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SEC Proposes Central Clearing Rules for US Treasury Security Transactions: ICI Member Call on Thursday, October 6 at 3:00 p.m. (ET)

[34299]

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TO: Fixed-Income Advisory Committee
Money Market Funds Advisory Committee
SEC Rules Committee RE: SEC Proposes Central Clearing Rules for US Treasury Security Transactions: ICI Member Call on Thursday, October 6 at 3:00 p.m. (ET)

On September 14, the SEC proposed rules that would mandate the clearing and settlement of certain secondary market transactions in US Treasury securities in which one of the counterparties is a direct participant of a covered clearing agency for such securities ("Treasury CCA").[1] As detailed further below, the SEC also proposed (i) rules to facilitate greater access for indirect participants (i.e., customers) to a Treasury CCA's clearing and settlement services; (ii) rules to collect and hold customer margin for Treasury transactions in a segregated manner from a direct participant's own required margin; and (iii) amendments to the Customer Protection Rule to allow broker-dealers, with certain conditions, to include required customer margin as a debit in the Customer Reserve Formula.[2] The SEC describes the proposal as "incremental steps," that are intended to strengthen risk management at a Treasury CCA and bring the benefits of central clearing and settlement to a potentially significant portion of the US Treasury market.

The SEC has not proposed a specific compliance date for these requirements, but instead requests comment on an appropriate timeframe.

Comments are due 60 days after the proposal is published in the Federal Register. We will hold a Zoom member call on Thursday, October 6 at 3:00 p.m. (ET) to discuss the proposal.

Clearing Mandate for Certain US Treasury Security Transactions

The proposed rules would mandate central clearing of certain Treasury security transactions to a Treasury CCA by requiring a Treasury CCA to have policies and procedures requiring its direct participants[3] to submit for clearing and settlement all "eligible

secondary market transactions" to which they are a counterparty. These transactions include:

- repo and reverse repo agreements in which a direct participant is a counterparty;
- Treasury security cash transactions involving an interdealer broker (IDB) acting in a riskless principal capacity;
- purchases and sales of cash US Treasury securities between a direct participant and a counterparty that is a (i) registered broker-dealer; (ii) government securities dealer, or government securities broker; (iii) a hedge fund;[4] or an account at (i) or (ii) that can take on significant leverage.[5]

The proposal does not apply to (i) transactions in the primary market nor (ii) "when-issued" transactions that occur before and on the day of a Treasury auction.

The SEC proposes several exceptions to the mandate. The proposal specifically excludes any Treasury transaction (both cash Treasuries and repo) in which the counterparty to the direct participant is a central bank, sovereign entity, international financial institution, or a natural person. The SEC also specifically notes that the proposal would exclude cash Treasury transactions involving buy-side participants that do not assume significant leverage, such as most bond mutual funds.[6] Among other reasons, the SEC states that such participants typically do not have existing infrastructure to readily connect to the Treasury CCA, which would make their upfront costs significantly higher than other participants. However, the SEC asks whether it should expand the scope of the proposed mandate for cash Treasury transactions to specifically include transactions between a direct participant and a registered investment company, a money-market fund, or other buy-side entity.[7]

The proposal identifies the market participants that the SEC believes would be affected by the proposal, such as FICC Sponsored Members that consist of "many" money market funds, other mutual funds, and a "smaller" number of ETFs.[8] The proposal also states that non-Sponsored Members that are registered investment companies—money market funds, mutual funds, and ETFs—would be potentially affected. For example, the SEC notes that money market fund investments in Treasury repo (bilateral and triparty) amounted to approximately $2.3 trillion in June 2022, of which $63 billion was centrally cleared through FICC's Sponsored Program.[9]

The SEC cites several perceived risk reduction benefits to increased central clearing and emphasizes its belief that the high quality and credit status of US Treasury securities does not necessarily eliminate the potential risk in the event of a counterparty default. These benefits include:

- reduced operational and liquidity risk through greater multilateral netting of transactions, which could ease bank capital and leverage requirements by increasing balance sheet capacity to enhance dealer market making capacity;[10]
- increased regulatory transparency into settlement risk, particularly in the "often opaque" repo market, which would allow a Treasury CCA to identify concentrated positions and crowded trades, and adjust margin requirements;[11]
- centralized default management, which would enable orderly handling of a counterparty default and reduce uncertainty about exposures across market participants; and
- mitigation of "contagion risk" to the Treasury CCA posed by transactions involving IDBs that are currently not submitted to central clearing;

Further, the SEC believes that lower counterparty credit risk—and potentially lower intermediation costs—could result in narrower spreads, which would enhance market quality by enhancing competition in liquidity providers and support movement to all-to-all trading, even potentially in the repo market.

