SEC Releases Final Rule Broadly Requiring Central Clearing of U.S. Treasury Transactions

January 8, 2024

On December 13, 2023, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 17Ad-22 under the Securities Exchange Act of 1934 (the "Exchange Act") to require covered clearing agencies ("CCAs") that provide central counterparty ("CCP") services for U.S. Treasury securities ("USTs") to impose mandatory clearing of certain secondary cash market and repurchase and reverse repurchase ("repo") transactions (the "Final Rules").[1] While the Final Rules are substantially narrower than the initial proposal in terms of cash market transactions, implementation of the Final Rules nevertheless will represent a sea change in the structure of the market for USTs. In particular, the Final Rules will require central clearing of virtually all UST repos if one party is a member of the Government Securities Division of the Fixed Income Clearing Corporation ("FICC"), which is the only U.S. clearing agency that currently clears such transactions. The Final Rules also impose certain new requirements on CCAs with respect to margining and the segregation of collateral, and amend Rule 15c3-3 under the Exchange Act (the "Customer Protection Rule") to potentially reduce the financial burden on broker-dealers in connection with intermediating cleared transactions.

The Final Rules' requirement to clear cash market UST transactions will be effective December 31, 2025, and the requirement to clear repos will be effective June 30, 2026. While this is a reasonably long compliance timeline, the Final Rules also require FICC to make a number of significant changes to its own clearing services in order to facilitate broader central clearing.

Moreover, the move to broader central clearing will likely impact all UST market participants, including banks, broker-dealers and other sell-side entities, as well as registered funds, private funds and other buy-side participants. Specifically, compliance with the Final Rules will require substantial efforts by sell-side FICC members to prepare to clear essentially all of their UST repo books and accommodate customers who wish to clear at third parties. As part of this preparation, these entities will need to

[1] SEC, 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 (Dec. 13, 2023) ("Adopting Release"), https://www.sec.gov/files/rules/final/2023/34-99149.pdf.

decide how much capacity (if any) to provide their counterparties to clear UST transactions, which types of trades to sponsor and set up the legal, documentation and operational platforms to clear counterparty transactions. Buy-side firms on either side of the repo market, including registered and private funds, may need to form contractual relationships with FICC members that are willing to clear their transactions.

These efforts will necessarily take place in an evolving clearing environment where there are currently few market standards and market participants will have a lot of developments to follow and work to do in the time that has been made available.

In Section I of this client memo, we begin with a very brief overview of the current clearing environment. In Section II, we provide a summary of the Final Rules and their implications for market participants. Finally, in Section III, we discuss steps required to implement the Final Rules and compliance dates.

I. Current Clearing Environment

Under FICC's current rules, "Netting Members" of FICC, generally referred to as "direct participants,"[2] are required to submit for clearing all UST transactions that are entered into with other direct participants.[3] However, FICC's rules do not require members to clear transactions with counterparties that are not direct participants of FICC.

FICC provides several services that allow for clearing of such transactions with other counterparties. On the repo side, these include the "Sponsored Service" and what FICC variously calls the "Prime Broker" and "Correspondent Clearing," both of which are for delivery versus payment ("dvp") trades, as well as the "Sponsored GC Service" for tri-party trades (through BNY Mellon) executed on a "general collateral" basis. According to the SEC, available estimates indicate that roughly 13% of cash market trades and 50% of UST repo trades are currently cleared through FICC.[4] For repo trades, daily volume across the market is as high as $4.6 trillion per day,[5] with more than $2 trillion non-

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[2] Consistent with usage in the Exchange Act, the Final Rules use the term "direct participant" to refer to entities that directly access a U.S. Treasury securities CCA in order to clear transactions and the term "indirect participant" to refer to those entities that rely on a direct participant to clear and settle their U.S. Treasury securities transactions with a CCA.

[3] Fixed Income Clearing Corporation, Government Securities Division Rulebook, Rules 2A, 18 (effective December 4, 2023), available *here*.

[4] Adopting Release at 234, 241.

