



April 28, 2016

**Via Electronic Submission ([www.regulations.gov](http://www.regulations.gov))**

David R. Pearl  
Office of the Executive Secretary  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

**Re: Notice Seeking Public Comment on the Evolution of the Treasury Market Structure (Docket No. TREAS-DO-2015-0013)**

Dear Mr. Pearl:

KCG Holdings, Inc. (“KCG”) appreciates the opportunity to respond to the Department of the Treasury (“Treasury”) and submit comments regarding its Request for Information (“RFI”) regarding the evolution of U.S. Treasury market structure.<sup>1</sup>

## **I. KCG Background**

KCG is a leading independent securities firm offering investors a range of services designed to address trading needs across asset classes, product types and time zones. As an electronic market maker, KCG commits its capital to facilitate trades by buyers and sellers on exchanges, ATSS, and directly with clients. We combine advanced technology with exceptional client service to deliver greater liquidity, lower transaction costs, improve pricing, and provide execution choices. KCG has multiple access points to trade global equities, fixed income, currencies and commodities through voice or automated execution.

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<sup>1</sup> See Department of the Treasury, Notice Seeking Public Comment on the Evolution of the Treasury Market Structure, 81 Fed. Reg. 3928 (Jan. 22, 2016). See also <https://www.treasury.gov/press-center/press-releases/Pages/jl0323.aspx>



KCG is an active U.S. Treasury market participant. We have participated in the Treasury market since 2004, primarily as a market maker in on-the-run securities on electronic central limit order book (“CLOB”) platforms, and more recently as a bilateral provider of liquidity in the wholesale space. As a result, we have a strong interest in ensuring and maintaining the confidence of investors and market participants in the integrity, liquidity and efficiency of the U.S. Treasury market.

## II. Discussion

**A Well-Functioning U.S. Treasury Market is Essential.** As noted in the RFI, the U.S. Treasury market is the deepest and most liquid market in the world. These characteristics are extremely important as the U.S. Treasury market serves several critical functions, including: supplying a source of low cost financing to the U.S. government; providing traders with a reliable interest rate benchmark; giving market participants a reliable vehicle to transfer substantial interest rate risk; and supporting the ability of the Federal Reserve to implement U.S. monetary policy. Trading in the U.S. Treasury market impacts many other markets and economies and it is widely considered the most important market in the world for price discovery. In short, as a crucial component of our financial market infrastructure, it is essential that the U.S. Treasury market remain a well-functioning, stable and efficient market.

**The October 2014 U.S. Treasury Market Dislocation Remains Unexplained but the Event Revealed Significant Market Structure Concerns.** On October 15, 2014, trading in the U.S. Treasury market abruptly experienced significant and unexplained volatility, particularly during a 12-minute “event window” beginning at 9:33am eastern time. U.S. Treasury securities, futures, and other closely related financial markets experienced unusually high volatility and liquidity conditions became severely strained. As noted by regulators in a Joint Staff Report that examined the October 15 dislocation (the “JSR”), “[f]or such significant volatility and a large round-trip in prices to occur in so short a time with no obvious catalyst is unprecedented in the recent history of the Treasury market.”<sup>2</sup> Although intensive study by regulators,

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<sup>2</sup> See Joint Staff Report: The U.S. Treasury Market on October 15, 2014 (July 13, 2015) published by the staffs of the U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, U.S. Commodity Futures Trading Commission at 1. See also <https://www.treasury.gov/press-center/press-releases/Pages/jl0106.aspx>.



academics, and market participants of the possible cause(s) of the extreme volatility experienced on October 15 has not identified an obvious catalyst, it has shed light on market structure concerns and forced policy makers to question the efficiency of price formation in the U.S. Treasury market.

One potential reason the volatility of October 15 remains unexplained is that the U.S. Treasury market lacks transparency—both pre-trade and post-trade. In large measure, the Treasury market is opaque to regulators and many market participants, thereby making the reconstruction of the events surrounding the October 15 dislocation nearly impossible.

