

SEC Proposes Treasury Clearing Mandate

September 20, 2022

On September 14, 2022, the Securities and Exchange Commission (“**SEC**”) proposed amendments to (i) the standards applicable to clearing agencies that provide central counterparty services for transactions in U.S. Treasury securities (“**Treasury CCPs**”) and (ii) the broker-dealer customer protection rule, SEC Rule 15c3-3a, as it applies to margin posted for transactions in Treasury securities cleared by a Treasury CCP (the “**Proposal**”). These amendments would have broad impacts on Treasury CCPs and other participants in the market.

The Proposal would require a Treasury CCP to mandate that its clearing members that are “**direct participants**” (*i.e.*, members of a Treasury CCP that access a Treasury CCP without going through another clearing member) submit for clearing all “eligible secondary market transactions” (“**ESMTs**”). Generally, ESMTs include any repurchase (“**repo**”) or reverse repo transactions in Treasury securities entered into by a direct participant and purchases or sales (“**cash transactions**”) of Treasury securities entered into by a direct participant that is an interdealer broker (“**IDB**”) or by any direct participant with a counterparty that is a broker-dealer, government securities broker or dealer, hedge fund, or leveraged account.

The Proposal would also require a Treasury CCP to (i) calculate, collect, and hold margin for a direct participant’s proprietary Treasury securities transactions separately from the margin calculated and collected for the direct participant’s customer transactions and (ii) take steps to facilitate access by market participants to its clearance and settlement services.

Finally, the Proposal would amend SEC Rule 15c3-3a to permit broker-dealers to include a debit in the reserve formula for cash and Treasury securities posted by a customer to the broker-dealer and delivered by the broker-dealer to a Treasury CCP to meet a margin requirement with respect to such customer’s Treasury securities transactions, subject to a number of conditions.

Comments on the Proposal must be received on or before 60 days after publication of the Proposal in the Federal Register.

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KEY TAKEAWAYS

The Proposal is the latest and most significant effort by the SEC to address concerns about the stability and resilience of the U.S. Treasury market. If finalized, it would result in a dramatic increase in the number of Treasury securities transactions submitted for clearing, as well as changes to the operation of Treasury CCPs. In particular:

- Direct participants (*i.e.*, members of a Treasury CCP that do not rely upon the services of another clearing member to access a Treasury CCP) would have to submit ESMTs for central clearing.
 - The definition of ESMTs would encompass:
 - all repo and reverse repo transactions on Treasury securities entered into by a direct participant;
 - all cash transactions in Treasury securities of a direct participant acting as an IDB;
 - all cash transactions in Treasury securities between a direct participant and a broker-dealer, government securities broker, or government securities dealer; and
 - all cash transactions in Treasury securities between a direct participant and a hedge fund or an account that can take on significant leverage (*e.g.*, prime brokerage accounts).
 - Transactions entered into with central banks, sovereign entities, international financial institutions, and natural persons would be excluded.
 - Notably, the definition does not include securities lending transactions. However, the SEC is soliciting comments on whether securities lending transactions should be added to the ESMT definition in the final rule.
 - Further, the SEC clarified that the proposed mandate would only apply to transactions that the Treasury CCP makes available for clearing, and would not require a Treasury CCP to offer additional products for clearing.
- CCPs would be required to put in place policies and procedures to “identify and monitor” direct participants’ submission of ESMTs for clearing and discipline any failure of a direct participant to submit ESMTs for clearing as required.
- Treasury CCPs would have to collect and hold margin for transactions submitted by a direct participant on behalf of customers separately from margin for the direct participant’s proprietary transactions.
 - However, a Treasury CCP would be permitted to net multiple customer transactions of a direct participant against each other in calculating the direct participant’s margin requirement.
 - This is similar to the existing margin rules for listed options, but contrasts with the margin rules for futures and cleared swaps, which require that margin be calculated and collected for each customer on a gross basis.
- A Treasury CCP would need to have appropriate means to “facilitate access” by market participants to clearing ESMTs, including those of customers that are not direct participants in a Treasury CCP.

