

An hourglass with blue sand is centered in the frame against a solid blue background. The sand is flowing from the top bulb to the bottom bulb. The hourglass is made of clear glass, and the sand is a vibrant blue color. The background is a uniform, bright blue.

This webinar will begin shortly.

FIA



The SEC's New Treasury Clearing Rule

—
21 March 2024



Reminders

- The webinar will be recorded and posted to the FIA website within 24 hours of the live webinar.
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Presentation prepared by **CLEARY GOTTlieb**



Background

The U.S. Treasury market is often considered “the single most important financial market in the world”, and indeed, the U.S. Treasury repo market is the source of SOFR today. Historically, it was also one of the most liquid and resilient markets

However, over the past decade, there have been various disruptions in the Treasury market, including:

the “flash rally” of October 2014, when yields on Treasury bonds plunged, leading to sharp increases in prices;

the September 2019 repo market disruptions, when repo rates increased dramatically in connection with a large withdrawal of reserves from the banking system and the settlement of Treasury securities auctions; and

the COVID-19 shock of March 2020, when market uncertainty caused a spike in volume in the market for Treasury securities, leading to intervention by the Federal Reserve

These disruptions have led market participants, academics, and regulators to consider whether market reforms are needed



G30 Report and Recommendations

In response to these events, the Group of Thirty (G30), a group of scholars, regulators, and market participants led by Tim Geithner, issued a report recommending certain steps to increase the resilience of the Treasury market.

- 1 Creation of a Standing Repo Facility by the Federal Reserve, providing broad access to repo financing for Treasuries (which the Fed created in July 2021)
- 2 Central clearing of all Treasury transactions executed on IDBs
- 3 Central clearing of all Treasury repos
- 4 Continuing to study how dealer-to-client Treasury cash transactions could be centrally cleared
- 5 Review the operation and design of the Fixed Income Clearing Corporation ("FICC"), the only Treasury central counterparty ("CCP")
- 6 Consider whether capital or other regulations could be modified to incentivize intermediation by banks and bank affiliates
- 7 Consider the robustness of regulation of independent broker-dealers
- 8 Increase reporting of Treasury transactions
- 9 Extend Reg ATS and SCI to all Treasury trading platforms, including IDBs
- 10 Interagency study on exemptions of Treasuries from US securities laws

FICC's Access Models

FICC Sponsored Member Service

DONE-WITH

— Sponsoring Member acts as processing agent and guarantor for Sponsored Member in connection with transactions **between Sponsored Member and Sponsoring Member**

DONE-AWAY

— Sponsoring Member acts as processing agent and guarantor for Sponsored Member in connection with transactions **between Sponsored Member and a third party**

SPONSORED GC REPO

— Done-with trading that **settles using BNYM's tri-party platform** pursuant to custodial undertaking or similar documentation between Sponsored Member and Sponsoring Member, rather than through FICC's DVP settlement service

FICC Agent Clearing Member

FICC has filed rules to amend its current Prime Brokerage and Correspondent Clearing models to provide a model that closely resembles the FCM model of clearing

Under this model, the customer need not be a member of FICC and can enter into trades with its clearing member or third parties

The clearing member clears the transactions as agent for the customer, but remains fully liable to FICC



Treasury Clearing Proposal

Since the G30 report, the SEC has issued a number of proposals to implement the G30 recommendations, including:

- Proposed expansion of the dealer definition to include PTFs
- Proposed expansion of Reg ATS to pick up IDBs
- **Proposed amendments related to the central clearing of Treasuries (“Proposed Rules”)**

Proposed Rules were issued in September 2021 and proposed to:

Require Treasury CCPs (including FICC) to require its direct participants (e.g., FICC Netting Members) to clear all Treasury repos/reverse repos and certain Treasury cash transactions

- Currently, direct participants must only clear Treasury repos/reverse repos and Treasury cash transactions with other direct participants, although there has been an increase in “client” clearing of such transactions, primarily driven by direct participants

Require Treasury CCPs to take steps to “facilitate access” by market participants to clearance and settlement services

Require Treasury CCPs to calculate, collect, and hold margin for a direct participant’s proprietary Treasury securities transactions separately from the margin for the transactions of the direct participant’s customers

Amend SEC Rule 15c3-3a to permit broker-dealers to include a debit in the reserve formula for customer cash and Treasury securities delivered to a Treasury CCP to meet a margin requirement with respect to such customer’s Treasury securities transactions, subject to several conditions



