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December 23, 2022

Ms. Vanessa Countryman
Secretary
US Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: 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 (File No. S7-23-22)

Dear Ms. Countryman:

The Investment Company Institute[1] is writing in response to the Securities and Exchange Commission's (SEC or "Commission") proposal ("Proposal") to increase central clearing of US Treasury security transactions to a Treasury covered clearing agency (CCA). The Proposal would require that a Treasury CCA have policies and procedures that require its direct participants to submit for clearing and settlement "eligible secondary market [Treasury] transactions" for which they serve as counterparty, subject to certain exceptions.[2] These eligible transactions include repurchase ("repo") and reverse repurchase ("reverse repo") agreements collateralized by Treasury securities, and Treasury security cash transactions with certain counterparties. The Proposal also includes related requirements that would amend the broker-dealer customer protection rule to permit margin required and on deposit with Treasury CCAs to be included as a debit (or offset) in the reserve formulas for customer accounts, thereby making

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[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $27.8 trillion in the United States, serving more than 100 million investors, and an additional $7.4 trillion in assets outside the United States. ICI has offices in Washington, D.C., Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] *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. 34-95763 (Sept. 14, 2022), 87 Fed. Reg. 64610 (Oct. 25, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-10-25/pdf/2022-20288.pdf ("Proposal"). The Proposal uses the term "direct participant" to mean "netting members" of the Treasury CCA (*i.e.*, the Fixed Income Clearing Corporation (FICC)) that are permitted to submit Treasury transactions, including Treasury repo and reverse repo transactions, to FICC for netting and novation. *See* Proposal, 87 Fed. Reg. at 64655. Indirect participants, which include sponsored members of FICC's Sponsored Service, rely on FICC netting members that qualify as "sponsoring members" to access FICC's clearing-related services. *See* FICC Government Securities Division (GSD) Rule 1 (effective as of Oct. 24, 2022) (defining a sponsored member as a "member" of FICC). For purposes of this letter, we distinguish between (i) FICC netting members; (ii) FICC sponsoring members, which are FICC netting members that qualify for participation in FICC's Sponsored Service; and (iii) FICC sponsored members, which include funds.

it more capital efficient for the broker-dealer to post margin to the clearinghouse for its customers.[3] Further, the Proposal would require a Treasury CCA to ensure that it is providing appropriate means to facilitate access to its clearing and settlement services.

ICI's members, which include US-registered investment companies—mutual funds, ETFs, money market funds, and other funds that are regulated under the Investment Company Act of 1940, as amended ("1940 Act"), ("registered funds")—and non-US regulated funds[4] (together with registered funds, "regulated funds" or "funds"), along with their advisers, are among the most significant investors in US Treasury markets, including the Treasury repo markets. The ability of funds to access the Treasury markets in an efficient and cost-effective manner that is consistent with applicable regulatory restrictions is critical to their ability to achieve their investment objectives, and their participation adds to the efficiency of these markets. We are concerned, however, that the Proposal could restrict funds' ability to participate in the Treasury markets.[5]

We agree with the Commission that funds' cash Treasury transactions should not be subject to the proposed clearing mandate and urge the Commission to confirm this position in any final rules. We further recommend that the Commission exclude from the cash Treasury clearing mandate cash Treasury transactions by non-clearinghouse members, including funds, conducted through Treasury trading platforms *(e.g.,* interdealer brokers).

We believe it is premature for the SEC to mandate clearing of funds' Treasury repo and reverse repo transactions and recommend a series of critical regulatory, structural, and operational changes that the SEC and FICC must make before a repo clearing mandate is viable for registered funds. We believe that many of the benefits that the SEC seeks from Treasury repo central clearing may be gained from increased voluntary clearing, especially once these necessary changes are made to the clearing infrastructure. We urge the SEC to provide an opportunity for central repo clearing to continue to evolve before imposing a mandate applicable to funds' transactions. Even if the Commission imposes a repo clearing mandate applicable to funds in the future, we urge the Commission to preserve the ability for funds to continue to

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[3] Rule 15c3-3 under the Securities Exchange Act of 1934, as amended ("Exchange Act") requires a broker-dealer holding customer cash and securities to, among other things, maintain cash or qualified securities in a bank account in an amount at least equal in value to the net cash owed to customers. The amount of net cash owed to customers is subject to specified debits or offsets and the total is computed weekly pursuant to a formula set forth in Rule 15c3-3a. Broker-dealers currently may not debit or offset the amount and must hold in the reserve account customer margin required and on deposit at FICC.

[4] "Non-US regulated funds" refer to funds that are organized or formed outside the United States and are substantively regulated to make them eligible for sale to retail investors, such as funds domiciled in the European Union and qualified under the UCITS Directive (EU Directive 2009/65/EC, as amended), Canadian investment funds subject to National Instrument 81-102, and investment funds subject to the Hong Kong Code on Unit Trusts and Mutual Funds.

[5] The Proposal identifies market participants that the SEC believes would be affected, including, among others, current FICC sponsored members that include "many" money market funds, other mutual funds, and a "smaller" number of ETFs. The Proposal also identifies that non-sponsored members that are funds, including money market funds, mutual funds, and ETFs, would be potentially affected. *See* Proposal, 87 Fed. Reg. at 64659-60.

engage in Treasury repo and reverse repo through tri-party arrangements on a bilateral basis (*i.e.*, outside of the clearing mandate) to ensure they can invest cash on a short-term basis.

I. Executive Summary

As discussed below, in Section III, we agree with the Commission's proposed decision to not apply any cash Treasury clearing mandate to funds' transactions. We urge the SEC, in any final rules, to explicitly exempt funds from any cash Treasury trading mandate. Such a requirement would not further the Commission's regulatory objectives and, instead, would result in considerable costs and burdens to funds, which would have to build out an entire new clearing infrastructure. These costs would be indirectly borne by fund investors. In addition, we urge the Commission to exclude from the cash Treasury clearing mandate transactions by market participants, including funds, conducted through Treasury trading platforms *(i.e.*, interdealer brokers). These trading platforms provide all-to-all access and are an important source of liquidity for funds and other investors. We do not believe that the benefits of exposing transactions between direct clearinghouse members and non-members to clearing outweigh the risks of reducing all-to-all trading and the attendant liquidity these platforms provide to funds and the market more generally.

As discussed in Section IV, it is premature for the SEC to mandate clearing of funds' Treasury repo and reverse repo transactions because the current clearing framework is not sufficiently developed to support such a mandate. Most, if not all, funds that centrally clear Treasury repo and reverse repo transactions must, as a practical matter, do so through FICC's Sponsored Service due to regulatory restrictions that hinder their ability to engage in direct clearing. Therefore, before clearing can be mandated for funds' Treasury repo and reverse repo transactions, the SEC and FICC must further analyze and make regulatory changes necessary to address specific limitations to which funds are subject under the 1940 Act, changes that may be necessary to FICC's sponsored clearing program, and other legal and operational issues that are raised by a Treasury repo clearing requirement. Once these changes are made, the SEC should provide an opportunity for demand for Treasury repo central clearing to continue to develop organically before imposing a clearing mandate applicable to funds. Our key recommendations include:

- The SEC should encourage FICC to enhance its Sponsored Service to meet the increased demand that would be created by a clearing mandate for Treasury repo and reverse repo, including further developing a "give up" access structure to facilitate best execution and providing a means for funds to directly post margin, consistent with the limitations of the 1940 Act. Section IV.B.

- The SEC should provide relief confirming that FICC may serve as a "securities depository" and may hold fund margin for purposes of the 1940 Act's custody provisions. Section IV.C.

- To protect fund assets, FICC GSD rules addressing margin posting should be amended to provide for enhanced recordkeeping, internal controls, and transparency regarding positions and related margin. ICI supports further enhancements to SEC and FICC GSD rules to ensure that customer margin is subject to the highest level of protection and, if an omnibus custody structure is permitted for FICC to hold customer assets, require an approach in which assets are "legally segregated, operationally commingled" (LSOC) to ensure protection of fund assets. Section IV.D-E.

- The SEC and FICC must clarify critical aspects regarding the default closeout process treatment in bankruptcy of funds' positions as sponsored members in FICC's Sponsored Service under a repo clearing mandate. Such clarification must address, among other issues, funds' closeout rights, as sponsored members, and their ability to continue to participate in FICC's Sponsored Service, such as through a replacement sponsoring member, in the event of a sponsoring member's insolvency. Section IV.F.

- The SEC must address the implications of a clearing mandate for funds' regulatory diversification requirements. The SEC should confirm that any repo clearing offerings made available by FICC to registered funds under the proposed clearing mandate would continue to satisfy the 1940 Act's diversification limits and that, under the proposed clearing mandate, cleared reverse repo transactions could be entered into by registered funds without application of diversification limits under the 1940 Act. As the SEC recognizes, for similar reasons, a repo clearing mandate also may adversely affect the credit ratings of money market funds—we urge the SEC to address this issue in any final rules. Section IV.I.

- The SEC should exempt from any repo clearing mandate applicable to funds tri-party repo so that funds—in particular, money market funds—continue to have the ability to sweep cash into Treasury securities on a short-term basis in the event cleared facilities are at capacity. Section IV.H.

In Section V, we explain that the benefits the Commission anticipates for central clearing of Treasury repo and reverse repo transactions appear to be premised in large part on the FICC direct clearing model and the characteristics of Treasury trading in certain markets (*e.g.*, the interdealer market). Funds, as a practical matter, are limited to engaging in cleared repo through the FICC Sponsored Service, which differs in certain key respects from FICC direct clearing. Accordingly, we do not believe that sponsored repo clearing in its current form would yield the key risk mitigation and liquidity benefits that the SEC anticipates and urge the Commission to further analyze FICC's sponsored repo clearing infrastructure and engage with FICC regarding potential changes to its clearing models that may be necessary to support a repo clearing requirement.

In Section VI, we explain that requiring that funds' repo and reverse repo transactions be subject to central clearing would impose significant costs on funds and their investors. In Section VII, we raise concerns that, under a clearing mandate, FICC's Sponsored Service may be subject to capacity constraints that would impede the ability of funds to engage in repo and reverse repo transactions.

Finally, in Section VIII, we urge the SEC to propose a viable compliance schedule for any Treasury repo clearing mandate applicable to funds. We explain that the Commission has neglected to consider the extensive regulatory and structural changes that would be necessary if funds were required to centrally clear their Treasury repo and reverse repo transactions. We therefore recommend that any repo clearing mandate be rolled out in a staged manner and not apply to funds until at least 3 years after finalization of any necessary SEC and FICC GSD rules.

II. Background on Funds' Treasury Repo Transactions

Funds, including money market funds and other mutual funds, use the repo markets to invest excess cash on a secure, short-term basis by acting as "buyers" that provide cash to other participants with cash borrowing needs ("sellers") in exchange for Treasury securities, with an agreement by the fund to sell (or the seller to buy) back those securities (or similar securities)—which act as collateral—after a specified period.[6] While the majority of Treasury repo transactions are conducted on a fixed, short term basis—typically overnight[7]—certain funds may also enter into repo agreements for a longer term (*i.e.*, "term repo") to obtain higher yields. Some funds may also conduct reverse Treasury repo transactions, in which the fund sells Treasury securities from its portfolio to another counterparty, in exchange for cash, with those securities serving as collateral in an agreement to repurchase the securities at an agreed-upon future date and price, including an additional interest payment.[8] Overnight repo transactions, which represent the largest segment of the Treasury repo market,[9] involve a sale of securities for cash (sometimes with an embedded excess)[10] but no additional margin deliveries since the transaction is unwound the next business day. Term repo, by contrast, requires the repo seller to post or deliver additional securities (or "margin") to the repo buyer if the value of the securities covered

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[6] ICI examined portfolio holdings (reported on Form N-MFP) of taxable money market funds, including government and prime money market markets. Based on this analysis, ICI estimates that taxable money market funds held $2.2 trillion in US Treasury repurchase agreements as of month-end September 2022. These Treasury repo holdings accounted for 49.1% of taxable money market fund assets. Additionally, ICI analyzed portfolio holdings of bond funds and ETFs (reported on Form N-PORT) and estimates that these funds held $45 billion in Treasury repo, accounting for 0.7% of fund assets, during the second and third quarter of 2022.

