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Enhancing Competition, Transparency, and Resiliency in U.S. Financial Markets

Policy Recommendations for the U.S. Securities and Exchange Commission

Citadel Securities has a strong interest in the efficiency and stability of U.S. financial markets. U.S. capital markets generally work better today for investors than ever before, and we are proud to consistently advocate for measures designed to enhance competition, transparency and resiliency.¹

As the Securities and Exchange Commission reviews financial market regulations, we believe that the preeminent global position of the U.S. capital markets can, and should, be further strengthened. In this white paper, we provide specific policy recommendations to increase competition, transparency, and resiliency in the following important markets:

- Equities,
- U.S. Treasuries, and
- OTC Derivatives.

Across these diverse asset classes, our recommendations are consistently intended to:

1. Increase trading on open, competitive and transparent trading venues;
2. Enhance market competition and reduce trading costs for investors; and
3. Ensure that both market participants and regulators have access to timely and comprehensive post-trade transaction data.

¹ See <https://www.citadelsecurities.com/public-policy/>.

Summary of Policy Recommendations

I. EQUITIES

A. Competition

1. Increase on-exchange trading and drive better prices by reducing the minimum tick size to a half-penny where appropriate.
2. Increase on-exchange trading and lower trading costs by reducing the current access fee cap by 50% where appropriate.
3. Level the competitive playing field by expanding fair access and public display requirements for dark pools.

B. Transparency

4. Ensure effective transparency of PFOF arrangements by comprehensively reviewing the 606 reports being published pursuant to the recently updated rules.
5. Modernize Rule 605 to provide more refined and detailed price improvement statistics by adopting the recommendations of the Financial Information Forum, including taking order size into account.

C. Resiliency

6. Unlock capital and operational efficiencies by endorsing and overseeing industry efforts to move to T+1 settlement.
7. Deliver greater transparency and predictability to market participants regarding CCP margin requirements.

II. U.S. TREASURIES

A. Transparency

1. Deliver greater transparency, fairness, and competition by implementing real-time public reporting.
2. Support efforts to increase the quality and timeliness of U.S. Treasury market data reported to regulators.
3. Collect data on uncleared bilateral repos.

B. Resiliency

4. Increase market resiliency and efficiency by transitioning more trading activity in both secondary cash market transactions and bilateral U.S. Treasury repos to central clearing.
5. Ensure appropriate oversight of multilateral trading venues by finalizing the Regulation ATS proposal and including multilateral RFQ venues in scope.

III. OTC DERIVATIVES

A. Competition

1. Deliver greater transparency, fairness, and competition by finalizing the SB-SEF rules, including impartial access for all market participants and prohibiting post-trade name give-up.

B. Transparency

2. Increase transparency by setting block trade thresholds and eliminating the 24 hour public reporting delay.

C. Resiliency

3. Implement straight-through-processing rules that are consistent with CFTC and EU standards.
4. Adopt a clearing requirement for single-name CDS.
5. Eliminate the exemption from initial margin requirements for uncleared interdealer transactions.
6. Ensure appropriate oversight over offshore transactions with a sufficient nexus to the U.S. with respect to public reporting, clearing, and trading requirements.

IV. RESEARCH UNBUNDLING

Increase market transparency, fairness, and competition by explicitly allowing broker-dealers to unbundle research and execution fees for all clients.

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I. Equities

Regulation NMS, and advances in technology, have helped to unleash an enormous degree of competition among market centers. This competition and innovation has markedly improved conditions for all investors, who benefit from dramatically lower trading costs and increased market transparency. Nonetheless, further measures can be taken to support on-exchange trading, enhance transparency around execution quality, and increase market resiliency.

A. COMPETITION

Competition for order flow is fierce, with sixteen exchanges and numerous alternative trading systems (“ATs” or “dark pools”) and individual market makers vying to provide the best execution quality to retail investors. This competitive market structure has enormously benefited retail investors – not only do they frequently get better prices than those publicly quoted on-exchange, but they often get their orders filled at such prices for more size than is publicly displayed. However, continued growth in retail trading¹ makes it timely for the Commission to review the current regulatory framework to ensure that exchanges are not operating at a competitive disadvantage. The transparency provided by on-exchange trading is a hallmark of U.S. equities markets, enhancing investor confidence and providing an objective standard against which investors can measure execution quality and hold their broker-dealers accountable.

1. Tightening Tick Sizes on Exchanges

Under Regulation NMS, exchanges are not permitted to have a tick size of less than one penny. This regulatorily-mandated tick size impedes the ability of exchanges to compete for order flow in symbols that are highly liquid and commonly trade inside a bid-offer spread of a penny. We believe this “constrained” tick size directly leads to complexities and inefficiencies – such as driving order flow into alternative venues, complex exchange pricing structures, and increased overall market fragmentation. Therefore, we recommend that the Commission reduce the minimum tick size to a half-penny for symbols trading above \$1.00 per share that are tick constrained (i.e. have a penny spread the overwhelming majority of the time).

Permitting a half-penny tick size for these highly liquid symbols will allow exchanges to display more aggressive pricing, without moving to full sub-penny quoting, which could raise other concerns. This change will improve on-exchange execution quality and increase the overall competitiveness of exchanges.

EQUITIES RECOMMENDATION #1: The Commission should reduce the minimum tick size to a half-penny for symbols trading above \$1.00 per share that are tick constrained (i.e. have a penny spread the overwhelming majority of the time)

¹ It is interesting to note that off-exchange trading has hovered around 40% of total notional traded. Market share statistics based only on shares traded can be misleading given retail trading activity in lower-priced stocks.

