

UPDATE ON THE U.S. TREASURY SECURITY CLEARING MANDATE AND FICC RULE PROPOSALS

On December 13, 2023, the U.S. Securities and Exchange Commission (the "**SEC**") adopted rule changes that will require direct participants of covered clearing agencies ("**CCAs**") to clear repurchase and reverse repurchase agreements and certain cash market transactions involving U.S. treasury securities, subject to enumerated exclusions (the "**Treasury Clearing Rules**").¹ The Treasury Clearing Rules are designed to facilitate the implementation of central clearing of U.S. treasury securities, including by requiring CCAs to adopt policies and procedures requiring their direct participants, or members, to submit for clearing "eligible secondary market transactions".

Separately, in March of this year, as directed under the Treasury Clearing Rules, the Fixed Income Clearing Corporation ("**FICC**"), the only existing CCA for U.S. Treasury securities, submitted to the SEC proposed changes to its rulebook (the "**FICC Proposed Rules**") designed to effectuate the central clearing mandate.² Among other things, the FICC Proposed Rules seek to expand the avenues by which market participants can submit U.S. Treasury securities to FICC for clearing and to bolster protections provided to market participants who are customers of FICC

¹ 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, Exchange Act Release No. 99149 (Dec. 13, 2023), 89 Fed. Reg. 2714 (Jan. 16, 2024) (the "**Treasury Clearing Adopting Release**").

² See (i) "Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change, as Modified by Partial Amendment No. 1, To Modify the GSD Rules To Facilitate Access to Clearance and Settlement Services of All Eligible Secondary Market Transactions in U.S. Treasury Securities", 89 Fed. Reg. 21362 (Mar. 27, 2024) (the "**Access Model Proposal**") and (ii) "Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change To Modify the GSD Rules (i) Regarding the Separate Calculation, Collection and Holding of Margin for Proprietary Transactions and That for Indirect Participant Transactions, and (ii) To Address the Conditions of Note H to Rule 15c3-3a", 89 Fed. Reg. 21603 (Mar. 27, 2024) (the "**Customer Protection Proposal**")

netting members³ for the purposes of entering into transactions involving U.S. Treasury securities.

Taken together, the Treasury Clearing Rules and FICC Proposed Rules represent a significant change to the operation and market structure of the world's largest and arguably most important securities market and will take considerable time and resources to implement.

BACKGROUND

The U.S. Treasury market is an integral part of both the U.S. and global economies. Specifically, U.S. Treasury securities are an important investment and hedging vehicle for investors, provide a benchmark for other financial instruments to evaluate their risks and are also used by the U.S. Federal Reserve to effect monetary policy.⁴ As such, it is of the utmost importance that there is confidence in the U.S. Treasury market and that the system is working as efficiently and effectively as possible.

Underscoring its importance, the U.S. Treasury market is also the largest and deepest securities market in the world, with a current issuance size of approximately \$27 trillion.⁵ It has grown tremendously in size in recent years and is reported to be six times larger than it was immediately prior to the 2008-2009 credit crisis. Despite this growth, the number of market makers and available liquidity in the market has shrunk and there have been a number of disruptions in recent years. These developments have gained the attention of regulators and have resulted in a variety of initiatives to improve and strengthen the U.S. treasury market.⁶

A cluster of these initiatives – which has resulted in the promulgation of the Treasury Clearing Rule discussed herein – has focused on improving the ability of central clearing agencies that clear U.S. Treasury securities to provide risk management to the U.S. Treasury securities market. In 2016, for instance, the SEC adopted the Covered Clearing Agency Standards which established enhanced standards for the operations and governance of clearing agencies for U.S. Treasury securities.⁷

However, despite the adoption of these standards, the number of U.S. Treasury transactions cleared in both cash and repo market have declined.⁸ The number is especially low for transactions in U.S. Treasury securities using the "hybrid" clearing model, where one counterparty transacting with an inter-dealer broker is a member of the CCA and submits the transaction for central clearing, but the other counterparty is not a member of the CCA and only bilaterally clears the

³ Throughout this memo, we will refer to "direct participants" and "FICC netting members" interchangeably for the convenience of the reader.