[7] The preference for Treasury overnight repo can be attributed to commercial and market-based reasons. *See, e.g.*, Risk.net, *All clear? Structural shifts add to repo madness* (Nov. 5, 2019) (noting the reliance in recent years on overnight Treasury repo by borrower market participants to facilitate certain fixed income arbitrage trades). With respect to a money market fund, overnight repo complies with Rule 2a-7's requirement that at least 10% of the fund's holdings are in one-day liquid assets. *See* SEC Rule 2a-7(d)(4)(ii).

[8] From a fund accounting perspective, the US Treasury securities sold to the repo counterparty in a reverse repo are treated as a sale of assets by the fund and, unlike collateral posted against a derivative, are not reflected in the fund's reported net asset value. As a result, the US Treasury securities delivered to the reverse repo counterparty may be freely used by the counterparty and are not required to be held with the fund's custodian, as would be the case for a secured loan. Similarly, funds are not limited in the way that they may use the cash received in the reverse repo and may use the cash proceeds from a reverse repo transaction for a variety of purposes that are consistent with their investment objectives, strategies, and policies.

[9] According to the SEC, overnight repo transactions account for 87.5% of daily transaction volume in the US Treasury repo market. *See* Proposal, 87 Fed. Reg. at 64645 n.270.

[10] *Id.* at 64653 ("Money market funds [which generally enter only into overnight repo transactions] also generally require margin of 2%, which is generally the case for other investment companies as well.").

by the transaction decreases.[11] Similarly, excess margin is typically returned to the repo seller when the securities go up in value. As a result, term repo generally involves daily mark-to-market margining after the initial delivery of the securities that are sold to the repo buyer for cash until termination or, if callable or "open," the earlier unwind date.[12]

Funds currently clear and settle their Treasury repo and reverse repo transactions primarily through a tri-party custodian or bilaterally,[13] and historically have not centrally cleared such transactions (or cash Treasury transactions) through FICC. FICC is currently the only central counterparty (CCP) that clears transactions in Treasury securities or repos and reverse repos collateralized by Treasury securities. Unlike other US financial clearinghouses, FICC does not maintain a guarantee or default fund but instead requires members, including sponsoring members under FICC's Sponsored Service (described in the Appendix to this letter), to post initial margin to secure proprietary and customer obligations through posting to the Clearing Fund and to support a liquidity facility, called the Capped Contingency Liquidity Facility (CCLF). The CCLF provides FICC with funding to risk manage a defaulting member's inventory upon the member's insolvency.

Direct access to clearing at FICC is available only to netting members of FICC's Government Securities Division (GSD).[14] While funds technically may qualify as "Tier Two" members, the criteria to do so and to maintain Tier Two netting member status would be very costly and

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[11] The transaction may also be adjusted in this situation by having the repo seller return a portion of the cash received under the repo so that the value of the securities is equal to the agreed upon maintenance amount, sometimes referred to as the "margin percentage."

[12] *Id.* ("In addition to term repos agreements with fixed maturity dates, there exist term repo agreements with embedded options that lead to an uncertain maturity date. For example, 'callable' repos include an option for the lender to call back debt (*i.e.*, resell securities) at their discretion. 'Open' repos have no defined term but rather allow either party to close out at the contract at any date after initiation of the agreement.")

[13] Comprehensive estimates of the relative overall volume of Treasury repo and reverse repo transactions that are centrally cleared versus not centrally cleared (*i.e.*, settled on a bilateral or tri-party basis) are limited in nature. The US Treasury Department estimates that approximately half of all bilateral repo transactions were cleared and settled directly between counterparties in 2020. Proposal, 87 Fed. Reg. at 64645-46 (citing R. Jay Kahn and Luke M. Olson, *Who Participates in Cleared Repo?*, Office of Financial Research Brief Series (July 8, 2021) at 4 (estimating that the average daily volume of centrally cleared repo transactions in 2020 ($1.1 trillion) is comparable to the average daily volume that is uncleared and settled on a tri-party basis ($1.3 trillion)); Sebastian Infante, Lubomir Petrasek, Zack Saravay, and Mary Tian, *Insights from revised Form FR2004 into primary dealer securities financing and MBS activity*, FEDS Notes (Aug. 5, 2022) (estimating, based on recent primary dealer reports, that 40-60% of aggregate primary dealer repo and reverse repo activity is uncleared, with approximately 20% of all repo and 30% of reverse repo centrally cleared via FICC).

[14] FICC netting members today consist of Tier One netting members (*i.e.*, primary dealers and other broker-dealers who meet stringent capital requirements and are also required to participate in FICC's loss mutualization arrangements) and Tier Two netting members, which are described below in note 15. FICC GSD Rule 2A, Section 2(a)(i)-(viii). In a transaction between two netting members, FICC novates the transaction and steps in as a counterparty to both sides, thereby guaranteeing settlement to both sides of the transaction. Importantly, novation enables each netting member to net all its positions that have been novated to FICC into a single long or short obligation to FICC.

burdensome for funds, with limited direct benefit.[15] For example, as a netting member, a fund must contribute to the Clearing Fund, participate in the CCLF, maintain specified capital requirements, and become a member of the Comparison System and the Netting System.[16] Funds generally have not pursued such membership as a result of regulatory restrictions that hinder their ability to contribute fund assets to the Clearing Fund or to the CCLF.[17] As a result, funds typically do not clear cash Treasury securities transactions.

In recent years, however, some funds have begun to centrally clear a portion of their respective repo and reverse repo transactions through FICC as a "sponsored member" through a FICC netting member that FICC has accepted as a "sponsoring member." Although funds' sponsored Treasury repo transactions have increased in recent years, their use of FICC's Sponsored Service remains modest relative to their overall participation in the Treasury repo market.[18] The recent increase is due, in part, to FICC's expansion of qualification eligibility,[19] as well as the addition

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[15] FICC offers a Tier Two membership category, with members referred to as "Registered Investment Company Netting Members," that is limited to funds and not subject to loss mutualization requirements per FICC's rules. FICC GSD Rule 2A, Section 2(a)(viii). Tier Two Members can be subject to loss allocation arising from another defaulting netting member, but only to the extent they traded with that defaulting netting member and otherwise would not be responsible for mutualizing losses with participants with which they do not trade. FICC GSD Rule 4, Section 7. According to FICC, the Tier Two membership category is designed to address funds' regulatory restrictions on participating in loss mutualization. *Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change To Introduce Cross-Margining of Certain Positions Cleared at the Fixed Income Clearing Corporation and Certain Positions Cleared at New York Portfolio Clearing, LLC*, Exchange Act Release No. 34-63986 (Feb. 28, 2011), 76 Fed. Reg. 12144, 12148 (Mar. 4, 2011). Among other criteria, a Tier Two Member must have minimum net assets of $100 million. FICC GSD Rule 2A, Section 4(b)(9).

[16] *See* FICC GSD Rule 4, Section 1 ("each Netting Member shall make and maintain on an ongoing basis a deposit to the Clearing Funds"). *See* FICC GSD Rule 22A, Section 2a (stating that all netting members must participate in the CCLF).

[17] We understand that fund sponsors have discussed with FICC and with the SEC the possibility of FICC direct membership. One important concern that funds have regarding membership is that contribution by a fund as a FICC member to FICC's Clearing Fund and liquidity facility could violate the 1940 Act. For example, if affiliated funds were to contribute to the facilities, the contributions might be deemed to be a prohibited joint transaction in violation of Section 17(d) of the 1940 Act. The contributions also raise potential issues under Section 18 of the 1940 Act (prohibiting issuance of "senior securities") and Section 17(f) of the 1940 Act (requiring fund assets to be maintained by a qualified custodian of the type specified). Such a contribution may also be contrary to the fund's purpose of "investing in securities" and its policies and organizational documents.

[18] For example, the Commission has noted that money market fund investments in Treasury repo (bilateral and tri-party) amounted to approximately $2.3 trillion in June 2022, of which $63 billion was centrally cleared through FICC sponsored clearing. Victoria Baklanova, Isaac Kuznits, and Trevor Raum, *Money Market Funds in the Treasury Market* at 5 (Sept. 1, 2022) ("SEC Staff Report").

[19] FICC's first sponsored repo service—FICC Sponsored DVP—was established in 2005, at which time funds were the only participants eligible to become sponsored members. In 2017, FICC expanded the eligibility criteria to allow Qualified Institutional Buyers, as defined under SEC Rule 144A under the Securities Act of 1933, to become sponsored members. *Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, to Expand the Types of Entities That Are Eligible to Participate in Fixed Income Clearing Corporation as Sponsored Members and Make Other Changes*, Exchange Act Release No. 34-80563 (May 1, 2017), 82 Fed. Reg. 21284 (May 5, 2017). FICC also subsequently expanded the

of the Sponsored General Collateral (GC) Service, which allows sponsors and sponsored participants to execute repo on a general collateral basis and settle on a tri-party repo platform.[20] These enhancements in the Sponsored GC Service provide a robust operational and recordkeeping framework and stronger ownership rights with respect to the repo securities or reverse repo cash, as compared with the requirements if margin were held through the sponsoring member or FICC through a control arrangement.[21] We provide additional detail on the various methods through which funds clear and settle their Treasury repo transactions in the Appendix attached to this letter.

Whether a fund chooses to transact a Treasury repo or reverse repo transaction on a centrally cleared basis, or on a bilateral or tri-party basis, depends in large part on market-based factors. These factors include the price and capacity offered by dealers on a centrally cleared basis,[22] as well as the relative rates of return offered and terms available to a repo buyer (*e.g.*, a money market fund seeking to invest its cash on a short-term basis may compare the available return and terms of a cleared repo transaction in relation to other short-term commercial deposit or investment options). Some funds may also utilize sponsored clearing to reduce risk concentration with a particular counterparty by clearing a portion of their transactions through FICC as a hedge to other uncleared transactions with the counterparty, or they may use the Sponsored GC Service based on operational efficiencies because the fund already has a tri-party repo arrangement in place with an agent bank.

III. The Cash Treasury Clearing Mandate Should Not be Applied to Funds

A. Background

The Proposal would mandate central clearing of certain Treasury security transactions by requiring FICC to have policies and procedures that require its direct participants, (*i.e.*, FICC

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eligibility criteria to increase the types of entities that could become sponsoring members. *Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change to Expand Sponsoring Member Eligibility in the Government Securities Division Rulebook and Make Other Changes*, Exchange Act Release No. 34-85470 (Mar. 29, 2019), 84 Fed. Reg. 13328 (Apr. 4, 2019).

[20] FICC modeled this program on its GCF Repo Service, which is available only to FICC netting members. According to FICC, the Sponsored GC Service was introduced in part based on feedback that funds may not operationally be able to provide or receive cash margin related to their term repo activity, but rather must utilize the transfer of securities through a tri-party repo custodian to maintain required margin. The service is also intended to promote greater clearing of term repo. *Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Add the Sponsored GC Service and Make Other Changes*, Exchange Act Release No. 34-92014 (May 25, 2021), 86 Fed. Reg. 29334, 29336 (June 1, 2021) ("FICC Sponsored GC Rule Filing").

[21] Under Article 8 of the Uniform Commercial Code which, as a matter of state law, governs perfection of security interests in collateral, perfection through "possession" provides the holder with stronger ownership rights in securities than perfection through "control."

