Treasury Market Best Practices

Compiled by the
Treasury Market Practices Group

This document is available on the Treasury Market Practices Group website at www.newyorkfed/tmpg. Market participants are encouraged to direct feedback on this document to tmpg@ny.frb.org before March 1, 2007

TREASURY MARKET BEST PRACTICES

Introduction

The Treasury Market Practices Group recognizes the importance of maintaining the integrity and efficiency of the over-the-counter U.S. government securities (Treasury) market. We believe that the public and all market participants benefit from a marketplace that is transparent and efficient. We believe that these characteristics help maintain vigorous competition and liquidity in the Treasury market. Toward that end, we recommend that *all* Treasury market participants incorporate best practices into their operations in order to promote trading integrity and support an efficient marketplace.

Best practices are meant to serve as guidelines for market participants seeking to organize their operations in a manner that fosters strong controls and reinforces overall market integrity. The best practices in this document are intended not only for dealers but for any market participant active in the wholesale Treasury market, including brokers, buy-side firms, investors, and custodians. We believe that these best practices, if adopted, can strengthen each market participant's existing controls. In addition, we believe that the implementation of these best practices will help reduce market disruptions—including but not limited to episodes of protracted settlement failure—and buttress overall market integrity with important benefits for Treasury market participants and the public alike.

These best practices seek to affirm existing notions of good market conduct and are intended as useful operational guideposts rather than binding rules or regulatory guidance. As each market participant makes use of these recommendations, it should take into account its own unique characteristics, such as asset size, transaction volume, and the form of the organization's participation in the market (for example, market maker, investor, custodian, etc.).

This compilation is by no means a comprehensive guide to doing business in the Treasury market. Rather, for market participants both new and established in the Treasury market, it can serve as a benchmark when reviewing the adequacy of operating procedures.

I. Promoting Market Making and Liquidity

The Treasury market's smooth and efficient functioning relies on the integrity, honesty, good faith, and mutual trust shown by all participants. An efficient market fosters liquidity, which helps all market participants find buyers and sellers more effectively. It is important for both buyers and sellers to promote market liquidity.

- **All market participants should behave in a manner that is consistent with supporting market liquidity.** Dealers, in particular, should promote market making and all market participants should avoid trading strategies that hinder market clearance. Examples of strategies to avoid include those that cause or exacerbate settlement fails, those that inhibit the provision of liquidity by others, or those that restrict the floating supply of a particular issue in order to generate price movements in related markets.

- **Market participants should be responsible in quoting prices and should promote overall price transparency in the inter-dealer brokers' market.**

  - While legitimate price discovery activities are an integral part of the Treasury market and should be encouraged, participants should avoid pricing practices that do not have an objective of resulting in a transaction.

  - Price discovery relies on efficient price reporting and transparent markets. Market participants should not conduct trades through inter-dealer voice brokers with electronic trading screens without having a record of the transaction published on the screen.

- **Market participants should ensure adequate oversight over their Treasury trading activity**. The nature of oversight may vary depending on the role that each market participant plays in the marketplace and the organizational structure of the firm. However, all firms should develop a mechanism for measuring and scrutinizing the market participant's overall trading activity in the Treasury market to ensure that trading behavior in the aggregate, as well as along individual business lines, is appropriate. Oversight coverage should include, at a minimum, the organization's activities in the Treasury cash markets (including the auction and secondary trading), financing markets (including repurchase agreements), and related derivatives markets.

II. Maintaining a Robust Control Environment to Monitor Questionable Trading Practices

Market participants active in financial markets are familiar with the importance of establishing and maintaining a rigorous internal control environment. Even though the over-the-counter Treasury market is not overseen by a single regulator or a unified set of rules, internal compliance is crucial in this area. Indeed, the variety of legal and reputational pressures to which a market participant's Treasury trading operations are subject suggests that a vigorous, well-informed, and assertive compliance program is essential. A compliance program should include the active engagement of business, legal, and/or compliance functions.

- **Each market participant should maintain a strong internal control environment sufficient to ensure that each of its business areas acts in accordance with applicable law and best market practices.** Depending on the organizational structure of a firm, a compliance program may rely on the engagement of personnel from various functions within the firm such as legal, compliance, or the business area. Ultimately, a firm's compliance program should be organized to identify and address questionable trading practices, should any arise.

- **Market participants should ensure that the individuals responsible for compliance and legal functions are well-integrated into trading operations**. **Senior business managers should take responsibility for ensuring that compliance policies are fully implemented and followed in their business areas.**

- **Individuals responsible for compliance and legal functions should have a basic understanding of trading strategies engaged in by trading desks sufficient to allow them to identify atypical activity.** Legal and compliance staff should have sufficient awareness and understanding of the objective and execution of trading strategies to enable them to detect and deter questionable trading before it can result in market disruption, illiquid market conditions, or legal or reputational risk for the organization.

- **Individuals responsible for compliance and legal functions should be empowered to bring any concerns to the attention of appropriate senior business managers within the organization**.