2. Reducing the Access Fee Cap

To the extent the Commission reduces the minimum tick size for certain symbols, the access fee cap should be commensurately reduced to reflect the reduction in bid-offer spreads. Regulation NMS establishes a maximum access fee of 30 cents per 100 shares, alongside the current minimum tick-size regime of a penny, and exchanges are permitted to share these access fees with liquidity providers in the form of exchange rebates. A meaningful reduction in the maximum access fee would materially reduce exchange rebates, while still acknowledging that exchange rebates reward and encourage displayed liquidity, which greatly benefits the price discovery process.

We recommend that the current access fee cap be reduced by 50% to 15 cents per 100 shares for symbols captured by our previous recommendation to reduce the minimum tick size to a half-penny. This would effect a reduction in access fees that is proportionate to the tick size reduction recommended for these symbols, thereby reducing trading costs and increasing the competitiveness of on-exchange trading.

EQUITIES RECOMMENDATION #2: The Commission should reduce the current access fee cap by 50% to 15 cents per 100 shares for symbols trading above \$1.00 per share that are tick constrained (i.e. have a penny spread the overwhelming majority of the time).

3. Updating Regulation ATS

Exchanges directly compete for order flow with dark pools that are registered as ATSS. When adopting Regulation ATS, the Commission noted that it was in the public interest to ensure fair competition “between exchange markets and markets other than exchange markets.”² In the more than twenty years since Regulation ATS was adopted, dark pools have increased in significance and have become an integral part of U.S. equity markets. The recent adoption of ATS-N brought increased transparency to the operation of these venues. It is therefore appropriate for the Commission to now re-examine Regulation ATS with a view to ensuring that dark pools do not have inappropriate competitive advantages over exchanges when competing for order flow.

For example, ATSS are only subject to fair access and public display requirements if certain volume-based thresholds are met. In practice, ATSS rigorously manage to these thresholds in order to ensure that they remain exempt. As a result, ATS quotes are not included in public quote data and ATSS often discriminate among market participants with respect to access, functionality, order interaction and fees. Given that the volume-based thresholds in Regulation ATS have not been updated since 2005, we recommend that the Commission consider eliminating or substantially reducing these thresholds as part of its review of Regulation ATS.

EQUITIES RECOMMENDATION #3: The Commission should re-examine Regulation ATS with a view to ensuring that dark pools do not have inappropriate competitive advantages over exchanges when competing for order flow, including expanding the application of fair access and public display requirements.

² See 63 FR 70844 (Dec. 22, 1998) at 70858 FN 113, available at: <https://www.govinfo.gov/content/pkg/FR-1998-12-22/pdf/98-33299.pdf>.

B. TRANSPARENCY

1. PFOF and Price Improvement

PFOF

We have consistently supported efforts by the Commission to ensure that market participants publicly disclose all payment for order flow (“PFOF”) arrangements. For example, we strongly supported the Commission’s recent revisions to Rule 606 that were implemented in 2019 to provide more granular information to market participants regarding PFOF, including detailing the terms of any such arrangements and disclosing the net aggregate amount of any PFOF received, as well as payments from profit-sharing relationships and transaction fees and rebates, both as a total dollar amount and on a per share basis.³ These revisions also require Rule 606 reports to be publicly available for at least three years so that market participants can better evaluate performance and trends over time.

In our view, in a market with many competing market centers (as opposed to the U.S. options market where order flow must be executed on-exchange), permitting transparent and fully disclosed PFOF arrangements is far preferable to attempting to effectuate a complete prohibition. Prohibiting PFOF would not only significantly change the underlying economics for retail broker-dealers, creating a revenue gap that likely would be closed by increasing trading costs for retail investors (including through higher commissions), but would also risk a return to the opaque, anti-competitive reciprocal business practices that

flourished prior to the implementation of Regulation NMS that allowed intermediaries to extract disproportionate rents from investors. In addition, current exchange rebates are inextricably linked to PFOF arrangements, and therefore would also need to be covered by any regulatory review.

We strongly believe that the Commission should remain focused on ensuring that retail investors have access to all relevant information regarding the order routing decisions made by their broker-dealers, so that they can make informed investment decisions and direct order flow on the merits. We recommend that the Commission perform a comprehensive review of the 606 reports being published pursuant to the recently updated rules and propose any necessary enhancements to further increase the transparency of PFOF arrangements.

³ See 83 FR 58338 (Nov. 19, 2018), available at: <https://www.govinfo.gov/content/pkg/FR-2018-11-19/pdf/2018-24423.pdf> and <https://www.sec.gov/comments/s7-14-16/s71416-29.pdf>.

Price Improvement

It is clear that the intense competition between exchanges, ATSS, and market makers directly benefits retail investors – not only do they frequently get better prices than those publicly quoted on-exchange, but they often get their orders filled at such prices for more size than is publicly displayed, with greater certainty of execution and often without being subject to exchange trading fees. According to publicly disclosed statistics calculated pursuant to the Commission’s prescribed methodology, approximately \$3.7 billion in price improvement was provided by market makers to retail investors in 2020.⁴

In response to those who question the accuracy of these statistics, we highlight the following:

- First, we agree that the Commission’s prescribed methodology for calculating the price improvement achieved by retail investors can be improved. In fact, we have been a leading voice in industry efforts to detail necessary enhancements to Rule 605 and have consistently urged the Commission to adopt these recommendations.⁵ We reiterate this recommendation here – it is critically important that there are accurate, transparent, and standardized execution quality metrics that allow order flow to be directed on the merits.
- Second, more refined execution quality statistics are likely to show that price improvement is actually materially understated by current metrics.

➤ This is because one of the main shortcomings of Rule 605 is that order size is not taken into account, meaning that a retail order for 1,000 shares is benchmarked the same as an order for 5 shares without any consideration as to whether

the retail order was filled for more size than was publicly displayed. This type of “size improvement” is commonly provided by market makers and is material to overall price improvement.

