December 22, 2022

Submitted electronically via SEC.gov
Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. S7–23–22
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

Dear Ms. Countryman:

The Securities Industry and Financial Markets Association ("SIFMA")[1] and the Institute of International Bankers ("IIB")[2] appreciate the opportunity to comment on the proposal of the Securities and Exchange Commission (the "Commission") on 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 (the "Proposal").[3]

I. Executive Summary

SIFMA and IIB recognize the risks in the U.S. Treasury ("Treasury") market, in particular the liquidity problems exemplified by the "flash rally" of 2014, the Treasury repo market stress of September 2019, and the COVID-19 shock of March 2020. We also agree that benefits exist to central clearing in certain situations. The cited benefits of increased central clearing in the Treasury market—increasing liquidity, resilience and intermediation capacity—

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit https://www.sifma.org.

[2] IIB is the only national association devoted exclusively to representing and advancing the interests of the international banking community in the United States. Its membership consists of internationally headquartered banking and financial institutions from over 35 countries around the world doing business in the United States. The IIB's mission is to help resolve the many special legislative, regulatory, tax and compliance issues confronting internationally headquartered institutions that engage in banking, securities and other financial activities in the United States. For more information, visit https://www.iib.org.

[3] *See* 87 Fed. Reg. 64,610 (Oct. 25, 2022).

have not yet, however, been sufficiently proven to outweigh potential costs of a broad central clearing requirement for secondary market transactions in Treasury securities ("Treasury Transactions"). The Proposal may, in fact, risk decreasing liquidity if market participants reduce activity or leave the market and increasing concentration at the Fixed Income Clearing Corporation ("FICC"), the only current clearing agency that provides central counterparty services for transactions in Treasury securities (a "Treasury CCP").

Given the importance of the Treasury market, other reforms already proposed that are intended to strengthen the Treasury market and the risks we note above, we recommend the Commission follow a more incremental and calibrated process as outlined below. In this way, the Commission will be able to target its approach, minimize potential unintended negative outcomes for market participants and broaden market resilience.

- **Increase incentives**. The Commission should increase incentives for buy-side and sell-side participants to centrally clear Treasury Transactions and address barriers to clearing in existing regulations and market infrastructure prior to requiring Treasury Transactions to be centrally cleared.

- **Conduct further study**. Prior to introducing a central clearing requirement for Treasury Transactions, the Commission should conduct detailed analysis on the costs and benefits of central clearing across market segments and participant types, as well as analyze the overall impact on Treasury market liquidity. It is widely recognized within existing literature on Treasury market structure reform that further detailed study is needed in this area.[4] Increased central clearing resulting from incentives to centrally clear Treasury Transactions would provide additional data for this analysis.

- **Only if supported by further study, implement a targeted clearing requirement**. The Commission should determine whether to proceed with a central clearing requirement only after considering the findings from the cost-benefit analysis, addressing existing barriers to central clearing and implementing proposed changes with respect to customer protection. If warranted by these analyses, such a requirement should be introduced initially on a targeted basis, focusing on segments of the market that would realize the most net benefit from increased central clearing and that would not otherwise have a natural incentive to centrally clear.

    - If the Commission determines to move forward with a clearing requirement, based on the limited analysis currently available we would suggest that the

[4] *See* Darrell Duffie, *Still the World's Safe Haven?*, 15, 17 (Hutchins Center Working Paper No. 62, June 2020), https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf ("Duffie") ("It would be difficult to estimate the amount of liquidity savings associated with central clearing without conducting a quantitative analysis of Treasuries transactions data"); Nellie Liang & Patrick Parkinson, *Enhancing Liquidity of the U.S. Treasury Market Under Stress* 3 (Hutchins Center Working Paper No. 72, Dec. 16, 2020), https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf ("Liang & Parkinson") ("[A] thorough study should be conducted to assess the costs and benefits [of a mandate for wider use of central clearing for Treasury securities]. If such a study were to conclude that expanded clearing is not appropriate for Treasury securities, it should explain what distinguishes Treasury markets from the many other markets, such as equities and Treasury futures, for which there is a clearing mandate.").

Commission first target Treasury cash transactions ("Treasury Cash Transactions") executed by a direct participant that is an interdealer broker ("IDB") ("IDB Transactions"), as it is more challenging to incentivize clearing in Treasury Cash Transactions than in Treasury repurchase and reverse repurchase transactions ("Treasury Repos") and IDB Transactions have been recognized to pose a particular contagion risk due to "hybrid clearing."

- With respect to Treasury Repos, we note there are existing incentives for central clearing due to the ability of dealers to achieve efficiencies with respect to balance sheet capacity through netting trades cleared at a Treasury CCP. Therefore, a central clearing requirement with respect to Treasury Repos should only be considered at a later stage if justified by robust analysis. Were the Commission to determine that a central clearing requirement with respect to Treasury Repos is warranted, the requirement's scope should be limited to Treasury Repos entered into by a direct participant that is an IDB or by any direct participant and a counterparty that is a broker-dealer or a government securities broker or dealer.

- **Phase in any clearing requirement**. The implementation of any central clearing requirement should be done on a phased basis and at a measured pace commensurate with the size, scope and scale of the implementation program required. A phased implementation will provide a deeper understanding of how targeted changes impact certain market segments or market participants.

These steps will ensure that the Commission and the market are able to analyze comprehensively the impacts of additional clearing of Treasury Transactions on each segment of the Treasury market and determine whether the benefits to any central clearing requirement outweigh the costs.

II. Introduction

SIFMA and IIB support the broad policy objective of enhancing the resilience and capacity of the U.S. Treasury market through carefully calibrated reforms that encourage broad and deep market participation. The benefits of any such reforms, including requiring additional central clearing of Treasury Transactions at a Treasury CCP, however, must be assessed and balanced against the risks and possible consequences of such reforms.

In this regard, we appreciate the Commission's request for comments on all aspects of the Proposal. However, changes of this magnitude require significantly more time for the Commission and the public (including SIFMA and IIB members) to assess the benefits and costs associated with the increased central clearing of Treasury Transactions, collect data and understand the possible effects on the Treasury market and the financial markets as a whole. We urge the Commission, therefore, to take a measured and incremental approach to any increase in the central clearing of Treasury Transactions in order to allow time to perform the analysis and research necessary for a deliberate and thorough rulemaking process. This is especially essential in the context of the Treasury market, the main source of funding for the U.S. government and the basis for borrowing costs globally across a wide variety of assets, where any changes could have significant consequences that ripple out to the entire global financial system.

A. Increased Central Clearing Will Not Necessarily Achieve the Commission's Aim of Increasing Liquidity in the Treasury Market, and Instead May Reduce Liquidity

As an initial matter, we recognize that the Proposal is part of a series of proposed reforms by the Commission aimed at addressing concerns raised by disruptions in the Treasury market, including the "flash rally" of 2014, the Treasury repo market stress of September 2019 and the COVID-19 shock of March 2020.[5] These disruptions were, at their core, liquidity crises, which are unlikely to be solved by a broad central clearing requirement.[6] While central clearing could reduce risk of *on-time* settlement failure, it is not clear that it would help with *time-of-trade* liquidity that is central to the recent Treasury market disruptions. While central clearing may allow for increased balance sheet netting in the context of Treasury Repos, it is unclear how meaningful any incremental benefits would be given that dealers are already naturally incentivized to seek these benefits, including for purposes of leverage ratio requirements. Further, accounting and regulatory capital rules already allow dealers to net unsettled Treasury Cash Transactions across all counterparties on their balance sheets at time of trade.[7] Thus, there is little evidence that mandatory central clearing is likely to improve liquidity in the Treasury market by meaningfully increasing the capacity of dealers to trade. In fact, requiring broad

[5] 87 Fed. Reg. at 64,614. Other reforms include requiring certain principal trading firms ("PTFs") to register as dealers and subjecting interdealer brokers to regulation under Reg ATS. *See* Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23,054 (proposed Apr. 18, 2022) ("Dealer Definition Proposal"); Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems (ATSs) That Trade U.S. Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15,496 (proposed Mar. 18, 2022). We also note that Treasury has published a request for information, in consultation with the Inter-Agency Working Group on Treasury Market Surveillance ("IAWG"), which includes staff of the Commission, the U.S. Department of the Treasury, the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the Federal Reserve Bank of New York ("FRBNY") and the U.S. Commodity Futures Trading Commission ("CFTC"), with respect to post-trade transparency of data for secondary cash market transactions of Treasury securities. Notice Seeking Public Comment on Additional Transparency for Secondary Market Transactions of Treasury Securities, 87 Fed. Reg. 38,259 (June 27, 2022) ("RFI"). Based on responses to the RFI, Treasury recently proposed "to release transaction data for on-the-run nominal coupons, with end-of-day dissemination and with appropriate cap sizes" because "[t]hese benchmark securities represent the most liquid segment of the Treasury securities market." *See* Nellie Liang, Under Secretary for Domestic Finance, Dep't, of the Treasury, Remarks at the 2022 Treasury Market Conference (Nov. 6, 2022), https://home.treasury.gov/news/press-releases/jy1110 ("Liang Remarks").

[6] In fact, even Chair Gensler of the Commission suggested that the effect of central clearing on liquidity in the Treasury market is marginal. *See Can Gary Gensler solve every problem in American finance?*, The Economist (Oct. 26, 2022), https://www.economist.com/finance-and-economics/2022/10/26/can-gary-gensler-solve-every-problem-in-american-finance ("[Mr. Gensler explains that central clearing] 'enhances and expands access, lowers counterparty risk, helps broaden the market…and on the margin, results in a bit more liquidity.'") (emphasis added).

[7] IAWG, *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report* 30 (Nov. 8, 2021), https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf ("IAWG Report"). Regulatory capital is only held against such transactions should they fail for more than five days. Therefore, the impact of short-term settlement fails in Treasury Cash Transactions on liquidity in the Treasury market, and accordingly, the liquidity benefit of reducing such settlement fails, is limited.

central clearing of Treasury Transactions is likely to substantially increase the costs of entering into such transactions and could generate additional financial resource requirements such as standardized risk-based capital requirements, amongst others, which may risk *decreasing* liquidity in the Treasury market if participants reduce activity or leave the market. Increased costs may not only cause market participants to leave the market, but such increased costs will also possibly limit the access of non-bank broker-dealers that might otherwise add liquidity in the space.