[5] Adopting Release at 230.

centrally cleared, and Sponsored Service activity for the 12-month period ending on August 15, 2023 ranging from $265.8 billion to $771.7 billion.[6]

Notably, the treatment of FICC non-members and the margin or collateral they may post with respect to their repo transactions varies by service and differs from the treatment by other clearinghouses for products such as swaps, futures and options. Currently, under the Sponsored Service: (i) indirect members become contractual counterparties to FICC with respect to their cleared repos; (ii) their "Sponsoring Members" act as agent for all receipts and deliveries and guarantee "Sponsored Member" obligations; and (iii) FICC requires Sponsoring Members to provide margin on a gross basis for all Sponsored Member positions. Under the current Prime Broker/Correspondent Clearing model, (i) an indirect participant "gives up" its trade to a FICC member acting as intermediary for clearing; (ii) FICC treats the direct participant as having all of the same rights and obligations as for proprietary trades and the indirect participant has no contractual privity with FICC; and (iii) trades are net margined with other agent and principal trades of the intermediary. Further, while Sponsoring Members are required to maintain separate omnibus accounts at FICC for indirect participant transactions cleared under the Sponsored Service, all margin provided to FICC under any of these models effectively becomes part of its clearing fund, meaning it is available for loss mutualization across the customers of the clearing intermediary as well as among FICC clearing members.

II. Transactions Required to be Cleared Under the Final Rules

Against this background, the Final Rules direct CCAs that clear U.S. Treasury transactions to establish rules requiring direct participants (generally banks and broker-dealers) to clear all "eligible secondary market transactions." They do so by amending current standards for CCAs in Rule 17Ad-22(e)(18) when they clear UST transactions.[7] "Eligible secondary market transactions" are certain cash market purchases and sales, as well as repos of specified types that are accepted for clearing at a registered CCA. The Final Rules do not impose a requirement on CCAs to offer additional products for clearing.

More specifically, "eligible secondary market transactions" are defined as:[8]

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6 Adopting Release at 241. Clearing for non-FICC members via one of its other services was significantly lower.

7 As noted above, FICC is currently the only such CCA.

8 Adopting Release at 397–98, to be codified at 12 CFR 240.17ad-22.

- U.S. Treasury collateralized repurchase and reverse repurchase agreements between a direct participant and any counterparty; and
- purchases and sales (cash transactions) between a direct participant and:
  - any counterparty, if the direct participant is acting as an interdealer broker; and
  - a registered broker-dealer, government securities broker or government securities dealer (if the direct participant is not an interdealer broker).

These definitions are subject to the following exclusions:[9]

- Transactions in which one counterparty is a central bank, sovereign entity, international financial institution or natural person.
- Repos in which one counterparty is a CCA, a derivatives clearing organization ("DCO") or a CCP regulated as such in a non-U.S. jurisdiction.
- Repos in which one counterparty is a state or local government (though not a state or local government pension plan).
- Repos between a direct participant and an affiliate, if the relevant affiliate submits all of its UST repos for clearing.

The requirements with respect to repos will attach to both bilateral and tri-party repos using USTs. At least for tri-party repos, where multiple types of collateral are permissible, a repo will not be subject to clearing if USTs are substituted for non-UST securities after execution. However, to the extent that USTs are intended to be delivered at the outset of a mixed-CUSIP tri-party repo, the repo would need to be cleared.

CCAs would be required to have rules and procedures to monitor compliance with these requirements and to discipline members in the event of a failure to comply.

Margin Requirements

The Final Rules also amend Rule 17Ad-22(e)(6) to require CCAs (*e.g.*, FICC) to adopt and enforce policies and procedures reasonably designed to calculate, collect and hold margin amounts for a direct participant's proprietary positions separate from the margin for indirect participant positions intermediated by the direct participant. The Final Rules prohibit a UST CCA from netting a direct participant's proprietary and

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[9] Adopting Release at 397–98, to be codified at 12 CFR 240.17ad-22.

customer positions but would not require the CCA or a direct participant to collect a specified amount of margin for indirect participant transactions or determine margin for such transactions in a particular manner. Customer margin could be individually segregated in separate accounts or commingled in an omnibus account, provided that it is segregated from margin for proprietary positions. Similarly, a UST CCA and its direct participants would have discretion to collect margin for indirect participant transactions on either a gross or a net basis.

