The SEC's Treasury Clearing Mandate

December 22, 2023

Mandatory central clearing is coming to the US Treasury market. Citing the many virtues of clearing — mitigation of the "overall amount of counterparty credit risk," centralized default management, multilateral netting of transactions, and the potential "to unlock further improvements" in market structure — the Securities and Exchange Commission (SEC) has adopted a suite of new rules under the Securities Exchange Act of 1934 that will require central clearing of a broad range of repo and cash market transactions in US Treasuries that currently transact bilaterally or on triparty repo platforms. As adopted, the new clearing mandate is less comprehensive than as proposed in September 2022. That proposal had included in the definition of "eligible secondary market transactions" required to be cleared cash transactions with hedge funds and with leveraged accounts held with broker-dealers (that is, any account permissioned to borrow more than one-half of its value). Stating that this part of the proposal merited further consideration, the SEC promised to continue evaluating whether further action to extend the mandate is appropriate.

These are the transactions in the scope of the mandate:

- Repo or reverse repo agreements collateralized by US Treasuries, in which one of the counterparties is a member of the Fixed Income Clearing Corporation (FICC); and
- Any purchase and sale (cash market) transaction between an FICC member and any counterparty that is executed on an interdealer broker platform (that is, a trading system operated by the FICC member that "brings together multiple buyers and sellers" and on which the FICC member is counterparty to both the buyer and seller in two separate transactions), as well as any transaction between an FICC member and a registered broker-dealer, government securities broker or government securities dealer.

There are exceptions to the mandate for inter-affiliate repo and cash market US Treasury transactions, as well as transactions with central banks, sovereigns, international financial institutions, state or local governments (but not state pension and retirement plans), a covered clearing agency or derivatives clearing organization and natural persons.

The rule has a relatively long compliance runway — FICC has until March 31, 2025, to implement changes to its rules, policies and procedures, and its members have until December 31, 2025, to comply with mandatory clearing for cash market transactions and June 30, 2026, for repo transactions. But those intervals will be busy and challenging for affected market participants — FICC members, principal trading firms, funds and fund managers, end users, and, of course, FICC itself. Currently, Treasury clearing for entities that are customers of FICC members is offered through what FICC refers to "Correspondent" or "Prime Broker" clearing, or alternatively, through the "Sponsored GC Service." Correspondent and prime broker members ("Submitting Members" under the FICC rules) are permitted to submit transactions to FICC on behalf of clients that have no membership status ("Executing Firms"). The Sponsored service provides access to FICC-cleared cash market transactions, cash borrow/lending transactions, overnight and term repo, and triparty repo to "sponsored members" under a guarantee provided by eligible ("sponsoring") FICC members. The correspondent/prime broker and sponsored clearing services will likely have to be adapted and reconfigured to accommodate new regulatory requirements, as well as a significantly larger number of sponsored members and higher volume of trades.

The following highlights some of the issues and questions that will figure in the transition to mandatory clearing.

Haircuts on Repo Transactions

In a Treasury repo, the seller receives cash (in effect, a loan), and the buyer receives Treasuries (collateral on the loan) to be returned to (repurchased by) the seller at a later date (typically, overnight or for a longer or indefinite term, as specified by the parties). The buyer typically receives slightly more in cash than the market value of the security — this is the haircut on the trade (equivalent to the interest rate on the loan).

The adopting release commends the risk-mitigating effect of FICC-mandated haircuts for transactions subject to the clearing mandate — distinguishing central clearing in this respect from "current margining practices in the bilateral" market, where "competitive pressures" exert "downward pressure on haircuts, sometimes to zero." Market participants who are used to negotiating haircuts on repo based on their strong credit or market dominance (as well as bilateral repo arrangements that are not typically subject to margin calls) will find themselves subject to FICC rules that require margining and minimum haircuts.

Enhancements to the FICC's Existing Client Clearing Services

A theme running through the comment letters on the SEC's proposal was concern over the capacity of the FICC's existing client clearing infrastructure to meet the demands of mandatory clearing. The counterpoint running through the adopting release in response is a sanguine expectation that market participants, working with the FICC, will work it out.

Commenters noted that sponsored triparty repo has only been available since 2021. In response, the SEC states that "the infrastructure is operational, and its usage appears to be increasing." Commenters urged the SEC to exempt registered investment companies from mandatory clearing "because the current clearing framework is not sufficiently developed." In response, the SEC incorporated a no-action position into the adopting release, incentivizing FICC to implement functionality that would enable registered funds to custody margin collateral directly with FICC (rather than with the sponsoring member, which then posts to the FICC on behalf of the fund, passing the cost of doing so back to the fund). Commenters cautioned that increased demand for sponsored access to FICC could "put pressure on existing sponsoring members and reduce their ability or willingness to onboard additional clients." The SEC, seeing the glass half-full, responded that "this could also present an opportunity for dealers that currently do not offer the Sponsored Service to enter the market, resulting in more competition and a wider range of counterparties." And in response to reservations expressed by commenters seeking an exception from the mandate for futures commission merchants engaging in permitted repo transactions using customer funds that the FICC's correspondent and sponsored account structures are not consistent with CFTC regulations applicable to such transactions, the SEC urged FCMs "to engage with [FICC]" to develop account structures that would be.

Customer Asset Protection and a Segregation Regime at the FICC

In addition to the enhancements to Treasury clearing services that the SEC expects to emerge from consultation with market participants, the SEC adopted rules "designed to address the likely increase" in client clearing trade volume, including a requirement that FICC implement a regime for segregating the proprietary margin assets of its members from margin assets held by members on behalf of their customers and prohibiting FICC from netting customer and proprietary positions. Notably, while the SEC approved the customer clearing model in place at the Options Clearing Corporation, it declined to adopt the CFTC's "LSOC" model (the abbreviation for "legal segregation with operational commingling" coined by the CFTC in its proposal to adopt Part 22 of the CFTC Regulations governing FCM and DCO obligations relating to the asset protection requirements applicable to the clearing of customer cleared swaps). Specifically, where LSOC permits customer collateral to be held by the clearinghouse commingled in a single customer account, it prohibits the clearinghouse in the event of a clearing member default

from using the collateral of non-defaulting customers of the defaulting member to cover losses attributable to a defaulting customer of the member (thereby mitigating "fellow customer risk"). Noting that "this type of segregation does not occur at the CCP level under the current market structure for cash securities and listed options," the SEC "declined to require such an approach" for FICC.

Finally, the SEC adopted amendments to Exchange Act Rule 15c3-3 to permit a debit in the broker-dealer reserve formula for margin required and on deposit at FICC resulting from customer cash market and repo transactions cleared by FICC for customers of the broker-dealer (that permission conditioned on the FICC's having implemented segregation of customer and proprietary assets).

The adopting release and SEC presser are available here.

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