We have long supported review and recalibration of prudential rules—most notably risk-insensitive balance sheet measures, such as the Supplementary Leverage Ratio ("SLR") and Tier 1 leverage ratio, as well as the global systemically important bank ("GSIB") surcharge and certain risk-based indicators ("RBIs") used by the Federal Reserve Board for the purposes of applying enhanced prudential standards—as the best way to allow dealers to continue to provide liquidity during all stages of a market cycle.[8] Experts and policymakers have called for and supported SLR reforms.[9] The Federal Reserve Board itself expressed its intent to reconsider SLR reforms when the temporary relief during the COVD-19 pandemic expired.[10] With the U.S. Treasury Total Public Debt Outstanding increasing approximately 193% from $10,699BN on December 31, 2008, when the "ratio" levels were established, to $31,352BN as of December 5,

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[8] *See, e.g.*, Letter from Kenneth E. Bentsen, Jr., President and CEO, SIFMA, et al. to three Federal Reserve Board Governors (Feb. 23, 2021), https://www.sifma.org/wp-content/uploads/2021/02/SLR-Exemption-Extension-Letter-02.23.2021.pdf; Letter from Kenneth E. Bentsen, Jr., President and CEO, SIFMA et al.to Federal Reserve Board (Apr. 2, 2015), https://www.sifma.org/wp-content/uploads/2017/05/sifma-the-clearing-house-and-fsr-submit-comments-to-the-federal-reserve-on-the-gsib-surcharge-for-gsibs-headquartered-in-the-us-1.pdf. In terms of changes to the calculation of the RBIs used by the Federal Reserve, we support two changes that more accurately reflect the risk posed by U.S. Treasuries and would better enable dealers to provide liquidity throughout all stages of the market cycle. First, under the Federal Reserve Board's tiering rule, the financing of U.S. Treasury-backed repo funding by dealers is punitively weighed at 25 percent in the less than 30-day bucket for the weighted short-term wholesale funding RBI, in contrast to the 0 percent weighting such assets receive under the Liquidity Coverage Ratio ("LCR"). We believe that a lower risk weight for U.S. Treasuries in the short-term wholesale funding RBI should be applied, consistent with the treatment under the LCR. Second, the treatment of U.S. Treasuries in the nonbank asset RBI should be revisited. Currently, the nonbank asset RBI does not differentiate assets based on risk, and U.S. Treasury positions at a dealer would be treated the same as other riskier nonbank assets at the dealer. As a result of this miscalibration of U.S. Treasury risk-weighting, banking organizations limit their U.S. Treasury market intermediation to avoid crossing a new tiering threshold. Changing the weighting of U.S. Treasuries in the Board's tiering rule to reflect the low-risk nature of U.S. Treasuries would support the balance sheet capacity of dealers in the market.

[9] *See* Letter from Pat Toomey, Ranking Member, Senate Comm. on Banking, Hous. and Urb. Affs., to Jerome Powell, Chair, Federal Reserve Board, 2 (Nov. 3, 2022), https://www.banking.senate.gov/imo/media/doc/toomey_letter_to_fed_regarding_treasury_market.pdf (Toomey Letter) (". . . the Fed should follow through with its commitment to modify the [SLR]."). The Group of Thirty's Working Group on Treasury Market Liquidity ("Group of Thirty"), *U.S. Treasury Markets: Steps Toward Increased Resilience* 1, 15 (July 2021), https://group30.org/publications/detail/4950 ("G-30 Report"); Liang & Parkinson at 3; Sharon Thiruchelvam, *Geithner Stresses Need for SLR Reform to Restore UST Liquidity*, Risk.net (June 30, 2022), https://www.risk.net/regulation/7951276/geithner-stresses-need-for-slr-reform-to-restore-ust-liquidity.

[10] *See* Press Release, Federal Reserve Board, Federal Reserve Board announces that the temporary change to the SLR for bank holding companies will expire as scheduled on March 31 (Mar. 19, 2021), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20210319a.htm.

2022,[11] it is essential that the Commission work with prudential and other regulators to implement reforms to improve Treasury market resiliency, including ensuring that examiners treat Treasuries and reserves equivalently for purposes of the internal liquidity stress tests of banks.[12]

B. Other Benefits of Central Clearing Require Further Study

In the Proposal, the Commission aims to improve the functioning of the Treasury market not only by increasing liquidity, but also by lowering systemic risk and providing greater transparency.[13] We support these goals and recognize there is some role for central clearing in achieving them. However, studies, including those cited by the Commission in the Proposal, have not produced strong evidence that the benefits of requiring central clearing of Treasury Transactions outweigh the potential costs.[14] At the same time, any benefits of increased central clearing under the Proposal must be viewed in the context of the other reforms already proposed by the Commission and other policy makers that are intended to strengthen the Treasury market (*e.g.*, implementing additional transparency requirements with respect to Treasury Transactions, requiring certain PTFs to register as dealers, subjecting IDBs to regulation under Reg ATS and releasing transaction data for on-the-run nominal coupons).[15]

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[11] *See* U.S. Department of the Treasury, *Debt to the Penny*, https://fiscaldata.treasury.gov/datasets/debt-to-the-penny/debt-to-the-penny (*Total outstanding public debt of the U.S. government reported daily)*.

[12] *See* Toomey Letter at 2.

[13] 87 Fed. Reg. at 64,614.

[14] For instance, the Commission cited studies by Darrell Duffie, Nellie Liang, and Pat Parkinson several times in the Proposal, including on "ways in which central clearing could have reduced these problems, mitigating the large price swings due to illiquidity in the market just when it was most needed." 87 Fed. Reg. at 64,654. However, these studies all acknowledge their limitations and the need for further research. *See* Duffie at 15, 17 ("It would be difficult to estimate the amount of liquidity savings associated with central clearing without conducting a quantitative analysis of Treasuries transactions data"); Liang & Parkinson at 3 ("[A] thorough study should be conducted to assess the costs and benefits [of a mandate for wider use of central clearing for Treasury securities]. If such a study were to conclude that expanded clearing is not appropriate for Treasury securities, it should explain what distinguishes Treasury markets from the many other markets, such as equities and Treasury futures, for which there is a clearing mandate."). Similarly, the Commission cited the "G-30 Report" as support for a clearing requirement, but the same report stated that "[m]arket participants and regulators should continue to study how dealer-to-client cash trades of Treasuries might best be centrally cleared, including via the sponsored clearing model, and assess the private and public policy cases for central clearing using whatever is the optimal mode." G-30 Report at 8 (emphasis added). Compare this to the cost-benefit analysis supporting mandatory clearing of swaps, which included detailed review of industry research on additional costs associated with increased collateral requirements, and which one commenter described as "among the more thoughtful and comprehensive the Commission has ever prepared." Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284, 74,323-30 (Dec. 13, 2012).

[15] *See supra* note 5.

Given the "critical and unique role" that Treasury securities play in the U.S. and global economy,[16] if the Commission does not have a full and accurate picture supported by comprehensively developed evidence of the impact that a central clearing requirement may have on the market, including in conjunction with other proposed reforms, any final rulemaking in this area may hamper rather than improve market liquidity and resiliency.[17] Accordingly, the Commission should first pursue approaches that are more measured and incremental, such as focusing on incentivizing central clearing of Treasury Transactions, while working with regulators and market participants to collect data and monitor the market.[18] If the Commission determines to move forward with a requirement to clear Treasury Transactions at this time, it should narrowly scope such a requirement to the segments of the Treasury market that would most benefit from additional central clearing, *i.e.*, Treasury Cash Transactions executed with a direct participant that is an IDB. This would allow the Commission to study the impacts of incremental additional central clearing in the Treasury market before taking broader action.

We look forward to continuing to engage with the Commission and other policy makers on potential structural reforms in the Treasury market that would contribute to increased resilience and capacity in this important market.

III. Given the Limited Cost-Benefit Analysis Available Today, the Commission Should Take an Incentive-Based Approach to Increase Central Clearing of Treasury Transactions to Allow for Additional Study of the Impacts of Additional Central Clearing in the Treasury Market Prior to Proposing Any Clearing Requirement

We recognize that there may be benefits to central clearing for certain segments of the Treasury market. However, in our view, there is a need for additional study and cost-benefit analysis before the Commission imposes a broad central clearing requirement. Accordingly, the

[16] 87 Fed. Reg. at 64,612. In addition to the sheer size of the Treasury market, Treasury securities are the main source of funding for the U.S. government. Further, central banks (including the Federal Reserve) rely on Treasury securities to implement monetary policies, and the global financial system in general utilizes Treasury securities not only as an instrument for investment and risk management, but also as a benchmark for the pricing of other financial products.

[17] In this regard, we note that it is extremely difficult to consider and quantify the costs and benefits of the Proposal in conjunction with other reforms when the Commission has simultaneously proposed multiple reforms that significantly impact the Treasury market. Similarly, it is not truly possible to quantify costs and benefits of the Proposal without knowing how FICC proposes to implement the Proposal. Thus, in order to meet its burden on performing necessary cost-benefit analysis, the Commission should take an incremental approach with respect to this and other proposals, and coordinate with FICC on proposing and finalizing the changes necessary to prepare for any requirement to clear Treasury Transactions (*e.g.*, separating customer margin from proprietary margin, implementing the amendments to Rule 15c3-3a and reviewing access models), *before* proposing a requirement to clear Treasury Transactions.

[18] *See* Liang Remarks (noting that the Office of Financial Research ("OFR") "conducted a pilot data collection on the non-centrally cleared bilateral repo market in June 2022, covering nine U.S. registered broker-dealers over three days in that month" and "will continue to study data from this pilot collection, collaborating with the IAWG members and Financial Stability Oversight Council's working group on hedge funds. These efforts are also informing a rulemaking by the OFR to establish a permanent collection of data for this significant segment of the Treasury repo market.").

Commission should first take steps to incentivize central clearing in certain Treasury market segments. This approach would allow the Commission to undertake further study of the impacts of additional central clearing on each segment of the Treasury market before implementing any requirement.

A. Benefits of Central Clearing Must Be Weighed Against the Costs and Risks of Requiring Additional Central Clearing

1. *The increased costs of centrally clearing Treasury Transactions may reduce liquidity and diversity in the Treasury market*

A broad central clearing requirement for Treasury Transactions may lead to less liquidity and diversity in the Treasury market if firms reduce activity, leave the market or if barriers to market entry are too high, given the significant costs of central clearing for market participants. These include, for example: (i) initial margin requirements (which in practice are held as "clearing fund" at FICC and subject to loss mutualization and the attendant adverse capital implications);[19] (ii) clearing fees; (iii) obligations with respect to FICC's capped contingency liquidity facility ("CCLF");[20] (iv) the operational build necessary to access central clearing (either as a direct participant or as an indirect participant); and (v) legal costs and time associated with onboarding customers for indirect central clearing, including, *e.g*., the need for Sponsoring Members to file UCC financing statements with respect to Sponsored Members under the Sponsored Member program.[21] The impact of these costs would be disproportionately felt by small and mid-sized participants in the Treasury market. If such participants elect to reduce activity or leave the market, it would reduce diversity in the market and further increase concentration among the largest market participants (which may increase systemic risk).

In addition, these costs may incentivize non-direct participants of a Treasury CCP to look for ways to trade away from direct participants in order to not have to centrally clear Treasury Transactions (as the Proposal's central clearing requirements only apply when a direct participant to a Treasury CCP is a party to the Treasury Transaction), undermining the policy goals of the Proposal. This is particularly true if there is not sufficient optionality in the methods of access to FICC, the only existing Treasury CCP, to effectively accommodate all market participants. Currently, FICC allows non-direct participants to access its services via two models: the Sponsored Member program and the correspondent clearing / prime brokerage

[19] In this letter, our discussion of margin generally refers to initial margin, or "clearing fund" at FICC, and not variation margin, or "funds-only settlement" payments at FICC.

[20] As a systemically important financial market utility, FICC should have the ability to access a Federal Reserve standing repurchase facility, which would reduce the need for a participant-funded CCLF, thereby incentivizing further clearing. This would be consistent with the recommendations in the G-30 Report. *See* G-30 Report at 7.