➤ Conversely, some have suggested that current price improvement statistics are overstated due to increased trading activity in odd lots (i.e. orders of less than 100 shares), which are not factored into Rule 605 reports. On this point, however, we note:

- We support expanding Rule 605 to include odd lot orders and it is appropriate for the Commission to consider the inclusion of odd lot quotes provided that size is taken into account (as detailed above);
- We expect the increase in reported price improvement resulting from accurately taking size into account will significantly outweigh any change to price improvement statistics resulting from the inclusion of odd lot quotes; and
- It is also important to note that the Commission recently finalized, but has yet to implement, a revised round lot definition that is tiered based on the price of a stock.⁶ This revised round lot definition will encompass many orders and quotes that are currently considered to be odd lots, particularly for higher priced stocks, thereby reducing overall trading activity in odd lots. We supported this revised round lot definition and look forward to it being implemented.⁷

⁴ <https://twitter.com/ltabb/status/1364960155486552073/photo/1>.

⁵ See the Rule 605 modifications recommended by the Financial Information Forum, available at: <https://www.sec.gov/comments/s7-02-10/s70210-5002077-182848.pdf>.

⁶ Exchange Act Release No. 34-90610 (Dec. 9, 2020), available at: <https://www.sec.gov/rules/final/2020/34-90610.pdf>.

⁷ <https://www.sec.gov/comments/s7-03-20/s70320-7235178-217088.pdf>.

Nothing should be allowed to distract from the inarguable reality that the fierce competition between exchanges, ATSS, and market makers for retail order flow directly benefits retail investors (in terms of better prices and larger fills) and improves their execution quality. We urge the Commission to continue to prioritize the interests of retail investors when evaluating policy recommendations in this area.

EQUITIES RECOMMENDATION #4: The Commission should perform a comprehensive review of the 606 reports being published pursuant to the recently updated rules and propose any necessary enhancements to further increase the transparency of PFOF arrangements.

EQUITIES RECOMMENDATION #5: The Commission should perform a comprehensive review designed to modernize Rule 605, similar to the effort recently undertaken for Rule 606.

- At a minimum, adopt the recommendations put forward by the Financial Information Forum to improve the reporting of price improvement achieved by retail investors, such as taking order size into account and including odd lot orders.
- In addition, determine if additional disclosures or detail would be helpful in enabling market participants to evaluate execution quality.

C. RESILIENCY

1. Moving to T+1 Settlement

The Depository Trust & Clearing Corporation (“DTCC”) has provided a roadmap for shortening the settlement cycle to one day.⁸ Benefits include reduced liquidity requirements for

the clearinghouse, and capital and operational efficiencies for clearing members. In particular, DTCC has estimated that the volatility component of its margin requirements could be reduced by 41% by moving from T+2 to T+1 settlement.⁹ In light of these benefits, we recommend that the Commission endorse and oversee industry efforts to move to T+1 settlement.

EQUITIES RECOMMENDATION #6: The Commission should endorse and oversee industry efforts to move to T+1 settlement.

2. Predictable and Transparent CCP Margin Requirements

Clearing agencies (“CCPs”) are integral to U.S. equity markets, managing the settlement process for trillions of dollars of transactions daily and netting transactions and payments in order to increase efficiency and reduce operational and counterparty risk. As part of their risk management frameworks, CCPs require margin contributions from member firms. It is important that margin requirements are calculated pursuant to a predictable and transparent methodology that enables member firms to accurately model and forecast margin calls. This assists member firms in appropriately managing liquidity requirements and minimizes the risk of market disruptions.

EQUITIES RECOMMENDATION #7: The Commission should assess whether greater predictability and transparency can be provided to market participants regarding CCP margin requirements.

⁸ See DTCC, “Advancing Together: Leading the Industry to Accelerated Settlement” (Feb. 2021), available at:

https://perspectives.dtcc.com/articles/leading-the-industry-to-accelerated-settlement?utm_source=dtcc.com&utm_medium=press-release&utm_campaign=accelerated_settlement.

⁹ *Id.* at page 5.

II. U.S. Treasuries

The U.S. Treasury market is the deepest and most liquid government securities market in the world, and plays a fundamental role in the U.S. and global economies. The liquidity, integrity and resiliency of the U.S. Treasury market support both the efficient funding of the U.S. government and the widespread use of Treasuries as an investment and hedging instrument. The U.S. Treasury market has undergone significant change over the course of the last decade, with technological innovation spurring a transition to electronic trading. While this market evolution has benefited investors, it has also revealed the need to modernize aspects of Treasury market structure.¹⁰ Recent reforms in other fixed income markets, such as the OTC derivatives markets, demonstrate the importance of modernizing regulatory frameworks to improve market transparency and resiliency.

A. TRANSPARENCY

1. Implementing Real-time Public Reporting

Despite being one of the largest and most liquid markets in the world, transactions in U.S. Treasuries are not publicly reported post-trade. Although certain trading venues are

able to provide market participants with information regarding trading activity on that specific venue, estimates suggest that over 50% of the secondary U.S. Treasury market operates without meaningful post-trade transparency.¹¹ This lack of transparency is in stark contrast to the comprehensive post-trade transparency that is a hallmark of virtually every other major market, including U.S. equities, options, futures, corporate bond, municipal bond, and OTC derivatives markets.

Academic research has found that real-time public reporting implemented in other fixed income asset classes has delivered tangible benefits to investors. These benefits include:

- **Reducing transaction costs.** Post-trade transparency reduces transaction costs, transferring wealth from dealers to customers, as customer bargaining power increases and liquidity providers can be held more accountable.¹²

¹⁰ See, e.g., Joint Staff Report: The U.S. Treasury Market on October 15, 2014 at https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2014.pdf.

