asset management group

December 23, 2022

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: 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 (File No. S7–23–22)[1]

Dear Ms. Countryman:

The Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA AMG")[2] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposed rule regarding 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 "Proposed Rule").

Introduction

SIFMA AMG strongly supports the Commission's objective of increasing the resilience and capacity of the market in U.S. Treasury securities. We also share the Commission's concerns about maintaining adequate liquidity and the potential for future dislocations and disruptions in this market to negatively impact investors. Our members are active participants in the U.S. Treasury markets and we have a strong interest in promoting stability and ensuring that any proposed reforms will protect the interests of the investor community.

As outlined in greater detail below, we believe that the Proposed Rule, if implemented without first requiring certain enhancements to the current market infrastructure and time for cleared liquidity to build, could inadvertently reduce market liquidity while at the same time exposing market participants to additional credit exposures and risks. While we know it is not the

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[1] SEC Release No. 34-95763 (September 14, 2022), 87 Fed. Reg. 64610 (October 25, 2022).

[2] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

Commission's intention, we are concerned the Proposed Rule, absent our recommended changes, will only create ***costs*** and <u>not</u> create ***capacity***. Our concerns are magnified by the absence of evidence and data on how the Proposed Rule will achieve the broad and deep market participation that the Commission is seeking to promote. Given the domestic and global importance of the U.S. Treasury market, we believe that any proposed reforms of this magnitude should be based on evidence showing how increased central clearing will promote greater transparency, stability and liquidity. We have seen in other markets, such as the over-the-counter derivatives market, how carefully calibrated central clearing mandates can reduce systemic risk while also promoting market liquidity. However, it is unclear how the broad clearing requirement contemplated in the Proposed Rule will address the challenges facing the U.S. Treasury and Repurchase Agreement ("<u>Repo</u>") market, particularly given that the only currently available clearing house (Fixed Income Clearing Corporation ("<u>FICC</u>")) would have to undertake significant work before it is ready to meet and fulfil the proposed new requirements.

In light of the current state of FICC's readiness, the Commission should consider sequencing its approach to reforms in this market in a different order. The Commission should start with efforts to incentivize central clearing without prematurely making it a requirement. This could be achieved by requiring covered clearing agencies to offer central clearing models that offer appropriate protections for investors as well as more straightforward central clearing characteristics. We believe that more robust clearing models will incentivize voluntary clearing so as to build liquidity, and then an assessment can be made of the merits of any requirement to clear. A broad requirement to clear should only be imposed once other approaches to incentivize clearing have been advanced and the scope of voluntary clearing demonstrates desired improvements to the U.S. Treasury market more generally.

In addition, before introducing a broad requirement to clear, convincing evidence should be produced that such a requirement will in fact promote liquidity and the other goals articulated in the Proposed Rule. In addition, a clearing requirement should only be imposed once we have a robust clearing ecosystem which has been designed with input from all relevant stakeholders. We respectfully ask the Commission to take account of the concerns and suggestions outlined below and solicit further public comment on these issues as necessary, before advancing the sort of central clearing mandate envisioned in the Proposed Rule.

As discussed in more detail below and assuming the Commission decides to proceed with the vision embodied in the Proposed Rule, SIFMA AMG recommends that the Commission amend and revise its approach as follows:

1. ***Substantiate Benefits and Potential Costs of Clearing through Additional Studies and Data***. We believe the Commission's proposals should be reconsidered after the Commission has had an opportunity to gather additional data and further assess whether increased clearing is the best way to mitigate the risks confronting the U.S. Treasury market. Included in this review should be a more in-depth understanding of how these changes will affect the costs of transactions for institutional investors who depend on

access to these markets for active portfolio management and, as a result, represent a significant source of market liquidity. The economics of transactions will be affected by the higher margin requirements, as well as the potential of further concentration in the Treasury and Repo markets that could result in reduced sell-side competition that limits investors' choices and increases transaction costs.

2. ***Incentivize Clearing of Treasury Transactions and Promote Alternatives to Central Clearing***. We believe there are other ways to incentivize clearing without prematurely imposing a broad-based central clearing requirement. We urge the Commission to advance these other incentives before making clearing a requirement. We also caution against an over-reliance on central clearing as a means of ensuring smooth functioning of the U.S. Treasury market and encourage the Commission to consider alternative solutions to achieve the goals of the Proposed Rule.

3. ***Robust Clearing Infrastructure (including a minimum of two covered clearing agencies) should be a Pre-Requisite to any Clearing Mandate***. The Commission should only impose a clearing mandate once FICC and at least a second covered clearing agency are able to offer access to clearing solutions that will fulfill enhanced rule requirements and meet the needs of market participants.