[21] We refer to "Sponsored Member", "Sponsoring Member", in this letter as such terms are defined in the FICC Rulebook. *See* FICC, *Government Securities Division Rulebook* ("FICC Rulebook") at Rule 1 (effective as of Dec. 5, 2022), https://www.dtcc.com/~/media/Files/Downloads/legal/rules/ficc_gov_rules.pdf.

clearing model.[22] Different market participants choose to participate in different models based on various regulatory requirements or commercial objectives. While these models have increased access to FICC, some market participants still find that the costs of these models are prohibitive, that the models increase their credit risks or otherwise find that the models do not meet their needs. Therefore, as discussed below in Section V, we support the Commission's proposed requirement that a Treasury CCP ensure that it has appropriate means to facilitate access to the central clearing of Treasury Transactions, including for indirect participants. We urge the Commission and FICC to both retain optionality for diverse market participants and to engage with market participants on possible revisions to access models to better accommodate market participants. Without this engagement and resulting revisions to the FICC Rulebook *prior* to any broad requirement to clear Treasury Transactions, the Proposal may risk reducing liquidity and diversity in the Treasury market.

Further, the increased costs of centrally clearing Treasury Transactions may have knock-on effects. For example, it may increase the cost of borrowing and capital formation for market participants as a whole given the integral role that Treasury securities play in the broader financial markets, and may drive market participants to other, similar securities markets not subject to a central clearing requirement (such as agency securities or other sovereign bonds). Additionally, increased loss mutualization resulting from any expansion of access to FICC, which would require current FICC members to bear additional default risks, could reduce the market-making capacity of such members.

2. *Central clearing can have procyclical effects in times of market stress due to the margin requirements of clearing agencies, further reducing liquidity when it is most needed*

Requiring the central clearing of Treasury Transactions could also increase the risk of procyclicality. Depending on the applicable margin models, clearing can be procyclical in times of market turmoil, as increased margin requirements (including intraday and ad hoc calls) drive demand for liquid assets, which in turn increases the scarcity of those assets and further drives market stress. FICC's rules allow FICC to demand, at any time in its discretion, additional margin from its members in times of market volatility, including through intraday calls, to safeguard the clearing infrastructure.[23] As seen in March 2020, increased margin requirements in times of market stress exacerbate liquidity problems.[24] The same effect was seen in the Gilt

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[22] *See* Depository Trust & Clearing Corporation ("DTCC"), Making the U.S. Treasury Market Safer for All Participants: How FICC's Open Access Model Promotes Central Clearing (Oct. 2021), https://dtcc.com/-/media/Files/Downloads/WhitePapers/Making-the-Treasury-Market-Safer-for-all-Participants.pdf.

[23] *See* FICC Rulebook at Rule 4, Sections 2(d) and 2a (respectively allowing FICC to set the daily Required Fund Deposit and to require additional Intraday Supplemental Fund Deposits in its discretion).

[24] Studies have discussed how central clearing transforms counterparty credit risk into liquidity risk, as margin calls transform accounting losses into realized losses that affect the liquidity buffers of direct participants. *See* Rama Cont, *Central Clearing and Risk Transformation* (Norges Bank Working Paper 3/2017, Apr. 20, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2955647.

markets earlier this year due to margin requirements with respect to cleared derivatives.[25] Increasing the volume of transactions that must be cleared at a Treasury CCP subjects an even greater portion of the market to these accelerative effects, and could lead to wider liquidity crises. The Commission should engage in additional study on the procyclical effects of central clearing before implementing a central clearing requirement, focusing on the appropriate balance from a systemic-risk perspective of rigorously managing the risk of positions cleared through a Treasury CCP as compared to minimizing liquidity strains on the Treasury market.

3. *A central clearing requirement for Treasury Transactions increases concentration risk*

Requiring central clearing of Treasury Transactions would significantly increase concentration risk at FICC, the only current Treasury CCP. Concentrating such significant levels of settlement, operational, liquidity and credit risk in *one* institution means that were there operational or liquidity stress at FICC, widespread dysfunction in the Treasury markets could result. Indeed, the Financial Stability Oversight Council noted in its 2020 report that in March of that year, FICC (together with its central clearing affiliate National Securities Clearing Corporation) "reported large margin breaches that could have led to significant losses in the event of a large clearing member default."[26] Further, DTCC, which through its subsidiaries (including FICC) serves as the only provider of central clearing of government securities, mortgage-backed securities and cash equity in the United States, is already one of the largest counterparties for several direct participants at FICC. Such a participant must manage its exposure to DTCC through prudent risk management, including tracking and limiting its activities in trades cleared through DTCC. A requirement to centrally clear Treasury Transactions would significantly increase such exposure (and the corresponding risk management costs, including those due to the Single Counterparty Credit Limits ("SCCL"), as discussed in Section VIII.B below).

Additionally, risk may also become concentrated among FICC's Sponsoring Members as more market participants join the Sponsored Member program and clear through a relatively small group of Sponsoring Members that retain bilateral counterparty risk to their Sponsored Members, even with respect to centrally cleared Treasury Transactions given the guarantee Sponsoring Members provide FICC.

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[25] *See* Christopher Whittall, *Derivatives clearing exacerbated LDI cash crunch*, Int'l Fin. Rev. (Oct. 7, 2022), https://www.ifre.com/story/3544414/derivatives-clearing-exacerbated-ldi-cash-crunch-yrp11f0qrn.

[26] Financial Stability Oversight Council, *2020 Annual Report* 119 (Dec. 3, 2020). Such concentration risk is another reason why FICC should have the ability to access a Federal Reserve standing repurchase facility—in addition to the fact that this would reduce the need for the CCLF as noted above. Further, given FICC's systemic importance, and the increased concentration risk associated with any central clearing requirement, FICC should have commensurately robust governance, risk management and oversight, including appropriate transparency to direct participants who mutualize the risk.

4. *Cost-benefit analysis should take into account that the benefits of central clearing could be achieved in less onerous ways*

The cited benefits of a central clearing requirement could also be achieved in other ways.

- **Liquidity**. Liquidity is most directly addressed through revisions to prudential requirements such as leverage ratios (both SLR and Tier 1) and the GSIB surcharge, as well as certain RBIs used by the Federal Reserve Board for the purposes of applying enhanced prudential standards.

- **Transparency**. Transparency of settlement risks to regulators can be achieved without a central clearing requirement. Requiring (non-public) disclosures for electronic broker platforms, PTFs and other high frequency trading entities would give regulators the visibility they need in these critical markets. Moreover, the OFR's recent data collection pilot program on the non-centrally cleared bilateral repo market represents another means by which regulators can improve transparency in the Treasury market.[27]

- **Counterparty credit risk**. With respect to counterparty credit risk in Treasury Repos, instead of imposing a central clearing requirement, the Commission could consider more directly and effectively addressing counterparty credit risk by working with other regulators to develop an internationally agreed upon framework requiring counterparties to post margin for non-centrally cleared bilateral Treasury Repos. This would also help address a key risk identified by a recent Treasury Market Practices Group ("TMPG") consultative paper, that the clearing and settlement of non-centrally cleared bilateral Treasury Repos is bespoke and opaque, including with respect to haircut/initial margin requirements.[28]

B. There Is a Need for Further Study of the Costs and Benefits of a Central Clearing Requirement Given the Importance of the Treasury Market and the Lack of Empirical Data

As the Commission itself notes in the Proposal, "data needed to quantify [certain economic effects of the Proposal] is not currently available."[29] Respectfully, the Commission should not engage in a rulemaking that will have sweeping effects on one of the most critical financial markets in the world without better data on whether the Proposal might cause unintended disruption to market liquidity, heighten concentration of credit risk or have other

[27] *See* Liang Remarks ("OFR will continue to study data from this pilot collection, collaborating with the IAWG members and Financial Stability Oversight Council's working group on hedge funds. These efforts are also informing a rulemaking by the OFR to establish a permanent collection of data for this significant segment of the Treasury repo market.").

[28] TMPG, *White Paper on Clearing and Settlement in the Market for U.S. Treasury Secured Financing Transactions* 5 (Nov. 9, 2022), https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_SFT_2022.pdf ("TMPG 2022 White Paper").

[29] 87 Fed. Reg. at 64,642.

unintended consequences on the global financial system as a whole. Many commentators have written of the need to study the effects of a central clearing requirement.[30] In addition, in her statement about the Proposal, Commissioner Peirce expressed the need for more careful consideration of the potential effects of a central clearing requirement.[31] She questioned whether the Proposal "adequately grapple[s] with the complex set of trade-offs associated with central clearing," and whether it "take[s] sufficient account of the potential unintended effects of the proposed clearing mandate." She cited the risk that the higher costs of central clearing could lead to participants leaving the market and lower liquidity, and the risk that FICC might grant "easy access to the less creditworthy firms doing business with its members."

C. There Are Several Methods by Which the Commission and Other Regulators May Incentivize Central Clearing

Given the reasons discussed above, the Commission should first look to incentivize central clearing in the segments of the Treasury market that would most benefit from central clearing, rather than requiring central clearing for the vast majority of Treasury Transactions. There are a number of possible steps that could be taken to durably and significantly increase central clearing in segments of the Treasury market in which central clearing would be most beneficial. Were the Commission to subsequently impose a central clearing requirement, these steps would buttress the goals of such a requirement. For example:

- **Rule 15c3-3a debit**. As proposed, the Commission should allow a debit under the Rule 15c3-3a customer reserve formula, subject to appropriate customer protection requirements, so that broker-dealer direct participants are able to pass through customer margin to a Treasury CCP, reducing the costs of centrally clearing Treasury Transactions and thus incentivizing the central clearing of more Treasury Transactions.[32]

- **Segregation of customer positions**. As proposed, the Commission should require segregation of customer positions from proprietary positions. Separating customer and proprietary positions would allow for a dealer's proprietary positions to be netted against the dealer's proprietary positions vis-á-vis other dealers, allowing more central clearing of Treasury Transactions. Without such segregation, submitting dealer-to-customer Treasury Transactions for central clearing does not change the dealer's net position at a Treasury CCP.[33]

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[30] *See, e.g.*, Liang & Parkinson at 3 (advocating for any central clearing requirement to be preceded by "a thorough study"); Duffie at 17 (noting that "[i]t would be difficult to estimate the amount of liquidity savings associated with central clearing without conducting a quantitative analysis of Treasuries transactions data.").

[31] Hester M. Peirce, Commissioner, SEC, Treasury Clearing Standards for Membership Requirements and Risk Management (Sept. 14, 2022), https://www.sec.gov/news/statement/peirce-statement-treasury-clearing-09142022.

[32] *See* Section VII.

[33] *See* Section VI.A.