⁴ Treasury Clearing Adopting Release at 2715-2716

⁵ See discussion generally about U.S. Treasury, *Id.* at 2716-2717. Also see Wallerstein, Eric, *The \$27 Trillion Treasury Market is Only Getting Bigger*, the Wall Street Journal (March 24, 2024).

⁶ Treasury Clearing Adopting Release at 2790.

⁷ *Id.* at 2716.

⁸ *Id.*

transaction with the interdealer broker. This pattern of trading arguably undermines many of the benefits of central clearing and, in the view of the SEC, can lead to significant contagion risk, as the standards are so different.⁹

These concerns were central in prompting the adoption the Treasury Clearing Rules, which seek to increase dramatically the number of transactions in the U.S. Treasury cash and repo market that are centrally cleared.¹⁰

THE TREASURY CLEARING RULE

Central Clearing Requirement

As stated above, the Treasury Clearing Rules require that all CCAs that provide central counterparty services for U.S. Treasury securities have policies and procedures in place that require their direct participants to submit for clearing "all of the eligible secondary market transactions to which they are counterparty."¹¹

For these purposes, a "*direct participant*" is a member of a CCA. Currently there is only one CCA, FICC, although the Chicago Mercantile Exchange (CME) has announced that it will be submitting an application to become a CCA.¹² Direct participants are distinguished from "*indirect participants*" who, generally, are not CCA members but who clear transactions through direct participants.

"*Eligible secondary market transactions*" include (subject to several exemptions noted below):

- All repurchase and reverse repo transactions ("**repos**") collateralized by U.S. Treasury securities where one of the counterparties is a direct participant; and
- All purchases and sales of U.S. Treasury securities between a direct participant and:
 - Any counterparty, if the direct participant of the covered clearing agency brings together multiple buyers and sellers using a trading facility (such as a limit order book) and is a counterparty to both the buyer and seller in two separate transactions (i.e., the direct participant is acting as what is known as an "**interdealer broker**"); or
 - A registered broker-dealer, government securities broker or government securities dealer.¹³

The following transactions are excluded from the definition of "*eligible secondary market transaction*":

- Repos and cash transactions where the counterparty is a central bank, sovereign entity, international financial institution or a natural person;

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 2771.

¹² Asgari, Nikou and Hughes, Jennifer, *CME Group Bids to enter US Treasury Clearing Business*, the Financial Times (March 12, 2024).

¹³ *Id.* at 2723.

- Repos where one counterparty is another clearing organization or a state or local government; and
- Repos between a direct participant and its affiliate.¹⁴

Additional Requirements

In addition to the requirement to centrally clear eligible secondary market transactions, the Treasury Clearing Rules require CCAs to take certain other actions in an effort to bolster their risk management function and to incentivize market participants to centrally clear such transactions.¹⁵

General Access

The Treasury Clearing Rules require each CCA to establish policies and procedures that allow all market participants, both direct and indirect, to access its clearance and settlement services for all eligible secondary market transactions in U.S. Treasury securities. Under the current FICC regime, indirect participants access and obtain clearing services from direct participants of FICC using a number of different models, including the sponsored member model and the correspondent clearing/prime brokerage model. The Treasury Clearing Rules require CCAs to prioritize and facilitate access by ensuring that their offerings will be available to market participants, especially indirect participants.

Customer Margin

The Treasury Clearing Rules also require CCAs to adopt and enforce policies and procedures to calculate, collect and hold margin applicable to transactions of their direct participants separately from transactions submitted on behalf of indirect participants customers. This rule change was adopted to give CCAs a more complete picture of the risk associated with particular transactions in the U.S. Treasury securities market, as it will help CCAs distinguish between margin being collected in respect of direct participants' trading activity and their customers' trading activity.

