

Uncle Sam Wants U ... S Treasury Trades Cleared

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On December 13, 2023, the Securities and Exchange Commission (the “SEC”) voted 4-1 to approve final rule changes¹ (the “Final Rules”) addressing a number of points relating to the clearing of US Treasuries (“USTs”). Given the size of the UST market (\$26 trillion, approximately 95% of the US gross domestic product²), the SEC places great emphasis on the impact UST securities have on the global economy, citing a number of events over the past few years³ as the reason for the reforms required under the Final Rules.

Specifically, the Final Rules: (i) require covered clearing agencies that provide central counterparty services for US Treasury securities (“UST CCPs”) to have policies and procedures requiring their direct participants (“Members”) to submit certain eligible secondary market transactions (“Covered Transactions”) for clearing⁴; (ii) require UST CCPs to have policies and procedures to calculate, collect, and hold margin for their Members’ proprietary transactions (“house margin”) separately from margin for transactions submitted on behalf of indirect participants (“customer margin”)⁵; (iii) require UST CCPs to have policies and procedures to facilitate access to clearance and settlement services of all Covered Transactions, including those of indirect participants⁶; and (iv) modify the reserve formula in the broker-dealer customer protection rule to permit margin that is required and on deposit at a UST CCP to be recorded as a debit item (currently, it is not, but this change will allow broker-dealers to collect margin from their customers and pass such margin on to the UST CCP)⁷.

¹ The adopting release for the Final Rules is available here: <https://www.sec.gov/files/rules/final/2023/34-99149.pdf>.

² Speech by SEC chair Gary Gensler on November 7, 2023, at: <https://www.sec.gov/news/speech/gensler-fall-feelings-20231107>.

³ In his speech (note above), Chairman Gensler notes that disruptions in the UST market have caused increasing concerns regarding their stability and the global impact – the “flash rally” of October 15, 2014 (where US Treasury yields plunged and then rebounded within a day), the September 2019 dramatic spike in repo rates amid a large drop in reserves, the March 2020 “dash for cash” where investors moved assets into cash, and the regional bank crisis in March of 2023 are examples. Several of these are also discussed in the release accompanying the Final Rules.

⁴ Requirements to clear Covered Transactions and monitor of the submission of such transactions: changes to Rule 17ad-22(e)(18)(iv)(A) and (B).

⁵ Requirements to separate house and customer margin: changes to Rule 17ad-22(e)(6)(i). Customer margin can be net margin and does not have to be collected on a gross basis.

⁶ Requirements to facilitate access: changes to Rule 17ad-22(e)(18)(iv)(C). An example of such access is the FICC sponsored member program. Examples of indirect participants include registered investment companies, investment advisers, asset managers, hedge funds and pension funds.

⁷ Requirements to change formula in broker-dealer customer protection rule: changes to Rule 15c3-3a.

Covered Transactions include repurchase agreements and reverse repurchase agreements (“repos”) of USTs, where at least one of the counterparties to the repo is a Member of the UST CCP. They also include purchases and sales of USTs (“cash transactions”) where: (i) the Member is an interdealer broker (i.e. where the Member brings together multiple buyers and sellers, where it acts as counterparty to both the buyer and the seller, using a trading facility) and (ii) the Member faces a counterparty that is a registered broker-dealer, or a government securities broker or dealer. Cash transactions where the counterparty is a central bank, sovereign entity or natural person are not Covered Transactions. Covered Transactions also do not include repos where: (i) the counterparty is a central bank, sovereign entity or natural person, central counterparty (including US clearing agencies, US derivatives clearing organization, or foreign central counterparties), or a state or local government entity; and (ii) the Member faces an affiliate, so long as the affiliate is a bank or futures commission merchant (or foreign equivalent of either) and so long as such affiliate submits all its other UST repos for clearing (*including* repos that are not themselves Covered Transactions).

The Final Rules are substantially similar to the rules originally proposed by the SEC,⁸ although the SEC did narrow the scope of cash transactions subject to the Final Rules, added exceptions for certain counterparties (as noted above), and certain inter-affiliate transactions (subject to the restrictions noted above). Although the Final Rules still condition the debit in the customer protection rule formula on the UST CCP segregating the margin and calculating margin on a gross basis, as proposed, the SEC did make some changes in this area that should provide some relief. These changes include: (i) permitting broker-dealers to post any FICC-eligible securities (as opposed to just cash and UST) as margin; (ii) permitting broker-dealers to record a debit when they temporarily pre-fund customer margin obligations, pending receipt of such margin from the customer; and (iii) not requiring the UST CCP to return excess collateral relating to customer positions to broker-dealer Members within one business day.