Corresponding to the above, the SEC also declined to require that the margin of indirect participants be protected from loss mutualization at the CCA. In other words, it refused to require rules akin to the futures model or the "legally segregated, operationally commingled" or "LSOC" model applicable to swap clearing. However, changes to the broker-dealer customer reserve formula (discussed below) are likely in practice to compel FICC to establish rules providing that the margin of a direct participant's customers is not subject to loss mutualization across FICC members.

Access Requirements

Given that the rulemaking is intended to effectively require central clearing on a broad basis, the Final Rules also require a UST CCA (*e.g.*, FICC) to adopt, implement and enforce written policies and procedures designed to ensure that it has appropriate means to facilitate access to clearance and settlement services of all eligible secondary market transactions, including those of indirect participants.

This provision does not prescribe specific methods for providing indirect access and the SEC also explicitly declined to require CCAs to adopt access rules requiring their direct participants to clear "done away" trades (those originally executed with another counterparty). Instead, these rules are intended to provide flexibility for FICC to develop models that meet the needs of different market participants and presumably also for the SEC to intervene if it deems necessary.

On this point, the SEC conducted some pointed signaling in the preamble, noting that it agrees that a workable "done away" model will be critical to the market and that CCAs should (i) seek to provide access in as flexible a means as possible consistent with sound risk management; (ii) consider a wide variety of appropriate means to facilitate access; (iii) consult a wide range of stakeholders, including indirect participants; (iv) review, document and justify any instances where participants are treated differently based on their identity; (v) consider whether to further enable direct members to clear transactions between two indirect participants; and (vi) consider the volumes being cleared via different models as part of the CCA's evaluation of whether it is meeting its access requirements.

The Final Rules' Amendments to the Customer Protection Rule

Currently under the Customer Protection Rule, a broker-dealer is required to segregate cash and securities received from customers to provide that sufficient assets are available for distribution under the Securities Investor Protection Act in the event of the broker-dealer's insolvency. Cash is segregated through application of the customer and PAB account[10] reserve formulas in Exhibit A of the Customer Protection Rule. These formulas operate by (i) treating customer account cash balances and cash raised through use of customer assets as "credits"; (ii) treating customer margin loans and certain other payables as "debits"; and (iii) requiring segregation of the net excess of credits over debits in special bank accounts subject to terms intended to prevent the use of deposits to cover broker-dealer debts or to invest in risky assets. The current Customer Protection Rule permits futures, options and swap margin required to be put on deposit with certain clearing agencies to be treated as debits in the formula but does not afford similar treatment for assets deposited with FICC. Accordingly, when broker-dealers sponsor their customers for UST repos, they are effectively required to post proprietary cash as repo margin, which can be a drain on liquidity.

The Final Rules will permit customer margin on deposit with a UST CCA to be treated as a debit item in the customer and PAB reserve formulas, subject to certain conditions designed to protect this collateral against undue risk. Specifically, to qualify for debit treatment, the following conditions will need to be met:[11]

- The debit is limited to customer position margin required and on deposit with the UST securities CCA resulting from customer transactions.
- Permissible collateral is limited to cash, USTs and other securities that are eligible to be used as margin at the CCA under its rules.
- The collateral consists of cash owed by the broker-dealer to the specific customer or securities held in custody by the broker-dealer for the customer. Cash and securities owed to another customer cannot be used.
- The CCA (FICC) adopts and implements SEC approved rules:
    - requiring the CCA to calculate, and the broker-dealer to deliver, a separate margin amount for each customer on a gross basis;

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[10] A "PAB account means a proprietary securities account of a broker or dealer." 17 CFR 240.15c3-3(a)(16).

[11] Adopting Release at 168–97, 381–396, to be codified at 12 CFR 240.15c3-3a.

- restricting the CCA's use of customer cash outside of a default to investing such cash in U.S. Treasury securities with a maturity of one year or less;

- limiting the CCA's use of customer margin as a credit resource to margining the UST transactions of customers of the broker-dealer and requiring the CCA to enter into certain supporting contractual commitments;

- requiring customer margin to be deposited in a segregated account at a Federal Reserve Bank or an FDIC-insured bank; and

- requiring the CCA to return to the broker-dealer customer collateral no longer needed for margin requirements.

