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News

# Treasury Market's $220 Billion Black Box Lures Citadel, Virtu

Long the exclusive domain of the largest banks, a key part of the U.S. Treasury market is gaining two of the world's most sophisticated traders.

Citadel Securities, the broker-dealer arm of Ken Griffin's firm, in November broke into a $220-billion-a-day segment of the market traditionally open only to dealers and their customers. Computerized market maker Virtu Financial Inc. is poised to join Citadel there and also enter a planned "all-to-all" venue that mimics the way stocks and futures trade, according to two industry executives familiar with the matter.

New entrants could assuage investors who say Treasuries are getting harder to buy and sell because the top dealers handle a larger slice of the business, winnowing the list of potential trading partners. There's also concern that banks, hobbled by tougher capital requirements, are holding fewer bonds in their inventories to facilitate clients' transactions. Those concerns intensified after Oct. 15, 2014, when banks ignored about a third of requests to trade as yields swung wildly — an event that prompted regulators to try to figure out how to fix the market.

In that landscape, Citadel and Virtu — traders that have helped transform other asset classes including stocks — have spotted an opportunity.

## GETTING THERE FIRST

"They see the way the trend is going," said Anthony Perrotta, a partner at financial research firm Tabb Group LLC. "They're saying, 'We're making a bet on where the market will be two years from now, and we're getting there first.'"

Paul Hamill, global head of fixed income, currencies and commodities for Citadel Securities, confirmed his employer is now trading in the dealer-to-client Treasuries market. Alan Sobba, a Virtu spokesman, declined to comment.

"As dealers have pulled back, investors have sought additional sources of liquidity to fill that gap across a range of fixed income products," said Citadel's Hamill. Moving into the dealer-to-customer space "is a natural fit" for the firm, he said.

## TWO MARKETS

Treasuries are traded in two ways. The first is on electronic markets owned by ICAP Plc, Nasdaq Inc. and Tradeweb Markets LLC. Here, the size and price of trades are known to all users of the system, which are mostly Wall Street dealers and automated trading firms. The other market is direct trading between banks and customers. This can be done over the telephone or through electronic auctions hosted by Bloomberg LP and Tradeweb. Price and deal size here are only known to the participants in the deal and aren't made public.

Since November, Citadel has been active trading Treasuries on the platform run by Bloomberg News parent Bloomberg LP. Virtu is close to joining Citadel there, as well as preparing to participate on Direct Match, an electronic exchange that plans to offer Treasury trading to investors and banks in the same manner that stocks or futures are bought and sold, according to industry executives who asked not to be named because the information was private.

Allan Schoenberg, a spokesman for Bloomberg LP, declined to comment. Kristi Neller, head of sales at Direct Match, declined to comment.

The changes are happening in one of the most opaque parts of the financial world. While prices of stocks and corporate bonds are reported instantly or with a small lag throughout the day, Treasury deals between banks and their customers are never disclosed to the public. While the entry of non-banks such as Citadel and Virtu won't alter that, it does signal that change is afoot.

## FIVE BANKS

About $490 billion of Treasuries trade each day on average, according to data compiled by the Securities Industry and Financial Markets Association. Just under half of that takes place one-on-one between dealers and clients, according to a report last year from the Federal Reserve Bank of New York. This segment is dominated by five banks that control 60 percent of that volume, up from 44 percent a decade ago, according to consulting firm Greenwich Associates, which didn't name the firms.

Not only is more of the business handled by fewer firms, dealers are committing less money to help customers buy or sell Treasuries, adding a further constraint. The largest banks held about $230 billion on their balance sheets to facilitate Treasury trading in 2015, down from about $430 billion in 2010, according to Tabb Group.

Investors want the option of trading with more firms. Although Virtu, according to an industry executive familiar with its plans, isn't going to trade directly with investors such as insurers, pensions, corporations and asset managers, the Treasuries it sells to a dealer could ultimately be sold to investor clients of that bank.

"We are in the middle of a transition for the structure of the Treasury market, and it's very hard to see where the end is," said Amar Reganti, a strategist at money manager GMO LLC in Boston and a former deputy director of the Treasury's Office of Debt Management. "It is important to acknowledge that these changes are taking place," he said. "It's a market whose proper functioning touches a lot of things."

**STILL A MYSTERY**

Citadel and Virtu are jumping in at the same time that U.S. officials grapple with what's going on with Treasury trading. Yields swung wildly on Oct. 15, 2014. As government researchers tried to determine what happened that day, they were only able to gather information on the other half of the market that doesn't involve direct bank-to-customer trading. The result was a 76-page report based on the electronic exchange-like markets where firms like Citadel and Virtu already operate.

They had a much harder time collecting data to summarize the bank-to-client segment because that trading happens completely in the dark. "There is broad consensus on the basic notion that the official sector needs better access to trading data, particularly in the Treasury cash market," Antonio Weiss, the counselor to Treasury Secretary Jack Lew who steered the government review of trading that day, said in November.

As part of that effort, the Treasury Department last month asked for public feedback on how it should guide the evolution of the $13.2 trillion market.

**HERD THINS**

Some of the dealers that trade directly with investors are dialing back their presence in the market. CRT Capital LLC, a brokerage in Stamford, Connecticut, that once had ambitions to become a primary dealer — meaning it would buy government debt directly from the New York Fed — was said to scale back its Treasury trading operations last year. BNP Paribas SA, a primary dealer, was said to cut staff on its trading desk last year because of changes in the market. BNP spokeswoman Cesaltine Gregorio declined to comment. CRT executives didn't respond to messages seeking comment.

Wall Street dealers have also pulled back in times of stress. During about 30 minutes of wild trading on Oct. 15, 2014, they didn't respond to roughly 35 percent of their clients' requests to trade, according to a report presented more than a year after the event by the New York Fed. For the whole day, the non-response rate was about 20 percent, versus nearly 10 percent during other volatile trading days, the report said.

"There is a risk if it's so concentrated in the hands of a few," said David Ader, head of interest-rate strategy with CRT. "All of a sudden, if the auctions become more costly, or if I'm a client liquidating $1 billion or $2 billion, who do I go to? I only have five guys."

Virtu and Citadel have entered other markets traditionally dominated by dealers. Virtu is one of the largest participants in foreign-exchange trading, while Citadel Securities in 2014 began trading interest-rate swaps with investors. Both firms helped transform the U.S. equity market by increasing the speed with which trades were done.

They may face resistance in their efforts to break into the Treasuries market.

Dealers "are very competitive," said Peter Yi, director of short-term fixed income in Chicago at Northern Trust Corp. "Smaller players may try to fill some voids, but unfortunately, we think it's unlikely" they'll gain a substantial foothold, he said.

*By Matthew Leising and Alexandra Scaggs*