[22] The level of demand for cleared repo with sponsored members may depend on, among other things, the sponsoring member's desire to avail itself of regulatory relief from capital requirements that may result from centrally clearing the repo transaction and the ability of the sponsoring member to intermediate (*i.e.*, lend the cash received from the fund to other repo sellers in turn).

netting members) to submit for clearing and settlement all "eligible secondary market transactions" to which they are a counterparty.[23] The Proposal would require FICC to adopt policies and procedures that require a direct participant to submit cash Treasury transactions where it is acting as a counterparty to both sides of Treasury transactions through trading facilities[24] or is a transaction counterparty to a (i) registered broker-dealer; (ii) government securities dealer or government securities broker; (iii) a hedge fund;[25] or (iv) an account at (i) or (ii) that can take on significant leverage.[26] The Commission states that this mandate is directed in part to market participants that have assumed an increasingly prominent role in the US Treasury market, and accounts that can assume significant leverage because of their ability (and tendency) to engage in Treasury-related trading strategies that may heighten the risks of financial distress to their counterparties and other market participants.[27]

While the Proposal does not explicitly subject funds to this mandate, it requests comment on whether it should do so.[28] Although the cash Treasury clearing mandate is not targeted to funds, funds could inadvertently become subject to the mandate through participation on Treasury trading platforms.

B. The Costs of Cash Treasury Clearing for Funds Outweigh the Benefits and Would Not Further the Commission's Objectives

ICI strongly opposes mandating central clearing of funds' cash Treasury transactions that are effected through a FICC netting member as well as mandatory central clearing for all participants

[23] The SEC also proposes several exceptions to the mandate. The Proposal specifically excludes any Treasury transaction (both cash Treasuries and Treasury repo and reverse repo) in which the counterparty to the direct participant is a central bank, sovereign entity, international financial institution, or a natural person. Proposed Rule 17Ad-22(a) (definition of "eligible secondary market transaction"). The Proposal does not apply to (i) transactions in the primary market, or (ii) "when-issued" transactions that occur before and on the day of a Treasury auction. Proposal, 87 Fed Reg. at 64621. The clearing mandate also would not apply to transactions of interdealer brokers that are direct participants of a US Treasury CCA unless they are counterparty to both sides of each trade on their platform. In addition, as a practical matter, the scope of the clearing mandate for both repo and reverse repo and cash transactions may be further broadened prior to launch because the Proposal delegates to FICC the obligation to establish clearing standards through rules, which are yet to be developed.

[24] *See* Proposed Rule 17Ad-22(a)(ii)(A).

[25] The Proposal utilizes the definition of a "hedge fund" as defined in Form PF. The SEC notes that hedge funds are specifically included because they engage in trading strategies that may pose heightened risks of potential financial distress to their counterparties, including direct participants of a Treasury CCA. It also notes that hedge funds are increasingly large participants in the US Treasury market and "materially contribut[ed] to Treasury market disruption [in March 2020 as sellers]." Proposal, 87 Fed. Reg. at 64624.

[26] The Commission considers "significant leverage" to mean the ability to borrow in excess of half of the value of the account or may have gross notional exposure of transactions in the account that is more than twice the value of the account. The SEC states that this category is specifically intended to cover transactions with prime brokerage accounts, which may hold assets of entities (*e.g.*, private funds or separately managed accounts) and use leverage or engage in trading strategies that may pose a risk to the Treasury CCA and the broader financial system. Proposal, 87 Fed. Reg. at 64625.

[27] Proposal, 87 Fed. Reg. at 64623-24.

[28] Proposal, 87 Fed. Reg. at 64631.

on a Treasury trading platform. We believe that applying a cash Treasury clearing mandate to funds would not promote risk reduction or enhancements to market liquidity to a degree that would justify the considerable costs and burdens to funds, which would have to build out an entire new clearing infrastructure. These costs would be indirectly borne by fund investors.

Expanding the proposed cash Treasury clearing mandate to include funds' cash Treasury transactions also would not further the Commission's objectives. The characteristics of typical fund cash Treasury transactions are distinguishable from the types of cash Treasury transactions that the Commission is seeking to capture under the mandate for risk reduction purposes. For example, in describing which cash transactions to include in the definition of an eligible secondary market transaction subject to a clearing mandate, the Proposal focused, among other categories of counterparties, on transactions between direct participants and hedge funds and prime brokerage account holders. In that regard, the SEC noted that these entities were often "large players in the U.S. Treasury Market" and typically use significant leverage, which gives rise to potential "contagion risk."[29] Funds, on the other hand, invest in cash Treasury securities for purposes such as obtaining desired exposure, hedging risks associated with investments in other markets, diversifying their portfolios, and protecting capital, among other reasons.[30] These transactions are generally not linked to other leveraged strategies and, thus, broadening the mandate to capture them would not yield additional risk reduction benefits. In addition, funds are limited in their ability to incur leverage, both by statute (*i.e.*, Section 18 of the 1940 Act) and by SEC rules (*e.g.*, Rule 18f-4 under the 1940 Act). As a matter of investment strategy as well, which the Commission acknowledges, buy-side market participants such as bond funds generally do not acquire significant leverage, including when investing in Treasury securities.[31]

Further, expanding the cash Treasury clearing mandate to funds would not advance the Commission's objective of increasing dealers' balance sheet capacity. In contrast to repo or reverse repo transactions, we understand that dealers typically already net their own customer cash Treasury transactions on a bilateral basis, which affords them certain balance sheet benefits.[32] Accordingly, there would be little added benefit to a dealer to further net these positions at the CCP level against its other cleared positions. Additionally, because a substantial amount of fund transactions is long-only and in off-the-run and thinly-traded segments of the Treasury market, there would likely be fewer opportunities for achieving additional balance

[29] Proposal, 87 Fed. Reg. at 64624.

[30] As of the end of Q2 2022, funds were the third largest investors in the Treasury market, holding just under $3.6 trillion of Treasury securities and accounting for 14% of the total. Money market funds held approximately 7% of outstanding Treasury securities. SEC Staff Report at 2 (citing Financial Accounts of the United States, https://www.federalreserve.gov/releases/z1/20220909/html/l210.htm (last checked Nov. 7, 2022)).

[31] Proposal, 87 Fed. Reg. at 64673. Bond funds are typically "long-only" investors in cash Treasury securities.

[32] Cash Treasury transactions typically settle on a T+1 basis, which allows dealers to net such positions on their balance sheets and avoid a regulatory capital charge that would otherwise be incurred if there were a failure to settle after five business days.

sheet capacity through netting. There are also other important reasons dealer capacity may not increase.[33]

In addition, clearing cash Treasury transactions would require funds to develop an entire clearing infrastructure and separate reconciliation processes that currently do not exist. As the Commission and the Group of Thirty have recognized,[34] participants in the dealer-to-customer market wholly lack the infrastructure for central clearing of cash Treasury transactions. Establishing the technological, operational, and legal frameworks necessary for central clearing would likely take years to develop, given that it would require onboarding and account setup, along with separate documentation for each individual fund counterparty, as well as building out operational connectivity with FICC. These steps, when considered in conjunction with the clearing fees, margin requirements, and other administrative costs that would be imposed in connection with clearing, would result in a significant additional cost related to cash Treasury transactions that would be borne by funds, their advisers, and investors, as well as liquidity providers, other buy-side market participants, trading venues, and other financial market utilities. These costs would likely lead to higher costs to participate in the Treasury market. Given the effort and likely costs involved, market participants, including liquidity providers, may choose to rely more on other types of instruments, *e.g.*, Treasury futures and/or interest rate swaps, which not only would decrease investment efficiency and diminish returns for funds and their investors, but also further reduce Treasury market liquidity.

We also recommend that non-clearinghouse member participants in Treasury trading platforms, including funds, should not be required to clear cash Treasury transactions effected on those platforms. These trading platforms provide all-to-all access and are becoming an important source of liquidity and pricing information for investors, such as funds. Imposition of a clearing mandate on participants is likely to dissuade participants from using these venues, which could adversely impact overall market liquidity. We do not believe that the benefits of exposing transactions between direct clearinghouse members and non-members to clearing outweigh the risks of reducing all-to-all trading and the attendant liquidity these platforms provide to the market generally, as well as to funds.

We therefore urge the SEC to ensure that its rules regarding Treasury clearing and FICC GSD rules regarding application of the Treasury clearing mandate expressly exclude funds from the cash Treasury clearing mandate so that funds do not inadvertently become subject to mandatory clearing of cash Treasury transactions. Similarly, in recognition of the important liquidity provided by interdealer broker trading platforms, the rules should exclude from the definition of "eligible secondary market transaction" transactions by non-clearinghouse members conducted through those venues.

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[33] For example, dealer capacity may be limited by risk-based capital constraints. Increased dealer balance sheet capacity also may be offset by the increased costs of mandated clearing. The Commission does not provide data in the Proposal that demonstrates that the benefits of mandatory clearing would exceed the benefits from promoting voluntary clearing.

[34] *See* Group of Thirty Working Group on Treasury Market Liquidity, *U.S. Treasury Markets: Steps Toward Increased Resilience* at 14 (2021), *available at* https://group30.org/publications/detail/4950.

IV. It is Premature to Apply the Treasury Repo Clearing Mandate to Funds' Transactions

The SEC should not, at this time, require that Treasury repo and reverse repo transactions between a fund and a FICC netting member be subject to a clearing requirement because the current clearing framework is not sufficiently developed to support such a mandate.[35] We discuss below the regulatory, structural, and operational impediments that must be addressed before such a mandate would be viable. Even once these issues are addressed, we urge the SEC to continue to observe the organic growth of central clearing of Treasury repo based on evolving market conditions before making any determination regarding the necessity of a Treasury repo clearing mandate for funds' transactions. We believe many of the benefits the SEC seeks from a repo clearing mandate may be obtained from greater use of repo clearing on a voluntary basis. Even if the Commission does impose a Treasury repo clearing mandate on funds' transactions in the future, it should exempt tri-party Treasury repo and reverse repo transactions, which share key attributes with cleared transactions and are essential for funds (in particular, money market funds) to be able to sweep cash into Treasury securities on a short-term basis in the event cleared facilities are at capacity.

A. Background

The Proposal would require clearing of all repo and reverse repo agreements collateralized by Treasury securities in which a direct participant is a counterparty. The Commission cites several potential risk reduction benefits to broader central clearing and emphasizes its belief that the high quality and credit status of Treasury securities does not necessarily eliminate the potential risk in the event of a counterparty default. The SEC notes that the benefits of clearing include:

- reduced operational and liquidity risk[36] through greater multilateral netting of transactions, which could ease bank capital and leverage requirements by increasing balance sheet capacity to enhance dealer market making capacity;[37]

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[35] The SEC also requests comment on whether the Treasury clearing requirement should apply to securities lending transactions in which Treasury securities are borrowed. We do not believe securities lending transactions should be included in the clearing mandate. Securities lending transactions differ legally and operationally from reverse repos. *See, e.g.*, Letter to Ms. Vanessa A. Countryman, Secretary, SEC, from Susan Olson, General Counsel, and Sarah A. Bessin, Associate General Counsel, Investment Company Institute (Jan. 7, 2022). Furthermore, the infrastructure to clear securities lending transactions does not currently exist and developing it would present significant regulatory and operational challenges that would require further analysis.

[36] We understand "liquidity risk" to be the risk of having to convert securities to cash (or vice versa) to be able to make required settlement in the event of member default.

