SEC Adopts New Requirements for US Treasuries Clearing and Risk Management

January 2, 2024

On December 13, 2023, the Securities and Exchange Commission (SEC) voted (4-1) to adopt new requirements under the Securities Exchange Act of 1934 (Exchange Act), which will restructure the clearance and settlement of secondary market transactions involving the purchase and sale of US Treasury securities (cash transactions) and repurchase agreements and reverse repurchase agreements of US Treasury securities (repo transactions).[1]

Today, most US Treasury securities transactions are settled and cleared bilaterally—without a central counterparty to act as a guarantor of each transaction by standing in as a buyer to every seller and as a seller to every buyer. In adopting the new requirements, the SEC cited potential risks in the US Treasury securities market caused by the lack of uniformity and transparency in the clearance and settlement of US Treasury securities.[2] To address these risks, the amended rules will effectively mandate central clearing and settlement of certain eligible cash transactions and repo transactions through covered clearing agencies (CCAs).[3] Currently, the Fixed Income Clearing Corporation (FICC) is the only CCA for US Treasury securities transactions.

To enable this transformation, the SEC amended Rule 17ad-22(e) under the Exchange Act to require that FICC and any other future CCAs for US Treasury securities adopt policies and procedures to (i) require that their direct participants centrally clear eligible secondary market transactions, (ii) address separation of direct participant and customer margin, and (iii) facilitate broad access to clearing and settlement services for US Treasury securities. The amendments also modify Rule 15c3-3a under the Exchange Act by changing how broker-dealers treat US Treasury securities and certain other assets posted as margin and held at a CCA for purposes of the "Customer Protection Rule"[4] reserve formula, to reduce the burden of the margin requirements associated with mandatory central clearing of US Treasury securities transactions.

The new requirements will have a two-and-a-half-year phased implementation schedule (described more fully below). Below, we discuss (i) the policies and procedures that FICC and any other CCAs

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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, https://www.sec.gov/files/rules/final/2023/34-99149.pdf (Adopting Release).

2 *See* Adopting Release at 12. ("[B]ecause bilateral clearing involves varying risk management practices that are less uniform and less transparent to the broader market and may be less efficient with regard to netting exposures and use of collateral as compared to central clearing. Therefore, the [SEC] proposed amendments … to help reduce contagion risk to the CCA and bring the benefits of central clearing to more transactions involving U.S. Treasury securities, thereby lowering overall systemic risk in the market.")

3 "Covered clearing agency" means a registered clearing agency that provides the services of a central counterparty or central securities depository. 17 C.F.R. § 240.17Ad-22.

4 17 C.F.R. § 240.15c3-3.

for US Treasury securities will need to adopt under amended Rule 17ad-22(e), and (ii) the effects of the new requirements on broker-dealers, hedge funds and other US Treasury market participants.

Application to CCAs for US Treasury Securities: New Policies and Procedures

The amended rules establish several policy- and procedure-based requirements for FICC and any future CCAs for US Treasury securities. Specifically, CCAs will be required to establish, implement, maintain and enforce policies and procedures reasonably designed to:

- require direct participants to submit for clearance and settlement all the eligible secondary market transactions to which they are a counterparty ("Mandatory Central Clearing");
- calculate, collect and hold separately margin amounts of a direct participant and indirect participant ("Separation of House and Customer Margin"); and
- ensure that the CCA has appropriate means to facilitate access to clearance and settlement services of all eligible secondary market transactions ("Facilitating Access").

CCAs are self-regulatory organizations (SROs) under the Exchange Act and are required to submit proposed rule filings, including rules that would adopt or amend the CCA's policies and procedures, to the SEC for approval under Section 19(b) of the Exchange Act. The new policies and procedures to be adopted by CCAs will apply to firms that are CCA members or direct participants (generally, banks and broker-dealers), which in turn provide access to the CCA's payment, clearing or settlement facilities to indirect participants (e.g., customers and clients of the banks and broker-dealers, including funds, asset managers, and other, smaller banks and broker-dealers).

Mandatory Central Clearing

Rule 17ad-22(e)(18)(iv)(A) will require CCAs providing central counterparty services for US Treasury securities transactions to adopt policies and procedures to require direct participants to submit for clearance and settlement each "eligible secondary market transaction" to which they are a counterparty.