The SEC requests comment on many aspects of the proposal, including whether there are any impediments to increased clearing by indirect participants. The SEC also requests comment on the scope of the proposed mandate, including it should apply to:

- all secondary market cash Treasury transactions with a direct participant;
- cash transactions with a direct participant that also has repo/reverse repo transactions;
- transactions that meet a certain volume or account size; and/or
- securities lending transactions.

The SEC further asks whether the mandate should be limited to either bilateral or triparty repo, in part due to differences in prevailing haircuts or collateral requirements and/or whether inter-affiliate transactions be excluded.

Treasury Customer Margin Requirement

In conjunction with the proposed mandate, the SEC proposes to prohibit netting between proprietary and customer positions with respect to margin. Therefore, a direct participant would be required to calculate, collect, and hold margin for its proprietary positions separately from the margin calculated and collected for transactions by an indirect participant (customer). The SEC notes that existing margin requirements[12] provide a CCA with flexibility in administering its own margin methodology and do not specifically address margin for US Treasury security transactions (both cash and repo).[13] As proposed, however, a Treasury CCA would need to ensure moving forward that separation exists between proprietary and customer margin that is submitted by a direct participant.[14] The SEC states that this proposed approach is intended to improve Treasury CCA risk management, in part by allowing for better identification of potential risks and requiring collection of margin specific to customer transactions.

The SEC emphasizes, however, that the proposed approach is flexible in certain respects. The proposal does not require direct participants to collect a specified amount of customer margin, nor does it require customer margin be calculated in a specific manner, i.e., on a gross or net basis.[15] Further, the SEC states that it is not proposing to require any specific method for margin segregation, e.g., a legally segregated, operationally commingled ("LSOC") approach.[16]

The SEC seeks comment on the proposed requirement, including:

- whether customer margin to be determined on a gross (as opposed to net) basis;
- whether requirements such as LSOC bring costs or benefits to the market;
- whether the proposed requirement would support or not support the expanded use of cross-margining agreements; and
- how additional requirements with respect to customer margin would interact with SIPA and the Bankruptcy Code in the event of a broker-dealer default.

Access to Treasury CCA Services

The SEC further proposes to require a Treasury CCA to ensure that it is providing

appropriate means to facilitate access to its clearing and settlement services, including for indirect participants. The SEC says that while there are various access models for clearing that currently exist, these models may not meet the needs of the many different types of market participants who transact with direct participants.[17] Therefore, the SEC believes that that the proposed rule is needed to ensure that more transactions by indirect participants could be submitted to comply with the proposed clearing mandate.

The rule is intended to compel a Treasury CCA to review its indirect access models and make changes to provide access in as flexible a means as possible.[18] To ensure that it considers a sufficiently broad set of perspectives, the SEC states that a Treasury CCA generally should consult a wide range of stakeholders, including indirect participants.

The SEC requests comment on the proposed requirement, including:

- whether the Investment Company Act or the Investment Advisers Act would preclude funds or their sponsors from becoming direct participants of a Treasury CCA; and
- whether there are changes to existing indirect participation models that could help increase participation, including whether a direct participant should be required to submit for clearing a transaction between two other indirect participants.