¹¹ See "Primary Dealer Participation in the Secondary U.S. Treasury Market", Michael Fleming, Frank Keane, and Ernst Schaumburg, Liberty Street Economics (February 12, 2016), available at: <http://libertystreeteconomics.newyorkfed.org/2016/02/primary-dealer-participation-in-the-secondary-us-treasury-market.html>. There is little publicly available information regarding the "dealer-to-customer" segment of the market.

¹² See, e.g., Asquith, P., et al., "The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market" (April 2019) at page 29, available at: <https://www.nber.org/papers/w19417>; and Jacobsen, S., et al., "Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds" (2018) at pages 1 and 7, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171056.

- Improving liquidity conditions and increasing competition.

Post-trade transparency improves liquidity conditions and competition in fixed income markets.¹³ In particular, academic research has found that post-trade transparency can even improve liquidity conditions for large block trades, which is a concern frequently cited by those opposed to greater transparency.¹⁴

- Increasing efficiency and resiliency. A lack of post-trade transparency means that certain counterparties have more information than the rest of the market regarding the fair value of a particular instrument, which can impair end-of-day valuations and best execution assessments.¹⁵ These inefficiencies are particularly acute for less liquid off-the-run Treasuries and during periods of market volatility, and can impair liquidity in correlated products, such as Treasury ETFs.

- Enhanced investor confidence. Removing information asymmetries and leveling the playing field allows market participants to better manage risk, and more confidently quote prices, commit capital, and warehouse risk across all market conditions.

These same benefits should be expected to accrue to Treasury market participants, and ultimately the U.S. government as issuer. The responses to the 2016 Treasury RFI demonstrate that a diverse group of market participants support increasing post-trade transparency in the Treasury market, including buy-side firms, agency brokers, trading venues, clearing venues, electronic market makers, and academics.¹⁶ With the successful implementation of regulatory reporting to FINRA, the operational infrastructure is in place to introduce post-trade transparency in the U.S. Treasury market.

U.S. TREASURIES RECOMMENDATION #1: The Commission should work with other relevant U.S. policymakers to implement real-time public reporting in the U.S. Treasury market.

¹³ See, e.g., Loon, Y. C., Zhong, Z. K. The impact of central clearing on counterparty risk, liquidity, and trading: Evidence from the credit default swap market. *Journal of Financial Economics* (2013), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176561; and Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. *Journal of Financial Economics*, (2015), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654. See also Asquith, P., et al., “The Effects of Mandatory Transparency in Financial Market Design: Evidence from the Corporate Bond Market” (April 2019), available at: <https://www.nber.org/papers/w19417>; Edwards, A. K., et al., “Corporate bond market transaction costs and transparency” (2007) *The Journal of Finance*, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=593823; and Goldstein, M. A., et al., “Transparency and liquidity: A controlled experiment on corporate bonds” (2007) *Review of Financial Studies*, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=686324.

¹⁴ Jacobsen, S., et al., “Does trade reporting improve market quality in an institutional market? Evidence from 144A corporate bonds” (2018) at pages 1 and 7, available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3171056.

¹⁵ See generally *id.*

¹⁶ Available at: <https://www.regulations.gov/docket?D=TREAS-DO-2015-0013>

2. Supporting the Recent FINRA and Federal Reserve Board Proposals to Enhance Regulatory Reporting

It is important to increase the quality of U.S. Treasury market data that is made available to regulators in order to improve monitoring, surveillance, and analytical capabilities. In addition, with comprehensive data, regulators and policymakers are better equipped to evaluate additional policy proposals to modernize the regulatory framework applicable to Treasuries. FINRA recently proposed to enhance the current regulatory reporting regime by improving the timeliness of reported data and by specifically identifying, among others, whether a transaction (a) is executed on a multilateral trading venue that is not registered as an ATS and/or (b) is intended to centrally clear.¹⁷ These aspects of the Proposal, in particular, directly support and better inform the ongoing evaluation of policy proposals designed to enhance transparency and resiliency in the U.S. Treasury market, including introducing real-time public reporting, rationalizing the oversight of multilateral trading venues, and expanding central clearing in both the cash and repo markets.

Separately, the Federal Reserve Board recently proposed to require certain banking institutions to report Treasury transactions through FINRA's TRACE system, making the regulatory reporting regime more comprehensive.¹⁸

U.S. TREASURIES RECOMMENDATION #2: The Commission should support efforts to increase the quality and timeliness of U.S. Treasury market data that is being reported to regulators.

3. Collecting Data on Uncleared Bilateral Repurchase Agreements

The repurchase agreement ("repo") market is the largest short-term wholesale funding market in the U.S. and its stability is critical to U.S. financial markets. While data is collected on centrally cleared repo transactions and tri-party repos, comprehensive data is not collected by regulators on uncleared bilateral repos, which account for approximately 50% of the U.S. repo market.¹⁹ We recommend that regulators collect data on uncleared bilateral repos as well, as access to comprehensive data covering the entire repo market is critical to monitoring overall market stability. Comprehensive, market-wide data also enables regulators to monitor market trends, such as recent efforts by market participants to increase clearing for bilateral repos, and to evaluate the expected impact of subsequent policy decisions.

U.S. TREASURIES RECOMMENDATION #3: The Commission should work with other relevant U.S. policymakers to collect data on uncleared bilateral repos.

¹⁷ See <https://www.finra.org/rules-guidance/notices/20-43>.

¹⁸ See <https://www.federalreserve.gov/boarddocs/press/foiadocs/2021/20210121/foia20210121.pdf>.

¹⁹ See 83 FR 31896 (July 10, 2018) at 31901, available at: <https://www.govinfo.gov/content/pkg/FR-2018-07-10/pdf/2018-14706.pdf>.