"Eligible secondary market transaction" refers to a secondary market transaction in US Treasury securities of a type accepted for clearing by a CCA that includes:

- repo transactions in which one of the counterparties is a direct participant; and
- cash transactions between a direct participant and (1) any counterparty where the direct participant brings together multiple buyers and sellers using a trading facility and is a counterparty to both the buyer and seller in two separate transactions (e.g., certain interdealer broker transactions); or (2) a registered broker-dealer or government securities broker-dealer.

"Eligible secondary market transaction" does not include:

- cash or repo transactions where one counterparty is a central bank, a sovereign entity, an international financial institution or a natural person;
- repo transactions where one counterparty is a CCA providing central counterparty services, a derivatives clearing organization, an entity regulated as a central counterparty in its home jurisdiction, or a state or local government (but not public pension or retirement plans); and
- repo transactions between a direct participant and an "affiliated counterparty,"[5] provided that the affiliated counterparty submits for clearing and settlement all other repo

5 "Affiliated counterparty" generally refers to a bank, broker-dealer or futures commission merchant, or any entity regulated as such in its home jurisdiction that has majority ownership interest in the counterparty or is majority owned by or with the counterparty and meets certain financial reporting requirements. *See* 17 C.F.R. § 240.17ad-22(a).

transactions to which it is a party (either by submitting transactions through an agency clearing model or by becoming a direct participant).[6]

The definition of “eligible secondary market transaction” includes when-issued trades that occur the day after an auction but does not include when-issued trades before and on the day of the auction.

Notably, triparty repo transactions (i.e., transactions that involve a third-party agent that manages margin and collateral on behalf of the two transacting parties and provides back-office support) are subject to mandatory central clearing. In rejecting an exclusion for triparty repo transactions, the SEC noted that a triparty agent—even though it is subject to heightened prudential regulation—does not novate the transaction and insert itself as a central counterparty between the buyer and seller like a CCA and is not subject to regulation as a central counterparty, so the parties to the transaction are subject to counterparty credit risk in the event of a default (and contagion risk in the event of large, unsettled trading volumes) that could be managed by a CCA in a centrally cleared transaction.[7]

Similarly, the SEC specifically identified “hybrid” clearing arrangements often used in cash transactions as potential sources for contagion risk that would be addressed by the mandatory clearing requirement.[8] Hybrid clearing refers to transactions that are executed on an interdealer broker platform in which one counterparty is a member of a CCA and submits its transaction with the interdealer broker for central clearing, while the other counterparty is not a member of a CCA and bilaterally clears its transaction with the interdealer broker. As a result, FICC does not have information about the FICC member interdealer broker’s offsetting trade and the potential exposures arising from it, which the SEC believes could impair FICC’s ability to manage counterparty risk and lead to systemic risk.[9]

To enforce mandatory central clearing, Rule 17ad-22(e)(18)(iv) also requires a CCA to identify and monitor its direct participants’ required submission of transactions for clearing, including, at a minimum, addressing a direct participant’s failure to submit transactions. The SEC does not prescribe a manner in which this requirement should be enforced but provided several examples of how this obligation could be met, including by obtaining attestations from direct participants and reviewing publicly available information or other information made available to the CCA regarding direct participants’ transactions, such as TRACE reporting data.[10]

Separation of House and Customer Margin

Rule 17ad-22(e)(6)(i) will require a CCA to establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, calculate, collect and hold margin amounts from a direct participant for its proprietary US Treasury securities positions separately and independently from margin calculated and collected from that direct participant in connection with US Treasury securities transactions by an indirect participant. Effectively, this segregation requirement would prohibit a CCA from netting customer and proprietary positions. However, the rules do not prescribe a specific margin requirement; instead, CCAs remain responsible for establishing a margin methodology subject to SEC approval. Additionally, the SEC would permit a CCA to use an omnibus account structure, where all collateral belonging to all indirect participant customers of a particular direct participant can be commingled and held in a single account segregated from that of the direct participant.

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6 17 C.F.R. § 240.17ad-22(a). The inter-affiliate exclusion for repos is intended to be consistent with the Commodity Futures Trading Commission’s treatment of inter-affiliate swaps as well as existing FICC rules for inter-affiliate transactions.

7 *See* Adopting Release at 41.

8 *See* Adopting Release at 100-17.

9 *See* Adopting Release at 305-06.

10 *See* Adopting Release at 128.