Amendments to Customer Protection Rule

The SEC proposes to amend Rule 15c3-3a—the Customer Protection Rule—to permit margin required and on deposit at a Treasury CCA to be included as a debit item in the Customer Reserve Formula, subject to certain conditions.[19] The SEC emphasizes that this debit would be limited to customer margin amount actually required (and not in excess of[20]) and on deposit at the Treasury CCA. According to the SEC, this would ensure that there are resources that can be used to meet the Treasury CCA's margin requirements arising from the proposed clearing mandate. However, this would also be subject to several conditions that must be met by a broker-dealer:

- the customer margin is in the form of cash or Treasury securities and is being used to margin customer positions that are cleared, settled, and novated at the Treasury CCA;
- the broker-dealer must (i) use customer assets exclusively to meet the required customer margin; (ii) use a particular customer's assets exclusively to meet the margin required that arises from that customer's cleared Treasury security positions; and (iii) have delivered the customer's assets to the Treasury CCA;
- the customer margin must be treated in accordance with Treasury CCA rules designed to protect and segregate customer margin;[21] and
- the SEC has approved the Treasury CCA's rules that meet the conditions above for adding customer margin as a debit.

The SEC requests comment on the proposed requirement, including:

- how the definition of "excess margin securities"—currently defined under Rule 15c3-3 in part as securities carried for a customer account that have a market value in excess of 140% of the total debit balances in the customer's account—should be applied to cleared repo and reserve repo agreements?
- Whether the SEC should adopt further measures to protect customer cash and Treasury securities used to meet the customer margin requirement of the Treasury CCA, such as rules in the case of insolvency of the CCA.[22]

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Notes

[1] Standards for Covered Clearing Agencies for US Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to US Treasury Securities, Exchange Act Release No. 34-95763 (Sept. 14, 2022) ("Proposal"), available at https://www.sec.gov/rules/proposed/2022/34-95763.pdf. Many of the proposed rules are construed as requirements that a Treasury CCA must implement in their rules, policies, and procedures.

[2] See infra note 19 for a description of the Customer Reserve Formula.

[3] Direct participants, or "members," access a Treasury CCA directly and generally include banks and broker-dealers. Indirect participants, such as Sponsored Members of FICC's Sponsored Service, "rely" on direct participants to access the Treasury CCA's services. The SEC notes that the Fixed Income Clearing Corporation (FICC) is currently the only provider of clearance and settlement services for US Treasury securities.

[4] The proposal utilizes the definition of a "hedge fund" as defined in Form PF. The SEC notes that hedge funds are specifically included because (i) they engage in trading strategies that may pose heightened risks of potential financial distress to their counterparties, including direct participants of a Treasury CCA. It also notes that hedge funds are increasingly large players in the US Treasury market and "materially contribut[ed] to Treasury market disruption [in March 2020 as sellers]." Proposal at 57.

[5] "Significant leverage" means that the account may borrow in excess of half of the value of the account or may have gross notional exposure of transactions in the account that is more than twice the value of the account. The SEC states that this category is specifically intended to cover transactions with prime brokerage accounts, which may hold assets of entities (e.g., private funds or SMAs) and use leverage or engage in trading strategies that may pose a risk to the Treasury CCA and the broader financial system.

[6] Proposal at 235.

[7] Proposal at p. 87.

[8] Proposal at 179-80.

[9] Proposal at 50 n.128.

[10] The SEC cites data suggesting that additional central clearing may have lowered dealers' daily settlement obligations in the cash market by 60% in the run-up and aftermath of the March 2020 US Treasury market disruption and reduction settlement obligations by 70% during the disruption itself. Proposal at 73-74. For the repo market, the SEC cites estimates that additional central clearing for dealer-to-client repo transactions would have reduced dealer exposure from US Treasury repos by over 80% (from $66.5 billion to $12.8 billion) in 2015. Proposal at 74 n.185.

[11] The SEC believes that risk management in bilateral repo clearing is not uniform and transparent, leading to competitive pressures that increase risk. Subjecting those

transactions to mandatory clearing would impose risk management, etc. standards, including margin requirements. For example, the SEC cites its understanding that transactions between dealers and institutional customers are subject to a "variable 'good faith' margin standard," which can often result in fewer financial resources collected to margin exposures that what would otherwise be collected in a CCP-based model. Proposal at 49.

[12] See Proposal at 95 n.201 (citing SEC Rule 17Ad-22(e)(6)).