The opaqueness of the U.S. Treasury market presents additional ramifications beyond market event reconstruction and analysis. This lack of transparency provides a handful of incumbent participants with a tremendous informational advantage by creating a significant barrier for new entrants and stifling competition. These attributes of the U.S. Treasury market structure – opaqueness and competitive advantages for certain participants - need to change immediately. ***The key to making meaningful improvements to the U.S. Treasury market is providing regulators and market participants with greater pre-trade and post-trade transparency. The U.S. Treasury market is the most important market in the world for price discovery and yet there is no real-time price discovery in the U.S. Treasury market. This needs to change. We must redesign the structure of the U.S. Treasury market to create transparency so it provides benefits to all stakeholders. By doing so, risk transference can occur more efficiently, which will create a more reliable, stable, and efficient market.***

Regulators are right to question the efficiency of price formation in the U.S. Treasury market and to consider possible reforms to market structure. KCG believes it is imperative for market structure to evolve in order to avoid or mitigate future inexplicable dislocations and instability in the U.S. Treasury market similar to what was experienced on October 15, 2014.

**The U.S. Treasury Market Trading is Bifurcated and Needs to Evolve.** As noted in the JSR, Treasury securities are transacted across multiple secondary market venues. Treasury market trading is essentially bifurcated between the dealer-to-client market and the interdealer market. In the dealer-to-client market, trading is largely



accomplished on a bilateral basis where dealers make prices and respond directly to inquiries from their customers (“end users”) through voice or electronic means. This segment of the market historically has been dominated by several large bank dealers who have recently scaled back their trading activity in response to increased capital and leverage requirements. In the interdealer market, risk transfer of benchmark or on-the-run securities between dealers occurs primarily on centralized electronic trading platforms utilizing a CLOB protocol.<sup>3</sup> The result is a bifurcated market structure, where the interdealer segment of the market is more transparent, competitive and accessible while the dealer-to-client segment of the market is still opaque, bi-lateral, and dominated by a handful of banks despite their reduced intermediation capacity.

Since the financial crisis of 2007-2008, global policy makers have sought to reduce leverage and improper risk-taking in the financial markets as unchecked leverage was viewed as one of the primary causes of the financial crisis. Regulators have particularly focused on reducing the systemic risk of large, interconnected global banks and other financial institutions. While the Treasury market was not the cause of the financial crisis, these large systemically important banks have served as dealers and been a significant source of liquidity in the U.S. Treasury market, particularly in the dealer-to-client segment of the market. Regulations enacted in response to the financial crisis have forced bank dealers to deleverage and reduce risk, and in some cases to fundamentally rethink their business models. These actions have had a clear, though difficult to quantify, effect of reducing the risk capital available to bank dealers to make markets and trade in the U.S. Treasury market.

KCG believes the U.S. Treasury market is at an inflection point. It is unlikely - and in our view inadvisable - that global policy makers will roll back the financial market reforms designed to increase the stability of systemically important banks. These reforms have driven bank dealers to change their business models and diminished their risk appetite. The U.S. Treasury market, however, is still reliant on a legacy framework that largely depends on these same bank dealers to somehow continue to provide liquidity to the market and ensure efficient market functioning. This continued reliance on bank dealers - who have been forced to deleverage and reduce

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<sup>3</sup> BrokerTec and eSpeed are examples of central limit order book venues.



their risk capital for market making - to intermediate in the U.S. Treasury market is misplaced.

***In our view, the only feasible solution to this dilemma is for U.S. Treasury market structure to move beyond the outdated bifurcated model and evolve to remove the historical barriers between the interdealer and the dealer-to-client markets. The market needs to be more of an “all-to-all” ecosystem where all market participants – both buy side and sell side - are able interact with one another instead of being segmented into one or another market segment.*** One point to support this outcome is that despite the fact that risk capital and leverage among the bank dealer community has been reduced, reliance by end-users of the U.S. Treasury market (central banks, hedge funds, asset managers, *etc.*) has grown significantly.

**The U.S. Treasury Market Needs to Facilitate Competition and Attract New Participants and Capital.** In addition to evolving away from a two-tier framework, the U.S. Treasury market must also innovate to facilitate competition and replace the reduced intermediation capacity that has resulted from bank dealers becoming smaller. To accomplish this, it is necessary to both attract new capital willing to take on risk in the U.S. Treasury market and to introduce more efficient mechanisms for matching buyers and sellers to facilitate risk transfer. Doing so will facilitate a diversified ecosystem of smaller liquidity providers that, in KCG's view, is more sustainable and presents a less systemically risky framework than the pre-crisis model that relied on a handful of large bank dealers to provide liquidity.