Specific Treatment of RICs, FCMs and Indirect Participants

The SEC acknowledges in the Final Rules that registered investment companies ("RICs") are "important participants in the U.S. Treasury repo market" that invest substantial sums in UST repos, and that certain requirements under the Investment Company Act of 1940 (the "ICA") may impair RICs' ability to clear with FICC under FICC's current models.[12] Accordingly the Final Rules and preamble to the rulemaking provide two forms of relief.

First, should FICC allow RICs acting as indirect participants to post margin directly to FICC rather than to their Sponsoring Member, the margin would be eligible for no-action relief from custody requirements under Section 17(f) of the ICA provided that FICC satisfies certain segregation conditions as set forth in the Adopting Release.[13] The SEC notes that it is not taking a position on whether FICC currently qualifies as a securities depository eligible to act as a fund custodian consistent with SEC Rule 17f-4, and the no-action relief provided would require FICC to hold the relevant margin at an eligible fund custodian.

Second, the Adopting Release also provides no-action relief for five years for a RIC to hold margin at a Sponsoring Member who is a member of a national securities exchange (a broker-dealer), provided that (i) the RIC satisfies Rule 17f-1(a) (requiring board approval), (b)(5) and (d) and (ii) the contract with the Sponsoring Member includes certain segregation requirements.[14]

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[12] Adopting Release at 47.

[13] Adopting Release at 52-53. This relief is available for five years from the effective date of the Adopting Release. Five years is intended to provide sufficient time for FICC to develop and file any proposed rule changes to facilitate a registered fund's ability to post collateral to FICC.

[14] Adopting Release at 55.

The Adopting Release also acknowledges that because RICs would face FICC as their counterparty for cleared UST transactions when using the Sponsoring Service, RICs may be limited in the amount of reverse repos they may engage in consistent with regulatory diversification requirements under the ICA.[15] This issue may be salient as RICs, and especially money market funds, may use reverse repos to generate liquidity to satisfy redemption requests. Though the SEC acknowledges the issue, it does not provide relief asserting that RICs may generate liquidity through other means. As such, RICs may have to consider their liquidity management strategies once the Final Rules' central clearing requirements are in force.

Though, as discussed above, UST clearing requirements will have significant impact on RICs, we note that the Final Rules will impact virtually all market participants, including private funds.

As for Futures Commission Merchants ("FCMs"), the SEC acknowledges that under the Commodity Exchange Act and Commodity Futures Trading Commission ("CFTC") rules thereunder, FCMs are required to hold customer funds and securities subject to certain segregation requirements and CCAs are not eligible counterparties for repos using customer funds.[16] Accordingly, FICC's sponsored clearing model may not be available to FCMs as a means to invest customer funds in repo transactions on a going forward basis. However, while acknowledging the "tension" between the CFTC's rule and the clearing requirements, the SEC suggested that FCMs may be able to centrally clear repos through other models that do not create direct contractual privity between FICC and an indirect participant. Therefore, the SEC declined to provide an exclusion from the mandatory clearing requirement to UST transactions with FCMs.

Accordingly, FCMs may face a unique set of challenges in preparing to comply with the Final Rules. FCMs may wish to assess the adequacy of FICC's agent clearing models and remain engaged as FICC implements new rules related to holding margin.

III. Next Steps and Implications

In line with comments received on the proposed rule, the SEC adopted a phased implementation approach for the Final Rules, as follows:[17]

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15 15 U.S.C § 80a–5(b); 17 CFR 270.2a-7(d)(3).

16 17 CFR 1.25(d)(2); See Adopting Release at 76-77.

17 Adopting Release at 204-05.

Stage I

- Within 60 days of the publication of the Final Rules in the Federal Register, FICC is required to submit to the SEC proposed rules related to facilitating access to clearing, segregating margin and complying with the conditions to allow broker-dealers to record as debits customer margin posted at FICC.
    - These proposed rules must be effective by March 31, 2025.