- **Separation of initial margin from default fund**. The Commission should require FICC to consider amending its clearing fund structure to separate initial margin from default fund requirements that can be subject to loss mutualization, which would result in capital efficiencies for bank or bank-affiliated dealers and also may allow for increased participation from counterparty types that are restricted from participating in loss mutualization arrangements (*e.g.*, money market funds).[34]

- **Access models**. As proposed, the Commission should require Treasury CCPs to review their access models for non-direct participants and ensure that there are appropriate access models for all market participants.[35]

- **Cross-margining**. The Commission should take steps to allow cross-margining of customer Treasury Transactions between Treasury Transactions and treasury futures, so long as any such cross-margining is supported by a strong risk framework with conservative offsets, robust legal and operational mechanisms and appropriately defined and coordinated default management plans. Reduced margin requirements obtained through cross-margining serve an important function in increasing market liquidity through balance sheet savings and incentivizing risk reduction through hedging.[36] In addition, the Group of Thirty has observed that "[w]ider use of cross-margining would reduce the risk that increases in initial margin requirements on the futures leg of cash-futures basis trades result in forced sales of Treasury securities, which may have contributed to selling pressures in the Treasury market in March 2020."[37] However, currently cross-margining is only available with respect to proprietary positions of direct participants given the regulatory impediments to extending cross-margining to customer positions.

- **Initial margin requirements for uncleared bilateral Treasury Repos**. Requiring counterparties to post margin for non-centrally cleared bilateral Treasury Repos through internationally agreed upon standards could level the playing field for margin requirements in Treasury Repos, whether or not centrally cleared, and, therefore, incentivize market participants to centrally clear Treasury Repos.[38]

- **Access to Federal Reserve standing repurchase facility**. As a systemically important financial market utility, FICC should have the ability to access a Federal Reserve

[34] *See* Section VI.C.

[35] *See* Section V.

[36] *See, e.g.*, Brandon M. Hammer & Kathryn E. Witchger, *Facilitating Cross-Margining: Treasury Market Trades and Interest Rate Futures*, 55 Review of Securities & Commodities Regulation 151 (Aug. 17, 2022); IAWG Report, at 30 ("[c]ross-margining between the cash and futures markets can . . . provide balance sheet savings and have the effect of netting down some exposures.").

[37] G-30 Report at 14.

[38] TMPG 2022 White Paper at 5.

standing repurchase facility, which would (i) reduce the need for a participant-funded CCLF, thereby reducing costs and incentivizing further central clearing, and (ii) mitigate the increased concentration risk of substantially increasing the Treasury Transactions centrally cleared at FICC. This would be consistent with the recommendations in the G-30 Report.[39]

- **Treatment of CCLF under the SCCL**. Exempting CCLF exposure from the SCCL or increasing the SCCL with respect to exposures to FICC, due to the larger possible CCLF exposure that bank holding companies may end up incurring, would allow market participants to clear additional Treasury Transactions at FICC without risking exceeding SCCL limits.

There is evidence that the market will move toward additional central clearing with the appropriate incentives. For example, in the Treasury Repo market, the central clearing of dealer to customer Treasury Repos is well established and continues to grow, with 33 Sponsoring Members and 1,928 Sponsored Members (some Sponsored Members are entities within the same fund family) participating in the FICC Sponsored Member program.[40] This is largely because there are natural incentives for central clearing in this market as dealers are able to utilize central clearing to increase balance sheet capacity.

IV. To the Extent the Commission Requires Central Clearing of Treasury Transactions, It Should Do So in a More Targeted Manner

The Commission should rely on an incentive-based approach to increase central clearing in the Treasury Market as a first step. However, if the Commission were to move forward with a central clearing requirement at this time, the Commission should ensure that the scope of Treasury Transactions subject to a central clearing requirement is congruent with the potential benefits and drawbacks of additional central clearing in each segment of the Treasury market.

A. The Benefits of Central Clearing Are Not Uniform Across Market Segments

We agree that central clearing may provide benefits for certain segments of the Treasury market. For example, central clearing generally enhances risk management practices through standardized margin requirements set by the Treasury CCPs that are subject to Commission oversight, and Treasury CCPs can require that participants meet certain operational and financial standards. The combination of collecting margin, membership requirements and monitoring reduces the risk that the failure of one market participant could destabilize other market

[39] *See* G-30 Report at 7.

[40] *See* Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Add the Sponsored GC Service and Make Other Changes, 86 Fed. Reg. 29,334, 29,335 & n.9 (June 1, 2021) (noting the "steady increase" of participating firms in the Sponsored Member program); DTCC, *FICC Sponsored Activity* (updated through Dec. 9, 2022), https://www.dtcc.com/charts/membership (showing sponsored member volume).

participants.[41] In the market for Treasury Repos, central clearing increases the balance sheet capacity of dealers through the ability to net trades cleared at a Treasury CCP. This may increase the ability of dealers to enter into additional Treasury Repos, contributing to the depth of liquidity in the Treasury market. We note, however, that such balance sheet capacity is a natural incentive to central clearing without necessitating a requirement, particularly given the expanded access to FICC with the Sponsored Member program. Indeed, dealers are realizing such efficiency today through FICC's Sponsored Member program, to the benefit of clients and overall market liquidity. Nevertheless, central clearing may not lead to a materially increased ability of dealers to intermediate Treasury Transactions due to risk-weighted asset constraints, counterparty credit risk limits and bilateral margin agreements that remain present in an indirect clearing model such as FICC's Sponsored Member program. Further, in the interdealer Treasury Cash Transaction market, the specific contagion risk associated with "hybrid" clearing on IDBs[42] could be alleviated through central clearing of both legs of Treasury Cash Transactions executed on IDBs, as is discussed in more detail in Section IV.B below.

However, the benefits of central clearing are less clear in other respects. The Proposal states that increased central clearing would reduce liquidity risk in the Treasury market.[43] This would purportedly result from the increase in multilateral netting through the Treasury CCP and more all-to-all trading.[44] As noted above, with respect to Treasury Repos, multilateral netting at a Treasury CCP is already incentivized and can be achieved through the Sponsored Member program without a central clearing requirement. With respect to Treasury Cash Transactions, the availability of multilateral netting at a Treasury CCP does not influence the propensity for dealers to trade. In addition, the liquidity benefit from all-to-all trading is uncertain and likely to be substantially reduced during times of stress as liquidity providers may not continue to provide liquidity in such times even in an all-to-all trading environment. All-to-all trading could also diminish the incentives for institutions to be primary dealers, which have historically been relied upon to provide liquidity during both stressed periods and normal operations.[45] For this and

[41] As discussed below, however, central clearing increases the concentration risk at Treasury CCPs as a potential single point of failure.

[42] "Hybrid" clearing exists with respect to Treasury Cash Transactions executed on IDBs in which only one of the parties is a direct participant of a Treasury CCP and therefore only the resulting trade between the IDB and the direct participant would be centrally cleared (the resulting trade between the IDB and other party would be bilaterally cleared).

[43] *See* 87 Fed. Reg. at 64,628.

[44] *See* G-30 Report at 10.

[45] Primary dealers—that is, banks and broker-dealers that have been designated as counterparties of the FRBNY—have traditionally constituted the largest group of buyers in such auctions (bidding on behalf of their own accounts or on behalf of identified customers). Other direct auction bidders include investment funds, pensions and retirement funds, insurance companies, foreign accounts and others. Primary dealers are, however, the only market participants that are obligated to participate in all auctions of U.S. government debt and are each required to make pre-agreed minimum bids.

other reasons discussed above, liquidity benefits of central clearing are arguably marginal at best.[46]

In addition, central clearing does not provide the same balance sheet capacity benefits with respect to Treasury Cash Transactions as it can with respect to Treasury Repos because, as discussed in Section II.A, existing accounting treatment for Treasury Cash Transactions already allows dealers to net unsettled Treasury Cash Transactions on their balance sheets.[47] Furthermore, as they settle currently in one business day, Treasury Cash Transactions do not accumulate on balance sheets like some Treasury Repos do, except in cases where supply outstrips demand. In those cases, a dealer may end up holding Treasuries on its balance sheet and be constrained by this inventory. However, this will be true regardless of whether the Treasury Cash Transactions are centrally cleared.

Further, while central clearing can reduce the risk for settlement fails, such fails in Treasury Transactions were relatively low during the March 2020 COVID event as compared to the 2008-2009 financial crisis. This is possibly due to post-crisis reforms to settlement practices, such as settlement-fail penalties,[48] which allow the buyer to claim monetary compensation from the seller if the seller fails to deliver the securities on time.[49] Such penalties increase the cost of settlement failures such that sellers are incentivized to make timely delivery (usually by borrowing the security and then delivering it to the buyer). Therefore, while reducing settlement fails is certainly beneficial, it may not be as significant a concern as it may have been during the 2008-2009 financial crisis.[50]

B. To the Extent the Commission Requires Central Clearing of Treasury Transactions, It Should Limit the Scope of Treasury Transactions Required to Be Centrally Cleared to Treasury Cash Transactions Executed by a Direct Participant That Is an IDB

Based on the limited analysis currently available, in our view, any central clearing requirement should, at least initially, be limited to IDB Transactions. We recognize that it is more challenging to incentivize clearing in Treasury Cash Transactions than Treasury Repo

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[46] *See* Section II.A.

[47] *See* G-30 Report at 13 ("central clearing of cash trades would not free up nearly as much dealer balance sheet as central clearing of repos"); G-30 Report at 13 n.20 ("[i]n effect, accounting rules allow purchases and sales of the same security to be netted but do not allow reverse repos and repos of the same security to be netted, unless the repo and reverse repo are with the same counterparty and the trades have been documented under a master netting agreement.").

[48] *See* Kenneth D. Garbade et al., *The Introduction of the TMPG Fails Charge for U.S. Treasury Securities*, FRBNY Econ. Pol'y Rev. 45 (Oct. 2010) (describing the introduction of the fails charge in the Treasury market).

[49] *See* Michael J. Fleming, Frank M. Keane, Antoine Martin, & Michael McMorrow, *Measuring Settlement Fails*, FRBNY: Liberty Street Economics (Sept. 19, 2014), https://libertystreeteconomics.newyorkfed.org/2014/09/measuring-settlement-fails/ (discussing the reduction in settlement fails after reform).

[50] *See supra* note 7.

Transactions. In addition, the specific contagion risk associated with "hybrid" clearing on IDBs cited by the Commission and other industry participants could be alleviated through central clearing of both legs of Treasury Cash Transactions executed with IDBs, which the SEC estimates to account for 19% of the overall dollar value of Treasury Cash Transactions.[51] This would be consistent with addressing concerns raised by the TMPG in 2019 regarding "distinct settlement risks" with the hybrid clearing model.[52] Therefore, limiting the Treasury Cash Transactions covered by a central clearing requirement to IDB Transactions would capture the segment of the Treasury cash market that presents the most salient risks that could be ameliorated through additional central clearing. By contrast, increasing central clearing in the Treasury Repo market (i) represents a more significant risk of unintended knock-on effects in the broader funding market, and (ii) is more naturally incentivized through balance sheet benefits. Therefore, any central clearing requirement should not include Treasury Repos, at least until the Commission has had the benefit of studying the impact of increased clearing in Treasury Repos after implementing the incentives we recommend for that market.