B. RESILIENCY

1. Expanding Central Clearing of U.S. Treasury Transactions and Repos

U.S. Treasury market resiliency can be improved by expanding central clearing of both secondary cash market transactions and bilateral U.S. Treasury repos. Transitioning more secondary market trading activity in U.S. Treasuries to central clearing is recommended given the projected increases in total issuance and constrained dealer balance sheets.²⁰ In addition, central clearing standardizes settlement workflows, establishes greater valuation and margin discipline, and mitigates counterparty credit and settlement risk through the elimination of bilateral exposures.

In turn, a market-wide clearing solution for bilateral repos would increase the availability of stable and efficiently priced financing for inventory and reduce transaction costs to trade U.S. Treasuries. There is a trend of declining availability and rising costs for U.S. Treasury repos, with dealers reducing the amount of balance sheet allocated to this segment of the market. The reduced availability of stable and efficiently priced financing increases transaction costs to trade U.S. Treasuries, particularly impacting the ability of market participants to maintain directional positions or to correct price dislocations.

A market-wide repo clearing solution would alleviate many of these constraints, as dealer balance sheets would benefit from netting and more favorable regulatory treatment for exposures to a qualifying CCP. In addition to increasing liquidity in these securities financing transactions, a market-wide clearing solution for Treasury repos would enhance market resiliency by eliminating the current interconnected web of counterparty credit exposures and bilateral settlements, and by reducing dealer concentration and the number of fails. Finally, transitioning more bilateral repos to central clearing would increase the number of transactions supporting the calculation of the Secured Overnight Financing Rate (“SOFR”).²¹

The Commission should work with other relevant policymakers to exercise a leadership role in transitioning more trading activity in both secondary cash market transactions and bilateral U.S. Treasury repos to central clearing. Estimates indicate that less than 25% of secondary cash market Treasury transactions are centrally cleared,²² while uncleared bilateral repos account for approximately 50% of the U.S. repo market.²³ To the extent voluntary initiatives are not effective in increasing market-wide clearing rates, U.S. policymakers should consider other tools, such as a clearing mandate or increased margin requirements for uncleared transactions.

U.S. Treasuries Recommendation #4: The Commission should work with other relevant U.S. policymakers to transition more trading activity in both secondary cash market transactions and bilateral U.S. Treasury repos to central clearing.

²⁰ See “Dealers warn of trouble ahead as Treasury issuance swells,” Risk.net (Mar. 16, 2020), available at: https://www.risk.net/investing/markets/7808816/dealers-warn-of-trouble-ahead-as-treasury-issuance-swells?utm_source=signal&utm_medium=syndication and “Still the World’s Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis,” Duffie, D., (June 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf. See also “Enhancing liquidity of the U.S. Treasury market under stress,” Liang, N. and Parkinson, P., (Dec. 2020), available at: <https://www.brookings.edu/research/enhancing-liquidity-of-the-u-s-treasury-market-under-stress/>; and “The Netting Efficiencies of Marketwide Central Clearing,” Fleming, M. and Keane, F. (April 2021), available at: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf

²¹ See <https://apps.newyorkfed.org/markets/autorates/SOFR>.

²² See “Still the World’s Safe Haven? Redesigning the U.S. Treasury Market After the COVID-19 Crisis,” Duffie, D., (June 2020) at page 14, available at: https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf.

²³ See *supra* note 19.

2. Regulating Multilateral Trading Venues

In light of the rapid growth of electronic trading in the U.S. Treasury market, it is critical that multilateral trading venues be subject to appropriate regulatory oversight. We support the Commission's recent proposal to require multilateral U.S. Treasury trading venues that meet the definition of an ATS to formally register and comply with a number of requirements designed to increase market resiliency and transparency.

However, the Commission's current definition of an ATS has been interpreted to exclude multilateral trading venues utilizing request-for-quote ("RFQ") trading protocols, which are some of the most significant multilateral trading venues operating in fixed income markets regulated by the Commission, including the U.S. Treasury market.²⁴ We recommend the Commission address this significant gap in connection with finalizing the proposal by clarifying the scope of, or amending, Rule 3b-16 to include multilateral RFQ trading venues.

U.S. Treasuries Recommendation #5: The Commission should finalize the Regulation ATS proposal for multilateral Treasury trading venues and include multilateral RFQ venues in scope.

²⁴ See also U.S. Securities and Exchange Commission, Fixed Income Market Structure Advisory Committee, Preliminary Recommendation Regarding Defining "Electronic Trading" for Regulatory Purposes (October 2020) at FN 2, available at: <https://www.sec.gov/spotlight/fixed-income-advisory-committee/fimsac-preliminary-recommendation-re-definition-of-electronic-trading.pdf> and Remarks at U.S. Treasury Market Conference, Commissioner Elad L. Roisman (Sept. 29, 2020), available at: <https://www.sec.gov/news/speech/roisman-us-treasury-conference-2020-09-29>.

III. OTC Derivatives

The OTC derivatives markets were notoriously concentrated, opaque, interconnected, and under-collateralized in the years preceding the 2008 financial crisis. The legacy structure of the OTC derivatives markets was a significant source of systemic risk and led directly to taxpayer-funded bailouts. Policies implemented by the CFTC have substantially improved safety and stability and have made these markets more fair, open, competitive, and transparent. However, the Commission has yet to implement many of the OTC derivatives reforms set forth in the Dodd-Frank Act, even though credit default swaps regulated by the Commission played an important role in exacerbating the financial crisis.²⁵ Below, we detail several priority issues to increase competition, transparency, and resiliency in the wide range of instruments classified as security-based swaps, including single-name credit default swaps and equity total return swaps.