4. ***Conflation of Cash and Repo Transactions in Proposed Rule should be Revisited***. The markets for cash U.S. Treasury transactions ("Cash Transactions") and repurchase and reverse repurchase transactions ("Repo Transactions", and together with Cash Transactions, "Treasury Transactions") need to be addressed separately. As discussed in greater detail below, we do not presently support a clearing requirement or otherwise see the current imperative for incentivizing the central clearing of Cash Transactions. In our view, any requirement to clear Cash Transactions will serve to increase costs, generate operational complexities, and reduce liquidity without producing meaningful benefits to address perceived issues with respect to the Cash Transaction market. If gathered data demonstrates the benefits to be achieved from cleared market enhancements, and the Commission ultimately decides to proceed with a clearing mandate, the initial phasing of a clearing mandate should be limited to Repo Transactions before proceeding with a Treasury Transaction clearing requirement.

5. ***Clearing Model Must Offer Protections more like those applicable to Cleared OTC Derivatives***. Although the market for Treasury Transactions is very different from the OTC derivatives markets, prior to any clearing mandate being imposed, there must be an available clearing solution which provides market participants with a level of resilience and protection more like that currently provided for cleared OTC derivatives cleared through a futures commission merchant. Among other things, this model should ensure that collateral posted by customers is appropriately segregated and not subject to the risk of a direct clearing member default.

6. ***Address Constraints on Certain Market Participants Limiting their ability to Clear***. Several categories of active participants in the U.S. Treasury market are subject to unique restrictions or regulatory/statutory requirements (including state and local governments) that may impact their ability to continue trading on a cleared basis. Solutions to those restrictions and requirements should be addressed as appropriate before the imposition of a clearing mandate.

7. ***Allow significant lead time for implementation of any new requirement to clear***. Our recommended enhancements to the existing market infrastructure, together with the need to build liquidity in voluntarily cleared trades and assess the merit of a clearing mandate, will require a significant, multi-phase implementation period over many years to allow for the best chance of achieving the Commission's objectives without unintended negative consequences to the critically important U.S. Treasury market.

Discussion

1. ***Substantiate Benefits and Potential Costs of Clearing through Additional Studies and Data***

SIFMA AMG believes the Commission and other regulators should embark on additional studies and analysis of the U.S. Treasury market which consider all available market data before taking the significant step of imposing central clearing on broad portions of this market. Given the state of the existing clearing infrastructure. the immediate benefits of a central clearing mandate are not obvious, and more evidence is required to demonstrate how clearing will mitigate contagion and systemic risk and improve capacity and resiliency in this market. Even the studies which the Commission cites in the Proposed Rule acknowledge that additional data and evidence are needed in order to properly assess the amount of liquidity savings to be gained from central clearing and the costs and benefits of imposing a clearing mandate. We have seen no convincing data showing how a requirement to centrally clear along the lines proposed in the Proposed Rule would have fixed the issues and liquidity problems experienced during the "flash rally" of 2014, the stress in the Treasury repo market during September 2019 and the COVID-19 market shock of March 2020.

In addition, while central clearing may allow for increased balance sheet netting in the context of Repo Transactions, we note that accounting rules already allow dealers to net unsettled Cash Transactions across all counterparties on their balance sheets. Thus, it is unclear how central clearing will increase depth and participation in the market by dealers in the manner the Commission asserts in the Proposed Rule. Many asset managers and other buy-side investors transact in U.S. Treasury securities for short-term investing or to post those U.S. Treasury securities as collateral for other financial products. Those purposes could be frustrated by a clearing requirement, which would result in less activity by these market participants and less overall liquidity in the market.

The Commission states that its proposals would decrease the overall amount of counterparty credit risk in the secondary market for U.S. Treasury securities. However, absent significant enhancements to the existing clearing infrastructure and clearing offerings at FICC, we believe the Commission's proposal would increase the counterparty credit risk which exists in this market. That is particularly the case with the existing sponsored member clearing model at FICC. While some regulated funds used third-party custodians to hold securities and cash posted as credit support, there is no requirement to segregate customer assets and therefore most sponsored members have exposure to their sponsoring members for all collateral and other property held with the sponsoring member. While counterparty credit risk has been better addressed in the cleared derivatives and futures markets, the existing clearing model for some Repo Transactions addresses counterparty credit risk very differently and should be assessed independently from other cleared markets. Even if the Commission's proposals would mitigate some of the risks it has identified with hybrid clearing, the potential to introduce other counterparty risk must be evaluated and tested based on the specific features of the clearing model which market participants are being asked to adhere to. Again, we think the perceived potential benefits of clearing need to be demonstrated through appropriately deeper market analysis and data before imposing substantial new requirements to clear on such a critical market. The potential consequences for liquidity and pricing disruptions are too great to proceed in an untested manner.