[13] The SEC notes that direct participants' positions between one another are currently netted into a single payment obligation to or from the Treasury CCA. For a dealer-to-client transaction, however, FICC novates the transaction and becomes a counterparty to the direct participant that submitted the trade, but it does not have a direct relationship with the client. Nevertheless, FICC margins the transactions in the direct participant's account on a net basis, allowing any of the transactions of the participant's own accounts to net against transactions by the participant's customers. Proposal at 95-96.

[14] The SEC states that the calculation and collection of margin between a direct participant and its customers would be based on other applicable regulations and bilateral negotiation between the member and its customer, where applicable. Proposal at 98.

[15] For example, under a netted approach, a Treasury CCA could collect a single amount for each direct participant's customer account as a whole, i.e., netting each customer's margin against that of other customers within an omnibus customer account. A Treasury CCA, however, would need to calculate margin on a gross basis and a broker-dealer would have to deliver that margin on a gross basis for the broker-dealer to include customer margin as a debit in the Customer Reserve Formula pursuant to the SEC's customer protection rule under Rule 15c3-3. See infra note 21. The SEC also notes that given FICC's status as a systemically important financial market utility, changes to programs that enable indirect participants to clear or changes to margin methodologies or practices may need to be filed as advance notices, to the extent that these changes materially impact the nature or level of risk presented by that CCA. Proposal at 94.

[16] While the SEC notes that this is the approach for derivatives clearing organizations regulated by the CFTC, it is not the approach for other clearing agencies that facilitate clearing in cash securities and listed options. The SEC further notes that cash securities and listed options markets are already protected under the Securities Investor Protection Act (SIPA), which acts to protect customer securities and funds at a participant broker-dealer. Proposal at 100-101.

[17] For example, the SEC notes that indirect participants have cited instances where a sponsoring member (direct participants) will not submit transactions for sponsored members (indirect participants) unless they are a counterparty to that transaction. Further, the SEC highlights arrangements where clearing services are bundled with trading and execution services within a single entity that is a direct participant of the Treasury CCA. Proposal at 102.

[18] SEC Rule 17Ad-22(e)(18) currently requires a CCA to establish, implement, and maintain and enforce written policies and procedures reasonably designed to establish objective, risk based and publicly disclosed participation criteria, which permit fair and open access by direct, and where relevant, indirect participants.

[19] The Customer Protection Rule is designed to protect customers of a broker-dealer by requiring the broker-dealer to segregate their securities and cash from the broker-dealer's own proprietary business activities. The rule further requires the broker-dealer to calculate what amount, if any, it must deposit on behalf of customers in a reserve bank account under the formula set forth in Rule 15c3-3a ("Customer Reserve Formula"). The Customer Reserve Formula generally requires a broker-dealer to calculate any amounts it owes its customers and the amount of funds generated using customer securities ("credits") and compare this amount to any amounts its customers owe to the broker-dealer ("debits"). If credits exceed customer debits, then the broker-dealer must deposit that net amount in the reserve bank account.

[20] The SEC says that this limitation is designed to protect a broker-dealer from artificially increasing the debit amount by depositing cash and securities that are not needed to meet a margin requirement resulting from customers' Treasury security positions. Proposal at 112.

[21] This condition consists of several components. First, a Treasury CCA must have rules to perform a separate customer margin amount for each customer of the broker-dealer and that the broker-dealer must deliver the amount for each customer on a gross basis. Second, the customer margin is invested in Treasury securities of one year or less. Third, the customer margin must be held in an account of the broker-dealer at the Treasury CCA that is segregated from any other account of the broker-dealer at the CCA, along with account designation, a written notice requirement, and a written contract requirement designed to alert creditors of the broker-dealer and the CCA that the assets in that account are not available to satisfy any potential claims they may have. Fourth, the customer margin must be held by the CCA itself or either at a US Federal Reserve bank or a bank insured by the FDIC. Fifth, customer margin that is no longer needed to meet a current customer margin requirement must be returned to the broker-dealer by the close of the next business day after the day in which the margin is no longer needed.

[22] For example, the SEC suggests that those securities could be held at a third-party bank. Proposal at 125.