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- This would likely include an initial review by the Treasury CCP of its access models, consultations with a wide range of stakeholders, and annual reviews by the Treasury CCP's board of directors.
- The Treasury CCP would likely need to consider whether to adopt models that allow for the submission of ESMTs between two customers (rather than between a customer and a direct participant) as well as non-discrimination principles.
- Broker-Dealers would be able to include cash and Treasury securities margin required and on deposit with a Treasury CCP as a debit in the customer reserve formula, subject to certain conditions.
 - This would allow broker-dealers to collect such margin from customers and use that margin to satisfy the margin obligations arising from the customers' transactions. Currently, broker-dealers are required to finance such margin obligations with their own funds.
 - Among the conditions, discussed in more detail below, are that broker-dealers calculate margin separately for each customer and deliver margin for each customer on a gross basis, and that a Treasury CCP return excess customer margin to broker-dealers no later than the close of the next business day after the margin is no longer needed.
- Although the Proposal was approved unanimously, the Commissioners' statements suggested there is not agreement on every aspect of the Proposal. Commissioner Pierce noted that the Proposal might be taking a "considerably heavier hand to achieve the goals of central clearing than seems necessary." We expect comments will focus on whether less sweeping changes may be able to achieve the Commission's stated goals.

BACKGROUND

(1) The Treasury Market

The Proposal comes on the heels of a number of recent disruptions in the Treasury securities market, including:

- the “flash rally” of October 2014, when yields on Treasury bonds plunged, leading to sharp increases in prices;
- the September 2019 repo market disruptions, when repo rates accelerated dramatically amidst a large withdrawal of reserves from the banking system and the settlement of Treasury securities auctions, which generated a significant need for cash reserves; and
- the COVID-19 shock of March 2020, when market uncertainty caused a spike in volume in the market for Treasury securities, leading to intervention by the Federal Reserve.¹

Academics, regulators, and market participants have discussed and theorized a number of causes for these disruptions and potential solutions.² Some of these analysts have spotlighted the changing nature of the market, including an increased role of principal trading firms (“**PTFs**”), the use of IDBs, and a decrease in the proportion of transactions submitted for central clearing.

In November of 2021, Chairman Gensler described a number of steps the SEC may take to address these concerns, including requiring certain PTFs to register as dealers, subjecting IDBs to regulation under Reg ATS, and expanding central clearing of Treasury transactions.³ Earlier this year, the SEC released proposals to address the first two points.⁴ The Proposal aims to address the third issue.

¹ The Federal Reserve announced purchases of treasury securities to “support the smooth functioning” of the market. *Federal Reserve issues FOMC statement* (Mar. 23, 2020), available at [Federal Reserve Board - Federal Reserve issues FOMC statement](https://www.federalreserve.gov/newspapers/20200323a.htm).

² See e.g., Group of Thirty Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience* (2021), available at <https://group30.org/publications/detail/4950> (“G-30 Report”); TMPG, *White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities* (July 2019), available at

(2) Central Clearing of Transactions in Treasury Securities

Central clearing involves the novation of a transaction to the Treasury CCP, such that the Treasury CCP becomes the buyer to every seller and the seller to every buyer and guarantees settlement of the transaction. In the Proposal, the SEC notes that clearing improves the safety and efficiency of securities markets through multilateral netting, substitution of the Treasury CCP as buyer to every seller and seller to every buyer, standardized risk and default management, and enhanced transparency.

The Fixed Income Clearing Corporation (“**FICC**”), a subsidiary of the Depository Trust and Clearing Corporation, is the only existing Treasury CCP. Most of FICC’s direct participants are banks and broker-dealers. Many IDBs, which operate platforms that bring together multiple buyers and sellers and which become counterparty to each side of the trade executed on the platform, are also direct participants of FICC. FICC’s existing rules require that direct participants submit for clearing all eligible transactions between direct participants. However, no such requirement applies to trades between a direct participant and a customer that is not a direct participant.

Many IDB participants, such as some PTFs, as well as most investment funds, pension plans, and other buy-side institutions are not direct participants in FICC. These institutions may access central clearing services indirectly through FICC’s direct participants (e.g., through FICC’s sponsored member program) or may simply elect to settle their trades on a bilateral basis.