In assessing our recommendations, we feel it is important for the Commission to understand that the two existing sponsored member offerings[3] – the Sponsored DVP Service and the Sponsored GC Service – do not align with the description of central counterparty services in the Proposed Rule. The Proposed Rule describes a CCP as a "clearing agency that interposes itself between the counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer". However, we submit that neither the Sponsored DVP Service nor the Sponsored GC Service operate in this manner. In the case of the Sponsored DVP Service, there is no interposition of FICC for the start leg of the "cleared" transaction; rather, these transactions are bilaterally settled and governed under an annex to a Master Repurchase Agreement (MRA)/ Global Master Repurchase Agreement (GMRA) between the original parties to the transaction. Only the end leg of these transactions is novated to FICC for clearing. Also, FICC does not guarantee settlement to the sponsored member of their transaction in the event the intermediating sponsoring member defaults. As between FICC and the sponsored member, it is hard to see how this equates to FICC acting functionally as "the buyer to every seller and the seller to every buyer" as the Commission itself has described the components of central clearing.

[3] FICC sponsored service includes two offerings: (i) a sponsored DVP service which offers eligible clients the ability to lend cash or eligible collateral via FICC-cleared DVP repo transactions in U.S. Treasury and Agency Securities on an overnight and term basis, as well as outright purchases and sales of such securities, to be settled on a Delivery-vs-Payment (DVP) basis; and (ii) a sponsored General Collateral (GC) service, which offers eligible clients the ability to execute general collateral repo transactions (in the same asset classes currently eligible for Netting Members to transact in via FICC's existing GCF Repo® Service) with each other and settle such repo transactions on the tri-party repo platform of BNY Mellon.

The Sponsored GC Service occurs completely outside of FICC with both the start and end legs of the transactions settled by The Bank of New York Mellon as tri-party agent (similar to any other tri-party transaction). In FICC's own advance notice to the Commission of the Sponsored GC Service, FICC acknowledged that this service was designed to overcome constraints limiting the ability of dealers to support more repo activity. It was not designed with a view to maximize protections to the participants trading in this market. As the existing model lacks clearing components and protections the Commission has identified as having a beneficial effect, we are firmly of the view that a precursor to a clearing mandate must be the introduction of a true clearing model that has been thoroughly vetted and designed with customer protection and legal certainty as its primary goals.

The Commission also states that its proposal would help a covered clearing agency avoid a potential disorderly member default. However, there is no evidence offered in the proposal as to how that goal would be achieved. While FICC conducts close-out simulations and other exercises to test its default management processes and procedures, we are not aware of any stress tests of FICC's default management capabilities which take into account the increase in transaction volumes FICC would have to handle under the Proposed Rule. Such tests should be conducted, and the results made public. We believe this is particularly important given that FICC is currently the only covered clearing agency for U.S. Treasury securities clearing activity and the proposal would result in significant increases in the volumes of cleared trades that FICC is required to handle.

The Commission also cites enhanced regulatory visibility as a rationale for requiring central clearing. However, we submit that there are other ways for regulators (including the Commission) to obtain greater insight into activity in this market without forcing large volumes of activity into central clearing. The Commission should assess whether alternatives (such as enhancements that overcome current limitations facing TRACE) would be a less burdensome means for Commission staff to obtain greater insight into the activity in this market. There are other markets (such as the OTC derivatives market) where activity that is not subject to a clearing mandate is reported to regulators, and we do not see why an overall transformational clearing requirement is needed for regulators to achieve greater transparency into market activity. One alternative means of promoting transparency would be to expand and make permanent the Office of Financial Research’s recent pilot program for collecting data on the non-centrally cleared bilateral repo market. We understand this program was informative and, if made permanent, it could provide another means by which regulators could gain increased visibility over the Treasury market.

In addition to substantiating the purported benefits of a central clearing requirement, a realistic evaluation should be undertaken of the costs which will be incurred by market participants in implementing the proposal. We believe those costs would be substantial and would include, among other things, increased margin, default fund contributions and clearing fees. They would also include the costs incurred to put in place the operations, infrastructure, and standard documentation required to support clearing. We are concerned that those costs will cause dealers

(especially smaller market participants) to reduce activity or leave the market entirely. This reduces competition on the sell-side and restricts the choices that institutional investors currently have. When competition is reduced, transactions costs will rise. In the case of both Cash Transactions and Repo Transactions, intra-day margin calls will simply create operational burdens and costs with no obvious benefit given that many margin calls will be met late in the day only to be returned to the posting party the next day. To the extent dealers are required to post collateral to a covered clearing agency without compensation or incur other costs associated with client clearing, those costs will either have to be absorbed by clients or dealers, which may reduce their capacity and would further constrain liquidity. As opposed to increasing participation and therefore competition in this market in the manner the Commission suggests, the proposed new requirements could discourage participation due to these increased costs and burdens – resulting in reduced liquidity. Some market participants may migrate trading to other markets in similar securities that are not subject to a requirement to clear. Expanded access to FICC may increase the potential for loss mutualization and exposure to default risk, which may constrain the market-making capacity of existing FICC members. This risk of reduced liquidity runs counter to the work of the Interagency Working Group on Treasury Market Surveillance ("IAWG") [4] and the Group of Thirty ("G30")[5] which is focused on improving resilience and liquidity in the markets.