Customer Protection Rule Amendments

Finally, the Treasury Clearing Rules amend the Exchange Act Rule 15c3-3 (the "**Customer Protection Rule**") to permit required margin on deposit at a CCA to be included as a "debit" item in a direct participant broker-dealer's customer reserve formula. This provides a strong incentive to direct participants who are broker dealers to collect and post customer margin to the CCA in order to gain the benefit of the debit and free up their own capital. It could also have the practical effect of establishing a margin model that is analogous to the "legally segregated, operationally commingled" (**LSOC**) model with respect to cleared futures, where indirect participants are insulated from losses experienced by another customer in connection with the insolvency of a direct participant (i.e., limiting "fellow customer risk") because of segregation.

¹⁴ *Id.* at 2748.

¹⁵ See discussion beginning on *Id.* at 2753.

Changes from the Proposal

The final Treasury Clearing Rules narrowed considerably the definition of "eligible secondary market transactions" from the definition included in the proposed rule. The SEC acknowledged commenters concerns that extending the definition to include repo transactions with certain types of entities, such as repos with other clearing organizations and state and local governments, were impractical, and agreed to exclude such transactions with those entities from the rules.¹⁶ Perhaps more importantly given the dramatic impact it would have had on the market, the SEC declined to adopt a requirement that cash market transaction between hedge funds or other leveraged vehicles and direct participants be cleared.¹⁷

However, due to the recently adopted SEC rules expanding the definition of a "dealer" and a "government securities dealer," some of these entities would be required to register as broker-dealers whose cash market transaction with direct participants would be subject to the clearing mandate.¹⁸ Additionally, in the definition of "eligible secondary market transaction" in the final Treasury Rules, hedge funds and other private funds would also be subject to the clearing mandate if facing a direct participant that brings together multiple buyers and sellers using a trading facility (such as a limit order book) and is a counterparty to both the buyer and seller in two separate transactions.¹⁹

Additionally, in the adopting release for the Treasury Clearing Rules, the SEC provided no-action relief to registered investment companies ("RICs") from the custody requirements of 17(f) of the Investment Company Act of 1940, to the extent such RICs are required to post margin at FICC under the Treasury Clearing Rules.²⁰

Compliance Dates

The SEC has decided on a staggered approach to implement and enforce the final rules.²¹

FICC's rule proposals regarding access to central clearing, CCA's separate calculation, collection and holding of customer margin and the amendments to the Customer Protection Rule, must be effective by **March 31, 2025**.²²

FICC's rule proposals requiring direct participants to clear eligible secondary market transactions must be effective for cash transactions by **December 31, 2025** and for repo transactions by **June 30, 2026**.²³

¹⁶ *Id.* at 2741.

¹⁷ *Id.* at 2747.

¹⁸ The SEC has indicated that some private funds may fall within the expanded "dealer" definition (e.g., hedge fund that employ strategies involving automated or high-frequency trading) and, accordingly, would be required to register as broker-dealers with the SEC." I would also adjust the cite to point to page 14970 where a statement to that effect appears. FWIW, the SEC has also indicated that private equity funds are unlikely to be caught by the expanded dealer definition and that they expect only a limited number of private funds to be affected. Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer in Connection With Certain Liquidity Providers, Exchange Act Release No. 99477 (Feb. 29, 2024), 89 Fed. Reg. 14938 (Apr. 29, 2024).

¹⁹ Treasury Clearing Adopting Release at 2723.

²⁰ *Id.* at 2727.

²¹ *Id.* at 2769.

²² *Id.* at 2770.

²³ *Id.*

FICC RULE PROPOSALS

In March 2024, as directed by the SEC in the Treasury Clearing Rules, FICC filed with the SEC, and the SEC published, a series of rules that seek to implement the changes required by the Treasury Clearing Rules. Collectively, these rules amount to a re-write of portions of FICC's current rule book pertaining to access, membership and margining and will take time for market participants to evaluate and implement. Below is a high-level summary of the two principal rule proposals addressing access to FICC's clearing and settlement services and how margin is calculated, collected and held.