Stage II

- Within 150 days of the publication of the Final Rules in the Federal Register, FICC is required to submit to the SEC a proposed rule requiring direct members to clear eligible secondary market transactions.
    - This proposed rule must be effective for cash transactions by December 31, 2025, and for repos by June 30, 2026. Direct participants must comply with the new rules for cash and repo transactions on their respective effective dates.

The objective of the phased approach is to provide that the full set of terms under which FICC will clear UST transactions will be in place sufficiently in advance of mandatory clearing to give market participants time to put in place appropriate arrangements. However, the initial interval will be a busy one for FICC, as the Sponsored, Prime Broker/Correspondent and Sponsored GC services will all likely have to be adapted to accommodate the SEC's requirements. In addition, FICC may choose to streamline its offerings or introduce new models to accommodate market demand. And as FICC itself noted in its comment letter to the SEC, FICC will need to develop and test systems, operations and documentation needed to accommodate a far greater volume of transactions, develop new compliance programs and build new arrangements around margin segregation.[18]

Accordingly, there is significant uncertainty with this timeline, including, at the highest level, what FICC will specifically put in place by March 31, 2025 and whether its models will continue to materially evolve after that deadline.

That said, certain practical consequences are clear. Banks, broker-dealers and other sell-side firms that are members of FICC will need to prepare to clear essentially all of their UST repo books through some combination of sponsoring their own counterparties at FICC (or providing Prime Broker/Correspondent clearing on an enhanced basis) and accommodating customers who wish to clear at third parties. Entities that already sponsor their counterparties will need to decide how much additional capacity to

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[18] Adopting Release at 197-98.

provide, at what price and whether to begin sponsoring trades originally done "away." Entities that do not sponsor their counterparties will need to decide whether to begin sponsoring and, if so, set up the legal, documentation and operational platforms to do so. Funds and other buy-side firms on either side of the repo market that have not already done so will need to form relationships with FICC members that are willing to clear transactions, which in turn requires the negotiation and execution of additional agreements.

At the same time, trading patterns as a whole are likely to evolve as the picture at FICC clarifies and market participants work through the implications of central clearing from legal, financial and risk perspectives. In addition, repo pricing is likely to be a significant consideration. While the SEC touts the risk mitigation benefits of central clearing, it also observes that competitive pressures have frequently compressed UST repo haircuts to zero[19] whereas cleared repos are expected to have minimum margin requirements funded by either the direct parties or their intermediaries. Clearing capacity may also become a scarce resource for which market participants may need to compete while new capacity providers and alternatives to clearing may emerge. Material changes in pricing thus appear likely to drive changes in behavior as well as legal and other requirements.

Accordingly, market participants that are accustomed to bilaterally negotiating terms will need to scope their current trading relationships against the Final Rules, assess the economic and operational impacts on their institutions and potentially re-strategize their trading as the alternatives become clear.

In light of the above, affected market participants should proactively monitor developments and prepare as these events develop. In particular, market participants should consider engaging with FICC, the SEC and primary regulators like the CFTC on key business and regulatory matters as FICC prepares new rule filings to publicly map out its path forward. FICC's rules and amendments to comply with the SEC mandate are subject to a public notice and comment process under Section 19 of the Exchange Act and Rule 19b-4 thereunder.[20]

Market participants should also assess readiness for mandatory clearing and potentially develop clearing or alternative relationships well in advance of the March 31, 2025 end of the first implementation phase.

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[19] Adopting Release at 254-55.

[20] 17 CFR 240.19b-4.

Please do not hesitate to contact us with any questions.

Gregory J. Lyons
Partner, New York
+1 212 909 6566
gjlyons@debevoise.com

Marc Ponchione
Partner, Washington, D.C.
+1 202 383 8290
mponchione@debevoise.com

Jeff Robins
Partner, New York
+ 1 212 909 6526
jlrobins@debevoise.com

Sheena Paul
Counsel, Washington, D.C.
+1 202 383 8178
spaul@debevoise.com

Chen Xu
Counsel, New York
+ 1 212 909 6171
cxu@debevoise.com

Tejas N. Dave
Associate, New York
+1 212 909 6155
tndave@debevoise.com

Tzerina Dizon
Associate, New York
+1 212 909 6055
tdizon@debevoise.com