As part of assessing costs, consideration should be given to unintended consequences given the impact U.S. Treasury markets have on financial markets more generally. For example, the Secured Overnight Financing Rate ("SOFR") is calculated largely based on implied financing rates of Repo Transactions cleared at FICC. Given the importance of SOFR as a new reference rate replacing LIBOR, we believe an assessment of the potential impact of an increased volume of cleared Repo Transactions on SOFR is important. To our knowledge, no study or impact analysis along these lines has been completed. We also see the potential for unintended consequences given the procyclical nature of central clearing. Rather than improve liquidity, a clearing requirement could constrain liquidity by requiring additional margin to be posted – often in the form of U.S. Treasury securities – at a time when markets are already strained.

All of these potential costs and unintended consequences could undermine any benefits of clearing and destabilize as opposed to strengthen the U.S. Treasury market. We believe a full analysis of these issues is warranted before taking such a significant step as introducing a requirement to clear to a large segment of the Treasury Transaction market.

2. ***Incentivize Clearing of Treasury Transactions and Promote Alternatives to Clearing***

We believe there are ways for the Commission to incentivize clearing without going so far as requiring covered clearing agencies to impose clearing on the market. We also believe there

[4] For work undertaken by the IAWG, see *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.
[5] For work undertaken by the G30, see the G30's Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience* 1 & 15 (July 2021), https://group30.org/publications/detail/4950.

are alternative solutions, other than clearing, which the Commission should consider and promote in order to achieve the stated goals of the Proposed Rule.

There are several ways to incentivize clearing which we support, some of which are included in the Proposed Rule. For example, we support a requirement for covered clearing agencies to review their access models for non-direct participants and ensure that adequate access exists for all market participants (both direct participants and indirect participants). We also support imposing a requirement that covered clearing agencies segregate customer positions from proprietary positions as contemplated in the Proposed Rule. This should allow for a dealer's proprietary positions to be netted against that dealer's proprietary positions via-a-vis other dealers, allowing more central clearing of Treasury Transactions.

Subject to appropriate customer protection requirements, we also agree with the Commission's proposal to allow a debit under the 15c3-3a customer reserve formula so that broker-dealer participants are able to pass through customer margin to a covered clearing agency. It does not make sense that margin cannot be freely rehypothecated from a customer through a broker-dealer to FICC without the dealer getting a beneficial adjustment as part of its reserve formula calculation. This change should incentivize central clearing of Treasury Transactions by reducing costs. However, these proposals will only work if further protections are adopted for the margin posted by customers for their cleared transactions as discussed in detail below.

The Commission should explore developing a framework which would allow cross-margining of customer Treasury Transactions between FICC and interest rate futures cleared on the Chicago Mercantile Exchange. We also encourage the Commission to work with other regulators to advocate for improvements to prudential rules which would have the effect of enhancing liquidity in the U.S. Treasury market. For example, a recalibration of the Supplementary Leverage Ratio ("SLR") and other largely risk-insensitive capital requirements, like the temporary changes the Federal Reserve Board introduced at the onset of the COVID-19 pandemic to ease strains in the Treasury market, would in our view increase capacity in the U.S. Treasury market.

We also believe it is important to promote alternatives to central clearing which could improve liquidity and strengthen the U.S. Treasury market. One tool which has been proposed is CUSIP aggregation, which has been applied successfully in the past to agency mortgage-backed securities and may improve liquidity by increasing the size of certain off-the-run U.S. Treasury issuances. The U.S. Treasury could also continue to consider engaging in buybacks of existing U.S. Treasury securities as a way of improving liquidity. The Commission could also further engage with the industry in discussions on how to expand all-to-all trading in secondary market Cash Transactions as a way to promote liquidity. We also think that other recent rule proposals and enhancements to the TRACE reporting obligations for U.S. Treasury securities will in time give the Commission greater visibility into this market.

It would be prudent in our view to advance these alternative means to strengthen the U.S. Treasury system and assess whether they would obviate the need for a clearing requirement.