As the TMPG has estimated, roughly three-quarters of Treasury Cash Transactions executed with an IDB clear bilaterally.[53] Bilateral clearing through IDBs (when one party to the Treasury Cash Transaction with the IDB is a direct participant of a Treasury CCP and the other party is not a direct or indirect participant, or when neither party to the trade is a direct participant) creates counterparty credit risk indirectly through the clearing chain that may not be transparent to participants in the market and introduces varying risk management practices. Requiring IDB Transactions to be centrally cleared through a Treasury CCP would reduce such risk by subjecting IDB Transactions to the Treasury CCP's centralized risk management practices, including standardized margin calculation and collection process and loss-mutualization arrangements.[54]

Further, settlement risks are particularly distinct with respect to Treasury Cash Transactions executed with IDBs in which only one of the parties is a direct participant of a Treasury CCP (so-called "hybrid clearing"). In this instance, the IDB is not in a zero net settlement position with respect to the Treasury CCP at the settlement date, as its rights and obligations against the Treasury CCP are not offset (as only one leg is bilaterally cleared). Therefore, the IDB holds overnight credit risk. While central clearing would not always eliminate the overnight credit risk (which exists in FICC's Sponsored Member program because each Sponsoring Member must guarantee the performance of its Sponsored Members), such risk is mitigated by a Treasury CCP's standardized margin and risk management practices. This will be especially true if (as we recommend in Section VI.B below) the Commission were to require Treasury CCPs to cause each direct participant to collect margin from its customers with respect

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[51] *See* 87 Fed. Reg. at 64,622.

[52] TMPG, *White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities* 9 (July 11, 2019), https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_FinalPaper_071119.pdf ("TMPG 2019 White Paper").

[53] *See* TMPG 2019 White Paper at 2.

[54] *See, e.g.*, FICC Rulebook at Rule 4.

to each such customer's Treasury Transactions cleared through the direct participant and to post such margin to the Treasury CCP (thus allocating the risk of a customer's Treasury Transaction to such customer).

In addition, in the hybrid clearing model, a Treasury CCP does not have visibility into or oversight over the IDB's corresponding bilaterally cleared Treasury Cash Transaction. Therefore, the Treasury CCP is indirectly exposed to the risk of the corresponding bilaterally cleared Treasury Cash Transaction without the ability to subject such transaction to its risk management practices (*e.g.*, it does not know the counterparty to that transaction and it cannot require margin for that transaction). If such risk is not managed correctly by the IDB, it could lead to the default of the IDB that is a direct participant and thereby expose the Treasury CCP to loss, as well as other direct participants through their obligations under the loss-mutualization arrangements.

For these reasons, both researchers and market participants have identified IDB Transactions as a particular source of risk, and accordingly such trades may benefit most from additional central clearing.[55] By contrast, the potential benefits of requiring central clearing of Treasury Cash Transactions entered into by any direct participant with a counterparty that is a broker-dealer, a government securities broker or dealer, a hedge fund or a highly leveraged account ("Other Covered Cash Transactions"), as proposed by the Commission,[56] are not as well supported. First, many Other Covered Cash Transactions (*e.g.*, transactions between a direct participant and a registered broker-dealer) may be transactions between two direct participants that are already required to be cleared under FICC's rules. Second, as staffs of various U.S. financial market regulators (including the Commission) have recognized, balance sheet savings would not be as pronounced with respect to Treasury Cash Transactions given that unsettled cash transactions can already be netted for accounting purposes.[57] Therefore, as there would not be a meaningful increase in balance sheet capacity, centrally clearing Treasury Cash Transactions is unlikely to accomplish a key purpose of the Proposal of increasing liquidity in the Treasury market. Moreover, counterparty credit risk and settlement risk are relatively low in the Treasury Cash Transaction market given the short settlement timeframe. Because of the lack of clear

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[55] *See, e.g.*, TMPG 2019 White Paper at 27-28 (highlighting risks of IDB Transactions because of market participant's incomplete understanding of counterparty credit risk and potential lagging of risk management in high-speed trading, which "has become an increasingly prominent feature of the U.S. Treasury market, particularly in the electronic IDB market"); DTCC, *More Clearing, Less Risk: Increasing Centrally Cleared Activity In The U.S. Treasury Cash Market* 5 (May 2021), https://www.dtcc.com/-/media/Files/PDFs/DTCC-US-Treasury-Whitepaper.pdf (noting that IDB Transactions that are not centrally cleared creates "fragmentation [that] directly reduces the systemic benefits that FICC was created to provide").

[56] Proposed Rule 17Ad-22(a) (definition of "eligible secondary market transaction," subparagraph (ii)(B), (C) and (D)).

[57] IAWG Report, at 30. In this regard, we note that the report cited by the Commission in the Proposal for the statement that additional central clearing may have lowered dealers' daily settlement obligations in the cash market by 60 to 70 percent before, during, and after the March 2020 Treasury market disruption assumed that there is no bilateral netting in dealer-to-customer trades. *See* Michael Fleming & Frank Keane, *Netting Efficiencies of Marketwide Central Clearing* 7 (FRBNY, Staff Report No. 964, Apr. 2021), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf.

advantages and the fact that Other Covered Cash Transactions do not present the same risks as IDB Transactions as discussed above, the costs resulting from requiring central clearing of Other Covered Cash Transactions cannot be justified. In addition, in light of the Commission's pending rulemaking regarding the definition of "dealer" and "government securities dealer," the scope of any requirement to centrally clear transactions between a direct participant and such an entity will be uncertain.[58] Accordingly, the impact of such a requirement cannot be comprehensively assessed at this stage and the Commission should not consider imposing any such requirement before it has completed the rulemaking process on the Dealer Definition Proposal.

C. <u>To the Extent That the Commission Requires Central Clearing of Treasury Repos, It Should Limit the Scope of Treasury Repos Required to Be Cleared to Treasury Repos (i) Executed by a Direct Participant That Is an IDB or (ii) Between a Direct Participant and a Counterparty That Is a Broker-Dealer or a Government Securities Broker or Dealer</u>

In contrast to Treasury Cash Transactions, where the uncleared portion of the Treasury cash market has significantly increased,[59] Treasury Repos are increasingly centrally cleared given the natural incentives for such clearing.[60] The introduction in 2005 and expansion since 2017 of FICC's Sponsored Member program, for example, has accelerated this trend and expanded central clearing of Treasury Repos to a larger group of institutional actors such as hedge funds and money market funds.[61] Since clearing is already occurring in the Treasury Repo market and would likely grow with the incentives we have suggested, the Commission can take more time to study the impact of Treasury Repo clearing, as we have suggested above, rather than adopt its Proposal at this time to require central clearing of all Treasury Repos entered into by a direct participant.[62]

Based on the limited currently available analysis, to the extent the Commission chooses to move forward with a requirement to centrally clear Treasury Repos, we recommend that the Commission limit such requirement to only those Treasury Repos where (i) the direct participant acts as an IDB or (ii) where the direct participant's counterparty is a broker-dealer or a government securities broker or dealer ("<u>Covered Repos</u>").

First, based on our experience, counterparties to Covered Repos—direct participants, IDBs and market intermediaries—are the most active participants in the Treasury Repo markets. Applying a central clearing requirement to Covered Repos would allow the Commission to meaningfully increase central clearing in the Treasury Repo market without applying a categorical requirement applicable to all Treasury Repos by a direct participant.

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[58] *See* Dealer Definition Proposal, *supra* note 5.

[59] *See* IAWG Report at 6.

[60] *See* Section III.A.

[61] *See* note 40.

[62] Proposed Rule 17Ad-22(a) (definition of "eligible secondary market transaction," subparagraph (i)).

Second, Covered Repos are entered into by counterparties that are more interconnected with the rest of the market and have a higher possibility to transfer risk to outside parties (including potentially a Treasury CCP). At the same time, most counterparties to Covered Repos should already be either part of or able to access the national system of clearance or settlement, such that a requirement to centrally clear Covered Repos would not incur as heavy a cost as it would if applied to other Treasury Repos, including those entered into by other counterparties.

Therefore, limiting any requirement to centrally clear Treasury Repos to Covered Repos could represent an incremental step in reforming the Treasury Repo market that would both be more targeted in approach and allow the Commission to monitor and study how requiring central clearing in the Treasury Repo market would impact Treasury market liquidity and resiliency on a smaller scale. By contrast, given the limited risks posed by Treasury Repos other than Covered Repos and their lower volumes, any additional advantages from a broad requirement to centrally clear all Treasury Repos would be outweighed by the potential downsides discussed in Section III above. In particular, including other counterparties increases the likelihood of parties exiting the market and reducing liquidity.

D. The Commission Should Exempt from the Scope of Treasury Transactions Subject to Any Central Clearing Requirement Those Transactions for Which a Central Clearing Requirement Offers Limited Gains or Is Unduly Onerous

We support the Commission's proposal to exempt from the central clearing requirement Treasury Transactions with a central bank, a sovereign entity, an international financial institution (collectively, "Sovereign Entities") or a natural person.[63] As the Commission correctly recognized, subjecting transactions with Sovereign Entities to a central clearing requirement may impede their ability to effectuate policy objectives, while subjecting transactions with natural persons to a central clearing requirement is unnecessary given the low volume and limited contagion risks associated with such transactions.

The Commission should similarly exempt other categories of Treasury Transactions on the basis of limited benefits or undue burden, including the operational impracticability of centrally clearing certain transactions. In particular, we recommend that the Commission adopt exemptions for the following transactions:

- **Tri-party repurchase or reverse repurchase transactions involving purchased securities that include both Treasury CUSIPs and securities with other CUSIPs or where permitted substitution may be made in CUSIPs other than Treasury CUSIPs** ("Mixed Tri-party Repos"). The fact that some CUSIPs in a Mixed Tri-party Repo are Treasuries should not bring that transaction into scope where the Mixed Tri-party Repo is of a type that is entered into in the ordinary course of business or otherwise in connection with legitimate business purposes (in other words, not structured with the inclusion of some non-Treasury CUSIPs to avoid clearing of the Treasury CUSIPs). Without an exemption for Mixed Tri-party Repos, a central clearing requirement could scope in

[63] Proposed Rule 17Ad-22(a) (definition of "eligible secondary market transaction," paragraph (iii)).

transactions of which Treasury securities only represent a small component, which would exceed the regulatory objective behind the Proposal.[64]

- **Treasury Transactions entered into outside of the operating hours of a Treasury CCP** that would settle on or before the next day on which FICC is open for business ("After-hour Transactions"). Firms routinely enter into Treasury Transactions after the close of business at FICC, for legitimate business or operational reasons, including for treasury management purposes. It may be that FICC will be able to increase its operating hours to accommodate this need, but firms will still need the ability to enter into After-hour Transactions at times that a Treasury CCP is not open to accept transactions for novation.[65]

- **Treasury Transactions with counterparties that lack access to a Treasury CCP's clearing service** ("Non-access Transactions"). Some Treasury market participants may not currently have access to FICC's clearing service due to being ineligible for such service under FICC's existing rules, regulatory burdens, or other material impediments that prevent such access. Not all market participants will be able to work with FICC to determine if there are serious obstacles to access during the comment period on the Proposal and, therefore, it may take more time for any possible issues to surface. There is a possibility that a central clearing requirement would significantly impair (if not completely shut out) the access of some market participants to the Treasury market, thereby reducing overall liquidity. Accordingly, we recommend that the Commission adopt an exclusion for Non-access Transactions such that a market participant would not be subject to a central clearing requirement until it has reasonable means to access central clearing.