In the Proposal, the SEC noted that the share of uncleared secondary market transactions in Treasury securities has increased considerably over the past several years, with only 13 percent of the overall volume in Treasury securities transactions centrally cleared as of the first half of 2017.

https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_FinalPaper_071119.pdf.

³ *Prepared Remarks at U.S. Treasury Market Conference* (Nov. 17, 2021), available at <https://www.sec.gov/news/speech/gensler-us-treasury-market-conference-20211117>.

⁴ *SEC Proposes Amendments to Include Significant Treasury Markets Platforms Within Regulation ATS* (Jan. 26, 2022), available at <https://www.sec.gov/news/press-release/2022-10>; *SEC Proposes Rules to Include Certain Significant Market Participants as “Dealers” or “Government Securities Dealers”* (Mar. 28, 2022), available at <https://www.sec.gov/news/press-release/2022-54>.

The SEC argued that part of the reason for this is the increasing share of the market occupied by PTFs and the increased use of IDBs. The SEC, in particular, identified “hybrid clearing” situations in which a direct participant and PTF would execute a trade on an IDB platform, but only the resulting trade between the IDB and direct participant would be cleared, as creating risk.

The SEC said that the increasing volume of uncleared transactions in Treasury securities may increase the risk to FICC and the market more generally. This is because a default on uncleared trades involving a direct participant (e.g., an IDB) could spill over to FICC and FICC’s broader membership.

PROPOSAL

(1) Mandatory Clearing of ESMTs

Under the Proposal, Treasury CCPs would be required to adopt policies and procedures that require direct participants to submit for clearance and settlement all ESMTs to which they are a counterparty.

Notably, the SEC did not seek to regulate market participants directly by requiring them to submit ESMTs for central clearing; instead, the Proposal would rely on the SEC’s authority over CCPs and lead to the same result indirectly by requiring CCPs to mandate that its direct participants submit ESMTs for central clearing.

Subject to certain exclusions discussed below, the definition of ESMTs would be:

- **Repos:** repo and reverse repo agreements on Treasury securities in which one of the counterparties is a direct participant;
- **IDB transactions:** any cash transactions in Treasury securities where a direct participant brings together multiple buyers and sellers using a trading facility and is a counterparty to both the buyer and seller in two separate transactions; and
- **Other cash transactions:** any cash transactions in Treasury securities between a direct participant and a counterparty that is:
 - a registered broker-dealer, government securities dealer, or government securities broker;
 - a hedge fund; or

- an account at a registered broker-dealer, government securities dealer, or government securities broker with the ability to borrow an amount in excess of one-half of the net value of the account or to have gross notional exposure of the transactions in the account that is more than twice the net value of the account.

While the definition of ESMT would apply to all types of transactions that are currently accepted for clearing at a Treasury CCP, it would not impose a requirement on a Treasury CCP to offer additional products for clearing.

Repo and Reverse Repo Agreements

The SEC stated that, while the Treasury repo market plays a key role in facilitating the flow of cash and securities in the financial system, risk management practices in the non-centrally cleared repo market are not uniform or transparent. In particular, pressures in the bilaterally settled market for repo transactions have exerted downward pressure on haircuts (which serve to mitigate counterparty credit risk), sometimes to zero.

The SEC believes that increased central clearing in the repo market could lead to improved market liquidity and smooth market functioning (as a result of additional balance sheet capacity of banks and dealer counterparties), increase FICC’s visibility into its direct participants’ exposures under repo transactions, and reduce the potential contagion risk to FICC due to the cascading effects resulting from the default of a direct participant’s counterparty.

Thus, the SEC proposes to include all repo and reverse repo agreements in which one of the counterparties is a direct participant in the definition of an ESMT.

IDB Transactions

IDBs typically act as counterparty to transactions executed on their platforms. As a result, when two parties execute a sale on an IDB’s platform, there will be a transaction between the IDB and the buyer and a transaction between the IDB and the seller.