3. ***Robust Clearing Infrastructure (including a minimum of two covered clearing agencies) should be a Pre-Requisite to any Clearing Mandate***

As noted above, our members have significant concerns about the imposition of a clearing mandate in advance of there being in place a strong central clearing infrastructure. In our view, a full assessment needs to be undertaken of the governance, margin levels, capital adequacy and loss-absorbing capacity of a central counterparty before it is mandated to clear large volumes of transactions in a market as critical as the U.S. Treasury market. At present, FICC is the only available central clearing agency which offers clearing for this market. This is highly problematic as it creates enormous concentration risk for market participants. It is an example of how forcing market activity towards clearing – even if that clearing ameliorates liquidity challenges – exposes market participants to new economic, operational, and legal risks and introduces the moral hazard of disrupting the U.S. Treasury market unintentionally. Given the importance of the U.S. Treasury market to the overall global economy, there needs to be a compelling reason for increasing the concentration of cleared trading activity in a single clearing house that is member owned and operated on a for-profit basis, particularly when there is no alternative or fallback venue should that clearing house experience a disruption to its operations or more significantly were to fail.

Our understanding is that FICC will have to undertake a significant body of work in order to determine whether it can support the expansion of clearing contemplated in the Proposed Rule. We feel strongly that progress needs to be made on FICC's readiness – with an opportunity for industry comment and input on their preparation – before a requirement to clear is contemplated. The current FICC clearing models do not satisfy the full range of buy-side requirements, and the needs of our members will need to be addressed before they will be comfortable directing a much larger volume of U.S. Treasury securities trading activity towards FICC.

To ensure the market gets the access models it needs, we believe that the Commission needs to be more prescriptive in directing covered clearing agencies on how they design their access models. The requirements in the Proposed Rule are very open-ended. For example, under the Proposed Rule a central counterparty like FICC is only required to have criteria for participation which "*ensure that it has **appropriate means to facilitate access** to clearance and settlement services of all eligible secondary market transactions in U.S. Treasury securities, including those of indirect participants, which policies and procedures the board of directors of such covered clearing agency reviews annually*." This leaves a great deal to the discretion of the clearing agency and its board. We believe the Commission should provide more direction on how a central clearing agency like FICC should provide access to clearing.

A successful clearing model must also facilitate and incentivize the clearing of "done away" transactions (i.e., transactions where the clearing member is not an executing party to the transaction to be cleared). In order to successfully migrate activity in Repo Transactions to

clearing and improve liquidity in the manner the Proposed Rule seeks to achieve, we believe a model that facilitates clearing of "done away" transactions is essential. This will require changes to incentives so that clearing brokers are compensated for facilitating this activity. Otherwise, clients will have to establish a separate clearing relationship with each executing counterparty, which bifurcates portfolios and increases margin costs and operational complexity for clients. In addition, permitting sponsoring members to compel clients to bundle execution and clearing services raises competitive and fair access concerns. If clearing is made a requirement before an appropriate give up model is put in place, we believe the result will be less as opposed to more liquidity in Repo Transactions. We also believe the Commission should require FICC and any other covered clearing agency to separate initial margin from default fund requirements that can be subject to loss mutualization. This separation 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 (*e.g.*, money market funds).

Adequate clearing access models will only materialize if the Commission is more prescriptive on how a clearing agency like FICC is to facilitate access and satisfy the other requirements in the Proposed Rule. Also, on an ongoing basis, there needs to be a more robust governance framework around the process for changing clearing agency rulebooks so that consequential amendments are not introduced without the required level of oversight, scrutiny and industry input.

Considering these shortcomings, we would ask the Commission to reconsider its overall approach and revisit whether the Proposed Rule is the right starting point for strengthening this market. We question whether a viable clearing model that achieves broad market acceptance will emerge simply by the Commission mandating that covered clearing agencies develop and adopt new policies and procedures. If the SEC proceeds with imposing a clearing requirement on Repo Transactions (as opposed to just incentivizing voluntary clearing of those transactions), we believe the only viable path is for the Commission to issue a detailed rulemaking establishing a common clearing model and standards which must be met by any covered clearing agency (including FICC) that wants to offer clearing services for Repo Transactions. As part of this rule making, the Commission could also address other regulatory changes (e.g., fund custody rules) that need to be amended in order for buy-side participants to participate in a cleared market while continuing to meet their other regulatory requirements.

4. __Conflation of Cash and Repo Transactions in Proposed Rule should be Revisited__

SIFMA AMG believes it is premature to contemplate any kind of central clearing requirement until alternative solutions are fully explored and an appropriate clearing model and infrastructure have been developed. However, if in the future a clearing requirement is pursued, we believe a distinction should be drawn between Repo Transactions and Cash Transactions.