[37] The Commission cites data suggesting that additional central clearing may have lowered dealers' daily settlement obligations in the cash market by 60% in the run-up and aftermath of the March 2020 US Treasury market disruption and may have reduced settlement obligations by 70% during the disruption itself. Proposal, 87 Fed. Reg. at 64628. For the repo market, the Commission cites estimates that additional central clearing for dealer-to-client repo transactions would have reduced dealer exposure from US Treasury repos by over 80% (from $66.5 billion to $12.8 billion) in 2015. Proposal, 87 Fed. Reg. at 64628 n.185 (citing Office of Financial Research, *Benefits and Risks of Central Clearing in the Repo Market* at 5-6 (Mar. 9, 2017)). We note, however, that this figure assumes that

- centralized default management, which would enable orderly handling of a counterparty default and reduce uncertainty about exposures across market participants;

- managing and reducing counterparty risk by substituting the creditworthiness and liquidity of the CCP for the creditworthiness and liquidity of the counterparties, thereby "making all-to-all trading more attractive;"[38] and

- increased regulatory transparency into settlement risk, particularly in the "often opaque" repo market, which would allow FICC to identify concentrated positions and crowded trades and adjust margin requirements.[39]

The Commission believes that lower counterparty credit risk—and potentially lower intermediation costs—could result in narrower spreads, which would enhance market quality by promoting competition among liquidity providers and support movement to all-to-all trading, including potentially in the Treasury repo market.

B. The SEC Should Encourage FICC to Enhance Its Sponsored Service

We strongly support FICC continuing to make the Sponsored Service available to registered funds. To address regulatory, structural, and operational issues raised by the proposed Treasury repo clearing mandate, the SEC should recommend that FICC consider potential enhancements to its Sponsored Service. We describe these potential enhancements in this section and then, in the sections below, include recommendations regarding how the SEC and FICC should address the regulatory and other issues that would be raised.

First, the SEC should encourage FICC to further develop a "give up" structure to facilitate best execution. The adoption of an efficient give-up structure by netting members is a critically important step to incentivize voluntary clearing, as it would generate increased competition among market participants, which may result in more efficient pricing. Further, an efficient give-

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every participant in the dealer-to-client market would be able to submit its transactions for central clearing, which is not feasible from a legal and operational perspective. It is also important to remember that a significant portion of the selling in the US Treasury market in March 2020 was by foreign central banks, which would be exempt from the proposed Treasury clearing mandate. *See, e.g.*, Colin R. Weiss, *Foreign Demand for U.S. Treasury Securities during the Pandemic*, FEDS Notes (Jan. 28, 2022), *available at* https://www.federalreserve.gov/econres/notes/feds-notes/foreign-demand-for-us-treasury-securities-during-the-pandemic-20220128.html.

[38] Proposal, 87 Fed. Reg. at 64612, 64628.

[39] The Commission believes that risk management in bilateral Treasury repo clearing is not uniform and transparent, leading to competitive pressures that increase risk. Subjecting those transactions to mandatory clearing would impose risk management standards on these transactions, including margin requirements. For example, the Commission cites its understanding that transactions between dealers and institutional customers are subject to a "variable 'good faith' margin standard," which can often result in fewer financial resources collected to margin exposures than what would otherwise be collected in a CCP-based model. Proposal, 87 Fed. Reg. at 64669. We do not view this observation as reflective of how funds participate in the Treasury repo and reverse repo markets, particularly given their primary role is as providers of cash. As noted above, funds typically mandate that a counterparty provide collateral that is at least equal to 102% of the cash value provided. *See supra* note 10.

up structure would be essential under a clearing mandate because the Sponsored Service may not be able to meet increased capacity requirements due to the limited number of sponsoring members and the increased demand for sponsored clearing under any mandate. We believe that the infrastructure currently used by FICC for prime brokerage clearing could be leveraged to develop a give up model outside of prime brokerage. Any such model will need to provide for standardized documentation that facilitates additions and deletions of approved brokers, agreed-upon terms for rejection of trades by a sponsoring member and centralized storage of delegation.

Second, the SEC should encourage FICC to add a feature permitting (but not requiring) sponsored members to directly support their obligations to FICC through margin posting rather than by paying fees to the sponsoring member reflecting the cost of its clearing fund contributions. The current Sponsored Service offered by FICC does not require funds to post margin to FICC and therefore does not raise custody issues for registered funds under the 1940 Act. Under the Sponsored Service, a fund delivers cash in exchange for securities purchased by the fund under a repo and delivers securities in exchange for cash under a reverse repo arrangement. In a tri-party arrangement, the cash and securities movements are handled by the custodian and under the DVP Service, cash and securities are exchanged on a delivery-versus-payment basis. A sponsoring member is required to provide credit support to the FICC Clearing Fund to guarantee performance of the sponsored member. Permitting funds to post margin directly could reduce costs for participating funds under both sponsored repo and reverse repo transactions. The ability of funds to post margin would also facilitate their use of cleared reverse repos and term repos.

Although a repo seller (but not a repo buyer) typically posts margin, in market conditions where the value of Treasury securities increases substantially after the execution of the trade (*e.g.*, due to a decrease in supply) a repo buyer may need to post margin to secure its obligations to resell the Treasuries. In the context of the Sponsored Service, the sponsored member posting margin to FICC (in situations where such posting is required) could be facilitated through implementation of a mechanism under which sponsored members can post margin to a sponsoring member which could on-post the margin to FICC, subject to FICC's compliance with 1940 Act custody requirements. Under current FICC GSD rules, even if the portion of the Clearing Fund attributable to a sponsoring member's sponsored member is operationally segregated (as it is today), that pool of assets is still subject to loss mutualization under FICC GSD's rules. Changing the sponsored member Clearing Fund contribution to a pool of margin that is used in the event of a default of the underlying sponsored member would more closely align a sponsored member's exposure to potential losses in a default scenario with its own creditworthiness (*i.e.*, the defaulter pays first) and be more cost effective for sponsoring members.

As a clearinghouse, FICC must be able to liquidate and, pending liquidation, risk manage a defaulting member's cleared Treasury repo and reverse repo positions. To be able to do this effectively, FICC must have adequate tools to prevent contagion and provide liquidity.[40] FICC relies on the Clearing Fund and margin posted through the Clearing Fund to ensure that there are sufficient assets available to meet member obligations. During periods of market volatility, FICC may impose additional margin charges on members. In expanding its cleared Treasury offerings in the future, we expect that any new structures FICC develops for sponsored clearing Treasury repo and reverse repo may require posting of margin to FICC by sponsored members as well as the sponsoring members. FICC may also require members and, possibly, indirect participants, to make contributions to the CCLF—particularly because FICC does not have a guarantee fund.

C. Potential Custody Issues for Funds

The legislative history of the 1940 Act reflects Congress's substantial concern with situations in which controlling persons of funds commingled investment company assets and then borrowed assets from the pool for their own use.[41] In light of these concerns, Congress adopted Section 17(f), which requires registered funds to maintain their securities and similar investments in the custody of a bank, a member of a national securities exchange, or to self-custody such assets subject to rules adopted by the Commission. Substantially all funds use a bank custodian. One of the benefits provided by reliance on a bank custodian is that a bank ensures that cash held by the fund will be protected in the same manner as portfolio securities.[42] In the context of repo and reverse repo, reliance on a bank custodian is particularly beneficial for a fund because the transaction by its nature involves custody of both securities and cash.

The SEC has adopted rules that specify required qualifications for entities other than those named in Section 17(f) to act as custodian of fund assets. Rule 17f-4 under the 1940 Act permits a fund to deposit the securities it owns in a system for the central handling of securities ("securities depository"). Under Rule 17f-4, the term "securities depository" includes a clearing corporation that is registered with the Commission as a clearing agency under Section 17A of the Exchange Act. Although FICC is registered as a clearing agency,[43] FICC has stated that it is not a securities depository and does not provide securities depository services.[44]

Because FICC is not deemed to be a securities depository eligible to custody fund assets, expanding its Sponsored Service for Treasury repo and reverse repo for funds would require addressing Section 17(f) if the offering would require margin posting by funds. One way in

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[40] Our understanding is that entities such as FICC that are Systemically Important Financial Market Utilities (SIFMUs) operate under the assumption that they will not have access to the Federal Reserve lending window although access could be possible in unusual or exigent circumstances.

[41] T. Lemke and G. Lins, *Regulation of Investment Companies*, §83.07 [10] at n.374 ("Lemke and Lins").

[42] *See id.* at §83.07(10][a][ii], n.377 *citing* Inv. Co. Act Rel. No. 6863, 1972 SEC LEXIS 2112 (Dec. 6, 1971).

[43] *See* Fixed Income Clearing Corporation, SEC No-Action Letter (Mar. 13, 2003), *available at* https://www.sec.gov/divisions/investment/noaction/ficc031303.htm (stating that the Mortgage-Backed Securities Division of FICC "is an eligible fund custodian under Rule 17f-4 under the 1940 Act because it is a division of FICC, a clearing corporation that is registered with the Commission as a clearing agency under section 17A of the 1934 Act.").

[44] FICC Disclosure Framework at 83.

which this could be achieved would be for FICC to obtain SEC relief to hold fund margin as an eligible securities depository within the meaning of Rule 17f-4. If FICC were permitted to serve as a "securities depository," for purposes of Rule 17f-4, then it would be eligible to custody margin for a fund, in the same manner as a clearinghouse, such as the Options Clearing Corporation (OCC), does today. In the alternative or as a supplementary service, FICC could establish a framework, such as the one currently used by FICC in connection with the Sponsored Service, where fund assets are held at a qualifying custodial bank that acts as agent for FICC. We also request confirmation from the SEC that, if FICC were to have authority under any future clearing offering to receive monies or securities in connection with cleared Treasury repo or reverse repo or to direct the transfer of fund monies or securities, FICC would not be deemed under those circumstances to have custody of fund assets for purposes of Section 17(f) of 1940 Act or the rules thereunder.[45]

Furthermore, a practical concern raised by custody arrangements for repo and reverse repo transactions is that the securities and cash delivered under the transactions are deemed to be part of a purchase and sale transaction, rather than part of a secured loan and, as a result, the repo seller typically will not hold the cash as collateral with a custodian but, instead will withdraw the money and invest it in securities or use it for other business purposes. Similarly, a repo buyer will also withdraw the posted securities from time to time to rehypothecate or otherwise use the assets in connection with its business. As a result, securities delivered by a repo seller to a repo buyer (both in the start leg and thereafter as a transaction is marked-to-market) are expected to be available to be withdrawn by the repo buyer. Unlike a derivatives transaction where collateral is held in a pledge account, securities delivered under a repo transaction have been purchased by the buyer, and the repo buyer must be free to use these assets. It is not clear from the Proposal how, as a practical matter, FICC would be able to offer a custodial account (either directly or through an agency bank) that would allow a repo buyer to withdraw the securities delivered to the repo buyer by the seller for use, as tri-party repo arrangements effected on a bilateral basis do today.

D. Recordkeeping Concerns

To address fund concerns regarding the security of fund assets under a Treasury repo clearing mandate, FICC GSD rules addressing margin posting will need to be amended to provide for enhanced recordkeeping, internal controls, and transparency around the positions and related margin. Enhanced recordkeeping and related controls are critical to appropriately identifying ownership of assets during a Treasury repo or reverse repo transaction particularly since, unlike a typical derivatives or cash transaction, ownership of the Treasury securities underlying a repo or reverse repo change owners during the transaction. If a Treasury repo or reverse repo counterparty becomes insolvent during the transaction, then the clearinghouse would be

[45] For example, by analogy, under SEC staff FAQs relating to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), an investment adviser may be deemed to have custody if it receives money or securities for its client and does not forward the assets to the client or a qualified custodian within a specified time frame and in a designated matter. *See* https://www.sec.gov/divisions/investment/custody_faq_030510 at II.1.

responsible for identifying whether the solvent or the insolvent counterparty owned the Treasury securities at the time the insolvency occurred.

FICC currently relies on broker-dealer members and, in certain cases, designated agency banks to maintain records regarding margin positions. FICC has indicated that it currently "is not able to identify positions or possess the assets of its Members' customers." Notwithstanding FICC's current lack of infrastructure to custody, identify, and reconcile customer holdings, the Proposal relies heavily on FICC to intermediate transactions under a clearing mandate and contemplates that this approach will provide a higher level of safety to the market than the current bilateral market, which relies on a well-diversified group of credit-worthy banks to hold collateral, including through robust tri-party arrangements, and utilizes an industry standard agreement that is well understood by market participants.