A. COMPETITION

1. Introducing Multilateral and Competitive Trading Venues

The Commission has yet to finalize rules to establish security-based swap execution facilities (“SB-SEFs”), which are intended to provide multilateral and competitive execution

for OTC derivatives market participants. SEFs established under CFTC rules have increased market competition, improved liquidity conditions, reduced transaction costs, and facilitated execution quality analysis.²⁶ It is important to deliver similar benefits to market participants in OTC derivatives markets regulated by the Commission by finalizing rules that address the topics below.

a. Trading Venue Scope

Similar to CFTC rules, all types of multilateral trading venues operating in the OTC derivatives market should be subject to registration and oversight, regardless of the specific trading protocol used (e.g. electronic, voice, order book, RFQ, auction). This will ensure a level playing field across multilateral trading venues.

b. Impartial Access

SB-SEFs are required to provide impartial access to all market participants.²⁷ To implement this requirement, all market participants meeting the definition of an “eligible contract participant” should be permitted to join and fully participate on these multilateral venues. However, the Commission’s proposed rules for SB-SEFs would allow a trading venue to deny access to market participants that are not registered as a security-based swap dealer, major security-based swap participant, or broker.²⁸ In practice, this would permit a SB-SEF to deny access to the vast majority

²⁵ See generally “Credit Default Swaps and Counterparty Risk”, European Central Bank (August 2009), available at: <https://www.ecb.europa.eu/pub/pdf/other/creditdefaultswapsandcounterpartyrisk2009en.pdf>.

²⁶ See, e.g., Benos, E., Payne, R., and Vasios, M., Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, Bank of England Staff Working Paper, May 2018, available at: <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/centralized-trading-transparency-and-interest-rate-swap-market-liquidity-update>; and Junge, J., Essays on the Market Structure and Pricing of Credit Derivatives, November 2016, available at: https://infoscience.epfl.ch/record/222511/files/EPFL_TH7322.pdf.

²⁷ See Exchange Act Section 3D at Core Principle 2.

²⁸ See Proposed Rule on Registration and Regulation of Security-Based Swap Execution Facilities, 76 Fed. Reg. 10948 (Feb. 28, 2011) at 11060, available at: <http://www.gpo.gov/fdsys/pkg/FR-2011-02-28/pdf/2011-2696.pdf>

of market participants and would allow some SB-SEFs to remain closed, dealer-only trading venues, in direct contradiction to the statutory impartial access requirement. Importantly, the Commission's proposed approach is inconsistent with CFTC rules and guidance that have interpreted the same statutory impartial access requirement as mandating the dismantling of barriers that serve to limit access to only dealers.²⁹ Furthermore, the Commission's proposed approach is inconsistent with international standards, as MiFID II requires MTFs and OTFs to establish non-discriminatory rules governing access and ESMA has issued additional guidance to clearly prohibit the same access barriers prohibited by the CFTC.³⁰

We urge the Commission to appropriately reflect the statutory mandate that impartial access be provided to all market participants when finalizing the SB-SEF rules.

c. Post-trade Name Give-up

SB-SEFs may elect to offer market participants pre-trade anonymous trading protocols, such as order book trading. For cleared security-based swaps, if a transaction is executed anonymously on a SB-SEF, then it should remain anonymous. However, many dealer-only venues continue to disclose counterparty identities post-trade in order to impede customer access.³¹ The CFTC concluded that the practice of post-trade name give-up is inconsistent with the statutory impartial access requirement and should be prohibited.³² We recommend the Commission reach the same conclusion when finalizing the SB-SEF rules.

OTC DERIVATIVES RECOMMENDATION #1: The

Commission should finalize its SB-SEF rules and apply them to all multilateral trading venues, require impartial access be provided to all market participants, and prohibit post-trade name give-up.

B. TRANSPARENCY

1. Implementing Real-time Public Reporting

In order to increase market transparency for end investors, Commission Regulation SBSR provides that public reporting of security-based swap transaction data will begin three months after the start of regulatory reporting, which is expected to begin in November 2021.³³ The implementation of both regulatory and public reporting will provide much-needed transparency regarding trading activity in the wide range of instruments classified as security-based swaps, including single-name credit default swaps and equity total return swaps.

²⁹ See 78 FR 33476 (June 4, 2013) at 33508, available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@Irfederalregister/documents/file/2013-12242a.pdf> and Staff Guidance on Swap Execution Facilities Impartial Access (November 14, 2013), available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf>

³⁰ MiFID II Article 18(3) and ESMA Q&A on MiFID II and MiFIR market structure topics, Section 5.1, Question 3, available at: https://www.esma.europa.eu/sites/default/files/library/70-872942901-38_qas_on_mifid_ii_and_mifir_market_structures_topics.pdf

³¹ See <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=62420&SearchText=>.

³² 85 FR 44693 (July 24, 2020), available at: <https://www.cftc.gov/sites/default/files/2020/07/2020-14343a.pdf>.

³³ Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 81 FR 53546 (Aug. 12, 2016) at 53608, available at: <https://www.govinfo.gov/content/pkg/FR-2016-08-12/pdf/2016-17032.pdf>.

However, the Commission stated that it lacked the necessary data to establish block trade thresholds when finalizing Regulation SBSR, and therefore established an interim approach that permits market participants to delay the reporting of all security-based swap transactions for up to 24 hours.³⁴ Permitting all security-based swap transactions to be reported with a 24 hour delay undermines the intended benefits of post-trade transparency, such as enabling investors to understand current market dynamics and compare liquidity provider prices with concurrent trading activity across the market, which not only improves execution quality assessments but also incentivizes price competition as investors are able to demand more accountability from their liquidity providers. This delay also sharply contrasts with current FINRA rules for reporting corporate and municipal bonds and CFTC rules for reporting swaps, where, in each case, a short 15 minute delay is allowed for block trades.³⁵ In addition, both FINRA and the CFTC recently consulted on extending these 15 minute delays for block trades, and shelved the proposals after the overwhelming majority of market participants expressed strong support for the current real-time public reporting regimes.³⁶

We recommend the Commission set interim block trade thresholds as quickly as possible. One solution is to set forth an objective formula for calculating the thresholds in

Regulation SBSR (for example, the CFTC uses a “67 percent notional amount calculation” that is intended to ensure that approximately two-thirds of the sum total of all notional amounts is reported on a real-time basis³⁷). Then, following the introduction of regulatory reporting, the Commission could use the first 3 months or 6 months of collected data to set the actual thresholds pursuant to the agreed formula, and these thresholds could be updated on an annual basis to ensure they remain representative of current market conditions.