Given the potential costs and absence of substantiated benefits, we submit that there should be no required clearing of Cash Transactions. In particular, we question the wisdom of a clearing

requirement that would only apply to Cash Transactions involving certain client segments. We see this as more likely to dampen as opposed to improve liquidity. There is no data to support imposing a clearing requirement that targets just hedge funds and leveraged accounts and we are concerned that a partial mandate may result in some dealers choosing to offer liquidity only in a cleared environment thereby reducing the liquidity available today to accounts in the uncleared cash market. If the Commission's concern is hybrid clearing involving inter-dealer brokers, we believe it would be more effective to focus on the regulation of the platforms where that activity is conducted as opposed to singling out a sub-set of customer Cash Transactions for clearing. In our view, any rule which differentiates between customer types (e.g., by requiring hedge funds and leveraged accounts to clear but not requiring clearing for other customers) will require dealers to engage in an enormous customer classification effort.

Moreover, the Proposed Rule's scopingin of hedge funds (using an over-broad definition of hedge fund) and accounts based on the mere ability to borrow, leverage their gross notional exposure, and/or short, or use commodity interests – rather than being based on whether there is actual activity that is above a relevant threshold - is flawed as it would potentially capture hedge funds and accounts that do not in practice engage in these activities despite their not being subject to a strict regulatory prohibition. Having undertaken similar client classification exercises over the last decade as part of implementing swap dealer and security-based swap dealer requirements under Dodd-Frank, it is unclear if dealers will be prepared to absorb the cost of another such exercise for U.S. Treasury clearing. Again, introducing such requirements could have the unintended effect of reducing dealer capacity and liquidity in this market.

While we believe there is a marginally stronger case for the clearing of Repo Transactions, even the case for clearing Repo Transactions is far from convincing. Much emphasis has been placed on the fact that the netting benefits of increased clearing would allow dealers to free up balance sheet and provide more liquidity to the U.S. Treasury market. However, it is unclear to us how much dealers are balance sheet constrained and whether reduced capacity is due to balance sheet scarcity or the need to optimize risk weighted assets. Before taking the significant steps of imposing a requirement to clear, we believe the Commission should have compelling evidence of approximately how much trading capacity and liquidity would be unlocked by increasing repo clearing. We believe this is a subject the Commission should study further and produce data for in order to fully understand the potential benefits of the proposed clearing requirement.

We also think the Proposed Rule is over-broad in how it defines Repo Transactions. As proposed, it would include any repurchase/reverse repurchase transaction that is "of a type accepted for clearing by a registered covered clearing agency". In our view, not all repurchase/reverse repurchase transactions that are accepted for clearing should be treated in the same manner. We note, for example, that tri-party repo arrangements are not explicitly discussed in the Proposed Rule and given their structure, we do not believe a requirement to clear them is warranted. In the event tri-party repo arrangements are not excluded, the Commission should coordinate with other regulators and agencies as to the impact any mandate to clear such products will have on markets they oversee or supervise (e.g., the Federal Reserve's reverse repo program).

Also, the proposals appear to have been developed largely with overnight repo in mind, but we would point out that term repo is a significant and increasingly important segment of the U.S. Treasury repo market. Among other things, term repo presents different considerations with respect to credit exposure and potential margining requirements. It is important that any clearing mandate take into account the various forms of repo agreement which are used in the market. Just as swaps are only mandated for clearing if they meet certain criteria that make them suitable for clearing, we think a similar granular approach needs to be taken to repo transactions (especially term repo). A clearing requirement should not be imposed across the board for all repo transactions; clearing should only be required for repo transactions that satisfy objective criteria that capture transactions that are appropriate and suitable for mandatory clearing.

Under the Proposed Rule, covered clearing agencies would be incentivized to accept as many products as possible for clearing to increase business even if those products are not suitable for central clearing. As opposed to simply being based on access, there should be other objective criteria or a process for the Commission to review and approve a product as in scope before it becomes subject to a rule requiring clearing.

5. ***Clearing Model Must Offer Protections more like those applicable to Cleared OTC Derivatives***.

It would be a mistake in our view if, to improve liquidity, the Commission were to impose a clearing solution which exposes buy-side market participants to significant new risks. As a general matter, we believe that a clearing requirement for U.S. Treasury securities should include protections that are more like the protections offered for cleared OTC derivatives cleared through a registered futures commission merchant ("FCM"). Those would include collateral segregation, insulation from fellow-customer risk and visibility at the clearing house level of customer transactions and positions. It is also important that market participants have access to standardized documentation to govern their clearing relationships as well as industry legal opinions that speak to the enforceability of netting and collateral arrangements for cleared Treasury Transactions under applicable bankruptcy laws. To our knowledge, no such standardized documentation or legal opinions currently exist for the clearing models currently accessible to indirect participants clearing through FICC.