IDBs are typically direct participants of FICC, but some of their users, including PTFs, frequently are not. As a result, transactions executed on IDBs typically result in the “hybrid clearing” situation noted above, where two separate transactions result: (i) a transaction between the IDB and a bank or broker-dealer that is cleared, and (ii) a transaction between the IDB and the PTF that is not cleared. Accordingly, FICC manages the risks arising from the IDB-

dealer transaction, but is more limited in its ability to manage the risks arising from the IDB's offsetting transaction with the PTF and the potential counterparty credit risk and settlement risk arising for the IDB from that transaction.

Thus, under this model, FICC is indirectly exposed to the IDB's non-centrally cleared transaction. The SEC's inclusion of IDB transactions in the Proposal's definition of ESMT is intended to specifically address the potential for contagion risks associated with such hybrid clearing.

Market Intermediaries

The SEC believes that, due to the high trading volume in the secondary cash Treasury market by non-FICC members (which is estimated to exceed that of FICC members), such trading activity collectively could present contagion risk to FICC. Given the role that registered broker-dealers, government securities dealers, and government securities brokers play in effecting transactions in the secondary Treasury market, including transactions between direct participants and these market intermediaries in the proposed clearing mandate could materially expand the share of centrally cleared transactions in the secondary Treasury market.

The SEC stated that there should be fewer obstacles to the requirement that transactions between direct participants and market intermediaries be submitted for central clearing because these entities are already either part of or able to access the national system of clearance and settlement.

Hedge Funds

The Proposal would include cash transactions between direct participants and hedge funds in the definition of ESMTs due to the unique risks that the SEC believes hedge fund activities pose to the Treasury market.

First, the SEC noted that hedge funds generally can engage in trading strategies, including the use of leverage, derivatives, complex structured products, short selling, high volumes of trading and concentrated investment, which may pose a heightened risk of potential financial distress to their counterparties and the financial markets.

The SEC stated that as a general matter, if any of a hedge fund's activities, even those that are *not related* to the Treasury market, cause financial stress to a counterparty that is a direct participant, the inclusion of a hedge fund's Treasury securities cash transactions with a direct participant in the definition of ESMT should help ensure that such financial stress would not transmit to the Treasury CCP and through to the Treasury market.

Further, hedge funds are increasingly large players in the Treasury market, but only report clearing about 15% of their overall net asset value. The SEC also states that hedge funds materially contributed to the Treasury market disruption during the 2020 market volatility.

The Proposal would define hedge fund as any private fund (other than a securitized asset fund):

- with respect to which one or more investment advisers (or related persons of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses);
- that may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital) ("**Leverage Prong**"); or
- that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration) ("**Short-selling Prong**").

The Proposal's definition of hedge fund is consistent with that in Form PF. However, the SEC seeks comments on whether the definition should be narrower, *e.g.*, by limiting it to one of the three prongs of the proposed definition, by qualifying the Leverage Prong or the Short-selling Prong such that the fund must have actually engaged in leveraging or short selling, or by limiting to hedge fund of a certain size or managed by advisers of a certain size.

Accounts with Significant Leverage

The Proposal's definition of ESMT would also include cash transactions between direct participants and accounts at a registered broker-dealer, government securities dealer, or government securities broker that either may borrow an amount in excess of one-half of the net value of the account or may have gross notional exposure of the transactions in the account that is more than twice the net value of the account (e.g., prime brokerage accounts). This is intended to capture, and address contagion risks arising from, transactions with accounts used by family offices or separately managed accounts that may use strategies similar to those of a hedge fund.

Exclusions

The SEC included several exclusions from the Proposal's mandatory clearing requirements of ESMTs.

First, the Proposal would not apply to the primary market (i.e., the issuance and sale of a Treasury security to a primary dealer or other bidder in a Treasury auction), given the existing regulatory regime and the role of such transactions in directly financing the Federal government.

Second, Treasury securities start trading after the auction announcement but before the auction, and continue trading through issuance and afterwards. "When-issued" trading generally includes trading that occurs after announcement and prior to issuance. The Proposal would not apply to "when-issued" transactions that take place before and on the day of auction. The SEC considers these transactions as distinct from secondary market transactions, but has asked commenters for views on this question.

Finally, the definition of ESMTs would exclude transactions where a counterparty is:

- a central bank, i.e., a reserve bank or monetary authority of a central government (including the Board of Governors of the Federal Reserve System or any of the Federal Reserve Banks) and the Bank for International Settlements;
- a sovereign entity, i.e., a central government (including the U.S. Government), or an agency, department, or ministry of a central government;

During the SEC open meeting at which the Proposal was adopted, Commissioner Pierce asked the SEC staff whether the carve-out for sovereign entities would include sovereign wealth funds and the rationale for such exclusion. The staff noted that this was a particular issue on which they believed further comment would be helpful.

- an international financial institution, i.e., African Development Bank; African Development Fund; Asian Development Bank; Banco Centroamericano de Integración Económica; Bank for Economic Cooperation and Development in the Middle East and North Africa; Caribbean Development Bank; Corporación Andina de Fomento; Council of Europe Development Bank; European Bank for Reconstruction and Development; European Investment Bank; European Investment Fund; European Stability Mechanism; Inter-American Development Bank; Inter-American Investment Corporation; International Bank for Reconstruction and Development; International Development Association; International Finance Corporation; International Monetary Fund; Islamic Development Bank; Multilateral Investment Guarantee Agency; Nordic Investment Bank; North American Development Bank; and any other entity that provides financing for national or regional development in which the U.S. Government is a shareholder or contributing member; or
- a natural person.

Compliance Monitoring

The Proposal would require that Treasury CCPs implement policies and procedures to identify and monitor compliance of direct participants' submissions for clearing. The SEC notes that such policies and procedures could take a number of forms, including a possible attestation from direct participants. Further, Treasury CCPs would be required to have a means to address the failure of a direct participant to submit an ESMT for clearing as required (e.g., fines, limitation of activities, suspension, etc.).

(2) Margin Requirements for Centrally Cleared Treasury Securities Transactions

Currently, Rule 17Ad-22 does not address how a Treasury CCP should calculate, collect, and hold margin amounts for

Treasury securities transactions that a direct participant may submit on behalf of a customer.

Given the significant expansion of central clearing if the Proposal's mandatory clearing requirements were adopted, the Proposal would also require Treasury CCPs to adopt policies and procedures to:

- calculate margin amounts for all transactions submitted by a direct participant on behalf of customers separately from the margin that is calculated for transactions that the direct participant submits on its own behalf;
- provide that margin collateralizing customer transactions be collected separately from margin collateralizing a direct participant's proprietary transactions; and
- ensure that any margin held for customers of a direct participant is held in an account separate from those of the direct participant.

The Proposal would not require that margin be collected for each customer on a gross basis, but would give a Treasury CCP the discretion to 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 the overall customer account.

However, for a registered broker-dealer to take advantage of the Proposal's amendment to the reserve formula discussed below, the Treasury CCP's rules must require that margin be calculated and collected from the broker-dealer's customers on a gross basis.

Notably, FICC, in its sponsored membership program, already calculates, collects, and holds margin amounts for its sponsoring members separately and independently from sponsored members. While FICC margins transactions in its direct participant's proprietary account on a net basis, FICC's rules specifically provide for the collection of margin for sponsored member transactions on a gross basis. On the other hand, FICC's correspondent clearing and prime brokerage services do not require gross margining.

(3) Facilitating Access to Treasury CCPs

FICC currently provides several existing methods to allow market participants to access central clearing services

through a FICC direct participant, including FICC's sponsored member service, centrally cleared institutional triparty service, correspondent clearing service, and prime brokerage service. However, the Proposal would require Treasury CCPs to adopt procedures to ensure that they have appropriate means to facilitate access to clearance and settlement services of all ESMTs, including those of customers. The Treasury CCP's board of directors must review such policies and procedure annually.

To comply with this proposed requirement, the Proposal notes that a Treasury CCP generally may need to:

- conduct an initial review of its access models and related policies and procedures;
- seek to provide access in as flexible a means as possible consistent with applicable laws and regulations;
- consider a wide variety of appropriate means to facilitate access to clearance and settlement services of all ESMTs, including those of customers.
- consult with a wide-range of stakeholders, including customers;
- review any instance in which its policies and procedures treat transactions differently based on the identity of the participant submitting the transaction, the fact that a customer is a party to the transaction, or the method of execution, or in any other way, and confirm that any variation in the treatment of such transactions is necessary and appropriate; and
- consider whether to include in its policies and procedures non-discrimination principles.