OTC DERIVATIVES RECOMMENDATION #2: The Commission should set block trade thresholds as quickly as possible and eliminate the current 24 hour public reporting delay for security-based swaps.

³⁴ *Id.* at §242.901(j)

³⁵ See §43.5(a) in Real-Time Public Reporting of Swap Transaction Data, 77 FR 1182 (Jan. 9, 2012), available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@Irfederalregister/documents/file/2011-33173a.pdf> and FINRA Rule 6730, available at: <https://www.finra.org/rules-guidance/rulebooks/finra-rules/6730>.

³⁶ See <https://www.finra.org/rules-guidance/notices/19-12#comments> and <https://www.cftc.gov/sites/default/files/2020/11/2020-21568a.pdf>.

³⁷ See Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 FR 32866 (May 31, 2013) at 32893, available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@Irfederalregister/documents/file/2013-12133a.pdf>.

C. RESILIENCY

1. Facilitating Central Clearing

The commitment to clearing all standardized OTC derivative contracts is a central pillar of the 2009 G20 OTC derivatives reforms and a cornerstone of Title VII of the Dodd-Frank Act.³⁸ Central clearing of derivatives mitigates systemic risk and improves conditions for all market participants by protecting customers and enhancing pricing, liquidity, and transparency.³⁹ We recommend the Commission take the following steps to facilitate greater central clearing.

a. STP Rules

In order to maximize the risk mitigation benefits of central clearing, it is critical to ensure that robust standards govern the operational workflow from trade execution to clearing submission and acceptance. Both CFTC rules and EU rules under MiFID II contain nearly identical straight-through-processing (“STP”) requirements for cleared OTC derivatives,⁴⁰ including (a) pre-execution credit checks, (b) short clearing submission timeframes, and (c) certainty in the event a trade is rejected from clearing.

These STP requirements have been critical in establishing global standards that reduce market risk, credit risk, and operational risk through a robust execution-to-clearing workflow for cleared OTC derivatives. Unfortunately, these standards are not being applied when market participants voluntarily clear security-based swaps regulated by the Commission, despite the availability of the necessary market infrastructure. It is therefore important that the Commission implement STP rules to govern the execution-to-clearing workflow that are consistent with CFTC and EU standards.

OTC DERIVATIVES RECOMMENDATION #3: The Commission should implement straight-through-processing rules to govern the execution-to-clearing workflow that are consistent with CFTC and EU standards.

b. Clearing Mandate

A large number of commonly traded reference entities (including, most importantly, the constituent names of the primary CDS indexes) are suitable for mandatory clearing, demonstrated by the current client clearing offerings and the large amount of voluntary clearing that already occurs. We recommend the Commission adopt a mandatory clearing requirement for single-name CDS instruments.

OTC DERIVATIVES RECOMMENDATION #4: The Commission should adopt a mandatory clearing requirement for single-name CDS.

³⁸ See “G20 Leaders Statement: The Pittsburgh Summit,” Sept. 25, 2009, available at: <http://www.g20.utoronto.ca/2009/2009communique0925.html>.

³⁹ See Loon, Y. C., Zhong, Z. K. Does Dodd-Frank affect OTC transaction costs and liquidity? Evidence from real-time CDS trade reports. *Journal of Financial Economics*, 119 (3), 645–672 (2016) at page 4, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443654.

⁴⁰ US: “Staff Guidance on Swaps Straight-Through Processing” (Sept. 26, 2013), available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/stpguidance.pdf>; and CFTC Letter No. 15-67 (Dec. 21, 2015), available at: <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/15-67.pdf>.

EU: Commission Delegated Regulation (EU) 2017/582, available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0582&from=EN>

2. Reconsidering the Interdealer Exemption From Uncleared Initial Margin Rules

While the CFTC and prudential regulators have applied initial margin requirements to interdealer uncleared OTC derivatives transactions,⁴¹ the Commission provided an exemption to this important segment of the security-based swaps market.⁴² This means that a dealer regulated by the Commission is not required to post or collect initial margin for uncleared security-based swaps entered into with another dealer. Exempting the interdealer portion of the security-based swaps market from uncleared initial margin requirements undermines the regulatory objectives of mitigating systemic risk and promoting central clearing.

The CFTC and prudential regulators specifically concluded that, in order to effectively mitigate systemic risk, it was necessary to apply initial margin requirements to uncleared interdealer transactions⁴³ and the Commission's final margin rule does not adequately explain how it reached a different conclusion. In addition, data shows that voluntary clearing rates increased for interdealer transactions following the

implementation of uncleared initial margin requirements by other regulators.⁴⁴ In contrast, data also shows that bilateral trading is less costly than central clearing if there is an available exemption from uncleared initial margin requirements.⁴⁵ As a result, the Commission's interdealer exemption can be expected to create a disincentive to centrally clear.

In light of the above, we recommend that the Commission reconsider the exemption from initial margin requirements for uncleared interdealer security-based swap transactions.

OTC DERIVATIVES RECOMMENDATION #5: The Commission should reconsider the exemption from initial margin requirements for uncleared interdealer security-based swap transactions.

