

SEC Adopts Treasury Clearing Rule

January 19, 2024

On December 13, 2023, the Securities and Exchange Commission (“**SEC**”) adopted rules (the “**Final Rule**”)¹ that, among other things, will require most market participants to submit for central clearing a large portion of their repurchase transactions (“**repos**”) on Treasury securities (“**USTs**”) as well as the clearing of purchases and sales (“**cash transactions**”) of USTs entered into between certain financial intermediaries. The Fixed Income Clearing Corporation (“**FICC**”) is currently the only clearing agency that clears UST repos and cash transactions for UST positions (a “**Treasury CCP**”).

The Final Rule also amends the SEC’s broker-dealer Customer Protection Rule and contains no-action relief under the Investment Company Act (the “**’40 Act**”) that will facilitate the ability of clearing members to collect, and customers to post, initial margin to FICC.

The Final Rule will dramatically change the way market participants execute and settle UST repos and cash transactions (collectively, “**UST transactions**”) and require firms to enter into new clearing agreements or amend existing documentation. Critically, unlike in other regulated markets in the United States, such as the cleared derivatives and futures markets, market participants are afforded broad flexibility in how they structure their clearing arrangements.

This flexibility will allow market participants to create bespoke solutions that fit their organizational, commercial, and regulatory requirements and objectives. It will also allow clearing members and their customers to allocate risk between themselves in ways that are not generally permissible in other cleared markets.

The Final Rule must be implemented in full no later than June 30, 2026. While this is a more generous timeline than anticipated by some, market participants will want to consider carefully their position in light of the options available to them and several significant issues that have not been addressed. This alert memorandum summarizes the Final Rule, identifies some issues for further consideration, and outlines some concerns market participants may wish to address in structuring their clearing documentation.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:

Deborah North
+1 212 225 2039
dnorth@cgsh.com

Brandon M. Hammer
+1 212 225 2635
bhammer@cgsh.com

Lauren E. Semrad
+1 202 974 1712
lsemrad@cgsh.com

Wankun (Charles) Wang
+1 212 225 2798
wawang@cgsh.com

Rishi Kumar
+1 202 974 1838
rkumar@cgsh.com

Abby Shamray
+1 212 225 2743
ashamray@cgsh.com

¹ *Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities*, 89 Fed. Reg. 2714 (January 16, 2024).



CLEARY GOTTLIEB

KEY TAKEAWAYS

Clearing Requirement

- **Scope:**
 - Under the Final Rule, a Treasury CCP must require its direct participants (*i.e.*, members of the Treasury CCP that do not rely upon the services of another clearing member to access the Treasury CCP) to submit all “**eligible secondary market transactions**” for central clearing.
 - Subject to certain exemptions, the definition of eligible secondary market transactions encompasses:
 - All repos on USTs entered into by the direct participant;
 - All cash transactions on USTs if the direct participant is an interdealer broker (“**IDB**”); and
 - All cash transactions on USTs with a broker-dealer, government securities dealer, or government securities broker.
- **Exemptions:** The Final Rule provides exemptions from the clearing requirement for:
 - Cash transactions and repos entered into with central banks, sovereign entities, international financial institutions (*e.g.*, multilateral development banks) and natural persons;
 - Repos entered into with:
 - State or local governments (but not pension plans);
 - Central counterparties; and
 - Affiliates, provided the affiliate (1) is a bank, broker-dealer, futures commission merchant (“**FCM**”), or foreign equivalent and (2) “submit[s] for clearance and settlement all other repurchase or reverse repurchase agreements collateralized by [USTs] to which the affiliate is a party” (the “**Inter-affiliate Exception**”).
- **Exclusions:**
 - In the preamble to the Final Rule, the SEC clarified that eligible secondary market transactions do not include:
 - Securities loans;
 - Repos that permit a party to substitute USTs for non-UST purchased securities, except mixed CUSIP repos that contain UST CUSIPs from the outset of the transaction; or
 - Primary market transactions.
 - However, the SEC declined to provide exclusions for:
 - Repos entered into by FCMs, including “in-house” transactions;
 - Off hours trades; or



- Triparty repos.