FIA's Comment Letter on Proposed Rules

Proposed Rules' conflict with CFTC Rule 1.25

- Futures commission merchants ("FCMs") may invest customer funds in certain securities, including U.S. Treasuries. Such investments may be made directly or using repos subject to the constraints of **CFTC Rule 1.25. Rule 1.25(d)** sets out the types of permitted counterparties to such repos. **A Treasury CCP is not a permitted counterparty**
- Proposed Rules would require central clearing of all Treasury repos, and FIA raised a concern that **a transaction between an FCM and a Treasury CCP as a novated counterparty would not be allowed under CFTC Rule 1.25(d)**

FCM's ability to conduct in-house transactions

- "The CFTC has advised that **in-house transactions** in which an FCM/BD receiving customer collateral that is not acceptable at a DCO or foreign board of trade **may, independent of CFTC Rule 1.25 requirements, exchange that collateral for acceptable collateral to the extent necessary to meet margin requirements**"
- In FIA's view, **in-house transactions do not have counterparty**, so the Proposed Rules do not affect in-house transactions
- FIA asked the SEC to confirm its view, however, as subjecting in-house transactions to the clearing mandate would interfere with FCM's ability to conduct in-house transactions under the CFTC's advice



FIA's Comment Letter on Proposed Rules

Compliance with CFTC Rules

CFTC Rule 1.25(d)(9)

- **CFTC Rule 1.25(d)(9)** requires simultaneous receipt of same-day funds credited to an FCM's customer segregated cash account at the custodian bank and delivery or transfer of securities from the customer segregated custodial account
- FICC offers a repo clearing structure providing for DVP settlement. FIA commented that it would need to understand such structure better to understand its compliance with **CFTC Rule 1.25(d)(9)**

CFTC Rule 1.25(d)(13)

- **CFTC Rule 1.25(d)(13)** requires that the repo must allow FCMs to transfer immediately any securities purchased with customer funds that are subject to the repo in case of an FCM bankruptcy. Also, in case of an FCM bankruptcy, it requires that the repo must provide that **the counterparty has no right to compel liquidation of securities subject to the repo or to make a priority claim** for the difference between the current market value of the securities and the price agreed upon for the resale of the securities to the counterparty, if the former exceeds the latter
- FIA raised doubts whether FICC, as the novated counterparty to all transactions, would be able to comply with **CFTC Rule 1.25(d)(13)** requirements in the case of FCM bankruptcy



FIA's Comment Letter on Proposed Rules

Compliance with CFTC Rules

- CFTC Rules require **1) customer funds used to margin permitted transactions under CFTC Rule 1.25 to be held in a customer segregated account established under 1.20, 22.2, or 30.7, and 2) the depository sign an acknowledgement in the form required**
- Currently, FICC rules allow FCM/BD to establish a separate account for FCM customer transactions; the Proposed Rules require a clearing agency to establish a regime to segregate customer funds used to margin customer cleared positions in accordance with Note H of the proposed amendment to Exhibit A of SEC Rule 15c3-3
- FIA notes that the **account set forth under Note H is unlikely to meet the CFTC requirements**

FIA's Recommendation

- To address the conflict between CFTC Rules and Proposed Rules, FIA requested the SEC to include **a clear exemption for FCMs and their counterparties from the clearing mandate** when FCMs enter into U.S. Treasury transactions.



Summary of Final Rule

Direct participants of certain Treasury CCPs, including FICC, must submit for clearing all Treasury repos/reverse repos and certain Treasury cash transactions (“eligible secondary market transactions” or “ESMTs”)

Treasury CCPs must calculate, collect, and hold a direct participant’s proprietary margin separately from customer margin

Treasury CCPs must take steps to facilitate access by market participants to its clearance and settlement services

Broker-dealers are permitted to record a debit in the 15c3-3a formula for eligible assets collected from a customer and on-posted to a Treasury CCP to meet margin requirements for customer transactions



Treasury Clearing Mandate

Under the final rule, direct participants of Treasury CCPs will have to clear ESMTs, which include:

All Treasury repos/reverse repos, including those where the counterparty is not a direct participant

Treasury Cash Transactions:

- Executed on IDBs, i.e., entered into by a direct participant that brings together multiple buyers and sellers using a trading facility and is a counterparty to both the buyer and seller in two separate transactions
- Between a direct participant and a counterparty that is a registered broker-dealer, government securities dealer, or government securities broker

Exclusions for:

- Repos or cash transactions where the counterparty is a central bank, sovereign entity, international financial institution, or a natural person
- Repos where one counterparty is a central counterparty (including U.S. clearing agency, derivatives clearing organization, or foreign central counterparty) or a state or local government (but not pension plans)
- Repos between a direct participant and an affiliate, provided that the affiliate submits for clearing all other Treasury repos to which it is a party
 - In addition, the affiliate must be a bank, broker-dealer, FCM, or foreign equivalent for the exclusion to apply



Inter-Affiliate Exemption

The availability of the inter-affiliate exemption is **conditioned on** “the affiliated counterparty submit[ting] for clearance and settlement **all other** repurchase or reverse repurchase agreements collateralized by U.S. Treasury securities to which the affiliate is a party”

Based on the plain language, the exemption would appear conditioned on the affiliate clearing Treasury repos, even if they are carved out of the ESMT definition (e.g., a repo between the affiliate and the central bank)

However, in the preamble to the final rule, the SEC asserted that “[b]y referring to all other repos or reverse repos, the exemption clarifies that the requirement does not encompass transactions between the direct participant and the affiliate, i.e., the transactions that are excluded, and also does not encompass the affiliate’s transactions that would otherwise be excluded under sections (iii), (iv), or (v) of the definition of an eligible secondary market transaction”



Other Requirements

Separate Calculation of Customer Margin

The final rule requires that a Treasury CCP establish policies and procedures to calculate, collect, and hold margin for a direct participant's proprietary Treasury securities positions separately from the margin calculated and collected from that direct participant with respect to its customer Treasury securities positions

- The final rule does not require that margin collected for customers be collected on a gross basis, but would allow net margining
- There is no limit on loss mutualization or other uses of the margin

Facilitating Access

The final rule requires Treasury CCPs to establish policies and procedures to facilitate access to clearance and settlement services of all ESMTs in Treasury securities, including those of indirect participants

- Indirect participants may include pension funds, asset managers, investment advisers and RICs
- It does not require that access for such participants take any particular form
- The SEC specifically declined to require that Treasury CCPs adopt a singular model or mandate that their direct participants offer particular models



Amendments to 15c3-3a Reserve Formula

The final rule amends Rule 15c3-3a to permit broker-dealers to include margin required and on deposit at a Treasury CCP as a debit item in the customer reserve formula, subject to certain conditions

This will “free up” broker-dealers’ resources to meet new Treasury CCP margin requirements

- Currently, the absence of a debit in the formula means that broker-dealers are unable to use margin posted by customers to fund margin/clearing fund obligations arising on account of customer transactions
- The debit item will effectively allow these broker-dealers to collect margin from their sponsored customers and pass it on to FICC
- Broker-dealers may post FICC-eligible securities (e.g., GSE securities) to meet customer margin requirements, in addition to cash and Treasuries
- Broker-dealers may record a debit when they temporarily pre-fund customer margin obligations pending receipt from the customer of the margin



Changes from the Proposal

CLEARING MANDATE

- In response to industry feedback, the SEC substantially narrowed the scope of cash transactions subject to the clearing mandate to exclude transactions with hedge funds, private equity funds, and prime brokerage clients
- In addition, the SEC added exceptions for central counterparties, state and local governments, and inter-affiliate transactions
 - As noted, there is some uncertainty on the scope of the inter-affiliate exemption

AMENDMENTS TO 15C3-3A

- Broker-dealers may post FICC-eligible securities (e.g., GSE securities) to meet customer margin requirements (the proposal would have limited eligible margin to cash and Treasuries)
- Broker-dealers may record a debit when they temporarily pre-fund customer margin obligations with U.S. Treasuries pending receipt from the customer of the margin
- A Treasury CCP need not return excess collateral with respect to customer positions to broker-dealers within one business day



Key Points from the Preamble

Securities Loans Excluded

- The SEC expressly noted that securities loans are not within the scope of the clearing mandate

No Legally Segregated, Operationally Commingled (“LSOC”) Mandate

- The SEC declined to require Treasury CCPs to adopt an LSOC model
- Further, the SEC left open the possibility that a Treasury CCP could allow net margining and loss mutualization for customer margin

Time-Limited No-Action Relief Under Investment Company Act Custody Rule for Margin Posted to FICC or Broker-Dealers

- Only applies to margin posted in connection with Sponsored Member Program
- Conditioned on margin being segregated and not subject to loss mutualization
- Time limited to five years



Key Points from the Preamble

No Exclusion for Triparty Repo

- The SEC declined to adopt an exclusion for triparty repo because the triparty agent does not serve as a CCP, and in its view does not have “controls equivalent to those available through central clearing”

