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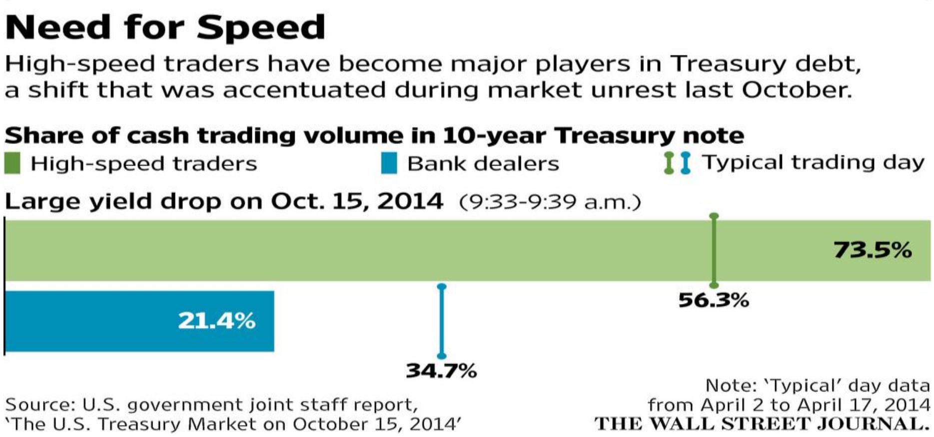
The New Bond Market: Regulators Scramble to Keep Up

Tech-fueled trading in U.S. Treasury bonds is fast, complex—and governed by rules built for paper and telephones



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The technology-fueled world of finance has grown faster, more sophisticated and incredibly complex. Meanwhile, the $12.8 trillion U.S. Treasury market is still governed by rules adopted during the age of paper filings and telephone trading.

The mismatch became evident to regulators probing how the yield on the 10-year Treasury note could plummet by 8%—then shoot back up and nearly level off just 12 minutes later—as it did last October in what has been billed a "flash crash."

Some government investigators were surprised to learn that lightly supervised firms using fast, automated strategies now represent about half of trading volume on a typical day, according to people familiar with the probe. They also couldn't quickly access the sort of minute-by-minute trading records that are now standard for stocks and other bonds.

"Put simply, we cannot get the information we need to analyze risk across Treasury markets in anything that approaches real time," Antonio Weiss, a senior adviser to Treasury Secretary Jacob Lew, said in a speech at a Washington think tank last month. "That has to change."

The Treasury, the Federal Reserve and the Securities and Exchange Commission are now hustling to catch up with plans for more data and closer oversight of firms in the market, people familiar with the matter said.

One requirement gaining traction is the creation of a regularly updated data feed that the government could use to track and reconstruct dealings in Treasurys, the people said.

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Officials are also discussing whether venues used to trade Treasurys should be subject to rules similar to those the SEC has adopted for counterparts in the world of stocks, the people said. That could mean more scrutiny of daily operations at Treasury trading platforms such as ICAP PLC's BrokerTec and Nasdaq Inc.'s eSpeed. Currently, platforms for Treasury securities are exempt from rules that impose basic safeguards like having a plan for an event that knocks the exchange offline.

Firms that trade Treasurys could also come under more scrutiny as a result of the review. The officials are discussing whether they should be required to register with the SEC or another regulator, the people said.

"At a minimum, we need full regulatory transparency into all the transactions," saidMichael Piwowar, a member of the SEC, in an interview.

Officials' discussions about new rules are still preliminary, and any proposal would be subject to debate among the government agencies involved, which could draw out the process for months or more.

The industry is wary of rules that could raise costs. James Overdahl, who advises the Futures Industry Association's Principal Traders Group, which includes fast-trading firms, said the group would want to see "a system that gives regulators what they need that is also cost effective."

Treasury Secretary Jacob Lew's office says regulators' inability to quickly get data on risk in the Treasury bond market 'has to change.' PHOTO: ANDREW HARNIK/ASSOCIATED PRESS

Joe Noviello, a Nasdaq senior vice president in charge of eSpeed, says his company already works to ensure its exchange runs safely and fairly. “We probably to this day put more practices around the operation of our market than are imposed on us by regulation,” he said.

In the past, regulators have taken a hands-off approach to overseeing trading in U.S. Treasurys because they considered the market safe and have been wary of making a change that could affect the U.S. government’s borrowing costs. The Commodity Futures Trading Commission has overseen trading in Treasury futures, while the Treasury Department, Fed and SEC each have some authority related to other parts of the market.

But the prospect of more volatility is a growing concern to U.S. officials, not only because the market sets U.S. borrowing costs but also because Treasury yields underpin a range of borrowing rates for homeowners and companies.

Treasury markets have traditionally been dominated by big Wall Street firms known as “primary dealers,” which have access to U.S. debt auctions. The dealers made money by reselling the bonds to their investor clients and to one another. As more Treasury trading went electronic in the mid-2000s, a door opened for fast-trading specialists such as Jump Trading LLC and Virtu Financial Inc. to compete with primary dealers on new trading platforms.

After the big market move last year, Mr. Lew and senior officials at the Fed, which implements monetary policy through the Treasury market, wanted to know what happened.

Their staff struggled to find quick answers, people familiar with the matter said. They dialed up market participants searching for answers, but couldn’t fact-check the traders’ anecdotes, because neither agency could quickly access data on individual transactions.

Meanwhile, accessing another crucial set of data—Treasury futures transactions—took more than two months. The Commodity Futures Trading Commission, which maintains the confidential data, didn’t initially have a legal agreement to share it with the other agencies.

The staff reported their findings on July 13, about nine months after the event that prompted their investigation. The report found no obvious cause for what happened, but said the available data “raises questions about whether events such as October 15 could occur more frequently going forward.”

None of the changes under consideration would prevent future bouts of volatility. But they would boost disclosure about trading in Treasurys, so regulators could take more action if they saw signs of trouble.

One thing regulators aren’t considering: Changing new capital rules spurred by the 2010 Dodd-Frank law. Big banks such as Goldman Sachs Group Inc. say those rules have forced them to pull back from the Treasury market, making it harder for buyers and sellers to find a partner during periods of volatility—and have also opened the door to other market makers, such as the fast-trading firms.

U.S. officials so far haven’t budged in response to those complaints, and Mr. Lew has said the new rules aren’t to blame for the Treasury market volatility last October.