Facilitating Access

Rule 17ad-22(e)(18)(iv)(C) will require a CCA to establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable, ensure that the CCA has appropriate means to facilitate access to clearance and settlement services of all eligible secondary market transactions in US Treasury securities, including those of indirect participants.

The SEC did not prescribe specific methods for market participants to obtain indirect access to a CCA but noted that access to clearance and settlement services should be in a manner suited to the needs and regulatory requirements of market participants. The SEC provided guidance on how a CCA should comply with the new access requirements, including that the CCA should:

- conduct and document an initial review of its access models and related policies and procedures;
- seek to provide access in as flexible a means as possible, consistent with its responsibility to provide sound risk management and comply with other provisions of the Exchange Act, the CCA Standards and other applicable regulatory requirements;
- consider a wide variety of appropriate means to facilitate access to clearance and settlement services of all eligible secondary market transactions in US Treasury securities in consultation with a wide range of stakeholders;
- review and document any instance in which its policies and procedures treat transactions differently based on the identity of the participant submitting the transaction, the fact that an indirect participant is a party to the transaction, or the method of execution or in any other way, and confirm that any variation in the treatment of such transactions is necessary and appropriate to meet the minimum standards regarding, among other things, operations, governance and risk management identified in the CCA Standards; and
- require its policies and procedures regarding access to be reviewed by the CCA's board of directors annually.[11]

Application to Other Market Participants

Broker-Dealers: Amendments to Rule 15c3-3a

As noted above, the SEC also amended Rule 15c3-3a under the Exchange Act, which establishes the reserve formulae used for purposes of Rule 15c3-3, the Customer Protection Rule, which in turn requires broker-dealers to maintain special reserve bank accounts for the exclusive benefit of customers and for the proprietary accounts of broker-dealers (PABs) separate from each other and separate from the accounts of the broker-dealer itself. In those reserve accounts, the broker-dealer must maintain cash and/or certain qualified securities in amounts computed in accordance with the reserve formulae for those accounts under Rule 15c3-3a.

Currently, the Customer Protection Rule does not permit broker-dealers to include a debit in the customer and PAB reserve formulae equal to the amount of margin required and on deposit at a CCA for US Treasury securities. This is because no US Treasury securities CCA has implemented rules and practices designed to segregate customer and PAB margin from broker-dealer margin and limit customer and PAB margin to being used solely to cover obligations of customers and other broker-dealers. Without changes to the reserve formula, mandatory central clearing of US Treasury securities would significantly increase the amount of margin a broker-dealer is required to post at a CCA resulting from having more customer and PAB US Treasury securities positions centrally cleared, increasing the broker-dealer's need to use its own assets to meet those requirements.

To reduce the amount of its own assets that a broker-dealer must post as margin to the CCA in connection with centrally cleared US Treasury transactions, the amended rules modify the reserve formulae to permit margin required and on deposit at CCAs providing central counterparty services for US Treasury securities to be included by broker-dealers as a debit in the customer and PAB reserve formulae, subject to four specified conditions. The margin on deposit at the CCA must be

11 *See* Adopting Release at 167-68.

required to be included as a debit in the reserve formulae, meaning that any margin on deposit at the CCA in addition to the required amount may not be included as a debit. The conditions below for the customer reserve computation are also applicable to the PAB reserve computation, except that the conditions relate to other broker-dealers rather than to customers. The conditions are largely contained in Note H to Item 15 of the Reserve Formula Calculation. Broker-dealers would need to update their written policies and procedures related to compliance with Rule 15c3-3 to address these requirements:

(1) ***Permitted Margin***: Customer position margin must be in the form of cash, US Treasury securities or "qualified customer securities,"[12] and must be used to margin US Treasury securities positions of the customers of the broker-dealer that are cleared, settled and novated at the US Treasury securities CCA.

(2) ***Customer Position Margin***: The broker-dealer must (i) use customer assets exclusively to meet the customer position margin requirement; (ii) use a particular customer's assets exclusively to meet the amount of the customer position margin requirement resulting from that customer's cleared US Treasury securities positions; and (iii) have delivered the customer's assets to the US Treasury securities CCA. Under certain conditions, a broker-dealer may deliver US Treasury securities that it owns to meet a customer margin obligation.