**Transparency is Key to Reforming U.S. Treasury Market Structure.** KCG believes transparency, pre-trade and post-trade, is the most critical issue facing the U.S. Treasury market. Transparency is important for several reasons, including: providing regulators with the data necessary to monitor and analyse the market; providing price discovery for market participants; and attracting new entrants to the market.

*Regulators Need Market Data.* One of the reasons it has been so difficult to determine a catalyst for the October 2014 dislocation is the lack of transparency in the U.S. Treasury market. At the moment, regulators do not receive comprehensive access to market data, particularly with respect to the U.S. Treasury cash market. As noted in the RFI, “the official sector does not currently receive any regular reporting of



Treasury cash market transactions. The JSR did not include any analysis of dealer-to-customer data ...”<sup>4</sup> There is simply no reason not to provide regulators with immediate access to comprehensive order and transactional data.

*Transparency Will Improve Price Discovery.* One of the goals of market structure is to encourage risk transference as cheaply and efficiently as possible, which permits more money to go towards investments instead of being diverted to intermediaries. All market participants are entitled to equal access to information. Basic economic theory highlights that efficient and competitive markets rely on information; the more perfect the information, the better the market quality. Conversely, the larger the information asymmetry, the less competitive and less efficient the market will be.

A common concern raised by large end user market participants across many markets, including but not limited to the U.S. Treasury market, is that increased post-trade transparency would impede their ability to execute large block transactions. According to this view, either bid-ask spreads would widen or dealers would refuse to quote such transactions. Although it may be convenient for an end user and dealer involved in a block trade to be able to transfer a large amount of risk without the rest of the market knowing such a transaction has occurred, this lack of transparency is unhealthy for the marketplace as a whole. Market prices should reflect the equilibrium clearing price where supply and demand balance – if supply and/or demand is obfuscated or non-transparent to the market, the market price will not convey the appropriate clearing price, which is an economic loss for the market as a whole. We believe that immediate and detailed transparency would result in a more efficient and more liquid market, which is the most important consideration given the vital role that U.S. Treasuries play in the global financial markets as the benchmark risk-free asset.

*Transparency Will Attract New Entrants.* Another reason transparency is key going forward is the U.S. Treasury market needs to attract both new capital and new participants in order to address the reduction in capital and liquidity provision by bank dealers. If trading is transparent and full information about market transactions are known, new participants will have confidence to quote or commit new capital; conversely, trades that occur “in the dark” introduce an information asymmetry

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<sup>4</sup> See RFI at 3931.



within the market which, in turn, decreases efficiency and acts to impede new entrants and other non-incumbents who are not plugged-in to the traditional channels of information.

### **III. Conclusion**

The U.S. Treasury market structure is presently in a transitional and highly sub-optimal state. The traditional bank dealer-centric model is breaking down and needs to evolve to a more open ecosystem that attracts new participants and facilitates competition. In short, the structure of the U.S. Treasury market must be modernized to look more like the structure of other highly liquid markets that facilitate greater participation by an array of market participants by creating a level playing field: all prices should be real-time and transparent, supply and demand for products should be real-time and transparent, and all trades should be real time and transparent.

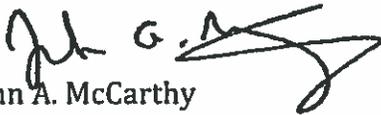
We are cognizant that it is impractical to immediately shift from a model with a small number of dealers who enjoy an informational advantage and dominate liquidity provision to more of an open, all-to-all type of structure. KCG therefore supports a thoughtful transition period where we seek to minimize market disruptions. This change in market structure, however, is overdue and needs to begin immediately as excessive delays present real risk to the U.S. Treasury market. For example, we believe transparency will be least disruptive for the most actively traded Treasury securities, such as the on-the-run securities while being more disruptive for securities with less turnover, such as TIPs or long dated STRIPs. Accordingly, we support a phased-in approach to transaction reporting that prioritizes on-the-runs before less actively traded instruments. However, we believe that all sectors of the U.S. Treasury market ultimately should be subject to real-time transaction reporting.

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KCG greatly appreciates the opportunity to comment on the RFI and would be pleased to discuss these comments in greater detail. If you have any questions, please do not hesitate to contact me at 646-428-1615 or [jmccarthy@kcg.com](mailto:jmccarthy@kcg.com).

Sincerely,

  
John A. McCarthy  
General Counsel