Prior to implementation of any clearing mandate for Treasury repo and reverse repo, it will be important for FICC to adopt a recordkeeping framework, reconciliation process and internal controls to oversee positions as well as calculation, collection and holding of margin both for existing cleared products and for any expanded offerings that include the ability to post margin. This framework should be at least as robust as what is currently in place in the bilateral market. To the extent that recordkeeping is delegated to a third party, FICC will need to monitor the third party and have controls in place to allow for prompt flow of information and control over information security. Counterparty reporting will also be a critical element of the process to ensure that funds receive real time or at least daily reporting of cleared Treasury repo and reverse repo positions (including both the start leg and the end leg) as well as the status of related margin postings and counterparty performance.

E. Segregation, Gross Margining, and LSOC

1. Background

In conjunction with the proposed Treasury clearing requirement, the Proposal includes new requirements related to netting and margin practices. Specifically, FICC would be required to establish, implement, maintain, and enforce written policies and procedures reasonably designed, as applicable, to calculate, collect, and hold margin from a direct participant (sponsoring members) for its proprietary Treasury positions separately from the margin that is calculated and collected for transactions by an indirect participant (sponsored member) that relies on the direct participant to access FICC's services.[46] The Commission explains that FICC's current practice of not segregating a broker-dealer's proprietary positions from its customer positions, together with the language in the Rules 15c3-3 and 15c3-3a under the Exchange Act, has resulted in broker-dealers not being able to include a debit in the customer reserve formula in respect to customer margin and, as a result, effectively having to finance the positions from their own assets.[47]

[46] The SEC notes that this segregation practice is consistent with the practice at the OCC and would be consistent with the proposed amendments to Rule 17Ad-22(e)(6)(i) under the Exchange Act. Proposal, 87 Fed. Reg. at 64634.

[47] Proposal, 87 Fed. Reg. at 64637.

The Proposal would also provide flexibility by not requiring FICC to calculate customer margin in a specific manner (*i.e.*, on a gross or net basis), even though FICC currently requires the former approach for sponsored clearing.[48] Further, FICC would not be required to mandate any specific method for segregating margin that is collected from customers, including sponsored members, such as a "legally segregated, operationally commingled" (LSOC) approach.[49]

To address anticipated increases in the margin that broker-dealers must post to FICC resulting from their customers' cleared US Treasury positions, the SEC not only has proposed to require that FICC segregate customer and broker-dealer proprietary margin accounts, but also has proposed to amend Rule 15c3-3a under the Exchange Act to permit margin required and on deposit at FICC to be included as a debit item (or offset) in the customer reserve formula, subject to certain conditions. According to the Commission, this would provide broker-dealers (sponsoring members) with more resources to meet the increase in required margin attributable to customer (sponsored member) transactions that would arise from additional central clearing. This proposed relief would be subject to several conditions that must be met by a sponsoring member.[50]

The proposed segregation requirements by FICC and relief for broker-dealers, including sponsoring members, from reserve formula requirements under Exchange Act Rules 15c3-3 and 15c3-3a would not impact funds under the current Sponsored Service, because funds do not post margin or hold assets with sponsoring firms or FICC under that program. If the Proposal is adopted, however, it is possible FICC may expand its Sponsored Service in a manner that contemplates funds posting margin or holding assets with FICC.

[48] For example, under a netted approach, FICC could calculate a single amount by netting each sponsored member's margin against that of other sponsored members within an omnibus customer account. However, as we discuss further below, a broker-dealer would have to post margin to FICC on a gross basis for the broker-dealer to be able to include customer margin as a debit in the customer reserve formula pursuant to the SEC's proposed amendments to its customer protection rule, Rule 15c3-3a under the Exchange Act.

[49] The SEC acknowledges that LSOC is the approach the Commodity Futures Trading Commission (CFTC) has adopted for cleared swap transactions, although it is not the approach for other clearing agencies that facilitate clearing in cash securities and listed options. The SEC notes, in this regard, that customers in cash securities and listed options markets are already protected under the Securities Investor Protection Act (SIPA), which protects customer securities and funds at a participant broker-dealer. Proposal, 87 Fed. Reg. at 64634. The CFTC's LSOC model requires each futures commission merchant (FCM) and derivatives clearing organization (DCO) to segregate on its books and records the cleared swaps of each individual customer and related collateral position. *See* 17 C.F.R. § 22.2 and 22.3. Each FCM and DCO is permitted to commingle customer collateral in one account. See 17 C.F.R. §22.2(c). FCMs and DCOs are also required to keep separate customer collateral from any account holding FCM or DCO property. *See* 17 C.F.R. § 22.2 and 22.3. Additionally, under the CFTC's rules, a DCO is not allowed to access the collateral of non-defaulting cleared swap customers to address losses of a defaulting swap customer in the event of a default of the clearing member (*i.e*., a "double default").

[50] *See* Proposed Rule 15c3-3a, Notes H(a)-(b).

2. ICI Supports Strong Protections for Fund Assets Including LSOC Protections

ICI supports the Commission's proposed requirement that FICC adopt a new framework under which it would be required to hold proprietary margin separately from customer margin positions in the Clearing Fund and call for margin separately for each of these accounts. If, in the future, FICC were to expand its current sponsored Treasury repo and reverse repo clearing offering to provide for margin posting by funds, segregation in this manner would be required for funds to post with FICC in a manner that complies with the 1940 Act.

The Proposal contemplates that cleared Treasury repo and reverse repo products could utilize a structure similar to that used by the OCC. Under this structure, member firms maintain separate proprietary and customer accounts and post customer margin with the clearinghouse through an omnibus account structure. Under the OCC structure, customer margin is netted within the omnibus account. If FICC were to adopt a similar model, we would urge FICC to maintain gross margining to ensure that customer assets are always adequate to satisfy obligations. As a regulatory matter, the fund assets would be required to be retained by a qualified custodian that satisfies the requirements of Section 17(f) of the 1940 Act. In addition, assets owned by a fund must be identified as fund assets and have the benefit of customer treatment (since the fund would be a customer of the custodian with respect to those assets).

Fund assets that are held through FICC, whether for the fund as repo buyer or as margin in a future clearing structure, must be held by FICC without the ability for FICC or any agent bank or other custodian to use the assets for the benefit of its own businesses. For example, SEC rules should clearly provide that margin posted in connection with cleared Treasury repo and reverse repo would be treated as fully-paid securities under Exchange Act Rule 15c3-3 and a broker-dealer acting as a sponsoring member would not be authorized to rehypothecate such margin or use it in its business. Instead, as contemplated by the Proposal, if a sponsoring member complied with the conditions of Rule 15c3-3a, as proposed to be amended, then it would be able to rehypothecate sponsored member collateral to FICC and treat that posted margin as a debit for purposes of calculating its reserve formula. We support the conditions for reliance on amended Rule 15c3-3a set forth in the Proposal.[51]

Notwithstanding the safeguards built into the proposed amendment to Rule 15c3-3a, we believe that any new sponsored Treasury repo and reverse repo clearing offerings available to funds that include a margin posting feature should either margin each fund on a stand-alone, proprietary account basis or, if an omnibus account structure is used, apply an LSOC approach. In our view, LSOC affords the highest level of protection of customer collateral against fellow customer risk within the context of a pooled account. As the SEC previously noted, fellow customer risk is of particular concern because customers may have limited ability to monitor or to manage the risk of their fellow customers.[52]

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[51] *See id.*

[52] *See Standards for Covered Clearing Agencies*, 79 Fed. Reg. 16865, 16905 (Mar. 26, 2014).

F. Bankruptcy Treatment Must be Clarified

The operation of FICC's Sponsored Service under the proposed repo clearing mandate, as well as possible future enhancements to the Sponsored Service, raises potential questions regarding the treatment in bankruptcy of fund assets, where a fund is a sponsored member. It is critical that the SEC and FICC provide certainty on these issues.[53]

First, FICC GSD rules should confirm that agreements entered into by repo and reverse repo counterparties will be enforceable against both parties, notwithstanding that the transactions are cleared. FICC GSD rules must also provide a clear process for closeout of transactions by FICC, including on the "start leg" of the transaction prior to novation. With respect to both the start leg and the end leg of a Sponsored Service transaction, FICC GSD rules should provide explicitly how closeouts could be carried out and make clear under the rules that the closeout would occur on the non-defaulting party's side of the market, as would be equitable in a default situation. The operation of closeout rights under the Sponsored Service model needs to be socialized with funds and other market participants to ensure that the methodology elected is operationally feasible.

Second, FICC GSD rules need to address what happens upon the insolvency of a sponsoring member. The rules should provide for prompt replacement of the sponsoring member by its sponsored members and handling of other functions typically performed by the sponsoring member to ensure that transactions by the sponsored member are maintained. For example, Section 9 of FICC GSD Rule 3A provides that a sponsoring member will act as processing agent for performing all functions and receive reports and information in the context of an insolvency of a counterparty under FICC GSD Rule 13. Similarly, the sponsoring member is responsible for postings to the Clearing Fund for the sponsored member. Pending handoff of these responsibilities to a replacement sponsoring member in the context of a sponsoring member bankruptcy, the sponsored member should have authority to receive such reports and information directly and to post to the Clearing Fund to preserve pending trades.

Because Sponsored Service transactions may include "done away" transactions as well as "done with" transactions, FICC GSD rules need to address how closeout will work in a variety of different factual situations. The procedures will vary depending upon: (i) whether a sponsoring member, a sponsored member, or a done away counterparty (or each of them or a combination of them) is insolvent or is otherwise a defaulting party; (ii) whether the default occurred in connection with the start leg or the end leg; and (iii) where the transaction is settling from a

[53] In developing rules for Treasury repo and reverse repo under a clearing mandate, FICC GSD rules should be clear about the status of the broker-dealer on the other side of the transaction for both closeout and regulatory purposes generally. Given the risk mitigation purposes of clearing, we would expect that FICC (and not the broker-dealer) would be deemed to be the counterparty for bankruptcy and closeout purposes (*i.e*., closeout would be by FICC, as counterparty to the broker-dealer) and regulatory purposes (*i.e*., FICC and not the counterparty would face a fund acting as repo buyer or repo seller), consistent with clearing models of other clearinghouses. In any event, the clearinghouse rules should address these issues directly to provide the legal certainty needed by funds and other counterparties to risk manage their Treasury security positions.

custody perspective. In all cases, FICC should have closeout rights upon a delivery or payment default.

Third, FICC GSD rules should provide clarity regarding how non-defaulting parties, such as funds, can exercise closeout rights, including those available under Sections 555, 559, 561, and similar sections of the US Bankruptcy Code. Exercise of closeout rights has been important to fund participants in bankruptcies in the past and has allowed funds and their investors to close out quickly on a collateralized basis, thereby avoiding market exposure and maintaining liquidity to ensure that the funds could continue to operate and that fund investors could continue to redeem their holdings on a timely basis.

Fourth, if, in the future, FICC decides to expand the Sponsored Service to permit (but not require) sponsored members such as funds to post margin, then the SEC and FICC should clarify that margin posted by a sponsored member with its sponsoring member for on-posting with FICC would be eligible for customer treatment under SIPA. This treatment would be consistent with Rule 15c3-3 of the Exchange Act since the assets would be “fully paid” (*i.e.*, not financed by the sponsoring member) and the sponsored member would not have a debit balance with the sponsoring member. Assets owned by a sponsored member and posted with a sponsoring member should be treated as customer property under Exchange Act Rule 15c3-3 and eligible for customer priority claims under SIPA in the event of the sponsoring firm’s insolvency.