(3) ***Rules of US Treasury Securities CCA***: Customer position margin must be treated in accordance with rules of the CCA designed to protect and segregate the customer position margin, including to (i) limit the CCA's use of such customer margin, (ii) require the use of a "Special Clearing Account for the Exclusive Benefit of Customers" of the broker or dealer, (iii) provide written notice from the CCA to the broker-dealer affirming that securities are held segregated for the benefit of customers, (iv) enter into a contract between the broker-dealer and the CCA containing "no lien" language, and (v) require the CCA to hold the customer margin securities in certain ways and subject to certain conditions that mirror the conditions to which the broker-dealer is subject.

(4) ***SEC Approval of Rules of US Treasury Securities CCA***: The SEC must approve rules of the CCA that meet the conditions discussed above and publish a notice that broker-dealers may include a debit in the customer reserve formula when depositing customer position margin to meet a margin requirement of the CCA resulting from positions in US Treasury securities of the customers of the broker-dealer.

Registered Funds

Funds registered under the Investment Company Act of 1940 (Investment Company Act), including money market funds and exchange-traded funds, are major US Treasury securities market participants that are indirect participants of CCAs (i.e., through FICC's Sponsored Service program).

Registered funds are subject to Section 17(f) of the Investment Company Act and the rules thereunder, which govern the safekeeping of investment company assets and require that such assets be maintained in the custody of certain specified entities (e.g., a bank, a national securities exchange or the fund itself). These safekeeping requirements also apply to fund assets required to be posted as margin, so posting fund assets as margin with FICC directly or through a member of a national securities exchange that provides the fund with sponsored access to the exchange could violate Section 17(f) because currently there is no existing framework for managing assets deposited with FICC in accordance with Section 17(f). As a result, currently, registered funds engaged in centrally cleared US Treasury securities transactions pay fees to a direct participant to post the participant's assets as margin with FICC on their behalf. However, costs associated with having direct participants post margin on a fund's behalf will increase if more transactions are required to be centrally cleared.

To mitigate these costs, the SEC stated in the Adopting Release that it would permit, but not require, a registered fund to post fund assets as margin with FICC, either directly or through a third

12 "Qualified customer securities" are any securities that a broker-dealer holds in custody for a customer and that are eligible to be used to meet margin requirements of the CCA.

party, rather than pay a direct participant to post assets as margin on its behalf.[13] This alternative could reduce costs for registered funds and free up direct participants' capital that otherwise would be required to be posted as margin. Because the framework for custody of fund assets held at FICC has not yet been developed, the SEC stated that, for a period of five years, registered funds using FICC's Sponsored Service program may post margin with FICC directly or through a member of a national securities exchange providing the fund with sponsored access to the exchange without facing enforcement under Section 17(f), provided that the arrangements meet certain conditions principally designed to segregate fund assets from FICC assets and direct participant assets and to limit FICC's ability to withdraw fund assets such that they can be withdrawn only upon the event of the fund's default.

The SEC indicated that the five-year no-enforcement positions are intended to provide sufficient time for FICC to develop and file any proposed rule changes under Section 19(b) of the Exchange Act that may be relevant to facilitate a registered fund's ability to post margin at FICC and for the SEC and market participants to consider the appropriateness of this framework or potential alternative frameworks.[14]

Hedge Funds and Leveraged Accounts

In a key departure from its proposal, the SEC did not include cash transactions between direct participants and hedge funds or leveraged accounts within the definition of "eligible secondary market transaction." The SEC had expressed concerns regarding the risks that these types of entities' trading strategies, which include the use of leverage, could pose to the health of the US Treasury securities markets.[15] However, the SEC narrowed in-scope transactions to remove transactions of hedge funds and leveraged accounts unless they are captured by another portion of the rule (e.g., cash transactions through interdealer broker platforms). Instead, the SEC adopted a "more incremental approach" to cash transactions in light of questions raised by commenters that the SEC believed "merit further consideration," and the SEC noted that it will continue to evaluate the issues raised to determine if any further action is appropriate with respect to transactions in the cash market.[16] There is no similar carve-out for repo transactions; the language defining repo transactions that fall within the definition of "eligible secondary market transaction" is more broadly drafted and would include a repo transaction between a direct participant and a hedge fund or leveraged account unless the transaction is otherwise excluded.