⁴¹ See 79 FR 59898 (Oct. 3, 2014) at 59907, available at: <https://www.govinfo.gov/content/pkg/FR-2014-10-03/pdf/2014-22962.pdf> and 76 FR 27564 (May 11, 2011) at 27571, available at: <https://www.govinfo.gov/content/pkg/FR-2011-05-11/pdf/2011-10432.pdf>.

⁴² 84 FR 43872 (Aug. 22, 2019), available at: <https://www.govinfo.gov/content/pkg/FR-2019-08-22/pdf/2019-13609.pdf>.

⁴³ See supra note 41.

⁴⁴ Incentives to centrally clear over-the-counter (OTC) derivatives: A post-implementation evaluation of the effects of the G20 financial regulatory reforms (Nov. 19, 2018) at Figure C.7 (page 21), available at: <http://www.fsb.org/wp-content/uploads/R191118-1-1.pdf>.

⁴⁵ Id. at pages 36-37.

3. Preventing Cross-Border Evasion

The Commission has correctly concluded that security-based swap transactions arranged, negotiated or executed using personnel located in the United States (“ANE Transactions”) fall squarely within the Commission’s jurisdiction, even if the transactions are booked to non-U.S. entities.⁴⁶ The Commission has estimated that ANE Transactions account for a significant portion of total security-based swap dealing activity in the U.S.⁴⁷ Given the Commission’s supervisory interests and policy objectives, we recommend the Commission exercise its jurisdiction over ANE Transactions with respect to public reporting, clearing, and trading requirements.

Since no foreign jurisdiction has implemented comparable public reporting requirements for OTC derivatives,⁴⁸ the Commission was correct to apply public reporting requirements to ANE Transactions.⁴⁹ However, in its final rules, the Commission granted a broad exception that permits U.S.-based personnel to provide “market color” without being considered to have engaged in ANE Transactions.⁵⁰ As a result, once public reporting begins, we recommend that the Commission closely monitor the extent to which ANE Transactions are being reported and make any

necessary rule revisions to ensure that U.S. investors are being provided with comprehensive transparency regarding security-based swap activity occurring in the United States.

To the extent the Commission imposes mandatory clearing or trading requirements, we recommend that the Commission also apply these requirements to ANE Transactions. It is interesting to note that, following the CFTC granting no-action relief from trading requirements for ANE Transactions, interdealer trading activity in EUR interest rate swaps began to be booked almost exclusively to non-U.S. entities, a fact pattern that academic research found was “consistent with (although not direct proof of) swap dealers strategically choosing the location of the desk executing a particular trade in order to avoid trading in a more transparent and competitive setting.”⁵¹

OTC DERIVATIVES RECOMMENDATION #6: The Commission should exercise its jurisdiction over offshore transactions with a sufficient nexus to the U.S. with respect to public reporting, clearing, and trading requirements.

⁴⁶ See Security-Based Swap Transactions Connected With a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598 (Feb. 19, 2016) at 8615-17, available at: <https://www.govinfo.gov/content/pkg/FR-2016-02-19/pdf/2016-03178.pdf>.

⁴⁷ *Id.* at 8616.

⁴⁸ We note that the EU MiFID II framework was intended to be comparable, but implementation and data quality issues have resulted in nearly all OTC derivatives being subject to a 4-week public reporting delay.

⁴⁹ 85 FR 6270 (Feb. 4, 2020), available at: <https://www.govinfo.gov/content/pkg/FR-2020-02-04/pdf/2019-27760.pdf>.

⁵⁰ *Id.*

⁵¹ Benos, E., Payne, R., and Vasios, M., Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act, Bank of England Staff Working Paper (May 2018) at page 30, available at: <https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2018/centralized-trading-transparency-and-interest-rate-swap-market-liquidity-update>

IV. Research Unbundling

The EU has unbundled research and execution fees since 2018. According to a review by ESMA, this change has improved the quality of research, lowered the costs of both execution and research, enhanced transparency, and promoted competition.⁵² The Commission has provided limited no-action relief from registration under the Investment Advisers Act of 1940 (“Advisers Act”) to broker-dealers providing research to investment managers subject to EU MiFID II requirements,⁵³ and has also clarified that client commission arrangements (“CCAs”) can be used to purchase research from a broker-dealer even if the broker-dealer does not have a trading relationship with the client acquiring the research.⁵⁴

We recommend that the Commission go further to explicitly allow broker-dealers to unbundle research and execution fees for all clients, for example, by clarifying that a broker-dealer accepting hard dollars for research does not constitute “special compensation” that disqualifies a broker-dealer from the exception to the “investment adviser” definition under Section 202(a)(1)(C) of the Advisers Act. Unbundling of research and execution will allow competitive market forces to govern the provision of research by broker-dealers, with clients able to select the research that genuinely adds

value with full transparency regarding associated costs.⁵⁵ Unbundling will also empower clients to shift their trading to more transparent and competitive trading venues, including in more traditionally “high touch” markets such as the ETF and fixed income markets.

V. Conclusion

Competition, innovation and smart regulation have contributed to the global success of U.S. capital markets. Well-functioning capital markets facilitate the efficient allocation of capital and strengthen the U.S. economy. As the Commission reviews financial regulation, we believe that the preeminent global position of U.S. capital markets can, and should, be further strengthened by making markets more competitive, transparent, and resilient.

⁵² See ESMA “Report on Trends, Risks and Vulnerabilities” No. 2, 2020 at pages 81-92, available at:

https://www.esma.europa.eu/sites/default/files/library/esma_50-165-1287_report_on_trends_risks_and_vulnerabilities_no.2_2020.pdf.

⁵³ <https://www.sec.gov/investment/sifma-110419>.

⁵⁴ *Id.* at FN 8.

⁵⁵ We note the broad and diverse support for this principle in filed comments letters at <https://www.sec.gov/comments/mifidii/mifidii.htm>.