



Best Practices for Treasury, Agency Debt and Agency MBS Markets

This document is available on the Treasury Market Practices Group website at www.newyorkfed.org/tmpg. Market participants are encouraged to direct feedback on this document to tmpg@ny.frb.org through July 29, 2010.

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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), agency debt, and agency mortgage-backed securities (MBS) markets. 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, agency debt, and agency MBS markets. Toward that end, we recommend that all Treasury, agency debt, and agency MBS 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, agency debt, and agency MBS markets, 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 resulting in important benefits for Treasury, agency debt, and agency MBS market participants and the public alike. Information about specific recommendations for minimizing widespread and persistent settlement fails in the Treasury market can be found on the TMPG's website.

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, or custodian).

This compilation is by no means a comprehensive guide to doing business in the Treasury, agency debt, and agency MBS markets. Rather, for market participants both new and established in the Treasury, agency debt, and agency MBS markets, it can serve as a benchmark when reviewing the adequacy of operating procedures. Of course, in addition to considering these best practices, market participants should ensure that they are following all applicable laws at all times and should avoid illegal activities such as price manipulation.

I. Promoting Market Making and Liquidity

The Treasury, agency debt, and agency MBS markets' 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 that security or 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, agency debt, and agency MBS markets and should be encouraged, market participants should avoid pricing practices that do not have an objective of resulting in a transaction, or that otherwise result in market distortions.
- 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 at the time of the transaction. In addition, market participants should avoid conduct that deliberately seeks to evade regulatory reporting requirements or impedes market transparency efforts.

❖ **Market participants should ensure adequate oversight of their Treasury, agency debt, and agency MBS 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, agency debt, and agency MBS markets to ensure that trading behavior in the aggregate, as well as along individual business lines, is understood by senior business managers. Oversight coverage should include, at a minimum, the organization's activities in the Treasury, agency debt, and agency MBS cash markets (including primary and secondary trading), financing markets (including repurchase agreement and dollar roll transactions), and related derivatives and structured products markets.

II. Maintaining a Robust Control Environment

Market participants active in financial markets are familiar with the importance of establishing and maintaining a rigorous internal control environment. Indeed, the variety of legal and reputational pressures to which a market participant's Treasury, agency debt, and agency MBS trading and settlement operations are subject suggests that a vigorous, well-informed, and assertive internal control program is essential. An internal control program should include the active engagement of the business, audit, legal, risk and 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.** Firms should ensure that its organizational structure supports a strong control environment, including appropriate information barriers, for example, between trading and origination functions. Trading desk management and the supervision, legal, and compliance staff should work collectively to ensure that any questionable trading practices are identified and addressed in a timely manner. Trading desk management and supervision should be aware of, and responsible for, strategies executed by the trading desk. Other control functions, and particularly legal and compliance staff, should be poised to promptly evaluate and respond to questionable trading practices should they

occur. Firms should aspire to provide system tools that relay real-time trade position information to the compliance function in order to provide timely notification of large positions.

- ❖ **Market participants should ensure that the individuals responsible for legal and compliance functions adhere to robust review and oversight procedures regarding trading and settlement operations. Senior business managers should take responsibility for ensuring that internal control policies are fully implemented and followed in their business areas.**
- ❖ **Individuals responsible for internal control functions should have a sufficient understanding of trading strategies engaged in by trading desks to allow them to recognize potentially problematic activity.** Individuals responsible for internal control functions, and particularly 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 which could result in market disruption, illiquid market conditions, or legal or reputational risk to the organization.
- ❖ **Individuals responsible for internal control functions, and particularly legal and compliance staff, should be empowered to bring any concerns to the attention of appropriate senior business managers within the organization.**
- ❖ **Individuals responsible for internal control functions that track capital charges associated with trading activity, including settlement fails, should communicate these charges and their source to senior and trading desk management.**
- ❖ **Internal control policies should identify the specific trading trends, positions, strategies, or behaviors 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. Triggers, among other controls, should aim to identify trading activities that reduce supply circulating in cash or collateral markets. Because the structure of the Treasury, agency debt, and agency MBS markets is always evolving, triggers for mandatory review—and the appropriate thresholds for individual triggers—may change over time as the size and structure of the market change. However, market participants should consider including the following non-exhaustive list of indicators in their compliance plan to prompt further review:
 - a large concentration of holdings in the floating supply of a particular Treasury or agency debt security, or the deliverable supply of a to-be-announced (TBA) MBS issue.
 - In the case of the Treasury or agency debt markets, floating supply, at its largest, reflects the amount of the security originally issued less the amount that has been stripped into zero-interest instruments. Other factors, such as holdings of large buy-and-hold investors, or defeasance programs, can limit floating supply further.
 - In the case of the agency MBS market, deliverable supply of a TBA MBS, at its largest, reflects the amount of the security originally issued less any amount that has been paid down or structured into REMICs. Other factors, such as holdings

of large buy-and-hold investors, or the categorization of a basket of pools as “specified collateral”, can limit deliverable supply further;

- elevated delivery or receive fails in a particular security and/or the presence of particular trades that persistently fail to settle;
 - elevated capital charges resulting from settlement fails;
 - 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; and
 - in the case of Treasury and agency debt, when securities are trading “special,” placing a substantial percentage of floating supply in general collateral funding arrangements, such as general collateral finance (GCF) or tri-party repo, an apparent increase in such financing over time, or placing large blocks of collateral with select counterparties that typically do not recirculate collateral.
- ❖ **Trading desk management and individuals responsible for the determination of credit management policies should ensure that they consider the counterparty and market risks associated with transactions and develop robust risk management processes.** Particularly with regard to forward-settling transactions, such as TBA MBS trades, firms should adopt a strong presumption in favor of requiring the execution of written agreements that facilitate the prudent management of the risks associated with such activities through the articulation of terms regarding issues such as the posting of margin, liquidation, and valuation.

III. Managing Large Positions with Care

Although large long 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, agency debt, or agency MBS 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 any 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.
- ❖ **Firms should adopt a strong presumption against using relatively more expensive funding arrangements to finance large portions of an issue trading deeply special, even on an overnight basis.** If such financing is used, senior management should fully understand

why the exception is appropriate. Management and legal and compliance functions should be notified of such activity in a timely manner. Failing to deliver is not an acceptable funding arrangement.

- In the Treasury or agency debt market, when a participant controls a significant percentage of the floating supply 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 collateral in relatively more expensive funding arrangements.
 - In the agency MBS market, when a participant holds a large TBA position or controls a significant percentage of the deliverable supply of a TBA issue that is trading deeply special, it should not finance the position with the intent to adversely affect the liquidity of the TBA issue. One example of this type of behavior would be financing a large TBA position in a more expensive manner through the repo market, rather than through the dollar roll market, in order to limit the deliverable supply of the TBA issue.
- ❖ **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 trading strategies designed to profit from settlement fails. Examples of this type of behavior include:
- the practice of selling short a security in the repo market around or below zero percent, or selling a dollar roll around or below zero percent, with little expectation of being able to obtain the security to make timely delivery. In cases where transactions are subject to a fails charge, different thresholds for profiting from such behavior may be relevant.
- ❖ **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 Treasury, agency, or agency MBS 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. For example, although open interest in MBS TBAs in a given issue often well exceeds the deliverable supply in the coupon, delivery decisions should not be made with the intention of distorting prices of either the cash security or the dollar roll. Senior management and legal and compliance functions should be made aware of any significant changes to trading strategies.
- ❖ **Management and legal 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 in legal and compliance are alerted in time to take actions to safeguard a market participant's reputation and manage any legal or regulatory risk.

IV. Promoting Efficient Market Clearing

Smooth and predictable settlement and clearing are crucial for preserving the liquidity and efficiency of the Treasury, agency debt, and agency MBS markets. Settlement fails prevent the market from clearing

efficiently and can damage the market's liquidity and function. While some settlement fails are 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.

- ❖ **A market participant's policies and systems should ensure that trades are entered promptly into trading systems by the trading desk staff and made available 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 managed independently of the trading desk. Settlement and clearing staff should have reporting lines that are separate from those of the trading staff. In addition, internal controls should be in place to restrict trading staff from delaying or influencing settlement of Treasury, agency debt, or agency MBS transactions.** Settlement staff should be empowered to question instructions from trading staff by elevating unusual instructions to the attention of management. In addition, policies should require that all requests that deviate from normal settlement practice be communicated to legal and compliance staff in a timely fashion.
- ❖ **Relevant transaction information should be provided to counterparties well in advance of applicable cutoff times such that counterparties can make timely delivery of securities.** Examples of such information include account allocation information, and in the case of agency MBS transactions, TBA pool information.
- ❖ **Market participants should avoid holding back deliveries until immediately before the close of the securities wire in order to promote efficient market clearing and reduce settlement fails.**
- ❖ **Practices that cause settlement fails should warrant high scrutiny from trading management, settlement staff, and compliance staff.** Intentionally failing to deliver on settlement date in order to "hold the box", "sort the box" or substitute TBA pools should be avoided. Repeated or systematic practices that cause settlement fails, should not be permissible under a market participant's operating procedures.
- ❖ **Delivery of Treasuries, agency debt, and agency MBS should minimize market congestion and the risk of settlement 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 new trade notifications. For same-day settlement trades entered very late in the trading session, deliveries should be processed as expeditiously as possible.
- ❖ **Incoming securities from counterparties that are to be delivered to other 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. In addition, market participants should seek to utilize netting solutions in the event of, and in order to mitigate round-robin fails.

- ❖ **Firms engaged in settlement activity involving deliveries or receipts of Treasuries, agency debt, or agency MBS should have controls in place that alert business and compliance managers to significant settlement fails in an individual issue or CUSIP.** For instance, approaches that such firms might use to monitor fails are:
 - identifying, for each specific issue, a maximum acceptable ratio of fails to aggregate receipts or deliveries during each settlement date,
 - identifying a maximum acceptable amount of net fails to deliver or receive, and
 - establishing a separate absolute dollar threshold for settlement fails in a specific issue.

Firms with significant financing activity, in particular, should consider including these measures in their internal controls. Internal controls that immediately bring significant fails in an individual issue to management's attention allow managers to respond before fails age or become systemic, thereby helping to improve overall market liquidity and functioning for all participants.