

Thomas Wipf
Morgan Stanley & Co.
1585 Broadway
New York, New York, 10036

April 22, 2016

Submitted Electronically

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

Dear Mr. Pearl:

Morgan Stanley appreciates the opportunity to comment on the observed structural changes in the U.S. Treasury market.¹ In this comment letter, we provide our thoughts on how the U.S. Treasury market has evolved and where we see opportunities to enhance liquidity and transparency in this market. Primarily, we believe that transparency should expand to account for the changing composition of market participants.

1. Liquidity in the U.S. Treasury Market

Morgan Stanley recognizes the importance of new regulation in addressing core contributors to the financial crisis. Reforms to capital, leverage and funding standards have improved the risk profiles of financial institutions, making them stronger and more resilient. While the nature of these regulatory reforms is expected to contract market liquidity to some degree, this contraction has been particularly impactful on high-quality liquid assets such as U.S. Treasuries.

U.S. Treasury securities underpin the broader financial system as the preeminent form of collateral for centrally cleared, bilateral and tri-party transactions, as well as for banks' and broker-dealers' liquidity reserves. The industry has expressed concerns about the impact of multiple regulations, and in particular, the effects of the Liquidity Coverage Ratio ("LCR") and the enhanced Supplementary Leverage Ratio ("eSLR") on liquidity in the U.S. Treasury securities market.

The eSLR imposes a 5% or 6% capital charge on U.S. Treasuries and financing against U.S. Treasuries (i.e., reverse repo), significantly increasing the capital costs to GSIBs maintaining inventory in these securities or providing financing against them. This has resulted in GSIBs having reduced capacity to provide marketplace liquidity for high-quality liquid assets ("HQLA"), such as U.S. Treasuries.

¹ *Notice Seeking Public Comment on the Evolution of the Treasury Market Structure*, 81 Fed. Reg. 3927 (Jan. 22, 2016).

Simultaneously, the LCR has increased the demand for HQLA, putting further pressure on broker dealers' capacity to intermediate. In addition, the LCR requirement for banks to hold sufficient HQLA unencumbered assets has also created an increased immobilization of US Treasuries, resulting in lower trading velocity.

While the LCR and eSLR are each logically designed in isolation, their interaction with each other could potentially contribute to a dampening effect on marketplace liquidity. Although GSIBs' U.S. Treasuries inventories will fluctuate for a number of reasons, including macroeconomic and interest rate conditions, the LCR and eSLR also play a major role. These regulations reduce GSIBs' incentive to provide clients with US Treasury financing, intermediation and access to inventory, which could potentially impair the cash-equivalent status of US Treasuries.

2. U.S. Treasury Trade Activity Reporting

The unique nature of the primary dealer structure that facilitates U.S. debt issuance has a significant impact on liquidity beyond the primary market. Changes in capacity within the primary dealer structure could have potential impacts in secondary trading in cash, Treasury futures and OTC interest rate derivatives.

Changes in U.S. Treasury financing markets have impacted the liquidity in U.S. Treasury cash markets, primarily driven by reduced intermediation capacity and reduced dealer inventory. Looking ahead, the suspension of Fixed Income Clearing Corporation's ("FICC") interbank GCF repo service could further reduce liquidity in the Treasury repo market. Offsetting this may be the anticipated entry of registered investment companies into the FICC GCF Repo service, which could increase banks' intermediation capacity through increased netting opportunities. This expansion of central clearing for repo should also have a positive impact to liquidity in the Treasury cash trading market.

There have been other changes in the U.S. Treasury market, including the liquidity bifurcation of on-the-run and off-the-run U.S. Treasury securities, the rise in automated trading systems, and the increased role of high frequency trading ("**HFT**") and principal trading firms ("**PTF**"). Real money clients, such as pension funds, asset managers, money market funds and insurance companies, generally have been focused on owning liquid points on the curve (i.e., futures and on-the-runs), while foreign reserve managers needing to sell U.S. dollars have largely targeted legacy off-the-run securities as the bonds to sell. PTFs and HFTs primarily concentrate their activity in futures and on-the run securities, while primary dealers remain the liquidity provider for the majority of off-the-run activity.

Today, the metrics available to assess liquidity in U.S. Treasury markets include depth of order book and bid/offer spreads reported by primary dealers. While it is difficult to determine which metrics would best represent the degree of market liquidity, the following data points could be indicative for official sector reporting: order-to-trade ratio, average resting time for an order, average order size (relative to issuance size), and average trades per day.

All transactions for cash and futures should be subject to official sector reporting by the seller (unless executed on an automated trading venue), and could be enhanced to include order date, settlement date,

venue, category of counterparty, price, order changes and time-stamps (excluding quotes, or un-filled orders). Transaction data should be considered on a trade-by-trade basis, inventory or positions on a counterparty basis, and order book on a venue basis. Timing requirements should vary based on transaction type, e.g., illiquid instruments should have a longer time period to report. We would also recommend the introduction of universal counterparty identifiers to ensure standardized categorization of end-investors.

The official sector should consider leveraging existing reporting requirements, including the Federal Reserve's FR2004 information collection on primary dealer activity in U.S. government securities, Markets in Financial Instruments Directive ("MiFID"), Dodd-Frank, FINRA's Trade Reporting and Compliance Engine ("TRACE"), or Municipal Securities Rule-making Board standards.

Overall, primary dealer reporting and risk management is robust, but the transparency guidelines around U.S. Treasury trading activity do not currently account for the change in composition of market participants. Morgan Stanley is supportive of increased transparency across the broader market scope of participants.

3. Risk Management Practices

Overall, the rise of electronic trading warrants further examination of market-wide risk controls. Increased speed of transactions in the secondary market brings risk such as information asymmetry. Risk management practices should be considered on three levels: 1) internal risk management, 2) platform-level risk management, and 3) market-wide risk management.

Market participants should have internal risk controls that are reviewed and monitored for effectiveness and should conduct their business in accordance with the Treasury Market Practices Group ("TMPG") best practice guidelines. In addition, market participants should invest in pre-, intra-, and post-trade controls commensurate with the increased risks presented by the level of their automated trading, including, but not limited to, systemic limits management (e.g., order message limits), kill switches, stress testing enhancements and surveillance around market conduct practices.

There is an opportunity to increase consistency and transparency across trading platforms (e.g., order-to-trade ratios), in line with the TMPG's best practices.

One potential solution to ensure market-wide risk management standards may be to expand the role of central clearing.

4. Central Clearing

CCPs have the potential to enhance transparency, liquidity, and capacity in the repo markets. Potential benefits to the Treasury market of increased access to repo clearing include, but are not limited to:

- Increased capacity and resource efficiency for the dealers and their clients,
- Reduced bilateral counterparty credit risk,
- Decreased contagion risk of fire sales, and
- Increased market liquidity.

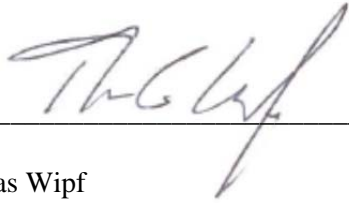
Furthermore, expanded clearing of U.S. Treasury cash products could create new capacity and centralize risk management for all market participants.

Morgan Stanley reiterates its appreciation for the opportunity to comment on the observed structural changes in the U.S. Treasury market and would welcome the opportunity to continue this dialogue.

Sincerely,

Morgan Stanley & Co. LLC

By: _____

A handwritten signature in black ink, appearing to read 'Thomas Wipf', written over a horizontal line.

Thomas Wipf

Managing Director and Global Head of Bank Resource Management