- **Treasury Transactions between affiliates** ("Inter-affiliate Transactions"). Inter-affiliate Transactions are important to corporate groups, which may use them to achieve efficient risk and capital allocation and obtain flexibility for addressing customer demands. Requiring Inter-affiliate Transactions to be centrally cleared would impose additional costs with limited benefits. First, if an Inter-affiliate Transaction is part of a back-to-back arrangement where the related external transaction between the affiliated counterparty and a non-affiliated counterparty is not centrally cleared, subjecting the Inter-affiliate Transaction to a central clearing requirement does nothing to reduce the contagion risk presented by the non-affiliated counterparty. But if that external transaction is already centrally cleared, the contagion risk would already be addressed and requiring the Inter-affiliate Transaction to be cleared would not create additional benefits. Second, a direct participant's affiliate's credit risk is already part of the group-wide financial risks to

[64] We also note that market participants already collect margin on Mixed Tri-party Repos.

[65] In this regard, we note that in the derivatives context, if a swap subject to mandatory clearing is executed after 4:00 p.m. or not on a business day, it must then be submitted for clearing by the next business day when a derivatives clearing organization ("DCO") is open. *See* CFTC Regulations 50.1 and 50.2. 17 C.F.R. §§ 50.1, 50.2 (defining "day of execution" as the next succeeding business day of a party if a trade is entered into after 4:00 p.m. or not on a business day). This approach is sensible in the context of derivative transactions, which mostly have longer terms, but is not as well suited in the context of Treasury Transactions, which mostly settle overnight.

which the Treasury CCP is exposed, and central clearing of Inter-affiliate Transactions is unlikely to meaningfully impact the risk profile. Thus, we recommend that the Commission exempt Inter-affiliate Transactions from any central clearing requirement.[66]

- **Treasury Transactions entered into with a commercial end-user** ("Commercial End-user Transactions"). Commercial entities participate in the Treasury market for various legitimate business reasons, including investment of extra cash balances. Corporations are often required under their credit agreements to invest cash in specified cash equivalents, which typically include Treasury Repos. In our members' experience, these Treasury Transactions are likely to be quite limited in size. Thus, consistent with our recommendation in Section IV that the Commission take a more incremental approach, and for the same reason as the Commission recognized in adopting the exclusion for natural persons, we recommend that the Commission exempt Commercial End-user Transactions from any central clearing requirement.[67]

Further, in response to the Commission's question about whether securities lending transactions should be subjected to a central clearing requirement,[68] we recommend that the Commission not expand the scope of the Proposal to cover securities lending transactions. While market participants sometimes structure a financing transaction as a securities lending transaction (which would functionally be similar to a repo), a typical securities lending transaction is driven not by an intent to provide financing, but rather by the borrower's need for a specific security (*e.g.*, to settle a short sale), and the cash provided is merely collateral. Thus, the economics and risk profile of a typical securities lending transaction are distinct from repos, and the Commission has not considered how such distinctions would affect the costs and benefits of a central clearing requirement if it were to cover securities lending transactions generally. Further, such a requirement could have significant capital consequences, particularly in the agency lending space, and such impacts have not been adequately studied. Accordingly, we recommend that the Commission not apply a central clearing requirement to any securities lending transactions.

To the extent the Commission has any evasion concerns that market participants may potentially structure a Treasury Repo as a securities lending transaction or otherwise abuse any of the exemptions we recommend above, the Commission can rely on its general anti-evasion authority. Additionally, the Commission notes in the Proposal that in some instances, "competitive pressures in the bilaterally settled market for repo transactions have exerted downward pressure on haircuts, sometimes to zero."[69] As noted above in Section C.4, the

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[66] For similar reasons, the CFTC has exempted inter-affiliate swaps from the swap mandatory clearing rules. *See generally* CFTC Regulation 50.52. 17 C.F.R. § 50.52.

[67] In this regard, the Commission may leverage the definition of commercial end user in the uncleared security-based swap margin rules or non-financial end user in the uncleared swap margin rules (which both similarly contain exemptions for such entities). *See* 17 C.F.R. §§ 240.18a-3(b)(2), and 23.151; 12 C.F.R. § 45.2.

[68] 87 Fed. Reg. 64,629.

[69] 87 Fed. Reg. at 64,622 (referencing G-30 Report at 13 n.124).

Commission should consider working with other regulators to develop internationally-agreed upon standards to require counterparties to post margin for non-centrally cleared bilateral Treasury Repos, which would help level the playing field between centrally cleared and bilateral Treasury Repos and reduce the incentive to find ways to get around any requirement to centrally clear Treasury Repos.

V. The Commission Should Carefully Consider How to Increase Access to FICC's Clearing Services and FICC Should Engage with Market Participants Regarding Whether Any Revisions to FICC's Access Models Would Be Necessary to Increase Market Uptake

The Proposal requests comment on proposed changes to further facilitate access to Treasury CCPs.[70] In particular, the Proposal would further expand current Rule 17Ad-22(e)(18) to require that Treasury CCPs consider whether they provide appropriate access for indirect participants.[71] We support the Commission's goal of ensuring that indirect participants are able to access Treasury CCPs. However, this goal should be balanced against sufficiently robust membership criteria to ensure risk is appropriately managed. Further, as all access models have costs and benefits, and different access models may be appropriate for different market participants or commercial arrangements, we urge the Commission to retain optionality in access models for Treasury CCPs.

A. <u>Treasury CCPs Should Offer Multiple Models to Facilitate Access to Central Clearing for a Diverse Range of Market Participants, and Market Participants Should Not Be Required to Offer or Utilize any Particular Access Model</u>

The Commission states that it intends for a Treasury CCP to seek to provide access in "as flexible a means as possible, consistent with its responsibility to provide sound risk management."[72] We agree that neither the Commission nor the rulebook of a Treasury CCP should mandate a single approach to access a Treasury CCP or require that direct participants that clear for indirect participants offer all possible access models. Rather, a Treasury CCP's access models should provide the flexibility necessary to allow market participants to match access models with the optimal use cases.

This flexibility encourages maximum market participation from a diverse group. This is true for both direct participants that offer access to Treasury CCPs to others, and for indirect participants that utilize access models. For example, dealers may prefer to utilize the Sponsored Member program in order to clear done-with trades so that they may increase their balance sheet capacity. Money market funds may prefer to access FICC indirectly through the Sponsored Member program because they cannot engage in loss mutualization and are restricted in their ability to pay fees associated with central clearing. On the other hand, entities that cannot meet

[70] 87 Fed. Reg. at 64,636 ("The Commission generally requests comments on all aspects of new proposed Rules 17Ad-22(e)(6)(i) and 17Ad-22(e)(18)(iv)(C).").

[71] 87 Fed. Reg. at 64,635-36.

[72] 87 Fed. Reg. at 64,636.

FICC membership requirements to become a direct participant or Sponsored Member may need to utilize the correspondent clearing / prime brokerage clearing model. These are just some examples that illustrate how flexibility maximizes market participation. This goal should not be sacrificed in favor of a prescribed approach to access. With adequate flexibility, FICC can consider whether there are gaps in the existing access models in facilitating market participation and whether other models should be introduced.

B. The Commission Should Undertake a Study of Possible Models to Access Treasury CCPs, Including Models Used in Other Markets

Given the importance of flexibility, prior to implementing a central clearing requirement, consideration should be given to (i) the currently available models to access central clearing in the Treasury market and (ii) models in other markets that could possibly be leveraged. Current access models may not be suited for all participants or commercial arrangements. The reasons for this are various, but include, *e.g.*, FICC membership requirements, operational constraints and resource costs associated with legal documentation. Implementing a central clearing requirement without a comprehensive analysis regarding the suitability of current models to access Treasury CCPs and whether there is a need for additional models or revisions to current models could drive market participants away from transacting with direct participants in Treasury CCPs, or from the Treasury market entirely, if such participants do not believe there is a reasonable means of accessing a Treasury CCP. This would undermine the goals of the Proposal by decreasing participation in the Treasury market. In addition, it is important to ensure that the fee structures and overall costs for clearing models are as competitive as possible in order to incentivize additional clearing and wide adoption of direct and indirect clearing models. We therefore support additional study on whether the available models for accessing FICC, as the only current Treasury CCP, are sufficient and whether any changes should be made to such models to facilitate access to central clearing for all market participants. For example, the Commission could analyze incentive and fee structures in the cash markets for why certain PTFs become direct members of the National Securities Clearing Corporation, and yet choose not to become members of FICC. Such study and engagement with market participants, and the implementation of any resultant recommended changes to the access models at FICC, should take place *prior* to the adoption of any rule requiring additional central clearing.

C. Any Expansion of Access to FICC Clearing Services Should Not Relax Membership Requirements Essential for Appropriate Risk Management

FICC's membership requirements with respect to each type of participant (*e.g.*, a direct participant, an Executing Firm (as defined in the FICC Rulebook) accessing central clearing through a prime broker or correspondent member or a Sponsored Member) are designed to facilitate risk management, thereby lowering the overall risk to FICC and, as a result, all participants. Indeed, the Commission states that "membership requirements help to guard against defaults of any CCP member, as well as to protect the CCP and the financial system as a whole from the risk that one member's default could cause others."[73]

[73] 87 Fed. Reg. at 64,623.

Less stringent membership requirements in the name of increasing access to central clearing would increase the risk of default of a participant, increasing risk to FICC. In turn, this could increase corresponding risk to all other participants and the possibility of contagion in the market, given that FICC distributes and mutualizes risk of loss across its direct participants. Any materially increased risk of participating in FICC may deter membership in FICC and participation in the Treasury market more generally. Therefore, any expansion of access to FICC central clearing services should be balanced against ensuring robust membership criteria and stringent risk management practices.

VI. We Support the Proposed Requirement to Segregate Proprietary and Customer Positions and Margin, but Recommend Further Changes to Margining Practices That Would Facilitate Increased Central Clearing. Specifically, the Commission Should Require That (i) Direct Participants of Treasury CCPs Collect Margin from Their Customers with Respect to Customer Treasury Transactions and (ii) FICC Consider Changes to Its Clearing Fund Structure to Separate Initial Margin from Resources for Loss Mutualization

A. The Proposed Changes to Require Treasury CCPs to Segregate Customer Positions and Margin from a Direct Participant's Proprietary Positions and Margin Would Lead to Increased Central Clearing

The proposed changes with respect to risk management requirements would facilitate the Proposal's goals of increased central clearing. Often, a direct participant's proprietary positions to hedge a customer position net against the direct participant's customer positions that are submitted to FICC as part of the direct participant's own positions. This is the case in the correspondent clearing / prime brokerage clearing model (in the Sponsored Member program, customer positions and proprietary positions are not netted). Therefore, upon submitting a customer position in which the direct participant is the counterparty (*e.g.*, a dealer-to-customer or IDB trade), there would be no impact on the net position of the dealer at FICC. If changes required that customer and proprietary positions be separated, a direct participant's proprietary positions would be available to net against other proprietary positions. This would incentivize additional central clearing.