Unfortunately, the current clearing solutions offered by FICC do not come close to meeting the necessary standards. Consider, for example, the lack of any protection for customer margin. While the Proposed Rule would require FICC to collect and hold margin for customer positions separately from a dealer's proprietary positions, there is nothing in the Proposed Rule which prescribes how that collateral can be applied by FICC. As a result, collateral posted by an indirect customer but held at FICC could be used by FICC to cover losses in the event of a direct participant default. In fact, there is nothing preventing a clearing house from applying customer collateral in this manner before accessing the clearing house funds or other resources. We view this as a major gap in the Proposed Rule and it will be difficult to support expanding cleared trading in U.S. Treasury securities until we have a framework which ensures customers can access clearing

solutions where their margin and collateral will be adequately protected, including from loss mutualization by the clearing agency. The market would also need greater transparency around the models which are used by the covered clearing agency to generate margin calls. At present, there is inadequate transparency into how FICC generates its margin calls and the inability to validate and monitor those models will raise liquidity concerns. Our members have significant concerns that market participants will be forced to back away from these markets – particularly the term repo market - if clearing is made a requirement before these shortcomings are addressed.

To illustrate the differences between OTC cleared derivatives and the current sponsored clearing model at FICC, we have prepared the following comparison chart for your consideration:

Comparison Chart: Cleared OTC Derivatives vs. FICC Sponsored Repo

	Issue	***Cleared OTC Derivatives***	***FICC Sponsored Repo***
1.	***Segregation of Customer Assets***	Customer funds are held in a separate cleared swaps customer account with a depository and properly titled as belonging to FCM customers.	No collateral segregation requirements. All funds are treated by FICC as proprietary assets of direct clearing member and can be used accordingly by FICC.
2.	***Residual Interest Buffer***	FCM required to maintain buffer in cleared swaps customer account to ensure compliance with collateral segregation requirements.	Not applicable as no collateral segregation requirements exist in current FICC model.
3.	***Exposure to Risk of Fellow Customer Default***	FCM prohibited from using funds of one customer to meet another defaulting customer's obligations to a DCO or clearing FCM.	No restrictions on use of posted collateral; posted collateral exposed to default risk of fellow customers. No scheme exists for how shortfall in assets gets allocated among customers.
4.	***Exposure to Risk of Clearing Intermediary Default***	In the event of FCM bankruptcy, assets in cleared swaps customer account attributable to non-defaulting customer cannot be used to meet shortfalls owed to FCM or DCO (though customers share any shortfalls in customer account pro rata).	No restrictions on use of posted collateral; posted collateral fully exposure to default risk of clearing intermediary.
5.	***Investment of Customer Assets***	FCM restricted to investing customer funds in permitted investments.	No segregation of customer funds and therefore no restrictions on their investment.
5.	***Clearing House Visibility of Customer Transactions***	DCO provided with information to identify each customer's transactions and margin within omnibus account.	All positions are treated as position of direct clearing member. FICC has no visibility of underlying customer positions.

	Issue	***Cleared OTC Derivatives***	***FICC Sponsored Repo***
7.	***Guaranty Fund***	DCOs require members to contribute to separate guaranty funds to remedy potential clearing member defaults.	FICC does not currently maintain a guaranty/default fund separate from its clearing fund in order to mitigate impact of defaulting member.
8.	***Clearing Agencies***	Multiple DCOs registered with CFTC.	FICC is sole covered clearing agency.
9.	***Documentation***	Standard Template (FIA-ISDA Cleared Derivatives Addendum) used to document relationship between clearing members and customers. Addendum is generic (i.e., not DCO specific).	No standardized documentation. Certain dealers use a form of Annex to the MRA/GMRA model. Other dealers and custody banks have developed their own stand-alone processing agent form of agreement. Each set of documents is unique, requires protracted negotiation to finalize and therefore is not currently scalable.

6. Need to Address Constraints on Certain Market Participants limiting their ability to clear

Many SIFMA AMG members have underlying clients that are significant participants in the U.S. Treasury market but who are also subject to regulatory and practical constraints, including on the State and local government level, which limit their ability to clear. Counterparty limitations and restrictions are a concern. For example, central counterparties like FICC are not eligible counterparties for certain entities under their specific regulations. In addition, counterparty limits may be imposed by the rating agencies which treat the clearing agency as if it was a dealer. For example, certain collective investment vehicles like SICAVs in Europe have a 15% counterparty limit for repo transactions, which includes clearing houses.