Futures Commission Merchants

The SEC considered and rejected an exclusion of repo transactions by futures commission merchants (FCMs) registered with the Commodities Futures Trading Commission (CFTC) from mandatory central clearing. Like broker-dealers, FCMs are market intermediaries that hold customer assets, and many FCMs are also registered with the SEC as broker-dealers. FCMs are permitted to invest customer funds in certain specified instruments, including US Treasury securities—through either cash or repo transactions.[17] However, FCMs are limited to certain counterparties for repo transactions, including a bank, broker-dealer or government securities broker-dealer.[18] Notably, CCAs are not permitted counterparties. Because the CCA would be stepping in as counterparty in any centrally cleared transaction, FCMs would not be able to centrally clear repo transactions involving FCM customer funds.

In rejecting the exclusion, the SEC stated that an exclusion for FCMs would be inconsistent with the purpose of requiring central clearing to reduce contagion risk and to bring any associated

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13 *See* Adopting Release at 47-70.

14 *See* Adopting Release at 54.

15 *See* Adopting Release at 103-06.

16 Adopting Release at 120.

17 17 C.F.R. § 1.25.

18 17 C.F.R. § 1.25(d)(2).

benefits.[19] The SEC recognized the tension with CFTC rules but pointed to the availability of alternative models—such as an agency clearing model under which the FCM could “give up” a transaction to a direct participant—that FCMs could use to settle US Treasury securities transactions.[20] The SEC encouraged interested parties to work with the CCA to identify any modifications to its client clearing models to better allow FCMs to access central clearing in the US Treasury market and suggested that, in the alternative, FCMs could enter into repo transactions with market participants that are not direct participants of a CCA for US Treasury securities.[21]

Implementation Schedule

The amended rules have a phased implementation schedule that will be implemented over two and a half years.

Requirement(s)	Implementation Date
Filing deadline for proposed CCA rule changes regarding separation of house and customer margin; facilitating access; and the Customer Protection Rule.	60 days after publication in *Federal Register*
Effective date for CCA rule changes regarding separation of house and customer margin; facilitating access; and the Customer Protection Rule.	March 31, 2025
Filing deadline for proposed CCA rule changes regarding the requirement to centrally clear eligible secondary market transactions.	150 days after publication in *Federal Register*
Effective date for CCA rule changes regarding mandatory central clearing for cash transactions.	December 31, 2025
Effective date for CCA rule changes regarding mandatory central clearing for repo transactions.	June 30, 2026

Conclusion

The SEC has recently sought to introduce additional regulatory oversight into the US Treasury securities markets,[22] and the finalization of these amended rules is another step in seeking to further centralize and regulate trading in the US Treasury securities markets. Critics, such as SEC Commissioner Hester Peirce—the lone dissenter from the adoption of the amended rules—question whether the SEC has sufficiently justified the rules’ central clearing mandate and have expressed concerns about the potential costs associated with central clearing as well as the risks

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19 *See* Adopting Release at 80.

20 *See* Adopting Release at 78.

21 *See* Adopting Release at 78.

22 *See, e.g.*, Amendments Regarding the Definition of “Exchange” and Alternative Trading Systems (ATSs) That Trade US Treasury and Agency Securities, National Market System (NMS) Stocks, and Other Securities, 87 Fed. Reg. 15496 (Mar. 18, 2022) (proposing to bring additional US Treasury trading platforms within the definition of “exchange” and removing exemptions from the requirements of Regulation ATS for such platforms); Further Definition of “As a Part of a Regular Business” in the Definition of Dealer and Government Securities Dealer, 87 Fed. Reg. 23054 (Apr. 18, 2022) (proposing to clarify that certain firms that engage in significant trading activity in US Treasury securities are within the definition of “dealer” and therefore are required to register with the SEC).

relating to concentration of US Treasury securities trading through a single central counterparty.[23] Although the amended rules are primarily framed as policy- and procedure-based requirements for CCAs, the changes will have a significant impact on the market structure for US Treasury securities because the vast majority of transactions today are cleared and settled bilaterally rather than through FICC. While the new requirements will represent potentially significant changes from current practice, it remains to be seen how these requirements will be implemented by FICC given the flexibility provided to CCAs in crafting their policies and procedures or the overall impact those changes will have on the US Treasury securities markets.

23 *See*, *e.g.*, Comm'r Hester M. Peirce, *Careening Toward Clearing: Statement on Rules to Improve Risk Management in Clearance and Settlement and to Facilitate Additional Central Clearing for the US Treasury Market* (Dec. 13, 2023), https://www.sec.gov/news/statement/peirce-statement-rules-improve-risk-management-12-13-23.

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