Amendment to SEC Broker-Dealer Customer Protection Rule to Allow Posting of Margin to Treasury CCPs

- The Final Rule amends the customer and PAB reserve formulas in SEC Rule 15c3-3a so as to allow a broker-dealer to record a debit in the formulas for cash or securities margin collected from a customer and on-posted to the Treasury CCP to meet a Treasury CCP's margin requirements with respect to the customer's UST transactions, so long as certain conditions are satisfied.
- The conditions include that the margin must be calculated and collected on a gross basis, segregated from the assets of the broker-dealer, and unavailable for loss-mutualization.

'40 Act No Action Relief for Margin Posted to FICC in the Sponsored Member Program

- In the preamble to the Final Rule, the SEC provided time-limited no-action relief under the '40 Act that will permit a Regulated Investment Company ("RIC") to post margin to FICC, including through a broker-dealer, to secure the RIC's obligation under transactions cleared through FICC's Sponsored Member Program, subject to certain conditions.
- The conditions include that the margin is calculated and collected on a gross basis, segregated from the proprietary assets of the clearing member, and only available to satisfy the obligations of the RIC that posted it.
- The relief expires in five years.

Margin Collection Practices

- The Final Rule requires Treasury CCPs to calculate, collect, and hold margin for customer transactions separately from the margin securing the direct participant's proprietary transactions.
- However, the Final Rule does not require a Treasury CCP to calculate customer margin on a gross basis, limit the ability of a Treasury CCP to subject customer margin to loss mutualization, or require customers to post margin. Nonetheless, as noted above, a Treasury CCP would need to provide for gross margining and exclude customer margin from loss mutualization to satisfy the conditions discussed above relating to the broker-dealer Customer Protection Rule and the '40 Act no-action relief.

Requirement to Facilitate Access

- The Final Rule requires a Treasury CCP to have appropriate means to "facilitate access" by market participants, including those of customers that are not direct participants of a Treasury CCP.
- However, the SEC declined to require Treasury CCPs to adopt a singular clearing or segregation model or require direct participants to offer a certain model (*e.g.*, done-away clearing).

Comparison to the Proposal

- The Final Rule is generally consistent with the SEC’s proposal published October 25, 2022 (the “**Proposal**”). However, the SEC made a few key changes in response to industry feedback:
 - The SEC substantially narrowed the scope of cash transactions subject to the clearing requirement to exclude transactions with hedge funds and prime brokerage clients.
 - The SEC added exemptions for repos with central counterparties and state or local governments, as well as the Inter-affiliate Exemption.
 - The SEC liberalized the conditions for broker-dealers to record a debit in the reserve formulas, including allowing the debit to apply to non-UST securities margin, removing the requirement that the Treasury CCP return excess margin within one business day, and allowing a broker-dealer to pre-fund the margin requirements in certain circumstances.
 - The SEC granted time limited and conditional no-action relief to allow RICs to post margin.

Compliance Dates

- The Final Rule includes staggered compliance dates as follows:

Action Item	Date
Proposal by FICC of rule changes regarding: <ul style="list-style-type: none"> ○ separation of house and customer margin; ○ facilitating access; and ○ changes to satisfy conditions for 15c3-3a debit. 	March 18, 2024
Proposal by FICC of rule changes regarding: <ul style="list-style-type: none"> ○ the requirement to clear eligible secondary market transactions. 	June 14, 2024
Effective date of rule changes regarding: <ul style="list-style-type: none"> ○ separation of house and customer margin; ○ facilitating access; and ○ changes to satisfy conditions for 15c3-3a debit. 	March 31, 2025
Effective date of FICC rule changes regarding: <ul style="list-style-type: none"> ○ the requirement to clear eligible secondary market transactions that are cash transactions. 	December 31, 2025
Effective date of FICC rule changes regarding: <ul style="list-style-type: none"> ○ the requirement to clear eligible secondary market transactions that are repos. 	June 30, 2026

BACKGROUND

(1) The Treasury Market Disruptions

The Final Rule comes on the heels of a number of recent disruptions in the UST market, including:

- The “flash rally” of October 2014, when yields on UST bonds plunged, leading to sharp increases in prices;
- The dramatic acceleration of repo rates in September 2019 amid a large withdrawal of reserves from the banking system and the settlement of UST 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 UST, leading to intervention by the Board of Governors of the Federal Reserve System (“**Federal Reserve**”).²