Finally, clarification of FICC GSD rules regarding exercise of closeout rights—particularly in respect to “done away” trades—is important to clarify a repo counterparty’s rights under different insolvency regimes applicable to cleared Treasury repo and reverse repo transactions, including foreign bankruptcy regimes. In addition to broker-dealers, which are subject to liquidation proceedings under SIPA, clearinghouse members may be banks (subject to receivership by the prudential regulators), insurance companies (subject to state insolvency regimes), foreign financial entities (subject to foreign bankruptcy regimes), and systemically significant entities (subject to resolution under the Orderly Liquidation Authority (OLA), adopted by Congress under Title II of the Dodd-Frank Wall Street Reform and Consumer

Protection Act (the "Dodd-Frank Act")).[54] FICC GSD rules should provide appropriate procedures to address the requirements under different insolvency regimes.[55]

G. Issues for Funds if Expanded Treasury Repo and Reverse Repo Products Require Contribution to the CCLF

Historically, registered funds have not pursued FICC membership in part because of regulatory restrictions that hinder their ability to contribute fund assets to the CCLF. For example, contribution by a registered fund to the CCLF could result in a prohibited joint transaction in violation of Section 17(d) of the 1940 Act if affiliates of the fund (*e.g.*, other funds managed by the same investment adviser) also contribute to the fund. Such a contribution may also be prohibited by Section 18 of the 1940 Act, which prohibits a registered fund from issuing "senior securities," and Section 17(f) (discussed above), which requires fund assets to be held by a qualified custodian, as well as a fund's investment purpose, policies and organization documents. A contribution may also raise fiduciary duty issues for a fund's board and its investment adviser.

Given these potential issues, the SEC will need to carefully evaluate the ability of a registered fund to become a FICC netting member and contribute to the CCLF. If the SEC concludes that such contribution would be permissible, then it should amend its rules to clearly confirm that view. In the alternative, to expand the services available to funds to participate in cleared Treasury repo and reverse repo, consistent with the 1940 Act, FICC could create a special category of netting member that would not require a fund to contribute to the CCLF.

H. Bilateral Tri-Party Repo should be Exempted

Tri-party repo is a primarily bilateral arrangement that incorporates operational efficiencies by providing for custody of all repo and reverse repo deliverables through a regulated bank that also maintains custody of accounts for both parties holding sufficient assets to satisfy all transactional requirements. The agreement and infrastructure underlying tri-party repo are robust and provide participants with credit protections, operational safeguards, and strict internal controls akin to those available through clearing. Funds—in particular, money market funds—must have the ability to sweep cash into Treasury securities on a short-term (*e.g.*, overnight) basis, SEC rules

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[54] *See, e.g.*, FICC, Disclosure Framework for Covered Clearing Agencies and Financial Market Infrastructure (Dec. 2021) ("FICC Disclosure Framework") at 24 ("The insolvency regime applicable to a FICC Member will generally depend upon the jurisdiction in which the Member is organized, its form of organization and its regulatory status (among other factors). The US insolvency regimes to which Members may be subject include Chapter 11 of the US Bankruptcy Code (reorganization), Chapter 7 of the US Bankruptcy Code (liquidation), SIPA (with respect to members of SIPC), the receivership provisions of the FDIA (with respect to insured depository institutions) and Title II of [the] Dodd-Frank [Act] regarding OLA (with respect to covered financial companies)." Although not expressly discussed in the FICC Disclosure Framework, because FICC members include foreign banks, their insolvency will be subject to foreign bankruptcy, liquidation, resolution, and similar regimes.

[55] For example, although FICC members that are banks will generally be subject to the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended, which recognizes the effectiveness of netting contracts and generally exempts security arrangements from application of a bankruptcy stay, contracts with banks subject to resolution under Title II of the Dodd-Frank Act may be subject to a one business day stay of closeout actions under certain circumstances.

must therefore provide for a backstop facility in the event cleared facilities are at capacity, especially for some time after a clearing mandate is imposed. We note that the Sponsored GC Service already relies on the infrastructure of tri-party repo without any clearing overlay. We therefore believe it would be consistent with the SEC's objectives to allow funds and other market participants to rely on tri-party repo platforms to conduct Treasury repo and reverse repo on an uncleared basis, even after implementation of a clearing mandate.

I. A Treasury Repo Clearing Mandate May Conflict with Funds' Regulatory Diversification Requirements

The Proposal is not clear regarding how a fund, under the Commission's Treasury repo clearing mandate, would comply with issuer diversification requirements under the 1940 Act for cleared repo and reverse repo transactions. To provide the certainty necessary for registered funds, including money market funds, to participate in the repo and reverse repo markets on an exclusively-cleared basis, the SEC should confirm that any repo clearing offerings made available by FICC to registered funds under the proposed clearing mandate would continue to satisfy the "collateralized fully" standard set forth in Rules 5b-3 and 2a-7 under the 1940 Act and would allow funds to achieve "look through treatment" for diversification purposes. Further, the SEC should confirm that, under the proposed clearing mandate, cleared reverse repo transactions could be entered into by registered funds without application of diversification limits under the 1940 Act.

1. Diversification Requirement for Funds

Funds are subject to strict diversification limits with respect to their investments in the securities of any one issuer, guarantor, or demand feature provider (excluding the US Government). Pursuant to Section 5(b)(1) of the 1940 Act, a diversified fund, with respect to 75% of its total assets, may not invest in securities of any "issuer"[56] if, as a result of the investment: (i) more than 5% of the value of the fund's total assets would be invested in the assets of any one issuer, or (ii) the fund would hold more than 10% of the outstanding voting securities of any one issuer. Under Rule 2a-7 under the 1940 Act, a money market fund is limited to investing no more than 5% of its total assets in securities of a single issuer (excluding securities issued by the US Government).

a. Confirmation Regarding "Look Through" of Repo Transactions

Under existing SEC guidance, funds may treat a repo agreement (but not a reverse repo agreement) as an acquisition of the underlying collateral and as outside the issuer diversification requirements under the 1940 Act if the transaction is deemed to be "collateralized fully."[57] This treatment is referred to as "look-through treatment." If funds apply look-through treatment to

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[56] The term "issuer" is defined in Section 2(a)(22) of the 1940 Act to mean "every person who issues or proposes to issue any security, or has outstanding any security which it has issued."

[57] The definition of "collateralized fully" under Rule 2a-7 is the same as the definition under Rule 5b-3(c)(1) under the 1940 Act, except that Rule 5b-3(c)(1)(iv)(C) does not apply.

cleared repo transactions involving US Treasury securities as contemplated by the Proposal, then a fund would treat its repo agreements that are collateralized fully by Treasury securities as investments in government securities themselves and outside the limitations of Rule 2a-7's and Rule 5b-3's issuer diversification requirements.[58]

The Proposal does not address whether cleared Treasury repo transactions effected through FICC under the proposed clearing mandate would be deemed to be "collateralized fully" for purposes of Rules 2a-7 and 5b-3 and, thus, eligible for look-through treatment.[59] A repo agreement entered into by a fund is considered to be "collateralized fully" when (i) the value of the securities collateralizing the repo agreement (reduced by the transaction costs (including loss of interest) that the fund reasonably could expect to incur if the seller defaults) is, and during the entire term of the repo agreement remains, at least equal to the Resale Price (as defined in Rule 5b-3) provided in the agreement; (ii) the fund has perfected its security interest in the collateral; (iii) the collateral is maintained in an account of the fund with its custodian or a third party that qualifies as a custodian under the 1940 Act; (iv) the collateral consists entirely of: (A) cash items; or (B) government securities; or (C) for non-money market funds, securities (i) whose issuers are determined by the fund board to have an exceptionally strong capacity to meet their financial obligations and (ii) are themselves determined by the fund board to be sufficiently liquid to be sold within seven calendar days, in the ordinary course of business, at approximately their carrying value; and (v) upon an Event of Insolvency (as defined in Rule 5b-3) with respect to the seller, the repo agreement would qualify under a provision of applicable insolvency law providing an exclusion from any automatic stay of creditors' rights against the seller.[60]

In evaluating and approving the FICC clearing structures that any final SEC rules would direct FICC to develop, it will be critical that the SEC confirm that any new FICC GSD rules address the "collateralized fully" condition for "look through treatment." The SEC should confirm through rulemaking or guidance that all FICC Treasury repo clearing offerings available to registered funds satisfy the diversification requirements under Rules 2a-7 and 5b-3 under the 1940 Act and allow funds to enter into cleared repo transactions without size limitations consistent with the trading volume carried out today and in a manner that would allow Treasury repo trading volume carried out by funds to continue to grow over time. This result would be consistent with the Commission's policy objectives in proposing a repo clearing mandate.

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[58] Funds also rely on the definition and characterization of repos as "collateralized fully" under Rule 5b-3(c)(1) to meet the federal income tax requirements to qualify as a regulated investment company (RIC). As provided in IRS Rev. Procedure 2004-28, a RIC may treat repos that are "collateralized fully" (as defined under Rule 5b-3(c)(1)) by government securities as government securities themselves for tax diversification purposes. Failure to meet the "collateralized fully" standard for securities law purposes thus could affect a fund's qualification as a RIC for federal income tax purposes.

[59] We also note that some money market funds, despite being eligible to rely on look-through treatment, may nevertheless choose to diversify their holdings based on counterparty for risk management purposes and subject themselves to the 5% diversification limits under Rule 2a-7.

[60] *See* Rule 2a-7(a)(5) and Rule 5b-3(c)(1) under the 1940 Act.

b. Relief for Reverse Repo Transactions

Unlike Treasury repo agreements that are "collateralized fully," Treasury reverse repo transactions entered into by funds (*i.e.*, where a fund is the seller) currently are not eligible for look-through treatment. As a result, under the Proposal, absent additional rulemaking or relief, most money market funds would be limited to investing no more than 5% of their total assets in reverse repo agreements because funds would face FICC as counterparty (*i.e.*, FICC would be an "issuer" under the diversification test).[61] In addition, diversified non-money market funds would be limited to investing either no more than 25% of their total assets in reverse repo agreements or no more than 5%, with respect to 75% of their total assets, in reverse repo agreements. That is less than they are currently permitted to carry out under the 1940 Act and, thus, may raise challenges for funds electing to utilize Treasury reverse repo agreements as a form of short-term financing to facilitate shareholder redemption requests. Accordingly, to permit funds to participate in Treasury reverse repo on an exclusively cleared basis, the SEC should provide relief, through rule making or guidance, to permit registered funds to enter into cleared Treasury reverse repo transactions without application of diversification limits under the 1940 Act.

2. Lack of Counterparty Diversification May Affect Credit Ratings of Money Market Funds

We also are concerned that the proposed Treasury repo clearing mandate would adversely affect money market funds' credit ratings. As the Commission acknowledges, "[c]redit rating agencies consider concentration of counterparty credit risk as one factor in determining their rating of money market funds."[62] For example, we understand that the Nationally Recognized Statistical Rating Organizations (NRSROs), for purposes of their ratings of money market funds, establish percentage limitations regarding the extent of exposure a money market fund may have to a particular CCP.[63] Under the Proposal, the novation of transactions by FICC would cause it to be a "substantially large counterparty" to money market funds,[64] thereby increasing this risk. Such concentration could alter a money market fund's credit profile and, therefore, its credit rating, potentially precluding a fund from maintaining its high rating from the different NRSROs. While the Proposal hypothesizes that credit rating agencies may quickly adapt their methods to distinguish FICC from a conventional counterparty, there is no guarantee that this would occur

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[61] Absent relief, a single state money market mutual fund would be limited to investing no more than 5% with respect to 75% of its total assets in a reverse repo having FICC as a counterparty. A single state money market mutual fund is a tax-exempt fund that holds itself out as seeking to maximize the amount of distributed income that is exempt from income taxes or other taxes on investments in particular states and subdivisions.

[62] Proposal, 87 Fed. Reg. at 64660 n.378.

[63] For example, Fitch's ratings criteria provide that direct counterparty exposure by money market funds to FICC for cleared repo is subject to a limit of 75%. Previously, the limit was 25%. *See* Fitch Ratings, Money Market Fund Rating Criteria (Nov. 2021), *available at* https://www.fitchratings.com/research/fund-asset-managers/money-market-fund-rating-criteria-02-11-2021.