Timeline

The timing for implementation of the Final Rules takes into consideration the tremendous number of steps that will be needed for this scale of market change. Currently, the sole UST CCP is the Fixed Income Clearing Corporation (“FICC”), so effectively any rules applicable to UST CCPs apply solely to FICC.

As such, the deadlines are:

- By no later than **60 days following the publication of the UST Rule in the Federal Register**, FICC must file proposed rule changes regarding (i) separation of house and customer margin (Rule 17ad-22(e)(6)(i)); (ii) facilitating access (Rule 17ad-22(e)(18)(iv)(C)); and (iii) the customer protection rule formula (Rule 15c3-3a).
 - The above three rule changes must be effective by **March 31, 2025**.
- By no later than **150 days following the publication of the UST Rule in the Federal Register**, FICC must file proposed rule changes regarding the requirement to clear and monitor Covered Transactions (Rule 17ad-22(e)(18)(iv)(A) and (B)).
 - The above rule changes must be effective by **December 31, 2025** for cash transactions.
 - The above rule changes must be effective by **June 30, 2026** for repos.

Considerations

The Final Rules will have far-reaching consequences on market participants, given the ubiquity of UST trades. Although the SEC has acknowledged the scope of the undertaking required to amend systems, documentation, onboarding processes and access models, it is reasonable to expect that there will be some amount of market turmoil and considerable cost over the course of the next two and a half years as the industry makes this shift.

⁸ The Federal Register version of the proposing release for the Final Rules is available here: <https://www.federalregister.gov/documents/2022/10/25/2022-20288/standards-for-covered-clearing-agencies-for-us-treasury-securities-and-application-of-the>.

There are valid concerns regarding barriers to competition and access – in response, the SEC has pointed out that clearing reduces the importance of counterparty creditworthiness (as compared to its significance in bilateral trades) and therefore opens the door to more participants, and that these rule changes are designed to require UST CCPs to make clearing more easily available.⁹ However, several steps will need to be taken by both FICC and market participants to effect this accessibility. There will be the need for changes to access and margin models at the FICC, as well as numerous changes to the operations of market participants in terms of how they run their margin calculations, how they onboard sponsored members at the FICC, and how they collect, hold and post margin. New standardized industry documentation will need to be developed as well. Though the phased in timeline seems generous at first glance, market participants will need to begin preparation for changes much earlier than the deadlines cited above.

Industry participants have questioned whether permitting customer margin to be collected on a net basis will be feasible in practice, given that the customer protection formula still requires use of gross margin in the calculation. Participants have also expressed concerns over the fact that FICC is the only UST CCP; the FICC expects there to be an unprecedented increase in demand for clearing, and although FICC has been studying the markets and preparing for this shift for quite some time,¹⁰ it is not entirely clear what would happen if FICC becomes unavailable or fails for any reason. The SEC did indicate that it would, if needed, rely on its exemptive authority under Section 36 (as it has done at certain critical times in the past),¹¹ but that response does not fully address concentration risk created by the dependence on FICC. We will continue to monitor and update our clients as we observe the industry’s response and implementation process.

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⁹ See the SEC open meeting on December 13, 2023 adopting the Final Rules (the “SEC Livestream”) at approximately 29 minutes, when Commissioner Hester Peirce begins her dissent and questions (the questions begin at approximately 34 minutes): <https://www.youtube.com/watch?v=umGPFvdRC04>.

¹⁰ See, for example, the white paper published by DTCC on September 13, 2023, available here: <https://www.dtcc.com/dtcc-connection/articles/2023/september/13/looking-to-the-horizon-assessing-a-potential-expansion-of-us-treasury-central-clearing>. DTCC has also created a dedicated microsite (established in late 2022) to provide more details and information for clients and the public sector regarding FICC’s various services for UST activity, its direct and indirect participation models for clearing, risk management practices, governance and thought leadership. This microsite is available here: <https://www.dtcc.com/ustclearing>.

¹¹ See the SEC Livestream (linked above) at approximately 37 minutes.