MEMO# 34453

November 30, 2022

ICI Draft Letter on SEC Proposal Regarding Central Clearing of US Treasury Transactions – Your Comments Requested by December 7

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TO: Fixed-Income Advisory Committee
Money Market Funds Advisory Committee
SEC Rules Committee RE: ICI Draft Letter on SEC Proposal Regarding Central Clearing of US Treasury Transactions – Your Comments Requested by December 7

On September 14, the SEC proposed rules ("Proposal") 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] The Proposal also includes (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 Rule 15c3-3 under the Securities Exchange Act of 1934, the Customer Protection Rule, to allow broker-dealers, with certain conditions, to include required customer margin as a debit in the Customer Reserve Formula.

ICI, with the assistance of our counsel at Willkie Farr & Gallagher, has prepared the attached draft comment letter in response to the Proposal. Comments on the Proposal are due December 27, but ICI plans to file our comment letter by Friday, December 23. Please provide your written comments no later than Wednesday, December 7 to Sarah Bessin at sarah.bessin@ici.org. We expect to hold a members-only call to discuss comments on the draft letter on Friday, December 9, from 3-4 pm ET. We will provide more information about that call. Following receipt of your written comments, we plan to circulate a revised draft of the letter for your final review. ICI's draft comment letter is summarized briefly below.

ICI's letter explains that regulated funds ("funds") and their advisers are among the most significant investors in US Treasury markets, including the Treasury repo markets. The Proposal would require funds to face a clearinghouse, either directly or indirectly, when entering into US Treasury repo and reverse repo transactions with a qualified netting member of FICC's Government Securities Division (GSD).

ICI supports measures that enhance the integrity, quality, and efficiency of the US Treasury markets. We urge the Commission to carefully evaluate whether the current framework utilized by funds for clearing repo and reverse repo—FICC's Sponsored Service—could realistically support mandated central clearing by funds and other market participants. In our view, the proposed repo clearing requirement is premature and considerable work is needed to achieve a more viable clearing infrastructure. At a minimum, this work includes ensuring that FICC's Sponsored Service will operate in a manner that achieves the SEC's objectives for central clearing of repo and reverse repo transactions and addressing other key legal and operational issues that would limit funds' ability to adopt greater central clearing of Treasury repo and reverse repo. In addition, our experience is that there are a limited number of FICC members that are willing to participate in the Sponsored Service in light of the high capital, Clearing Fund and Capped Contingency Liquidity Facility (CCLF) contribution requirements, and operational complexities of sponsored clearing. More broadly, we urge the SEC to carefully weigh the benefits of additional Treasury repo and reverse repo clearing against the potential consequences to Treasury market structure and market participants, including the significant costs and burdens that a requirement to clear repo and reverse repo would impose on funds and their investors.

ICI also cautions the Commission to be mindful of the fact that FICC is currently the only provider of clearance and settlement services for US Treasury securities, and thus, the Proposal would contribute to a further concentration of risk within a single clearing entity. Notwithstanding FICC's experience with Treasury central clearing, which has been growing but remains limited to date, requiring significant additional central clearing of Treasury transactions will be costly, and will expose FICC to greater counterparty risk and substantially more market participants. Before mandating clearing of a substantial portion of all Treasury transactions, the Commission should take steps to further identify and quantify the nature of and potential effect of these new participants' activities on FICC's risk profile and the cost structure.

We also concur with others that enhanced central clearing would not address the core structural issues with the current Treasury market, including concerns about diminished liquidity in the Treasury market in recent years. We therefore recommend that policymakers focus on other efforts that may be more directly impactful in promoting Treasury market liquidity and, in turn, Treasury market resiliency. These measures include, among others, modifying the supplementary leverage ratio (SLR) and promoting the expansion of "all-to-all" trading.

ICI asserts that funds should not be subject to a Treasury clearing mandate. We strongly urge the Commission to not expand the proposed cash Treasury clearing mandate to include funds' cash Treasury transactions because doing so would not further the objectives of the mandate and the considerable costs of being required to clear cash Treasury transactions would outweigh the limited benefits. We explain that it would be premature for the Commission to impose a requirement to increase central clearing of Treasury repo and reverse repo transactions. Compliance with a such a requirement would effectively require funds transacting Treasury repo or reverse repo with a FICC netting member to submit the transaction through FICC sponsored clearing. Most, if not all, funds that centrally clear Treasury repo and reverse repo do so through FICC sponsored clearing, in part because it may not be possible for them to satisfy the FICC netting membership standards. In light of this limitation, we urge the Commission to further evaluate what changes may be necessary to FICC's sponsored clearing program, and relevant regulatory requirements applicable to funds and other market participants, to support mandated central clearing of repo and reverse repo transactions.

The letter highlights ICI's concerns about the implications for funds of a Treasury repo clearing mandate, including:

- Protection of fund assets – repo clearing should not be mandated for funds until the Commission can provide clarity and certainty on key issues relating to the protection of fund assets, including providing or facilitating any necessary relief. These issues include treatment of funds' cleared repo transactions in bankruptcy, ensuring that funds can meet 1940 Act custodial requirements when engaging in cleared repo and reverse repo transactions, and protecting funds' margin associated with repo and reverse repo transactions.
- Diversification requirements – whether a repo clearing mandate would impede the ability of funds to satisfy diversification requirements under Rule 5b-3 under the 1940 Act, Rule 2a-7 (for money market funds), and tax diversification requirements under the Internal Revenue Code. We also raise concerns that a Treasury repo clearing requirement would adversely affect money market funds' credit ratings.

We emphasize that, absent additional regulatory relief, as described in the letter, the Proposal, if adopted, would restrict and in many cases prohibit funds from participating in the repo and reverse repo markets.

The letter explains that, in proposing a Treasury repo clearing requirement, the Commission's anticipated benefits appear to be premised in large part on FICC direct clearing and the characteristics of Treasury trading in certain markets, e.g., the interdealer market. Funds, however, as a practical matter, are limited to engaging in cleared repo through FICC sponsored clearing, which differs in certain key respects from FICC direct clearing. Accordingly, we question whether sponsored repo clearing in its current form would fully yield the key risk mitigation and liquidity benefits that the SEC anticipates and urge the Commission to further analyze FICC's repo clearing infrastructure and engage with FICC regarding potential changes to its clearing models that may be necessary to support a repo clearing requirement. The letter details our concerns in this regard, as well as concerns about capacity constraints raised by the sponsored clearing programs and highlights the significant costs that a repo clearing mandate would impose on funds and their investors.

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Notes

[1] For a summary of the Proposal, please see ICI Memorandum No. 34299 (Sept. 29, 2022), available at https://www.ici.org/memo34299. The Fixed Income Clearing Corporation (FICC) is the only existing Treasury CCA.