While there is no similar concentration risk for 2a-7 funds in the U.S., those funds are limited in their ability to participate in clearing and an alternative means needs to be found for them to compensate their intermediaries for facilitating their transactions. To the extent a 2a-7 fund transfers collateral or other assets to be held by a sponsoring member or other clearing intermediary, that intermediary needs to be approved by the fund's board as a custodian (which can be a lengthy process). In addition, the rating agency criteria for 2a-7 funds require them to limit the amount of the fund with one repo counterparty to 50% of the fund's assets in order to maintain a AAA rating. Certain offshore money market funds will be subject to more onerous haircuts in the event they are required to clear Repo Transactions with an entity like FICC that is not a regulated credit institution. More onerous haircuts would increase costs in a way that may discourage participation by these offshore money market funds in the U.S. Treasury repo market.

Many asset managers also use joint trading accounts to facilitate late day redemptions of funds. These accounts do not currently have the ability to access FICC. If clearing is mandated, FICC will need to expand Sponsored Member eligibility to include these joint trading accounts.

Before imposing a clearing mandate, it is important to understand how FICC's access models would address and accommodate the unique requirements and limitations applicable to these market participants. The failure to adequately address these regulatory constraints prior to the imposition of any clearing mandate may result in a reduction to (not an improvement on) current levels of liquidity.

7. ***Allow significant lead time for implementation of any new requirement to clear***.

If, having attempted to incentivize clearing of Treasury Transactions through other means, the Commission concludes - based on studies and data - that a clearing requirement is still essential to achieve its goals, we believe a measured approach to implementation is required. Any new requirement to clear should be introduced only after enhancements to the clearing infrastructure are achieved, FICC's readiness is assured, and at least one other covered clearing agency registered with the Commission is ready to support the market in clearing eligible secondary market transactions.

We believe a period of at least eighteen months should be allowed for industry participants to engage with each covered clearing agency on the design of an appropriate clearing model that provides the minimum level of protection highlighted above. Only once sufficient consensus has emerged around the appropriate clearing model, and appropriate regulatory requirements are developed, should a timetable be set for implementing the new requirements. Once the regulatory framework is enhanced and requirements are implemented, a mandate to clear should be phased in over several years based on the volume of Treasury Transaction activity in which a market participant engages (like the phase-in approach which was followed for regulatory initial margin requirements for uncleared OTC derivatives which took more than five years following the publication of final rules to be fully implemented). It will be important to phase in the new requirements in a manner that avoids too many market participants looking to finalize documentation and go-live with clearing all on the same day.

A long phase-in period is essential as there will be a significant implementation effort required to adhere to the new requirements. For example, if the proposal for clearing Cash Transactions under the Proposed Rule is eventually adopted, direct participants will need to obtain information to classify their counterparties to determine who qualifies as an interdealer broker, a hedge fund or a leverage account. It is unclear at what stage counterparty classification data will need to be collected and whether representations will need to be periodically confirmed or if counterparty classification is only required to be evaluated once at a single point in time. The Commission should clarify what will be required as part of any final rule making. We would also note that, once any in-scope client classification is completed, clearing agreements would need to be negotiated with each hedge fund and leverage account that is required to clear.

Significant lead time will be required for asset managers to implement documentation, such as clearing agreements, give-up agreements, and related infrastructure to comply with these

new requirements. In addition, with respect top managed funds, existing formation and distribution documentation (such as investment management agreements and investment guidelines) would not permit clearing activity or do not contemplate the clearing of U.S. Treasury securities at all. All of these documents will have to be revisited with underlying clients and renegotiated. As with all cleared products, buy-side firms will have to undertake a significant operational build in order to be able to settle and margin cleared Treasury Transactions. Many SIFMA AMG members trade in blocks on behalf of multiple underlying accounts. As part of implementation, the industry will have to consider and address how a mandatory requirement to clear will impact an asset manager's transaction allocation process where some accounts are mandated for clearing and others are not.

It is difficult to estimate the potential scope of this work and the effort which will be involved until the access models of the applicable covered clearing agencies are more developed. For example, there is currently no clarity on the impact of the margin cycle for cleared transactions, particularly Cash Transactions and whether there is the possibility for intra-day margin calls given the T+1 settlement cycle for U.S. Treasury securities.

Given the breadth of participation in the U.S. Treasury securities markets, the potential scale of the effort and time required to complete this work, implementation will take many years to complete once the Commission's final proposals are published.

On behalf of SIFMA AMG, we appreciate the opportunity to respond to the Proposed Rule and your consideration of our comments and recommendations. If you have any questions or require additional information, please do not hesitate to contact us by calling William Thum at (202) 962-7381.

Sincerely,

William C. Thum
Managing Director and Assistant General Counsel, SIFMA AMG

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
The Hon. Mark T. Uyeda, SEC Commissioner
The Hon. Jaime Lizárraga, SEC Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets