State of the Capital Markets
2018 Snapshot

September 2018
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While the U.S. already had an extensive financial services’ regulatory structure built up over a century, post-crisis regulations significantly added to the number of regulations. The industry remains focused on establishing smart regulations, ensuring economic incentives and costs are calculable, and enabling capital markets to run efficiently. The goal is not to start the regulatory process over, but rather to recalibrate those regulations which may have unintended consequences.
Corporate Credit Market

U.S. corporate credit markets serve as a vital source of financing for corporate borrowers and has seen significant growth in a relatively benign interest rate environment. The last several years have been a period of meaningful evolution in market structure driven both by regulatory requirements and dynamic market driven solutions to improve transparency, liquidity and efficient market functioning. The U.S. corporate credit markets are the largest in the world and continue to attract global issuers and investors.

In 2017, 1192 companies issued **$1.7 trillion**. Through June of this year, 622 companies issued **$814.7 billion**. Average daily trading volume was **$31.9 billion** for FY17 and **$35.5 billion** in the first half of 2018.

Key Developments

- Institution of new best execution standards, Sidebar markup disclosure confirmation requirements, and improved post-trade reporting.
- Introduction by market participants of innovative electronic trading solutions and with greater connectivity, electronic trading volumes continue to grow. A greater focus on data capture, aggregation and utilization has improved pricing efficiency and transparency.
- These developments have led to further automation and the use of smart ordering routing, algorithms and systematic or portfolio trading has improved operational efficiency. The developments of an ETF market has introduced new liquidity alternatives and is helping to spur integration of the overall market.
- The SEC’s newly formed Fixed Income Market Structure Committee (FIMSAC) offers a structured forum to promote constructive discussion between market participants and regulatory on market development and issues. Liquidity remains a focal point of market discussion, especially for block trades, and the FIMSAC has already put forth recommendations related to block transactions and the oversight of electronic trading platforms.
Derivatives

Over-the-counter (OTC) derivatives play an important role in the U.S. capital markets and broader economy, allowing businesses to manage and hedge risk. Companies of all types — including farmers, energy companies and corporate end-users — use derivatives as a key tool to protect against risks that are inherent to their businesses.

As of the end of 2017, the CFTC reported $239.5 trillion in total notional outstanding swaps.

Interest rate products accounted for the vast majority — $235.3 trillion — and credit swaps — $4.2 trillion — the remainder.

Key developments:

- Consistent with the G20 commitments and pursuant to Title VII of the Dodd Frank Act, U.S. regulators have adopted rules implementing regulation of OTC derivatives:
  - All CFTC-regulated swaps, amounting to over 95% of the notional value of the OTC derivatives markets, are now reported to trade repositories if a U.S. person or non-U.S. affiliate swap dealer is a party to the trade.
  - 100% of all mandated interest rate and credit default swaps are centrally cleared, amounting to over 88% of the notional volume of OTC interest rate derivatives and over 83% of the notional volume of index credit default swaps;
  - Trading on CFTC-registered SEFs amounts to over 57% of the notional volume of OTC interest rate derivatives and over 79% of the notional volume of index credit default swaps; and
- New non-cleared swaps between financial entities has been secured by daily mark-to-market, or variation margin, preventing the buildup of unsecured exposure over time and thereby significantly mitigating systemic risk.
- Entities engaged in certain levels of swaps dealing are required to register as a swap dealer and, as such, become subject to risk management, capital and customer protection requirements, among others.
- In addition, the SEC has proposed rules addressing each of the key Title VII reforms and finalized rules governing the reporting of security-based swaps and the registration and regulation of security-based swap dealers.
Equities

The U.S. equity markets are the largest in the world. In addition, the U.S. equity markets continue to be the deepest, most liquid and most efficient in the world, with investors enjoying narrow spreads, low transaction costs and fast execution speeds.

Representing $32 trillion, which is about 38% of the $85 trillion in global equity market cap.

Key developments:

- Establishment of the Limit Up-Limit Down Mechanism (LULD) in 2012 addressed market volatility by preventing trades from occurring outside of a specified price band, which is set at a percentage level above and below the average price of the stock over the immediately preceding five-minute trading period. If the stock price does not naturally move back within the price bands within 15 seconds, there is a five-minute trading pause.
- Adoption of Regulation Systems Compliance and Integrity (Regulation SCI) by the SEC in 2014 to reduce the occurrence of systems glitches and other issues; improve resiliency when systems issues do occur; and enhance regulatory oversight and enforcement of market technology infrastructure.
- In 2018, the SEC adopted amendments to Regulation ATS to enhance transparency of ATS operations that trade NMS stocks, requiring public disclosure of information about and activities of the broker-dealer operating the ATS and how the ATS is operated. The new ATS rules take effect in early 2019.
Market Infrastructure

Modernized Market Infrastructure is critical for the U.S. to maintain a leadership position in global capital markets. Efficient and highly dependable clearing and settling, trading, market resiliency and investor protections are key focuses post financial crisis. Financial service industry participants continue to meet new challenges in key areas like cyber security and evolving technologies.