Mixed Triparty CUSIP Repos must be Cleared if the Repo Includes Treasuries from the Outset

- The SEC stated that mixed CUSIP triparty repos are ESMTs “to the extent that a mixed CUSIP triparty repo contains U.S. Treasury CUSIPs from the outset of the transaction”
- What this means is somewhat unclear

No Carve Out for Off-Hours Trades

- The SEC declined to adopt an exemption for trades executed after normal business hours on the grounds that FICC’s hours sufficiently accommodate market practice

No Exclusion for End Users

- The SEC declined to adopt an exclusion for commercial end users, similar to that in place in the uncleared security-based swap margin rules and uncleared swap margin rules

No Exemption for FCMs

- The SEC declined to carve out an exemption for FCMs from the clearing mandate as requested by FIA



SEC Response to FIA Concerns

SEC on FIA's exemption request for FCMs

- The SEC **did not exempt FCMs from clearing mandate** as FIA requested in its comment letter
- The SEC granted CME's request to exempt DCOs from the clearing mandate

Proposed Rules' conflict with CFTC Rule 1.25 and FICC's compliance with CFTC Rule 1.25(d)(9) and (13)

- The SEC stated that FCMs could engage in the cleared repos consistent with CFTC Rule 1.25 through FICC's prime broker / correspondent clearing model because **FICC is not a party to those transactions**

FCM's ability to conduct in-house transactions

- The SEC did not exempt in-house transactions from clearing mandate, stating that such transactions would be subject to the clearing mandate if they are with a **participant of a US Treasury covered clearing agency** and **otherwise meet the definition of an eligible secondary market transaction**



CFTC Rule 1.25

Repo Transactions

- Repo transactions may be used by the repo seller to obtain financing or liquidity and can also be used by the repo buyer to invest cash into securities which pose less custodial risk than cash.
- Repo transactions expose the buyer and the seller to each other's credit risk; if the value of the purchased securities increase prior to the repurchase date, the seller is exposed to the buyer and vice versa.
- The right of U.S. Treasury repo counterparties to terminate and determine a net amount is generally safe harbored from the automatic stay under the US Bankruptcy Code

FCMs and DCOs may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (vii) of CFTC Rule 1.25 pursuant to agreements for resale or repurchase of the instruments, in accordance with CFTC Rule 1.25(d)



Counterparty Restrictions of CFTC Rule 1.25

Credit Risk in Repo and CFTC Rule 1.25(d)

The rationale behind CFTC Rule 1.25 is to allow FCMs and DCOs to invest customer funds but to do so in a manner that protects customer funds and maintains liquidity

In adopting limitations to the types of counterparties that an FCM and a DCO may face when entering into repo or reverse repo transactions in the aftermath of the financial crisis, the CFTC noted for example, that concentration of credit risk increases the likelihood that the default of one party could exacerbate financial strains and lead to the default of its affiliate

In addition to prohibiting FCMs and DCOs from entering into repo transactions with their affiliates, 1.25(d) limits the counterparties with which FCMs and DCOs can enter into repo transactions to those identified in 1.25(d)(2) (the “permitted counterparties”). **An SEC-registered clearing agency like FICC is currently not a permitted counterparty**



Relief from and Potential Changes to 1.25(d)

In 2011, CFTC introduced Rule 1.25(d) to limit permitted repo counterparties for FCMs and DCOs

On Nov. 19, 2012, CFTC published CFTC [no-action] Letter No. 12-34, noting that it will not recommend enforcement actions against an FCM ("X") using customer funds to invest in the repos of "government securities," as defined by subparagraphs (A), (B), and (C) of section 3(a)(42) of the Securities Exchange Act" cleared by the securities clearing agency ("Y"), even if the clearing agency is not a permitted counterparty under CFTC Rule 1.25(d)(2)

However, the no-action relief was limited to the facts and representations made by X, so it may not generally be applicable for all other FCMs (or clearing agencies)

On February 8, 2024, the CFTC's Global Markets Advisory Committee recommended adding "covered clearing agency" to the list of "permitted counterparty" under CFTC Rule 1.25(d)(2)

FIA

The image features the letters 'FIA' in a bold, sans-serif font. The 'F' is dark grey. The 'I' is dark grey with a green triangle on its right side. The 'A' is blue with a green triangle on its left side. The background consists of several overlapping geometric shapes: a light green triangle pointing down from the top left, a light blue triangle pointing up from the bottom left, a light green triangle pointing up from the bottom right, and a light blue triangle pointing down from the top right. The text is centered horizontally and partially overlaps these shapes.