The proposed change would also appropriately assign the risk of centrally cleared customer Treasury Transactions to the customer. Currently, because a direct participant's proprietary positions and margin net against those of its customers (other than in the Sponsored Member program), centrally cleared customer Treasury Transactions are not directly subject to the Treasury CCP's risk management procedures, including the collection of margin specific to those transactions. As a result of the proposed change, the indirect participant's positions would be subject to such risk management procedures and margin.[74] This would achieve the Commission's goal of "avoid[ing] the risk of a disorderly default in the event of a direct participant default, in that the [central counterparty] would be responsible for the central liquidation of the defaulting participant's trades and would be able to have a more holistic view of the market than would be available for competing bilateral efforts to close out transactions

[74] *See* 87 Fed. Reg. at 64,667.

with a defaulting entity."[75] Together with a requirement that direct participants of Treasury CCPs collect margin from their customers with respect to customer Treasury Transactions (as we propose below), and the proposed changes to allow broker-dealers to utilize a debit in the Rule 15c3-3a reserve formula with respect to customer margin requirement by and posted to a Treasury CCP, these amendments would increase central clearing and improve risk management.

B. The Commission Should Require That Direct Participants of Treasury CCPs Collect Margin from Their Customers with Respect to Customer Treasury Transactions

The Commission should consider additional changes that would compel FICC to require that all margin requirements related to customer positions be satisfied by those customers. This change would both appropriately allocate risk to the customer and lower barriers to participation in central clearing for customers by direct participants who otherwise may not be able to submit margin on behalf of their customers. Any such requirements would need to be implemented in conjunction with the proposed amendment to Rule 15c3-3a and changes to FICC's clearing fund structure to separate initial margin from assets subject to loss mutualization in order to ensure that all customer types can post margin and direct participants can pass it through to a Treasury CCP.

Today, direct participants typically shoulder the burden of margin requirements on behalf of their customers. Requiring those customers to post margin would appropriately allocate risk of customer positions to customers. Further, the expense of fronting customer margin is considerable and may not be within the capabilities of all potential direct participants, especially in light of the adverse capital implications of contributing to the clearing fund. By requiring customers of direct participants to post margin on their own behalf, this could level the playing field and increase participation in customer central clearing by direct participants. This requirement would also be analogous to the rules governing DCOs, which require DCOs to collect at least 100% of margin to cover customer positions.[76]

C. FICC Should be Required to Consider Changes to the Clearing Fund Structure to Separate Initial Margin from Resources for Loss Mutualization

FICC should consider additional changes that would recalibrate how FICC calculates and holds clearing fund. In particular, FICC should consider whether the clearing fund calculation should separate initial margin from resources made available for loss mutualization, which would be consistent with most other central counterparties.

If customers of direct participants of Treasury CCPs are responsible for their own margin, FICC's current clearing fund and loss mutualization structure may become incompatible for certain buy-side funds. For example, certain funds appear not to be able to subject their assets to

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[75] *See* 87 Fed. Reg. at 64,634.

[76] *See* 17 C.F.R. § 39.13(g)(8).

loss mutualization for a variety of regulatory, operational and documentational reasons.[77] Accordingly, to facilitate the collection of margin by direct participants from those funds, initial margin may be separated from resources made available for loss mutualization at FICC, such that one pool of assets is eligible for use by FICC for liquidity or loss mutualization purposes, and another pool of assets is not.

Separating initial margin for assets available for loss mutualization may also result in more beneficial capital treatment for direct participants subject to the regulatory capital rules. Currently, exposure to FICC for purpose of the clearing fund requirements has a higher risk weight under the risk-based capital requirements than most central counterparties because under FICC's current rules, initial margin is part of the single clearing fund subject to full loss allocation.[78] Direct participants may utilize advantageous capital treatment where initial margin is held in a bankruptcy-remote nature.[79] As such, additional changes that would permit initial margin to be separated from default fund contributions that may be utilized for loss mutualization and held in a manner that is bankruptcy remote could reduce costs and lead to increased central clearing.

VII. We Support the Proposed Amendment to the Rule 15c3-3a Reserve Formula. However, the Commission Should Not Impose Additional Limitations on Margin Posted to Treasury CCPs That Are Inconsistent with the Treatment of Margin Posted to Other Clearing Agencies

We support the proposed amendment to the Rule 15c3-3a customer reserve formula permitting broker-dealers to include margin required and on deposit at a Treasury CCP as a debit item in the customer reserve formula. As noted by the Commission, such an amendment would facilitate increased central clearing of Treasury Transactions, as otherwise the Proposal "could cause a substantial increase in the margin broker-dealers must post to a [Treasury CCP] resulting

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[77] *See, e.g.*, DTCC, *Making the U.S. Treasury Market Safer For All Participants: How FICC's Open Access Model Promotes Central Clearing* 3-4 (Oct. 2021), https://www.dtcc.com/-/media/Files/Downloads/WhitePapers/Making-the-Treasury-Market-Safer-for-all-Participants.pdf (noting that these funds "often face limitations that are not applicable to participants in the cleared derivatives market, including tight regulatory and operational restrictions on use of funds that can restrict their ability to pay fees to clearing members, post margin, satisfy liquidity requirements and participate in loss mutualization."); PwC & BNY Mellon, *The Future of Wholesale Funding Markets, A Focus on Repo Markets Post U.S. Tri-Party Reform* 26 (Dec. 2015), *https://www.asifma.org/wp-content/uploads/2018/05/the-future-of-wholesale-funding-markets.pdf* (buy-side firms may be "restricted from participating in mutualized risk models due to covenants" applicable to them under various arrangements they may have negotiated).

[78] Risk-based capital requirements for exposure to a central counterparty are driven by three parameters: trade exposure risk-weighted assets ("RWA") (which is calculated at 2%), initial margin RWA (which is calculated at 0% if collateral is held in a bankruptcy remote manner or 2% otherwise) and default fund RWA (which is calculated as the minimum of three methods). Because of how default fund RWA is calculated, the large clearing fund under FICC's waterfall structure drives a larger RWA calculation at FICC compared to other central counterparties. *See* 12 C.F.R. § 217.35.

[79] *See* 12 C.F.R. § 217.35(b)(4)(i).

from their customers' cleared U.S. Treasury securities positions."[80] The proposed amendment would reduce the costs of central clearing and level the playing field for all customers that indirectly access a Treasury CCP (whether through a broker-dealer or another type of direct participant) while continuing to provide protection to customers. Further, to the extent that the Commission moves forward with requiring that direct participants of Treasury CCPs collect margin from their customers with respect to customer Treasury Transactions, and post such margin to the Treasury CCP, the amendment to Rule 15c3-3a would be essential. However, several of the additional requirements that would be imposed upon the use of the debit item for margin delivered to Treasury CCPs are unnecessarily narrower than requirements for margin held at the Options Clearing Corporation ("OCC") or DCOs.

A. The Proposed Amendment to the Rule 15c3-3a Reserve Formula Facilitates Increased Central Clearing and Promotes an Equal Playing Field Between Different Means of Indirect Access to Treasury CCPs

Broker-dealers are currently required to finance the margin posted to a Treasury CCP with respect to Treasury Transactions of customers, as Rule 15c3-3a does not permit a broker-dealer to debit the amount of margin required and on deposit at a Treasury CCP with respect to such transactions. While a broker-dealer may collect margin from customers with respect to Treasury Transactions cleared at a Treasury CCP, under current requirements it would be required to segregate such margin in an appropriate control location and could not pass it through to the Treasury CCP. Therefore, a broker-dealer must either use its own assets or borrow assets to post to the Treasury CCP, incurring a financing cost that may be passed through to customers.

If adopted, a central clearing requirement for Treasury Transactions would substantially increase the margin broker-dealers post to Treasury CCPs due to customer transactions. If such clearing requirement were adopted without attendant changes to the reserve formula, broker-dealers clearing for customers would be required to hold significant assets to meet their obligations under Rule 15c3-3a. As a result, the costs to broker-dealers of facilitating central clearing of Treasury Transactions for customers would increase dramatically. If not passed through to customers, those costs may be so burdensome that some broker-dealers would significantly decrease the volume of Treasury Transactions they are able to clear for customers or cease clearing Treasury Transactions for customers altogether. If broker-dealers were to stop or reduce clearing Treasury Transactions for customers, it would significantly impact the ability of customers to access central clearing on a Treasury CCP. Customers that do not have a practical means of accessing a Treasury CCP may instead seek to enter into Treasury Transactions with counterparties that would not be subject to the proposed central clearing requirement. This could reduce the volume of Treasury Transactions submitted for central clearing and therefore undermine the central goal of the Proposal.

Further, if adopted, the revisions to Rule 15c3-3a would place broker-dealers and other direct participants in a Treasury CCP on an equal playing field. Other direct participants do not face similar restrictions to the Rule 15c3-3a requirements discussed above and, therefore, are able to collect and pass through margin that they collect from a customer to a Treasury CCP to

[80] 87 Fed. Reg. at 64,614.

meet a margin requirement with respect to the Treasury Transactions of that customer. This allows direct participants to clear customer Treasury Transactions at a lower cost for both the direct participant and the customer.

B. <u>The Proposed Conditions on Use of the Debit Item in the Customer Reserve Formula with Respect to Margin Required and on Deposit at a Treasury CCP Are Unnecessarily Restrictive as Compared to Those Applied to Margin Posted to Other Clearing Agencies</u>

We support the customer protection objectives of Rule 15c3-3a and agree that many of the proposed conditions on the use of a debit in the reserve formula for margin posted to a Treasury CCP are protective of customers. However, several of the proposed conditions that would be attached to the ability to pass through customer assets to a Treasury CCP as margin are unnecessarily restrictive and do not align with the treatment of customer margin posted to the OCC or DCOs.

First, the use of the debit should not be limited to margin in the form of cash or Treasury securities. The Proposal would allow broker-dealers to include the debit item in the Rule 15c3-3a formula "to the extent that the customer position margin is in the form of cash or Treasury securities."[81] The stated goal of this condition is to "limit the assets underlying the debit item to the safest and most liquid instruments."[82] However, FICC accepts additional securities as clearing fund deposits, including eligible obligations of U.S. agencies or government sponsored entities and eligible mortgage-backed securities.[83] When FICC sought to expand the types of securities participants may deposit to satisfy clearing fund requirements, it did so "in order to improve liquidity and minimize risk for FICC and its members."[84] The Commission found that the expanded scope of acceptable forms of clearing fund collateral deposits would "better enable FICC to assure the safeguarding of securities and funds in its custody or control or for which it is responsible," and therefore was consistent with the requirements of the Securities Exchange Act and other governing regulations.[85] With respect to the OCC and DCOs, "cash, proprietary qualified securities and letters of credit collateralized by customers' securities" are all permitted margin for purposes of the Rule 15c3-3a debit.[86] It is unclear why the use of the debit in the proposed amendment should be limited to margin in the form of cash or Treasury securities or why this condition is narrower than requirements for margin held at other clearing agencies.

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[81] 87 Fed. Reg. at 64,638.

[82] *Id*.

[83] *See* FICC Rulebook at Rule 4, Section 3 (regarding eligible forms of clearing fund deposit).