- **Compliance policies should identify the specific trading trends, positions, strategies, or behavior within the trading operation that constitute triggers for mandatory business and compliance review.** Mandatory review does not in itself automatically suggest that a trading position, strategy, or behavior must be altered; that will depend on the results of the review and consultations between management and compliance. Because the structure of the Treasury market is always evolving, triggers for mandatory review can change over time. However, market participants should consider including the following list of indicators in their compliance plan to prompt further review:

  - A large concentration of holdings in the floating supply of a particular security (floating supply, at it's largest, reflects the amount of the security originally issued less the amount stripped into zero-interest instruments; floating supply may be smaller than this amount);

  - Elevated delivery or receive fails in a particular security and/or the presence of particular trades that persistently fail to settle;

  - Persistent and deep "specialness" of a security;

  - An appreciable or unusual amount of market turnover in a particular security;

  - Unusual levels or patterns of either profits or losses;

- Changes in a market participant’s normal securities lending or borrowing patterns in a security in which a market participant has a large position; for example, a sudden hesitation to lend or a large reduction in the amount lent; and

- When securities are trading “special,” financing a substantial percentage of floating supply in general collateral funding arrangements, such as tri-party repo, or an apparent increase in such financing over time.

III. Managing Large Positions with Care

Although large or short positions are not necessarily problematic, these positions should be managed responsibly to avoid market disruptions. From time to time, a market participant may amass a particularly large long position in a specific Treasury issue or product. A market participant should manage that position with heightened vigilance, mindful of the need to support market liquidity. Market participants with large short positions or active shorting strategies have similar responsibilities to support the liquidity and smooth functioning of the market.

- **Market participants should avoid trading strategies that create or exacerbate settlement fails.** Such vigilance should be intensified when a large position predominantly or entirely results from proprietary positioning since the market participant has more control over that position’s size and growth.

- **When a participant controls a significant percentage of an issue that is trading deeply special, it should ensure that it is making a good faith attempt to lend the security into the specials market rather than choosing to finance large portions of this collateral in relatively more expensive funding arrangements.** Use of relatively more expensive funding arrangements by holders of large positions to finance large portions of an issue, even on an overnight basis, should require approval by compliance staff and senior management.

- **Market participants with large short positions should make deliveries in good faith.** Market participants with a particularly large short position in an issue should ensure that they are making a good faith attempt to borrow needed securities in order to make timely delivery of securities. Market participants should avoid the practice of “strategic fails”—that is, the practice of selling short a security in the repo market at or near zero percent with little expectation of being able to obtain the security to make timely delivery.

- **When evaluating trading strategies for large positions, market participants should take care that sudden changes in those strategies do not adversely affect the liquidity or settlement of the issue in the marketplace.** Market participants should not refrain from trading when they hold a large position. However, when market participants consider implementing a new trading strategy for a large position, they should evaluate whether it may affect market liquidity. Senior management and compliance staff should be made aware of any significant changes to trading strategies.

- **Management and compliance functions should be alerted as soon as possible about particularly large positions — long and short — taken by a trading desk**. Market participants should have policies and systems in place to ensure that appropriate personnel in management and compliance are alerted in time to take actions to safeguard the market participant's reputation and manage any legal or regulatory risk.

IV. Promoting Efficient Market Clearing

Smooth and predictable settlement and clearing are crucial to the Treasury market. Settlement fails prevent the market from clearing efficiently and can damage the market's liquidity and function. While some fails may be inevitable, market participants should take care that their internal policies promote practices that support efficient and timely clearing and that avoid unnecessary market congestion. Market participants should avoid practices that intentionally inhibit the efficient clearing of the market, such as "slamming the wire" — the practice of holding back deliveries until immediately before the close of the securities wire with the intention of causing fails in the market.

- **A market participant's policies and systems should ensure that trades are communicated from the trading desk to the operations area as quickly as possible in order to promote efficient settlement.**

- **Market participants should be organized to ensure that the settlement and clearing area is independent of the trading desk. In particular, market participants should be organized to restrict trading staff from delaying or influencing settlement of Treasury securities**. Settlement staff should be empowered to question or decline settlement instructions from trading staff. In addition, policies should require that all requests that deviate from normal settlement practice be made simultaneously to compliance staff.

- **A request to "hold the box" — to hold settlement of an executed trade for a period of time — should warrant high scrutiny from trading management, settlement staff, and compliance staff.** "Holding the box" is appropriate only in very specific and limited circumstances, such as to ensure a futures contract delivery obligation. "Holding the box" should be appropriately approved by trading management and compliance staff as an exception to the general restriction on traders directing securities settlement. Repeated or systematic use of "holding the box" for a particular security, absent exceptional circumstances, should not be permissible under a market participant's operating procedures.

- **Delivery of Treasury securities should minimize market congestion and the risk of fails.** Market participants should have clear policies on how and when to make deliveries of securities in the settlement and clearing process. These policies should include internal "cutoff" times comfortably in advance of any Fedwire deadlines by which market participants should provide delivery instructions. For same-day settlement trades entered very late in the trading session, deliveries should be processed as expeditiously as possible.

- **Incoming securities from counterparties should be turned around quickly to minimize fails and promote market clearing and settlement.** Internal policies and systems should identify a standard turnaround period for ensuring that securities are processed in a timely and efficient manner.

- **All market participants should be diligent in addressing persistent settlement fails.** Protracted settlement fails inhibit market function and can reduce market participation. All market participants should aim to resolve persistent fails as soon as possible.