Academics, regulators, and market participants have discussed and theorized a number of causes for these disruptions and potential solutions.³ Some of these analysts have spotlighted the changing nature of the market, including the greater role of principal trading firms (“**PTFs**”), the use of IDBs, and a decrease in the proportion of transactions submitted for central clearing. Others have pointed to the role of the Basel III capital requirements in constraining the ability and incentives of banks and bank affiliates to provide liquidity to the market. Indeed, the banking regulators disappplied the supplementary leverage ratio to U.S. Treasuries amid the 2020 market stress on the theory that doing so would allow bank affiliates to use their balance sheets to inject liquidity into the market.⁴

² The Federal Reserve announced purchases of UST 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/newsevents/pressreleases/bcreg20200515a.htm).

³ 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 https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_FinalPaper_071119.pdf.

⁴ Joint Press Release by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the

For its part, the SEC proposed a number of rule changes in 2022 relating to the UST market. These included requiring certain PTFs to register as dealers, subjecting IDBs to regulation under Reg ATS and Reg SCI, and the Proposal.⁵ The Final Rule is the first of these three proposals to be finalized.

(2) Central Clearing of UST Transactions

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.

FICC, a subsidiary of the Depository Trust and Clearing Corporation, is currently the only existing Treasury CCP. Most of FICC’s direct participants are broker-dealers, IDBs, and U.S. and non-U.S. banks. FICC’s existing rules require direct participants to submit for clearing all eligible transactions between direct participants. However, no such requirement applies to transactions between a direct participant and a third party 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.

Currency, Regulators temporarily change the supplementary leverage ratio to increase banking organizations' ability to support credit to households and businesses in light of the coronavirus response (May 15, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200515a.htm>.

⁵ *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>.

FICC's Variety of Clearing Models

Unlike other cleared markets that use a singular clearing model (e.g., the agency model for U.S. cleared derivatives), FICC offers a wide variety of models for indirect participants to access clearing. The roles and responsibilities of direct and indirect participants under the various models differ, as do the ways in which transactions are settled, and the loss mutualization and liquidity requirements applicable to participants. This flexibility provides market participants with the ability to select the model that meets their operational, organizational, regulatory, and commercial needs. It also provides firms with the ability to allocate between themselves various risks, which risks are typically mandatorily allocated in certain ways under the regulations governing other cleared markets.

FICC also does not generally dictate the terms of the relationship between a direct participant and an indirect participant. As a result, the allocation of risks between a direct participant and an indirect participant as well as the nature of their relationship will depend heavily on the relevant documentation between them as well as the applicable insolvency regime.

(3) The Proposal

The SEC published the Proposal on October 25, 2022.⁶ The Proposal provided for the amendment of the SEC's covered clearing agency standard in way that would have required Treasury CCPs to:

- Require their direct participants to submit for central clearing all repos and certain cash transactions (including cash transactions with hedge funds and prime brokerage clients);
- Take steps to "facilitate access" by market participants to clearance and settlement services; and
- Calculate, collect, and hold margin for a direct participant's proprietary UST transactions separately from the margin for the transactions of the direct participant's customers.

In addition, the Proposal provided for the amendment of SEC Rule 15c3-3a to permit broker-dealers to include a

debit in the customer and PAB reserve formulas for cash and USTs delivered to a Treasury CCP to meet a margin requirement with respect to such customer's UST transactions, subject to several conditions. The conditions included that the Treasury CCP must return excess customer margin to broker-dealers within one business day.

FINAL RULE

(1) Mandatory Clearing of eligible secondary market transactions

Under the Final Rule, Treasury CCPs must adopt policies and procedures that require their direct participants to submit for clearance and settlement all eligible secondary market transactions to which they are a counterparty.

Scope of eligible secondary market transactions

Subject to certain exclusions and exemptions discussed below, the definition of eligible secondary market transaction encompasses:

- Repos: Any repo collateralized by USTs in which one of the counterparties is a direct participant;
- Cash transactions executed on IDBs: Any purchase or sale of USTs with any counterparty if the direct participant (A) brings together multiple buyers and sellers using a trading facility and (B) is a counterparty to both the buyer and seller in two separate transactions; and
- Cash transactions with brokers or dealers: Any purchase or sale of USTs with a counterparty that is a registered broker-dealer, government securities dealer, or government securities broker.

In response to industry feedback, the SEC removed cash transactions with hedge funds and prime brokerage clients from the definition of eligible secondary market transaction.

Triparty Repos & Substitutions

Many market participants settle repos using a using a "triparty platform" under which a third-party custodian provides collateral management services. The SEC declined requests from commenters to exclude such transactions from the scope of the clearing requirement, reasoning that triparty custodians are not subject to the same level of comprehensive regulation as Treasury CCPs and do not novate or guarantee settlement of transactions.

⁶ *Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer*

Protection Rule With Respect to U.S. Treasury Securities, 87 Fed. Reg. 64,610 (Oct. 25, 2022).

However, some triparty repos are “mixed CUSIP,” in that the repo seller may use USTs or other specified kinds of securities to meet their obligations. Commenters sought clarification that the ability of a repo buyer to substitute in USTs would not in and of itself cause the transaction to be in scope of the clearing requirement. The SEC agreed, but noted that to the extent that a mixed CUSIP triparty repo “contains U.S. Treasury CUSIPs from the outset of the transaction,” it would constitute an eligible secondary market transaction.

Exemptions

The SEC exempted from the definition of eligible secondary market transactions repo and cash transactions where a counterparty is:

- A central bank, *i.e.*, a reserve bank or monetary authority of a central government or the Bank for International Settlements;
- A sovereign entity, *i.e.*, a central government or an agency, department, or ministry of a central government;
- An international financial institution, such as a multilateral development bank;⁷ or
- A natural person.

In addition, there are exclusions for repos entered into between a direct participant and:

- A central counterparty, *i.e.*, a U.S. clearing agency, derivatives clearing organization (“DCO”), or foreign central counterparty regulated as such;
- A state or local government, but not a pension plan; or
- An “affiliated counterparty” of the direct participant, provided that the affiliate submits for clearing “all other repurchase or reverse repurchase agreements collateralized by UST to which the affiliate is a party.”

⁷ The Final Rule defines “international financial institution” to include the 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;

An “affiliated counterparty” for this purpose is defined as a bank, broker-dealer, FCM, or any entity regulated as one of the foregoing in its home jurisdiction that is majority-owned (directly or indirectly) by the direct participant, an indirect or direct majority owner of the direct participant or subject to common majority ownership with the direct participant.

Ambiguity in the Inter-affiliate Exception

The scope of the Inter-affiliate Exception is not entirely clear. The text of the Final Rule states that exception is conditioned on “the affiliated counterparty submit[ting] for clearance and settlement all other repurchase or reverse repurchase agreements collateralized by USTs to which the affiliate is a party.” This language would seem to suggest that the affiliate must submit *all* UST repos, even if they are carved out of the eligible secondary market transaction definition (*e.g.*, a repo between the affiliate and the central bank), to central clearing in order for the exemption to apply.

However, in the preamble to the Final Rule, the SEC stated that, “[b]y referring to all other repos or reverse repos, the exemption clarifies that the requirement does not encompass transactions between the direct participant and the affiliate, *i.e.*, the transactions that are excluded, and also does not encompass the affiliate’s transactions that would otherwise be excluded” from the clearing requirement under other exceptions described above for direct participant transactions.

Exclusions & Inclusions

Primary Market Transactions. In the preamble to the Final Rule, the SEC made clear that eligible secondary market transactions do not include primary market transactions (*i.e.*, the issuance and sale of a UST 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. Eligible secondary market transactions also do not encompass transactions in “when-issued” Treasuries that take place *after* the Treasury Department announces the auction for

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.

such Treasuries but *before* the actual auction date. The SEC stated this is because such transactions are primarily used for price discovery leading up to the auction. However, transactions in “when-issued” USTs that start trading *after* the auction announcement but *before* issuance are within scope (if they otherwise qualify as eligible secondary market transactions), on the grounds that some IDBs treat such transactions as “on-the-run” and report them.

Off hour trades. Commenters had requested an exemption for trades executed outside a Treasury CCP’s business hours, arguing that market participants often enter into UST transactions after FICC stops accepting transactions and should not be prevented from entering into such trades. The SEC declined to provide such an exclusion on the grounds that FICC’s operating hours sufficiently accommodate current market practice.

Securities loans. The SEC expressly noted that securities lending transactions are not included in the scope of the definition of eligible secondary market transactions.

No Exception for Trades Entered into by FCMs

FCMs that hold customer cash often invest that cash in UST repos. U.S. Commodity Futures Trading Commission (“CFTC”) Rule 1.25 imposes strict limits on these investments, including the types of permissible counterparties. Those types do not include SEC-registered clearing agencies.

Citing this limitation, commenters requested an exclusion from the eligible secondary market transaction definition for repos entered into by FCMs using customer cash. They argued that without such an exclusion FCMs would be faced with conflicting requirements: the CFTC would prohibit the FCM from centrally clearing repos using customer cash, while the SEC would mandate such clearing.

The SEC declined commenters’ requests. It argued that FCMs could clear eligible secondary market transactions consistently with CFTC Rule 1.25 through the FICC prime brokerage or correspondent clearing model because, under those models, FICC does not enter into a transaction with the end-user customer. Whether the CFTC agrees with that view is unclear.

In addition, the SEC declined commenters’ request to confirm that the clearing requirement does not apply to “in-house” transactions, *i.e.*, transactions in which an FCM exchanges customer margin for other assets to meet a margin requirement, since there is no counterparty to such trades.

Compliance Monitoring

The Final Rule requires that Treasury CCPs implement policies and procedures to identify and monitor compliance of direct participants’ submissions for clearing. The SEC noted in the preamble to the Final Rule that such policies and procedures could take a number of forms, including an attestation from a senior official at a direct participant. Further, Treasury CCPs are required to have a means to address the failure of a direct participant to submit an eligible secondary market transaction for clearing as required (*e.g.*, fines, limitation of activities, suspension, etc.).

(2) Margin Requirements for Centrally Cleared UST Transactions

Under FICC’s current rules, only the direct participant bears an obligation to post initial margin, known as “fund,” for the positions the direct participant carries for customers. Indirect participants are not required to post clearing fund, and direct participants are not required to collect clearing

fund from their indirect participant customers. In light of this, FICC commingles all clearing fund posted by direct participants, and all such margin is available for loss mutualization. Furthermore, except under the Sponsored Member Program, all transactions carried by a direct participant in the same account at FICC, which may include proprietary and customer transactions, are margined on a net basis.

The Final Rule would change some, but not all, of these features. Specifically, the Final Rule requires 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;
- Collect margin for customer transactions 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 the account that holds the margin securing a direct participant's proprietary transactions.

Consistent with the Proposal, however, the Final Rule does not require "gross margining" of customer positions in the same way as is required in the cleared derivatives market. Rather, a Treasury CCP may continue to net the positions of multiple customers against one another in calculating initial margin requirements. Furthermore, the Final Rule does not prohibit a Treasury CCP from using margin posted in respect of customer positions for loss mutualization purposes. However, in order to allow participants to benefit from the reserve formula debit or the no-action relief under the '40 Act discussed below, the Treasury CCP would need to calculate the margin posted by such participants on a gross basis and would largely be unable to use such margin for loss mutualization purposes.

In response to the Proposal, some commenters argued that like the CFTC, the SEC should, require direct participants to collect margin from customers. The SEC declined to do this, noting that the requirement to collect, calculate, and hold customer margin separate from direct participants' proprietary margin should be sufficient for addressing customer risks at the Treasury CCP level.

The SEC also declined to require Treasury CCPs to adopt a "legally segregated, operationally commingled" ("LSOC") model like the one applicable to cleared swap transactions. Under such a model, margin posted by one customer cannot be used by the central counterparty to satisfy obligations of another customer. The SEC reasoned that it was not necessary to impose such a requirement given that customer positions and margin are protected under the Securities Investor Protection Act ("SIPA") and that the SEC has consistently preferred to allow each clearing agency to determine the method that works best for the products it clears and markets it serves. However, nothing would preclude a Treasury CCP from adopting such an LSOC model, and indeed, the '40 Act relief is conditioned on FICC applying an LSOC approach to margin posted by a RIC.

(3) Facilitating Access to Treasury CCPs

Consistent with the Proposal, the Final Rule requires Treasury CCPs to adopt policies and procedures to ensure that they have appropriate means to facilitate access to clearance and settlement services of all eligible secondary market transactions, including those of customers. The Treasury CCP's board of directors must review such policies and procedures annually.

The SEC specifically declined commenters' requests to require that Treasury CCPs adopt a singular model or mandate that their direct participants offer particular models. In particular, in contrast with the CFTC's approach to cleared derivatives, which prohibits the executing dealer from requiring customers to clear through its affiliated clearing member, the SEC rejected commenters' suggestion that Treasury CCPs require its members to accept "done-away" transactions (*i.e.*, transactions between a direct participant's customer and a third party). The SEC reasoned, in part, that "it is appropriate to allow the U.S. Treasury market to take [the Final Rule's] new requirements into account, before determining that additional access models are needed."

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

Currently, broker-dealers that are direct participants of a Treasury CCP are unable to use margin posted by customers to fund clearing fund obligations arising on account of customer transactions. This is because, if the broker-dealer were to collect margin from customers in the form of cash, it would need to record a credit in the customer reserve formula, but would not be able to record a corresponding debit for that margin to the extent it on-posted the margin to the Treasury CCP. This means the broker-dealer must “lock up” an amount equal to the collected margin in the reserve account, effectively preventing it from passing on the margin to the Treasury CCP. This creates competitive disparities with other kinds of FICC direct participants that are not subject to such limitations and makes it more expensive for broker-dealers to provide clearing services.⁸

In order to address this issue, the Final Rule amends 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 (and the PAB reserve formula). This allows broker-dealers to collect such margin from customers and use that margin to satisfy the margin obligations arising from the customers’ transactions. This aligns treatment of margin posted to a Treasury CCP with the treatment of margin posted to the Options Clearing Corporation and derivative clearing organizations, albeit with additional requirements. The availability of the debit is subject to the following conditions:

- The margin must be in the form of cash, USTs, or other securities eligible to be posted to the Treasury CCP as margin (*e.g.*, government sponsored entity securities and agency mortgage-backed securities);
- The assets must be used to meet a margin requirement imposed by a Treasury CCP on account of UST transactions carried for the customer that posted such assets (subject to a limited exception discussed below);
- The margin must be treated in accordance with rules of the Treasury CCP that impose the following requirements, and the Treasury CCP and broker-dealer must be 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 (*i.e.*, there must be *gross margining*) (but the Treasury CCP need not make separate calls on the broker-dealer with respect to individual customers);
 - The Treasury CCP may only invest cash margin in USTs with a maturity of one year or less;
 - The margin must be held in an account of the broker-dealer at the Treasury CCP that is segregated from any other account of the broker-dealer at the Treasury CCP and subject to account designation, written notice, and contractual requirements; and
- The margin must be treated in accordance with rules requiring that the Treasury CCP hold customer margin itself or at a Federal Reserve Bank or an FDIC-insured bank, subject to segregation, written notice, and contractual requirements.

The SEC must approve rules of the Treasury CCP promulgated to meet these conditions and will then issue a notice that broker-dealers may begin taking the debit.

In contrast to the Proposal, the Final Rule does not require that the Treasury CCP return excess collateral with respect to customer positions to broker-dealers within one business day.

⁸ The same result arises for margin or clearing fund in the form of securities. The broker-dealer would need to subject such securities to its possession or control (as they would be “fully paid” securities). Because Treasury CCPs are not good “control locations” under the customer protection rule, the broker-dealer would not be able to fulfill the possession or control

requirements by passing on the securities on to the Treasury CCP. The result is the same as for cash described above: the broker-dealer cannot pass on customer assets to the Treasury CCP to fulfill margin requirements arising as a result of customer obligations, and must instead use its own assets.

Pre-Funding of Customer Margin Obligations

A number of commenters expressed concerns about the practicality of the Proposal's condition that the broker-dealer collect the margin from customers before on-posting it to the Treasury CCP. These commenters noted that, given the tight timelines for meeting margin calls, clearing members will likely need to pre-fund the margin obligations and then collect that margin from the customers. In response to these concerns, the SEC included in the Final Rule a limited exception to the condition that the broker-dealer collect the margin from the customer. Specifically, the Final Rule permits a broker-dealer to record a debit for "pre-funded" margin, but only if (i) the margin consists of USTs (rather than cash or other securities), (ii) the broker-dealer does not owe the customer or hold for the customer sufficient cash or securities to meet the margin requirement, (iii) the broker-dealer calls the customer to deliver the margin on the same business day as it posts the margin, and (iv) the broker-dealer receives cash or securities to meet the margin requirement by the close of the next business day after the margin requirement arises.