Access Model Proposal

On March 21, 2024, FICC proposed changes to FICC's rulebook that are designed to facilitate access to its clearance and settlement services for all eligible secondary market transactions in U.S. Treasury securities (the "**Access Model Proposal**"). In pertinent part, the Access Model Proposal would:

- Rename the correspondent clearing/prime broker method of access the "Agent Clearing Service" and make conforming changes to the FICC rulebook designed to make it simpler and easier for indirect participants to use this method of access. The current correspondent clearing/prime broker method of access allows indirect participants to transact with third parties other than FICC Netting Members with which they have a primary trading relationship via the "Sponsored Service". The goal of recasting the correspondent clearing/prime broker model as the "Agent Clearing Service" is to expand the number of executing brokers with which indirect participants can enter into transactions involving U.S. Treasury securities, increasing access to clearing and promoting liquidity in the market.²⁴
- Eliminate the two existing categories of FICC Sponsoring Members, which apply different and potentially more stringent requirements to banks that wish to become Sponsoring Members than other types of entities, and replace it with one category and (ii) remove the requirement that a Sponsored Members be "qualified institutional buyer" as defined in Rule 144A under the Securities Act of 1933 (or otherwise meet the financial criteria set forth therein). The hope is that these changes will make it easier for financial institutions to become "Sponsoring Members" who can offer access to indirect participants via the Sponsored Service, thereby further expanding access to clearing.²⁵
- Provide a "public roadmap" of access models to market participants, showing them the different methods by which they can clear and settle transactions in U.S. Treasury securities in compliance with the Treasury Clearing Rules.²⁶

It is important to note that a driving force behind many of FICC's proposals, especially those in the Access Model Proposal, is the desire to foster the development of a workable "done-away" model where a market participant can execute a U.S. Treasury transaction with one FICC netting member (who, perhaps

²⁴ See Access Model Proposal at 21363 – 21365.

²⁵ *Id.*

²⁶ *Id.*

offers the best price or offers best execution), but then can "give up" or clear the transaction with another FICC netting member who has a primary relationship with such market participant. Having a robust "done-away" model in place would dramatically expand the number of direct participants with which customers could execute U.S. Treasury transactions and provide the sort of access to clearing that will be required for the Treasury Clearing Rules to be successfully implemented. Not surprisingly, industry participants are paying significant attention to FICC's efforts to promote done-away trading.

Comments to the proposed rule were originally requested to be submitted on or before April 17, 2024. However, industry participants have requested, and have been granted extensions to engage in further dialogue with the SEC regarding the Access Rule Proposal.

Customer Protection Rule Proposal

Subsequently, on March 22, 2024, FICC proposed a separate set of rule changes (the "**Customer Protection Rule Proposal**") that implement the Treasury Clearing Rules' requirements regarding the separate calculation, collection and holding of margin for direct participants' proprietary transactions and that specify the parameters around which broker dealer participants can apply customer margin on deposit at FICC as a "debit" in their customer reserve formula.²⁷

One of the most significant changes proposed by the Customer Protection Rule Proposal is the creation of two separate account classes for the purposes of determining a FICC netting member's obligation to post margin at FICC: "Proprietary Accounts", which will include margin posted in respect of a netting members' own transactions as well as those where they are acting as cash or repo brokers, and "Non-Proprietary Accounts", where netting members are transacting on behalf of customers through the "Sponsored Service" or on behalf of a third parties through the "Agent Clearing Service". Importantly, this change prohibits a FICC member from netting transactions held in its "Proprietary Account" against transactions of indirect participants held in a "Non-Proprietary Account" for the purposes of determining its margin requirement with FICC – a critical departure from existing practice, where netting members can net margin posted on behalf of indirect participants against its own "house" margin for the purpose of determining its own margin requirement.²⁸

The Customer Protection Rule Proposal also specifies the means by which broker-dealer netting members can count customer margin on deposit at FICC as a "debit" in their customer reserve formula, as contemplated under the Treasury Clearing Rules. Under the Customer Protection Rule Proposal, in order for a broker-dealer member to get the benefit of the "debit" in respect of margin posted on behalf of an indirect participant, the broker-dealer must first "designate" such indirect participant's account for segregation.²⁹ Then, it must calculate separately and deliver to FICC margin for such indirect participant customer on a gross basis. The indirect participant's margin would then be held at FICC in a segregated

²⁷ See Customer Protection Proposal at 21603.