[84] Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Modify its Rules to Diversify and Standardize Clearing Fund Collateral Requirements Across the Divisions to Improve Liquidity and Minimize Risk for its Members, 71 Fed. Reg. 65,855, 65,856 (Nov. 9, 2006).

[85] Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Modify its Rules to Diversify and Standardize Clearing Fund Collateral Requirements Across the Divisions to Improve Liquidity and Minimize Risk for its Members, 71 Fed. Reg. 77,837, 77,838 (Dec. 27, 2006).

[86] *See* 17 C.F.R. § 240.15c3-3a, Note F.

Second, the use of the debit should not be conditioned on the automatic return of excess margin to broker-dealers by no later than close of the next business day.[87] Currently, participants at FICC and other clearing agencies request margin after they are notified of excess by the clearing agency.[88] A required automatic return would add significant operational burdens, as broker-dealer participants will need to update their systems to accept an automatic return back without a request and ensure that any such amounts are appropriately treated as customer assets. This operational burden is amplified by the fact that the requirement would not be consistent with those of other clearing agencies. Finally, this is also without a clear benefit in terms of customer protection. The Proposal already would require that Treasury CCPs hold assets being used to meet customer position margin requirements in an account at the Federal Reserve or an FDIC-insured bank that is segregated from any other account and is for the exclusive benefit of customers.[89] The margin would not be safer at a broker-dealer than it would be at a Treasury CCP, and the condition that excess automatically be returned to broker-dealers by no later than the close of the next business day would not lead to more customer protection.

Finally, broker-dealers should not be limited to posting only the same assets received from its customer to a Treasury CCP. In many instances, broker-dealers post proprietary assets to a clearing agency on behalf of a customer given timing and operational constraints. This practice is permissible in the context of margin posted to the OCC and DCOs, and should also be permissible with respect to margin posted to a Treasury CCP.

VIII. The Commission Should Engage with Other Regulators to Ensure Any Central Clearing Requirement Is Consistent with Other Regulations

A central clearing requirement for Treasury Transactions may have unintended, negative interactions with other regulations, potentially leaving market participants without a commercially reasonable option to comply with all regulatory requirements. In addition, certain other regulations may constrain the ability of market participants to centrally clear Treasury Transactions. The Commission should work closely with other regulators to identify potential interactions and ensure that any central clearing requirement does not adversely impact the ability of participants to clear transactions.

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[87] 87 Fed. Reg. 64,640 ("Proposed Note H(b)(2)(v) to Item 15 would provide that the customer position margin is treated in accordance with rules of the clearing agency requiring systems, controls, policies, and procedures to return customer position margin to the broker-dealer that is no longer needed to meet a current margin requirement resulting from positions in U.S. Treasury securities of the customers of the broker-dealer no later than the close of the next business day after the day the customer position margin is no longer needed for this purpose.").

[88] *See* FICC Rulebook at Rule 4, Section 10 (providing that FICC will return excess cash or clearing fund securities upon request).

[89] 87 Fed. Reg. at 64,640.

A. The Proposal's Interaction with CFTC Regulation 1.25 Would Effectively Prevent FCMs and DCOs from Entering into Treasury Repos with Customer Money

Under CFTC Regulation 1.25, Futures Commission Merchants ("FCMs") and DCOs may only invest customer money in repurchase and reverse repurchase transactions with permitted counterparties.[90] Treasury Repos represent a critical and safe source of funding for FCMs and their customers that presents minimal exposure to credit, liquidity and market risks. Central counterparties (including any Treasury CCP) do not qualify as permitted counterparties under current CFTC regulations. If the Commission were to adopt a central clearing requirement with respect to all Treasury Repos in which one counterparty is a direct participant of a Treasury CCP, and the CFTC did not revise current CFTC Regulation 1.25, an FCM or DCO that is a direct participant of a Treasury CCP would no longer be able to enter Treasury Repos with customer money. Even if an FCM or DCO were not a direct participant of a Treasury CCP, it would not be able to enter into Treasury Repos with customer money when facing direct participants of a Treasury CCP. This is because the proposed central clearing requirement would require that all Treasury Repos entered into with a direct participant of a Treasury CCP be cleared by a Treasury CCP. Upon novation of the Treasury Repo to the Treasury CCP, the Treasury CCP would become the counterparty of the FCM or DCO. However, as noted above, CFTC Regulation 1.25 would forbid such FCMs and DCOs from facing Treasury CCPs under Treasury Repos entered into with customer money.

Taken together, the counterparty restrictions coupled with the central clearing requirement will effectively prevent Treasury Repos to be entered into with customer money, as the vast majority of Treasury Repos will involve FCMs and DCOs that are either direct participants of a Treasury CCP or face a direct participant of a Treasury CCP. This is clearly an undesirable outcome. It would not only make FCMs and DCOs less competitive, but it would also reduce liquidity available in the market, the opposite effect of the Proposal's intended objective.

B. The Inability to Exempt CCLF Exposures to a CCP From the SCCL Further Restrains Banks' Ability to Engage in Central Clearing

Another example of how a central clearing requirement would negatively interact with other regulatory requirements is the SCCL, which limits a bank holding company's credit exposure to a single counterparty to no more than 25 percent of its Tier 1 capital, subject to

[90] 17 C.F.R. § 1.25(d)(2). When adopting the current form of CFTC Regulation 1.25, the CFTC did not explain why central counterparties were not included as permitted counterparties for repurchase and reverse repurchase transactions. *See Rules Relating to Intermediaries of Commodity Interest Transactions*, 65 Fed. Reg. 77,993 (Dec. 13, 2000) (final rule); 65 Fed. Reg. 39,008 (proposed June 22, 2000). It would appear central counterparties were not considered. There is every reason, however, to include central counterparties as permitted counterparties, both to avoid the issue described above, and because central counterparties are at least as safe as the entities in the current permitted counterparties list, which includes banks and broker-dealers. This can be achieved by an amendment to current CFTC Regulation 1.25 or no-action relief. *See* CFTC Letter No. 12-34 (Nov. 19, 2012) (no-action relief for an SEF in connection with investing customer funds pursuant to repos cleared by an unnamed SEC-registered securities clearing agency that is not a permitted counterparty under CFTC Regulation 1.25(d)(2)).

certain exemptions. One of these exemptions is cleared activity with a clearing agency.[91] However, uncleared activity with a clearing agency is *not* exempted. This includes FICC's CCLF, the notional value of which is already quite large, and which increases the more a bank centrally clears at FICC. As entities subject to the SCCL submit more Treasury Transactions for central clearing, their CCLF exposure increases. It may therefore be necessary to consider exempting the CCLF exposure from the SCCL, or increasing the SCCL with respect to exposures to FICC, due to the larger possible CCLF exposure that bank holding companies may end up incurring. In addition, and as noted above, giving FICC access to the Federal Reserve's standing repurchase facility would provide liquidity when needed without ballooning the CCLF.

IX. If a Central Clearing Requirement Is Adopted, the Commission Should Ensure That There Is Sufficient Time to Implement the Significant Operational, Documentation and Other Changes That Would Be Required of the Industry

Given the complexity of the Proposal, the time necessary for FICC to revise its rules to accommodate a central clearing requirement and the extensive operational and documentation changes that will be necessary to comply with such a requirement, we support a multi-year and deliberate implementation timeframe. The Proposal envisions FICC engaging in a review of its access models and a consultation of various stakeholders in relation to its access models.[92] This alone will take a great deal of time, particularly if FICC determines that revisions to its access models, or the development of a new access model, would be prudent. The necessary revisions to the FICC Rulebook would further require careful deliberation, engagement with participants and drafting, followed by review and approval by the Commission. FICC may also need to increase its operational capacity to accommodate the increase in transactions submitted to FICC for central clearing if the Proposal is finalized as proposed. Once necessary revisions to the FICC Rulebook are adopted and FICC's operational build to roll out any new products is complete, front-to-back office operational changes at market participants would follow. This would involve major revisions to internal policies, significant IT and operational builds and lengthy renegotiations of underlying legal relationships. A longer timeline would allow market participants—especially smaller entities that do not currently engage in central clearing—to update their operations and documentation with the thoroughness and care such a sweeping regulatory requirement deserves. A rushed timeline, however, could result in a disruptive implementation, undermining the stability of the critical Treasury market—the opposite of the Proposal's intent.

Furthermore, before any central clearing requirement takes effect, (i) the proposed changes to the rules of Treasury CCP with respect to risk management and segregation of customer positions and margin, (ii) the addition of a debit under the Rule 15c3-3a customer reserve formula and (iii) any other steps the Commission takes to incentivize central clearing, as discussed above in Section III, should be prioritized. Only *after* these steps that prepare the Treasury market for central clearing are complete should the Commission turn to implementing any central clearing requirement.

[91] *See* 12 C.F.R. § 252.77(a)(3).

[92] 87 Fed. Reg. at 64,635-36.

Finally, the Commission should implement any central clearing requirement in stages and at a measured pace commensurate with the size, scope and scale of the implementation program required. In particular, the Commission should work to determine an implementation that will be the least disruptive to the market. Implementation should also account for the practical challenges that different industry participants may face as they prepare for a central clearing requirement, which may not be clear until participants are able to see and understand the concrete proposals from FICC of how the Proposal would be implemented. The Commission should engage with market participants to understand what those challenges may be. Staging implementation would allow the Commission to appropriately calibrate the costs and benefits of any requirement to clear Treasury Transactions. We note that similarly significant changes to market structure were successfully phased-in over five or more years to allow adequate time for market readiness while mitigating the potential for disruption.[93]

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[93] *See*, *e.g.*, Task Force on Tri-Party Repo Infrastructure, *Final Report* 4, (Feb. 2012), https://www.newyorkfed.org/medialibrary/microsites/tripartyrepo/pdf/report_120215.pdf ("The Task Force believes that implementation of its Target State vision over the next few years will provide a meaningful reduction in both the potential for systemic risk and the magnitude of the risk associated with the tri-party repo infrastructure"); 17 C.F.R. § 23.161 and 12 C.F.R. § _.1(e) (the CFTC and the prudential regulators both adopted a six-phase compliance period over seven years after they each finalized uncleared swap margin rules in 2016).

SIFMA and IIB greatly appreciate the opportunity to submit this comment letter on the Proposal. If you have any questions or require additional information, please do not hesitate to contact us at rtoomey@sifma.org or mmeertens@iib.org. You may also contact Joe Corcoran (jcorcoran@sifma.org) or Peter Ryan (pryan@sifma.org) at SIFMA or Justin Underwood (junderwood@iib.org) at IIB.

Sincerely,

Robert Toomey
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association

M. Meertens
Michelle Meertens
Deputy General Counsel
Institute of International Bankers

Cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime Lizárraga, Commissioner

Nellie Liang, Under Secretary for Domestic Finance, U.S. Department of Treasury
Joshua Frost, Assistant Secretary for Financial Markets, U.S. Department of Treasury
Brian Smith, Deputy Assistant Secretary for Federal Finance, U.S. Department of Treasury

Michael Gibson, Director, Division of Banking Supervision and Regulation, Federal Reserve Board
Jennifer Burns, Deputy Director, Division of Banking Supervision and Regulation, Federal Reserve Board
Christine Graham, Special Advisor, Federal Reserve Board