[64] Proposal, 87 Fed. Reg. at 64669.

or that it would occur quickly enough so as not to harm money market funds and, in particular, government money market funds, which invest a large percentage of their assets in repo agreements and, as a result, could elect to cease participating in the market due to the downgrade risk. Accordingly, this issue should be addressed through rulemaking and structuring of the clearing mechanisms to prevent such a result.

V. The Commission Must Address Other Limitations of the Sponsored Service to Better Promote the Objectives of Central Clearing

In proposing a Treasury repo clearing requirement, the Commission's anticipated benefits appear to be premised in large part on the FICC direct clearing model and the characteristics of Treasury trading in certain markets (*e.g.*, the interdealer market). As discussed above, funds are, as a practical matter, limited to engaging in cleared repo through FICC sponsored clearing, which differs in certain key respects from FICC direct clearing. Accordingly, we do not believe that sponsored repo clearing in its current form would fully yield the key risk mitigation and liquidity benefits that the SEC anticipates. We urge the Commission to further analyze FICC's repo clearing infrastructure and engage with FICC regarding potential changes to its clearing models that may be necessary to support a repo clearing requirement. We discuss these concerns in more detail below.

First, under its Sponsored GC Repo and Sponsored Bilateral DVP Repo clearing services, we understand that FICC does not novate the settlement of the start leg of a repo transaction that is submitted for clearing between a sponsoring Member and a sponsored Member; it does, however, novate the end leg of the transaction.[65] Therefore, counterparties continue to be responsible for settlement outside of FICC—whether bilateral or tri-party—and bear the risk of a settlement fail *vis a vis* one another. Currently, for both types of sponsored repo, if FICC does not novate a transaction that is submitted for novation by the applicable deadline, the sponsoring member and the sponsored member can contractually agree to rebook the transaction on a bilateral, uncleared basis; however, this would no longer be permissible if the Proposal were adopted. The practical implication of this is that funds could be left with large amounts of uninvested cash at the end of the day. FICC does novate the start leg of repo transactions between FICC netting members and has stated that doing so "could increase settlement efficiencies and decrease settlement risk because it would eliminate the movement of securities between members by centralizing the settlement of the Start Leg of same-day starting repos with

[65] With respect to Sponsored GC Repo, for example, FICC has stated that it does not novate the start leg of a Sponsored GC transaction because it believes that it would not be "efficient or appropriate" to do so, as that novation would "unnecessarily complicate an already efficient process" that would require the parties to make significant operational and business changes to insert FICC in the transaction chain with its tri-party platform. FICC GSD Rule 3A, Section 7(b)(i). *See Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Amendment No. 1 and Notice of No Objection to Advance Notice, as Modified by Amendment No. 1, To Add the Sponsored GC Service and Make Other Changes*, Exchange Act Release No. 34-92799 at 8 (Aug. 27, 2021), 86 Fed. Reg. 49387, 49388 n.26 (Sept. 2, 2021).

[it]."[66] Therefore, FICC sponsored clearing may not eliminate counterparty credit risk issues to the extent that the Commission anticipates would result from the proposed repo clearing requirement. As a result, a clearing mandate may not increase competition or reduce spreads as the Commission predicts.[67]

Second, neither the Sponsored Bilateral DVP Service nor the Sponsored GC Repo Service compel FICC to complete the settlement of a sponsored member's transactions in the event of a sponsoring member's default.[68] Where a sponsoring member has gone into default, or otherwise becomes insolvent, "[FICC], in its sole discretion" has the authority to determine whether to close out the sponsored member's affected positions or otherwise allow for settlement to proceed."[69] Otherwise, according to FICC, it does not assume independent liquidity risk. This approach is inconsistent with the Commission's assumption that central clearing increases the likelihood of settlement.

Third, market participants have raised concerns about the ability, as sponsored members, to engage with FICC to address issues arising from repo transactions that have been submitted through sponsored clearing. These challenges, if not addressed, may prove to be a further impediment to the expansion of sponsored repo clearing. For example, we understand that, from an operational and administrative perspective, FICC interacts solely with the relevant sponsoring member as processing agent for purposes of the day-to-day satisfaction of its sponsored members' obligations to or from FICC, including their securities and funds-only settlement obligations. Market participants that have participated in FICC sponsored clearing have cited

[66] FICC previously had not novated the start leg of a repo transaction submitted for clearing under its Sponsored Bilateral DVP Service, with certain exceptions, including "forward starting" repos (*i.e.*, a DVP repo that is scheduled to start one or more business days after the submission of trade details to FICC). In 2021, based on interest from its members, FICC expanded its service to include novation of the start leg of a "same-day starting repo" transaction (*i.e.*, a DVP repo that is scheduled to start on the same business day as when the trade details are submitted to FICC). *See Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Include Same-Day Settling Trades in the Risk Management, Novation, Guarantee, and Settlement Services of the Government Securities Division's Delivery-Versus-Payment Service, and Make Other Changes*, Release No. 34-90948 (Jan 19, 2021).

[67] Proposal, 87 Fed. Reg. at 64671.

[68] *See* FICC Sponsored GC Rule Filing at 29338 (stating that FICC does not assume "liquidity risk" because it is not required to complete settlement of a sponsored member's transaction if either the sponsoring member or sponsored member defaults).

[69] FICC GSD Rule 3A, Section 14(c). FICC states it also does not incur liquidity risk to the extent that the sponsoring member also either (1) runs a matched book of sponsored members (*i.e.*, enters into offsetting sponsored member trades with its own sponsored members) or (2) simply enters into sponsored member trades without entering into offsetting transactions. FICC Sponsored GC Rule Filing at 29338. This approach contrasts with instances where that defaulting sponsoring member had also entered into a separate offsetting transaction with another FICC netting member. In that case, FICC is required to settle the obligations of the defaulting sponsoring member.

challenges with seeking recourse from FICC in cases where the sponsoring member is in default.[70]

VI. Requiring Greater Use of FICC Sponsored Clearing Would Impose Significant Costs

ICI members generally view the level of overall risk in the Treasury repo and reverse repo market as relatively limited. A substantial majority of repo today is conducted on an overnight basis between, as the SEC has observed, large and sophisticated market participants transacting with one another on a disclosed basis. To the extent that funds and other market participants have availed themselves of FICC's sponsored repo clearing, ICI members describe the reasons as largely economic in nature and driven by commercial considerations, and not necessarily driven by a need to reduce counterparty risk. These reasons include inflows of cash to money market funds and their desire to obtain short-term returns on behalf of their investors, matched by the attractive lending rates offered by primary dealer banks wanting to avail themselves of central clearing to obtain balance sheet relief for repo activity. To the extent that market participants increase their use of term repo in the future, central clearing could potentially provide some benefits with respect to reducing counterparty risk.

Additional central clearing also could enhance netting and risk mitigation controls available in the market and, potentially, provide market participants with increased liquidity benefits. These benefits are not assured, however, and the potential for attaining these benefits must be measured against the costs to funds and their investors. Greater multilateral netting by dealers through a clearing mandate would help to ease certain bank capital and leverage requirements, potentially providing dealers with greater balance sheet capacity that they could utilize to enhance their market making capacity.[71] Whether dealers choose to utilize that additional capacity to enhance Treasury market liquidity for funds, however, is far from certain. While the mandate would directly benefit liquidity providers (*i.e.*, primary dealers and broker-dealers), it would impose significant costs and burdens on funds and their investors without a clear benefit.[72] As we describe in greater detail below, many funds would be required to bear significant technological, operational, and legal burdens and costs simply to develop the capacity to clear via FICC. Accordingly, a proposed clearing mandate would reduce flexibility for funds, which could ultimately limit their access to the Treasury repo markets and harm liquidity.

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[70] Brattle Group, *Summary of Reponses to the 2022 ISDA UST Survey Regarding Ongoing Efforts to Incentivize and/or Potentially Require Additional Clearing of U.S. Treasury (UST) Securities and Repos* at 7 (Aug. 10, 2022).

[71] Notwithstanding the ability to enhance market making capacity through greater balance sheet capacity, some dealers may still be subject to other regulatory capital and risk constraints, such as the Comprehensive Capital Analysis and Review requirements, that affect their ability to engage in market making activities.

[72] *See* FICC Sponsored GC Rule Filing at 29335. According to FICC, a primary benefit of sponsored clearing is that sponsoring members can offset on their balance sheets sponsored transactions novated to FICC against other FICC cleared activity, such as cleared transactions with other FICC netting members. Such increased balance sheet capacity through offsetting of repo transactions allows sponsoring members, as dealers, to incur lower regulatory capital charges.

Being effectively required to utilize FICC's sponsored clearing model to comply with a repo clearing mandate would be expensive and burdensome for funds. While a number of funds have onboarded to FICC's Sponsored Service, the volumes transacted through the service—currently estimated to be only 2-3% of overall repo market volume in 2021[73]—remain modest and are limited to large fund complexes and advisers that are able to transact on behalf of multiple funds and client accounts and allocate the associated costs efficiently. The Commission believes that a broad Treasury repo clearing mandate is appropriate based on its impression that repo market participants are "large and sophisticated," and thus most likely already have the infrastructure in place to clear through FICC's Sponsored Service. We do not believe that this is a valid assumption, given that the number of market participants participating in the Treasury repo market significantly exceeds those who have onboarded to FICC sponsored clearing. Instead, we believe it is likely that repo sponsored clearing is still unfamiliar to many market participants, even funds and advisers that may have experience with central clearing in other asset classes. For many reasons, they are not likely to be prepared and equipped to comply with a repo clearing mandate in the near future.

According to ICI members, onboarding to FICC sponsored clearing is a costly, operationally complex, and resource intensive process. A fund must establish separate documentation with FICC and each sponsoring member, including negotiating pricing for each sponsoring member's services. Currently, there is no standardized documentation for FICC's Sponsored Service. Instead, each sponsoring member has developed its own bespoke forms. As a result, negotiations across the industry are individualized, costly, and very time-consuming. Standardized documentation would need to be developed. Without such standardization, it could take years for all market participants that currently transact Treasury repo to establish necessary documentation and become ready to clear, which could have a negative effect on liquidity.[74] A sponsored member would also likely need to seek out sponsorship from more than one sponsor so that it could continue transacting and clearing repo in case the initial sponsor defaults. Further, a fund must establish protocols and procedures, as well as acquire or develop technology, to book multiple transactions and develop mechanisms to handle margining/collateral transfer (both end of day and intra-day) through the sponsoring member and FICC. Even firms that clear a portion of their Treasury repo transactions today would be subject to significant effort and cost to prepare for a Treasury repo clearing mandate.

Participation in FICC sponsored clearing may be costlier to both sponsoring members and sponsored members than bilateral or tri-party repo. As sponsored members, funds would incur initial margin, liquidity, and transactional and position management charges. Sponsoring members would incur various FICC fees, margin haircuts, and default fund and CCLF obligations, much of the cost of which will likely be passed down to sponsored members. The

[73] Sebastian Infane, Lubomir Petrasek, Zack Saravay, Mary Tian, *Insights from revised Form FR2004 into primary dealer securities financing and MBS activity*, FEDS Notes (Aug. 5, 2022), https://www.federalreserve.gov/econres/notes/feds-notes/insights-from-revised-form-fr2004-into-primary-dealer-securities-financing-and-mbs-activity-20220805.html.

[74] By way of example, industry participants have indicated that negotiating documentation with a new sponsoring member can take between 250-350 legal hours per relationship.

additional costs and operational requirements involved may make meaningful participation in the cleared repo market cost prohibitive for many, including smaller firms, which could contribute to less liquidity in the repo market overall.

Additionally, some fund complexes use joint trading accounts to facilitate settlement and decrease costs of traditional tri-party repo arrangements. Currently, FICC's Sponsored Service would not support these types of arrangements, which are economically important for participating funds and beneficial to their investors. Arrangements like these should be considered by FICC as it determines how to satisfy the SEC's mandate to facilitate clearing of Treasury repo transactions of indirect participants.