Key developments:

- In April 2012, CPMI- IOSCO published Principles for Financial Markets Infrastructure (PFMI), a set of 24 high-level principles, which set minimum recommended standards for the operations of Financial Markets Infrastructure (FMI). The principles were developed to strengthen FMI systems and reduce risk in the system.
- The U.S., along with Canada, Mexico, Peru and Argentina shortened the settlement cycle for equities, corporate bonds, municipal bonds and related products to T+2 on September 5, 2017 aligning with other major markets and substantially reducing settlement and systemic risk and increasing capital and operational efficiencies.
- Industry participants working with regulators and policy makers around the globe created and adopted the use of a Legal Entity Identifier (LEI) as a key risk identification and process efficiency tool. Currently there are approximately 1.2 million LEIs issued globally.
- In 2017, the U.S. Securities and Exchange Commission adopted Rule 613 Consolidated Audit Trail (CAT) in response to the 2010 flash crash to enable regulators to reconstruct market dislocation, identify market manipulators and detect insider traders. Industry Participants continue to collaborate on the development and implementation of the CAT.
- Cyber Security has become an increasingly important priority for financial services and the public sector due to the frequency, sophistication and number of cyber-attacks against the industry. The securities industry is working together to respond to this risk, through development of information sharing to protect against threats, incident response procedures, and industry exercises to test readiness to respond.
Municipal Bond Market

Municipal bonds are issued by state and local governments, agencies and authorities. Munis often represent investments in state and local government projects that have an impact within communities, including schools, highways, hospitals, housing, sewer systems and other important public projects.

Key developments:

- The Municipal Securities Rulemaking Board (MSRB) in 2009 implemented the Short-Term Obligation Rate Transparency (SHORT) System. The system collects and disseminates rates for Variable Rate Demand Notes and the limited number of remaining Auction Rate Securities, two areas of the market lacking in transparency in 2008.

- Implementation of a new regulatory scheme for municipal advisors (MAs), consultants who advise state and local governments on bond issuance and other financial transactions. Today MA’s are subject to a robust set of SEC and MSRB regulations.

- Implementation of a new regulatory scheme for over-the-counter derivatives. There are special protections built into the regulatory structure for state and local governments that engage in swaps and other derivatives.

- The MSRB put in place a best execution rule for transactions with individual investors, providing an additional layer of protection for municipal bond investors.
The repo market is a cornerstone of the financial system and is a fundamental contributor to the overall resiliency, risk mitigation activities and efficiency of financial markets. Both private market participants and central banks and regulators rely on the safety, liquidity and efficiency of this market to underpin market activities and implement official sector goals. U.S. Treasury securities are debt instruments issued by the U.S. government to fund governmental operations and are backed by the full faith and credit of the U.S. government.

The repo market for Treasury securities involves over $2.8 trillion in daily turnover. The tri-party repo market represents $1.8 trillion of that total and has been growing in recent years from a low of about $1.2 trillion in daily turnover.

The U.S. Treasury is expected to issue over $1 trillion in marketable debt this fiscal year with an additional $1.4 trillion expected in fiscal 2019. The record year for Treasury issuance was 2009 when over $1.8 trillion was issued.

Key developments:

- Triparty repo reform all but eliminated intraday extensions by the clearing banks of credit to market participants. In addition, better practices around settlement and trade confirmation were developed and contributed to the robustness of this market.
- Settlement fails in both the cash and repo markets are down substantially reflecting industry’s implementation of the Treasury Market Group’s fails charge best practice recommendation.
- In light of the 2014 “flash rally” in the U.S. Treasury market, the office sector now has a more comprehensive view of the secondary market in Treasuries. In July 2017, FINRA member firms began transmitting information on secondary market transactions to FINRA through the TRACE reporting engine. This will aid the official sector’s view of these markets and will allow for early warning for building risks. The Office of Financial Research is expected to mandate a collection of certain repo data within the next few months. This too will contribute to the overall resiliency of the market and will allow supervisory insight into market activity.
- Study continues around the 2014 “flash rally” and overall changes in market structure. The study has identified new types of market participants and a significant move to the electronification of the Treasury market.
- Treasury Market Practice Group recommendations covering fails, handling of large positions, handling of confidential information, automated activity and clearance/ settlement risks have been implemented over the last 10 years.
Securitization Markets

Securitizations, such as mortgage-backed securities and asset-backed securities, are bonds issued by a variety of entities – including but not limited to banks, broker-dealers, finance companies, and state and local authorities - that provide funding for mortgage, student, and auto loans, as well as funding to small and medium size businesses and local governments.

$2.6 trillion of securitizations were issued in 2017, of which $2.0 trillion funded mortgage lending.

$101.2 billion of auto loan securitizations were issued in 2017.

Nearly 67 of mortgage lending was funded by securitization in 2017.

Key developments:

- Implementation of risk retention rules, issued by the banking regulators along with the SEC and FHFA, require issuers of securitization bonds to retain a portion of what they issue in order that they remain exposed to the risks of the products they are funding
- Regulation AB 2, promulgated by the SEC, implemented sweeping new disclosure requirements for securitized products, including significant new asset-level disclosure requirements
- Expansion of TRACE reporting requirements by FINRA, the regulator of broker-dealers, to securitized products provides for transparency into pricing and other trade information in what were formerly less transparent markets