatory changes have not been levied on all market participants within the UST market. Certain market makers and liquidity providers do not need to adhere to such regulatory and capital requirements and thus do not incur the associated costs or burden. They are able to reinvest profits into superior technology allowing for almost speed of light transactions. This technological edge gives them a distinct advantage over most other market participants, including any end user customers.

⁵ See TRACE definition at: <http://www.finra.org/industry/trace>

According to a report by the International Capital Market Association, European global systemically important financial institutions (GSIFs) reduced the size of their repo books by 125 billion euros between June 2015 and December 2015. Leverage at bank, dealer and certain client segments has been generally reduced. Because there is less differentiation in the quality of the assets using that leverage when calculating a financial institutions' Liquidity Coverage Ratio (LCR), the incentive is to utilize available balance sheet capacity on higher yielding spread product assets, and not USTs. These higher yielding assets have more bid/offer spread and greater carry characteristics and therefore a better expected return per dollar of balance sheet used. This is visible in the reduction of the size of "matched-books" of repo and reverse-repos trades across the market.

Smaller dealers have seen their ability to fund themselves over quarter-end at market rates diminish, and that has led them to develop and trade on more of an agency basis. Reduced balance sheet for treasury trades at hedge funds, smaller dealers, and large European banks translates into less balance sheet available to end users in the market for off-the-run securities.

Relative value players have also had to make choices about where they concentrate their more limited asset base. Due to the low level of nominal interest rates and lower expected returns, they are now turning away from USTs as a trading vehicle. In our opinion, this has led to bids and offers in the off-the-run sector on Brokertec and eSpeed that are not nearly as competitive as in years past. Additionally, the large purchases of US Treasuries by the Fed, and banks seeking to satisfy their LCR liquidity needs, have reduced the trading float in all USTs. This is more pronounced in the off-the-run segment. Additionally, total Repo outstanding, which in pre-crisis times served as a low cost of funding source for banks, has fallen from approximately \$4.5 trillion to less than \$2.5 trillion.

An additional significant difference is the requirements regarding primary UST auctions by the US government. Although Primary Dealer market share in these auctions is down of late due to the Treasury selling bonds directly to end users, Primary Dealers are still the back stop and are required to participate in every auction. All other market makers face no such requirement.

If all liquidity providers (PTF and dealers) were required to adhere to consistently similar rules and regulations, the UST market would be more liquid and less volatile. Without this consistency, there will be reduced dealer participation, thus adding unwanted volatility to the UST market. Ultimately, we believe Treasury should consider adopting new rules that would require all market makers to become direct FICC members, register with FINRA and meet some pre-determined capital level that is consistent with financial institutions.

The reduction in leverage ratios at major financial institutions that has been a by-product of regulation has also had the unintended consequence of causing balance sheet dedicated to UST positions to shrink. This has resulted in negative impacts to on- and off-the-run treasury liquidity. That effect has likely been exacerbated by the global shortage of positive yielding highly rated safe assets which is a function of the ultra-low rate policies and QE programs in Japan and the ECB.

Further Examination Warranted into the Effects from High Speed Trading

As stated in the prior section, the global regulatory environment has significantly altered the business of trading following the 2008 financial crisis with most banking entities ("Bank Dealers") now required to adhere to more strict regulatory rules and dramatically different capital requirements resulting in an increased cost structure in the important UST client facilitation business model. Yet, many non-banking

entity market makers and liquidity providers do not need to adhere to such regulatory and capital requirements and thus do not incur those associated costs or burdens. These market participants are able to reinvest profits into superior technology in furtherance of the goal of having the fastest servers on the street. With the advent of speed and lack of consistency in rules across all market participants, the market may continue to see periods of large market dislocations and illiquidity as we saw on October 14, 2014. We encourage Treasury to consider the long term ramifications to a marketplace that has a divergent regulatory structure.

We do not stand against evolution in the electronic marketplace, as there are clear benefits to the end user from electronic trading including:

- Liquidity is deep in the six on-the-run UST securities
- Transaction costs for end users are down with a narrower bid/ask spread for most trades
- There is reduced operational risk with straight thru processing
- The marketplace has witnessed increased trading volumes
- More trades are done in competition benefiting the end user, and
- increased transparency to the market place

We look to the cash equity marketplace for insight as that marketplace underwent material structural change as a result of Regulation NMS. Many equity market participants would agree that speed has been beneficial for the retail investor, but there are distinct differences between Equities and UST.

The UST market place operates primarily as an at risk principal based market where dealers utilize their balance sheet to warehouse risk and the underlying securities for their clients. Through this process, these trades are inventoried and then hedged and/or worked out of at a later time. The cash equity model, however, is almost entirely traded on an Agency basis where dealers mainly work an order for or on behalf of their client with limited balance sheet or principal risk. This model is very similar to how most futures markets operate. Additionally, the equity market has a significant retail presence where the UST market is predominantly an institutional and Central Bank market. We believe further examination is necessary to ensure that there is a balance between speed of execution and best execution.

Summary

We are concerned that if the parts of the current UST market structure are left untouched, we will continue to see liquidity diminish, especially in the all-important Dealer-to-Dealer market where the majority of hedging and risk mitigation takes place. We also worry that the recent constraints put on Bank Dealer balance sheets through increased regulation will further impair Bank Dealers in their ability to provide adequate liquidity to their customers through the Dealer to Client marketplace. Finally, we are also very concerned with the current emphasis on speed of execution and how, if left unchecked could continue to reduce the average trade size and alter the market in a way that makes it extremely difficult to move sizable risk - something we believe is paramount to many of our end user customers.

There is no doubt that recent technological investments have contributed positively to the natural evolution of execution protocols and straight through processing that has improved liquidity and price transparency, and reduced operational risks for dealers that provide liquidity to customers in the Dealer to Client market. We, therefore, do not feel that additional regulation is warranted here; however, this

is not necessarily the case in the Dealer-to-Dealer market where we believe there should be consistent regulation and oversight of market behaviors amongst all liquidity providers. As the market structure currently stands, there are aspects that are very conducive to moving large blocks of risks and there are aspects that are detrimental to this process. Ultimately, it is our recommendation that US Treasury continue in its thoughtful analysis of the current state to ensure that the underlying customer base can operate within a marketplace that has the fundamentals to move large blocks of risk.

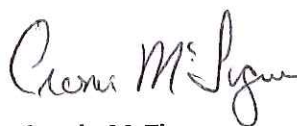
In summary, we would like to commend the US Treasury Department for proposing an in depth analysis of the current UST market structure through the recently released RFI. We understand the critical importance of a healthy market for primary and secondary trading of US Treasury debt, and we appreciate the focus that this RFI has brought to this process. A deep examination of the market led by feedback from the various participants across the board is a prudent approach toward resolving and reducing any current risks to the overall stability and liquidity of the marketplace.

Wells Fargo stands ready to partner with the US Treasury now and in the future to ensure a healthy continuation of such a critical part of the US economy. We appreciate your consideration of our comments and will gladly make ourselves available for any further consultations and/or questions you may have.

Sincerely,



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