VII. Required Use of FICC Sponsored Clearing May Affect FICC Sponsorship Capacity

The proposed repo clearing mandate would also create uncertainty for funds because their ability to transact in the Treasury repo markets would become dependent on the number and willingness of FICC netting members that currently are, or are willing to become, sponsoring members. As we have noted above, funds in practice would need to clear repo and reverse repo transactions through FICC's Sponsored Service. Although the number of sponsoring members has grown recently, we note that the stringent qualification criteria[75] and financial requirements for acting as a FICC sponsoring member could affect the scalability of the program.

In contrast to clearing requirements for derivatives, which generally apply based on the instrument, the proposed mandate would apply based on the counterparties. Specifically, at least one of the counterparties must: (i) be a FICC netting member; (ii) be also approved by FICC to be a sponsoring member; and (iii) sponsor a counterparty or counterparties. Where a sponsoring member and sponsored member (*e.g.*, a fund) currently transact and centrally clear through FICC sponsored clearing, the mandate would require all Treasury repo transactions between them to be submitted for clearing. Whether this would be feasible depends on several factors, including the willingness and ability of the counterparties to do so.[76] Additional issues may arise if a fund is transacting with a FICC netting member in non-cleared Treasury repo as, under the proposed mandate, that netting member would need to qualify and apply to become a sponsoring member to continue transacting repo with the fund counterparty. It is unclear whether netting members in

[75] Category 1 sponsoring members, for example, are required to be regulated banks having a minimum of $5 billion in equity capital and qualify as "well capitalized" under Federal Deposit Insurance Act regulations. *See* FICC GSD Rule 3A, Section 2(a).

[76] As discussed above, sponsored members such as money market funds and other funds are subject to diversification requirements and may seek to avoid excessive exposure to one counterparty, while some sponsoring members may seek diversity of counterparties for their own reasons. These considerations raise several questions that may affect the willingness and ability of a fund to engage in cleared repo and reverse repo transactions. For example, if the fund cannot extend its limits with the sponsoring member, does it have or can it develop a relationship with another FICC netting member that is also a FICC sponsoring member? Does the fund need to establish documentation with that additional sponsoring member and possibly even with other sponsoring members? To what extent are those other potential sponsoring member(s) willing to transact with the fund? Some sponsoring members may choose to limit the number of sponsored members that they sponsor and/or the volume of transactions they wish to engage in on a sponsored basis.

this situation would be willing and able to act as a sponsor and, if so, to what extent they would be willing to do so. For these direct participants, the determination may require an assessment of whether it is economically worthwhile to participate in the Sponsored Service, *i.e.*, whether the costs and burdens outweigh the benefits to them from a netting perspective and a risk perspective.

The extent to which FICC netting members are willing to serve as sponsoring members may ultimately influence the number of available counterparties that a fund can transact with. If the number of counterparties is limited, then market liquidity will be diminished in the repo market for funds and market participants more generally. In our view, constricting the liquid, bilateral market in this way runs a substantial risk of reducing liquidity and diminishing the ability of funds—which are a substantial portion of the repo market today—from participating in the repo market.

VIII. The Commission Must Propose a Viable Compliance Schedule for Treasury Clearing

The SEC does not propose a compliance date for the proposed amendments. Instead, the Commission requests comment regarding what would be an appropriate timeframe.[77] The changes that would be necessary to successfully implement a Treasury clearing mandate are extensive and have industry-wide implications. As detailed above in our letter, the Commission has failed to fully consider the extensive regulatory and structural changes that would be necessary if funds were required to clear their Treasury repo and reverse repo transactions. Any additional rule amendments and regulatory relief would need to be proposed for public notice and comment.

Thus, in considering an appropriate compliance timeframe for the Proposal, the Commission must build in the time necessary for: (i) FICC to work with the Commission to identify changes to its rules necessary to address the issues we have identified above with respect to the Sponsored Program; (ii) FICC to propose and adopt additional rules or amendments, subject to public notice and comment, that may be needed to address these issues; (iii) the Commission to propose and adopt amendments to its rules, subject to public notice and comment, and provide regulatory relief as needed to address the issues for funds that we have highlighted above; and (iv) FICC and industry participants to implement the extensive changes to policies and procedures, documentation, and operations (as detailed above for funds) that will be needed to comply with final rules. We believe these steps will require a significant amount of time and urge the Commission to propose a multi-year, staged, compliance schedule. At a minimum, industry compliance with a Treasury clearing mandate should be required no earlier than three years after the SEC and FICC have adopted final rules or amendments, as described in (ii) and (iii) above.

[77] Proposal, 87 Fed. Reg. at 64641.

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We hope that this information and recommendations are helpful to the Commission as it considers how to proceed on the Proposal. If you have any questions, please contact Sarah Bessin at sarah.bessin@ici.org or Nhan Nguyen at nhan.nguyen@ici.org.

Regards,

/s/ Sarah A. Bessin

Sarah A. Bessin
Deputy General Counsel

/s/ Nhan Nguyen

Nhan Nguyen
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US Securities and Exchange Commission

<u>Appendix:</u> Clearance and Settlement for Fund Treasury Repo Transactions[78]

Bilateral Approach

In a bilaterally cleared and settled Treasury repo transaction, the counterparties (*e.g.*, a fund (repo buyer) and broker-dealer (repo seller)) negotiate and agree to the transaction terms, including the length of the transaction (*i.e.*, overnight or term), the cash amount to be provided, the specific Treasury securities to be delivered in exchange to the fund's custodian, and the amount of over-collateralization required and margin calculation methodology, the latter terms of which the fund, as the cash provider, typically specifies. Importantly, the counterparties themselves carry out settlement of the transaction legs (*i.e.*, the start and the end legs), meaning that each is exposed to the risks of the other's performance. Where a repo seller ultimately fails to repurchase the securities, the repo buyer retains the collateral securities in lieu of the cash that would have resulted from the repurchase.

Tri-Party Approach

In a tri-party Treasury repo transaction—the most typical for funds engaging in repo or reverse repo—the counterparties negotiate the terms bilaterally but rely on a third-party custodian bank to facilitate clearing, custody, and settlement. The custodian bank performs several core functions related to the transaction, such as verifying and maintaining custody of the cash and Treasury collateral during both legs, as well as valuing and managing the collateral on an ongoing basis. Unlike bilateral repo, where collateral is specified, tri-party repo features general collateral where the parties agree to use any securities from a pre-approved basket of acceptable securities as collateral. Funds most frequently utilize tri-party repo as the means to comply with the custody requirements under Section 17 of the 1940 Act.[79] The tri-party custodian bank does not fulfill a CCP role—it does not guarantee either counterparty's performance through novation or otherwise and does not assume counterparty risk.

[78] For a more detailed description of these different approaches to Treasury repo clearing and settlement, please see Treasury Market Practices Group, White Paper on Clearing and Settlement in the Market for U.S. Treasury Secured Financing Transactions (Nov. 2022), *available at* https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/CS_SFT_2022.pdf.

[79] As discussed above, funds are required to custody their assets in accordance with Section 17 of the 1940 Act. Nearly all registered funds use a US bank custodian for domestic securities, although the rules under the 1940 Act permit other limited custodial arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self-custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository. Rule 17f-1 permits registered funds to use a broker-dealer custodian, but the rule imposes conditions that are difficult in practice to satisfy.

FICC Sponsored Service

FICC's Sponsored Service allows certain netting members[80] to sponsor, as sponsoring members, eligible legal entities (generally, entities that are "qualified institutional buyers," as defined in Rule 144A under the Securities Act of 1933, as amended) into FICC/GSD Membership in order to, among other eligible transactions, lend cash or lend eligible collateral via a FICC-cleared DVP repo (both overnight and term) or participate in the Sponsored GC service, which allows sponsoring members to carry out repo and reverse repo transaction with their sponsored members on a general collateral basis and settle those transactions on the tri-party repo platform of an agent bank.[81] Sponsoring members must contribute to the Clearing Fund based on gross exposure (*i.e*., on a sponsored member specific basis, not netted across sponsored member positions as a whole) to guarantee obligations of its sponsored members, so that if a sponsored member does not satisfy its obligations to FICC, FICC can invoke the sponsoring member's guaranty. Liquidity needs created by activity in the Sponsoring Member Omnibus Account that margins sponsored member exposure is factored into the sponsoring member's CCLF requirement.

Under FICC's Sponsored Service, a netting member that is approved as a sponsoring member submits a repo or reverse repo transaction (usually one in which it is a counterparty) with a sponsored member (*e.g.*, a fund) to FICC for to be cleared. After comparison of the terms and acceptance of the start leg of the transaction, FICC novates the end leg of the transaction. With novation, FICC becomes a counterparty to each of the sponsoring member and the sponsored member with respect to the end leg of the transaction. The sponsoring member, however, "guarantees" the settlement obligations of the sponsored member to FICC; where the fund is a repo buyer (providing cash) at the start, it is obligated to deliver the agreed-upon Treasury collateral at the end date, and vice versa in the case of a reverse repo transaction.[82] Importantly for funds, FICC also has a direct obligation to the sponsored member if its sponsor (as a repo seller providing Treasury collateral at the start) fails to repurchase the Treasury collateral or deliver that collateral (as a repo buyer providing cash at the start) at the agreed upon end date due to non-performance or default. In that situation, FICC may choose to close out a sponsored member's transaction rather than settle the trade.[83] Further, for sponsored transactions, FICC requires mark-to-market pass-through margin adjustments based on the difference in the transaction's posted collateral value against the dollar value of a transaction.[84] In the case of a

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[80] FICC permits all full-service netting members of FICC GSD (other than interdealer brokers acting in their capacity as brokers) to participate in the Sponsored Service as sponsoring members. See FICC FAQ – Sponsored Service, *available at* https://www.dtcc.com/-/media/Files/Downloads/Clearing-Services/FICC/GOV/Sponsored-Membership-Fact-Sheet.pdf.

[81] *Id*.

[82] Sponsored members are not direct participants of FICC, and therefore, they are not subject to certain FICC requirements, such as mandatory contributions to the Clearing Fund or the CCLF, or participation in the loss allocation waterfall; instead, sponsoring members are responsible for these contributions based on the trades that they submit, including on behalf of their sponsored members.

[83] FICC GSD Rule 3A, Sections 14(c) and 15(b).

[84] FICC GSD Rule 8 (Securities Settlement) and Rule 9 (Funds-Only Settlement).

Treasury repo, the sponsoring member would be required to post additional margin if the collateral value decreases; in a Treasury reverse repo, in which the fund (receiving cash) posts Treasury securities as collateral against cash provided by the sponsoring member, the fund's position would be subject to these margin requirements. Such margin adjustments, however, are otherwise funded by the sponsoring member itself pursuant to the requirements of Rule 15c3-3a under the Exchange Act, which obligates the sponsoring member to post the required margin and precludes it from collecting that margin from the sponsored member.

In addition to these requirements, FICC also imposes several other requirements related to the calculation and collection of margin in its Sponsored Service. For example, FICC requires the daily calculation and collection of margin for sponsored members' transaction activity to be on a gross basis, meaning that the daily margin amount overall represents the sum of each individual sponsored member's required margin associated with its positions.[85] Further, a sponsoring member is required to maintain an omnibus account for margin associated with its customer activity that is segregated from its own proprietary activity. In contrast to the approach that CFTC regulations require for cleared swap transactions,[86] FICC does not require an LSOC model for the segregation of margin to mitigate fellow customer risk.

[85] Clearing fund contributions are calculated twice daily on a gross basis—each sponsored member's trading activity is margined separately, and the sum of those total charges is collected and held by FICC separate from the Clearing Fund contributions posted by the sponsoring member for its proprietary activity. FICC GSD Rule 10(b).

[86] *See supra* note 49.