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# *SEC Proposal on Mandatory Central Clearing of U.S. Treasury Securities*

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## *Purpose of the Proposed Requirement*

The SEC seeks to require the central clearing through the FICC of

- Secondary market transactions in U.S. Treasury securities; and
- Repurchase transactions in U.S. Treasury securities.

## *Application of the Requirement*

Rule 17Ad-22(a)(6) would apply to any covered clearing agency that provides “central counterparty services for U.S. Treasury Securities.”

- There is only one such clearing agency, the FICC, so in this outline we will generally refer to the FICC specifically, rather than to clearing agencies in the abstract.

The FICC would be to impose requirements on its members that are “direct participants” including having a means to impose penalties on them to “address a failure” by such direct participants to comply with the clearing requirement.

The direct participants would, by reason of the FICC Rules, be required to clear eligible transactions with their customers that are not direct participants (such customers, “indirect participants”).

- Transactions between direct participants are already required to be cleared.

# *Transactions Subject to the Clearing Requirement*

Secondary market transactions in U.S. government securities.

- Secondary transactions are those that occur the day after an auction of Treasury Securities.
- Trades that occur on an auction day are not considered to be secondary transactions

## Repurchase Transactions

As to both secondary market transactions and repurchase transactions, between a direct participant and certain indirect participants.

## *Indirect Participants Subject to the Requirement*

- Customers of a direct participant that operates an ATS where the direct participant is a counterparty to both sides of the trade
- Registered broker-dealers and government securities broker-dealers (which would include banks registered as government securities broker-dealers)
- Private funds (other than securitized asset funds) if any of the following is true:
  - The adviser may earn a performance fee;
  - The fund may sell short other than to hedge currency or manage duration; or
  - The fund may borrow in excess of half its NAV or have gross notional exposure twice its NAV.
- An account at a registered BD that may leverage 2x as above (prime brokerage accounts; family offices; separately managed accounts)

## *Indirect Participants Not Subject to the Requirement*

- Natural Persons
- Central Banks
- Sovereign Entities; e.g. U.S. Government or an agency, department or ministry of a central government
- International Financial Institutions; e.g., various multinational Development Banks

## *Margin Requirements*

- FICC must establish “margin levels commensurate with the risks and particular attributes of each relevant product, portfolio and market”
- FICC would not determine the amount of margin that a direct participant requires of its customers
- FICC must segregate the proprietary margin of each direct participant from the margin of the customers (indirect participants) of that direct participant; i.e., margin of customers of a single direct participant are held in the aggregate.
- Broker-dealers that are direct participants and transmit margin on behalf of their customers can treat the margin as a debit item in the formula for purposes of SEA Rule 15c3-3.

# *Other Requirements Imposed on FICC*

## Membership requirements

- Transparent and fair criteria for membership
- Direct participants must have sufficient financial resources and robust operational capacity

## Oversight requirements

- Monitor participants' financial resources and operations
- Assure itself that direct participants are complying with clearance requirements and have the ability to “address a failure”;
  - FICC may seek “attestation” from direct participants as to compliance with clearing requirement
  - FICC Rules should provide for expulsion, suspension, limits of activities, fines and censures if participants fail to clear
- Maintain adequate operational abilities to clear all required transactions.
  - Release indicates that this would include facilitating access to central clearing by indirect participants (imposes requirement on FICC Board and “senior levels of the governance framework” to review procedures)

# *Securities Financing Transactions Outside Scope*

- Securities Lending
- Margin Financing
- Transactions Not Involving a Direct Participants; e.g., cross-border transactions

## *Benefits of the Mandate Claimed by the SEC*

- Mitigate the Potential for a single market participant's failure to destabilize the financial system
- Reduce the effects of misinformation and rumors
- Substitute the creditworthiness and liquidity of the FICC for that of individual counterparties
- Reduced costs
- Increased Operational efficiency
- More effective risk management
- Multilateral netting resulting in reduction of settlement obligations
- Centralized default management
- Reduction of counterparty risk
- Reduction of fails

## *Benefits of the Mandate Claimed by the SEC (con't)*

- Greater market transparency
- Facilitation of all-to-all trading
- Reduction of balance sheet allocation devoted to repo
- Reduction of chance of counterparty risk because margin levels will be generally increased through FICC requirements
- Facilitate competition by smaller banks and independent dealers

## *SIA Study Findings as to Views of Market Participants*

- Insufficient study, research along with & cost/benefit analysis of the proposal.
- Firms did not believe central clearing would reduce volatility, or increase liquidity across financial markets.
- Large Banks will be forced to absorb operational costs but smaller/mid size participants would be less likely to afford those investments.
- Business models would not support enhanced sponsorships which would result in endless client acquisition costs & lower spreads.
- Central Clearing would reduce counterparty risk, but would create new risks from concentration, market and liquidity challenges for the industry.
- All-to-All Trading which would be extended in the SEC proposal will limitedly enhance liquidity but not solve gaps in major market disruptions.
- The concentration of trading activity through a single CCP would raise the risk of a cyber attack, system and operational failures where contagion to impact other financial markets and exchanges.

## *SIA Study Findings as to Views of Market Participants (con't)*

- Higher margin levels would likely decrease demand for both U.S. Treasuries and repo products resulting in lessened liquidity
- Study participants emphasize the impact of losing cross product netting capacity as detrimental to risk mitigation and business growth.
- Participants noted that additional work was required to enhance transparency of the FICC margin models to ensure predictability for clients in times of market disruption and stress.
- Study participants reflected concern about the ability to build out the sponsored access model and agreed that the FICC needs to enhance visibility to their additional offerings.
- Client onboarding for sponsored clients would be time intensive and costly endeavor; lack of standardized documentation is a critical challenge to solve.
- Meaningful legal issues to resolve to re-document master agreements, reconciling differing CSA's and negotiating terms that are critical to the market and the management of credit risk.

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