The SEC believes that the review by the Treasury CCP's board of directors under the proposed rules should include consideration of whether to establish policies and procedures that enable direct members to submit to the Treasury CCP ESMTs for clearance and settlement that have been executed by two customers.

(4) Amendments to the Reserve Formula Under Rule 15c3-3a

If the Proposal's change to Rule 17Ad-22 were adopted, there would be a substantial increase in the margin broker-dealers must post at a Treasury CCP in connection with customer transactions. In order to "free up" resources that can be used to meet such margin requirements, the Proposal would amend Rule 15c3-3a to permit broker-dealers to include margin required and on deposit at a Treasury CCP as a debit item in the customer reserve formula. This would

align treatment of margin posted to a Treasury CCP with treatment of margin posted to the Options Clearing Corporation and derivative clearing organizations, albeit with additional requirements. Use of the new debit would be subject to the following conditions:

- the margin must be in the form of cash or Treasury securities and used to margin Treasury securities transactions of customers that are cleared, settled, and novated at a Treasury CCP;
- the margin must consist of cash owed to the customer or Treasury securities held in custody for the customer that were delivered to meet a margin requirement resulting from that customer's Treasury securities transactions at the CCP, and not for any other customer's or the broker-dealer's Treasury securities transactions;
- the margin must be treated in accordance with the rules of the CCP that impose the following requirements and the CCP and broker-dealer are in compliance with such requirements:
 - the margin must be calculated separately for each customer and the broker-dealer must deliver that amount of margin for each customer on a gross basis;
 - the CCP is limited to investing margin in Treasury securities with a maturity of one year or less; and
 - margin must be held in an account of the broker-dealer at the CCP that is segregated from any other account of the broker-dealer at the CCP, and that is (A) used exclusively to clear, settle, novate, and margin Treasury securities transactions of the customers of the broker-dealer, (B) specifically designated as "Special Clearing Account for the Exclusive Benefit of the Customers of [the broker dealer]", (C) subject to a written notice from the CCP that Treasury securities in the account are held for the exclusive benefit of the customers and are kept separate from any other accounts maintained by the broker-dealer or any other clearing member, and (D) subject to a written contract providing that cash and Treasury securities in the account are not available to cover claims arising from the broker-dealer or any other clearing member defaulting and are not subject to any other right, charge, security interest, lien, or claim of any kind except those arising from

a cleared transaction of a customer of the broker-dealer effected in the account;

- the margin must be treated in accordance with rules requiring that the CCP hold customer margin itself or at a Federal Reserve Bank or an FDIC-insured bank, and the account must be (A) segregated from any other account of the CCP or any other person and used exclusively to hold cash and Treasury securities to meet current margin requirements resulting from customer Treasury securities transactions, (B) subject to a written notice from the bank that the cash and Treasury securities in the account are held pursuant to Rule 15c3-3 and are kept separate from any other accounts maintained by the CCP or any other person at the bank, and (C) subject to a written contract between the CCP and the bank that the cash and Treasury securities are not subject to any right, charge, security interest line or claim of any kind in favor of the bank or any person claiming through the bank;
- the margin must be treated in accordance with rules that require the margin be returned to the broker-dealer if it is no longer needed to meet a current margin requirement with respect to customer Treasury securities transactions no later than the close of the next business day after the margin is no longer needed; and
- the SEC must approve rules of the CCP promulgated to meet these conditions.

The Proposal would also require broker-dealers to perform a separate reserve computation for their broker-dealer customers and maintain a separate reserve account regarding that computation.

(5) Compliance Date

The SEC did not propose a specific compliance date in the Proposal. Rather, the SEC is seeking comments regarding the appropriate timeframe. Given the expansive scope of the Proposal, the vast amount of market participants and transactions that would be affected by it, and the high implementation costs on FICC and other market participants, the market would likely require a significant amount of time to prepare for compliance.

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