(5) Time-limited No-Action Relief under Section 17(f) of the '40 Act

Under Section 17(f) of the '40 Act and regulations promulgated thereunder, RICs may only hold their assets at certain custodians, such as banks. Neither FICC nor broker-dealers are permissible custodians. Therefore, RICs are unable to post their assets to FICC or broker-dealer direct participants as margin. As a result, today most direct participants cover margin requirements arising in respect of their RIC customers' cleared transactions using the direct participant's proprietary assets.

In the Final Rule, the SEC provided no-action relief to RICs with respect to margin posted to FICC or broker-dealer direct participants in connection with FICC's Sponsored Member Program. The relief is subject to the following conditions:

- The margin provided by a RIC is not subject to loss mutualization, is not used by FICC for any purpose other than in connection with that RIC's default as a Sponsored Member, and is only withdrawn by FICC upon the RIC's default (*i.e.*, it is subject effectively to LSOC);
- FICC keeps the margin provided by a RIC separate from FICC's assets and at an eligible fund custodian under the '40 Act;

- FICC segregates on its books and records the margin provided by a RIC and identifies a value of margin in its books and records as being attributable to the RIC;
- The account into which a RIC's margin is deposited is governed by a contract by and among the RIC, its direct participant, and FICC providing for an arrangement consistent with the no-action relief (together, the "**RIC Margin Framework**"); and
- RICs receive quarterly statements of accounts concerning the margin provided in connection with eligible secondary market transactions showing, at a minimum, the name of the account, asset movements during the quarter, and quarter-end positions.
- If the margin is posted through a broker-dealer sponsoring member:
 - The margin provided by the RIC is kept separate from, the sponsoring member's assets;
 - The sponsoring member segregates on its books and records the margin provided by a RIC and identifies a value of margin in its books and records as being attributable to the RIC;
 - The RIC's provision of margin is consistent with the RIC Margin Framework; and
 - The sponsoring member does not hold RIC assets that exceed the amount required to be deposited as margin to FICC with respect to the RIC's outstanding eligible secondary market transactions.

This relief expires in five years, with the stated goal of providing FICC sufficient time to file rule changes to facilitate a registered fund's ability to post margin at FICC. Note that the relief is limited to the Sponsored Member Program.

(6) Compliance Dates

The Final Rule includes staggered compliance dates as summarized in the table in the Key Takeaways section above.

(7) Considerations for Market Participants

Many market participants will need to enter into new documentation or amend existing documentation to comply with the clearing mandate. Issues market participants may wish to consider when entering into such documentation include:

- Available clearing models:
 - Cost and capital implications; and
 - Regulatory and jurisdictional implications.
- Payment obligations:
 - Whether customer must post “funds-only settlement amounts” (*i.e.*, variation margin) for its positions;
 - Whether customer must “pre-position” funds/securities for settlement or “pre-settle” its obligations with its direct participant; and
 - How direct participant treats funds and assets received by customer or funds received on account of customer trades.
- Implications of rejected trades/settlement failures:
 - Whether trades remain bilateral;
 - Whether breakage is owing; and
 - Responsibility for fails charges.
- Implications of a Treasury CCP default:
 - Responsibility for taking market action; and
 - Direct participant’s obligations related to customer-posted clearing fund held at Treasury CCP.
- Implications of a customer or direct participant default:
 - Events of default;
 - Implications of direct participant’s failure on customer’s obligations; and
 - Netting/custodial/financial collateral analysis.
- Margin and collateral:
 - Whether customer must or may post “clearing fund” that Treasury CCP requires for customer’s positions;
 - Whether customer must post other collateral for its positions;
 - Collateral eligibility requirements;
 - How any clearing fund or collateral posted by customer is held, both at direct participant level and at Treasury CCP level;
- Rehypothecation rights of direct participant; and
- How direct participant perfects security interest in clearing fund/collateral posted by customer as well as customer’s positions (*e.g.*, financial asset election where UCC is applicable) or achieve a similar result (*e.g.*, agent-trustee model).
- Haircuts:
 - Whether haircuts are applied to purchased securities; and
 - Credit considerations.
- Cross-margining:
 - Scope of obligations secured by collateral that customer pledges; and
 - Relationship with other cleared/uncleared exposures.

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