²⁸ *Id.* at 21607.

²⁹ Notably, non-broker dealer netting members can also designate an indirect participant's account for segregation, but it is unclear what incentive a non-broker dealer member would have to do so (as they are not subject to reserve formula calculation under the broker-dealer Customer Protection Rule).

account unique to the indirect participant. This marks a significant change to FICC's current rules, where customer margin is currently not segregated, and, as noted above, could help to significantly reduce "fellow customer risk" in the current clearing model.³⁰ However, the proposed changes to require that a minimum of \$1 million of margin be deposited in each segregated account.³¹

All comments to the proposed rule were originally requested to be submitted on or before April 18, 2024. As with the Access Model Proposal, however, industry participants have requested, and have been granted extensions to engage in further dialogue with the SEC regarding the Customer Protection Rule Proposal.

Industry Response to the FICC Rule Proposals

A number of comment letters have been submitted in response to the FICC rule proposals.³² Concerns shared by market participants on both the sell-side and buy-side include, among other things, that the FICC proposed rules:

- Do not lay out or explain clearly enough the relative benefits of the various access models that are now contemplated (i.e., Agent Clearing Service model versus Sponsored Service model, and the "segregated" variants of each when a netting member designates an indirect participants' margin for segregation).
- Do not on their face allow direct and indirect participants in FICC to clear through other CCAs (if, and when, other CCAs become available).
- Do not have sufficiently adequate close-out mechanics, both in the event a netting member is in default of its obligations vis a vis a netting member and where the indirect participant is in default with respect to a netting member.
- Fail to provide a mechanism for transferring/porting of an indirect participant's positions from one netting member to another in the event one netting member is experiencing distress;
- Do not address or explain future plans for indirect participants to "cross-margin" their transactions involving U.S. Treasury securities with transactions in other financial instruments cleared on other clearinghouses.

Buy-side industry participants have expressed concerns that the changes that are proposed to be made to the current correspondent clearing/prime brokerage access model (i.e., recasting it as the "Agent Clearing Service", as described above) are not enough to lead to the development of a workable done-away model. Certain buy-side industry members have also said that the ability to designate whether an indirect participant's account is eligible for segregation or not should lie with the indirect participants themselves and not the netting member. Finally, among other things, the buy-side has questioned the rationale behind the requirement to deposit a minimum of \$1 million in margin in any "segregated" account of an indirect participant that is held at FICC, arguing that

³⁰ *Id.* at 21608-21609.

³¹ *Id.* at 21611.

³² See, generally, comment letters of several industry organizations available at <https://www.sec.gov/rules/sro/ficc>

the minimum deposit requirement should be determined on a customer-by-customer basis.³³

CONCLUSION

The Treasury Clearing Rules and FICC rule proposals represent a significant change to the world's largest, and arguably most important securities market which will require substantial time for market participants to digest and implement. A number of questions remain about how the market will, in practice, implement the rules and we will continue to follow the FICC rule making process as the deadline for implementation approach.

We encourage you to reach out to us with any questions regarding both the Treasury Clearing Rules and the FICC Proposed Rules and how you can best prepare for the upcoming changes.

³³ See, for example, the comment letter submitted by SIFMA AMG to the SEC, dated May 24, 2024 regarding the Access Model Proposal and the Customer Protection Proposal, available at <https://www.sec.gov/comments/sr-ficc-2024-005/sficc2024005-477891-1366714.pdf>

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