

MEMO# 34718

December 23, 2022

ICI Files Comment Letter on SEC Proposal Regarding Central Clearing of US Treasury Transactions

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TO: ICI Members
Fixed-Income Advisory Committee
Investment Advisers Committee
Money Market Funds Advisory Committee
SEC Rules Committee SUBJECTS: Bank Regulation
Compliance
Fixed Income Securities
Investment Advisers
Money Market Funds
Tax
Trading and Markets RE: ICI Files Comment Letter on SEC Proposal Regarding Central Clearing of US Treasury Transactions

On December 23, ICI filed a comment letter with the Securities and Exchange Commission on its 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.[\[1\]](#) Our comment letter is attached and is summarized below.

As discussed in Section III of ICI's letter, we agree with the Commission's proposed decision to not apply any cash Treasury clearing mandate to funds' transactions. We urge the SEC, in any final rules, to explicitly exempt funds from any cash Treasury trading mandate. Such a requirement would not further the Commission's regulatory objectives and, instead, would result in considerable costs and burdens to funds, which would have to build out an entire new clearing infrastructure. These costs would be indirectly borne by fund investors. In addition, we urge the Commission to exclude from the cash Treasury clearing mandate transactions by market participants, including funds, conducted through Treasury trading platforms (i.e., interdealer brokers). These trading platforms provide all-to-all access and are an important source of liquidity for funds and other investors. We do not believe that the benefits of exposing transactions between direct clearinghouse members and non-

members to clearing outweigh the risks of reducing all-to-all trading and the attendant liquidity these platforms provide to funds and the market more generally.

As discussed in Section IV, it is premature for the SEC to mandate clearing of funds' Treasury repo and reverse repo transactions because the current clearing framework is not sufficiently developed to support such a mandate. Most, if not all, funds that centrally clear Treasury repo and reverse repo transactions must, as a practical matter, do so through FICC's Sponsored Service due to regulatory restrictions that hinder their ability to engage in direct clearing. Therefore, before clearing can be mandated for funds' Treasury repo and reverse repo transactions, the SEC and FICC must further analyze and make regulatory changes necessary to address specific limitations to which funds are subject under the 1940 Act, changes that may be necessary to FICC's sponsored clearing program, and other legal and operational issues that are raised by a Treasury repo clearing requirement. Once these changes are made, the SEC should provide an opportunity for demand for Treasury repo central clearing to continue to develop organically before imposing a clearing mandate applicable to funds. Our key recommendations include:

- The SEC should encourage FICC to enhance its Sponsored Service to meet the increased demand that would be created by a clearing mandate for Treasury repo and reverse repo, including further developing a "give up" access structure to facilitate best execution and providing a means for funds to directly post margin, consistent with the limitations of the 1940 Act. Section IV.B.
- The SEC should provide relief confirming that FICC may serve as a "securities depository" and may hold fund margin for purposes of the 1940 Act's custody provisions. Section IV.C.
- To protect fund assets, FICC GSD rules addressing margin posting should be amended to provide for enhanced recordkeeping, internal controls, and transparency regarding positions and related margin. ICI supports further enhancements to SEC and FICC GSD rules to ensure that customer margin is subject to the highest level of protection and, if an omnibus custody structure is permitted for FICC to hold customer assets, require an approach in which assets are "legally segregated, operationally commingled" (LSOC) to ensure protection of fund assets. Section IV.D-E.
- The SEC and FICC must clarify critical aspects regarding the default closeout process treatment in bankruptcy of funds' positions as sponsored members in FICC's Sponsored Service under a repo clearing mandate. Such clarification must address, among other issues, funds' closeout rights, as sponsored members, and their ability to continue to participate in FICC's Sponsored Service, such as through a replacement sponsoring member, in the event of a sponsoring member's insolvency. Section IV.F.
- The SEC must address the implications of a clearing mandate for funds' regulatory diversification requirements. The SEC should confirm that any repo clearing offerings made available by FICC to registered funds under the proposed clearing mandate would continue to satisfy the 1940 Act's diversification limits and that, under the proposed clearing mandate, cleared reverse repo transactions could be entered into by registered funds without application of diversification limits under the 1940 Act. As the SEC recognizes, for similar reasons, a repo clearing mandate also may adversely affect the credit ratings of money market funds—we urge the SEC to address this issue in any final rules. Section IV.I.
- The SEC should exempt from any repo clearing mandate applicable to funds tri-party repo so that funds—in particular, money market funds—continue to have the ability to sweep cash into Treasury securities on a short-term basis in the event cleared facilities are at capacity. Section IV.H.

In Section V, we explain that the benefits the Commission anticipates for central clearing of Treasury repo and reverse repo transactions appear to be premised in large part on the FICC direct clearing model and the characteristics of Treasury trading in certain markets (e.g., the interdealer market). Funds, as a practical matter, are limited to engaging in cleared repo through the FICC Sponsored Service, which differs in certain key respects from FICC direct clearing. Accordingly, we do not believe that sponsored repo clearing in its current form would yield the key risk mitigation and liquidity benefits that the SEC anticipates and urge the Commission to further analyze FICC's sponsored repo clearing infrastructure and engage with FICC regarding potential changes to its clearing models that may be necessary to support a repo clearing requirement.

In Section VI, we explain that requiring that funds' repo and reverse repo transactions be subject to central clearing would impose significant costs on funds and their investors. In Section VII, we raise concerns that, under a clearing mandate, FICC's Sponsored Service may be subject to capacity constraints that would impede the ability of funds to engage in repo and reverse repo transactions.

Finally, in Section VIII, we urge the SEC to propose a viable compliance schedule for any Treasury repo clearing mandate applicable to funds. We explain that the Commission has neglected to consider the extensive regulatory and structural changes that would be necessary if funds were required to centrally clear their Treasury repo and reverse repo transactions. We therefore recommend that any repo clearing mandate be rolled out in a staged manner and not apply to funds until at least 3 years after finalization of any necessary SEC and FICC GSD rules.

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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 covered clearing agency for Treasury securities.