CAPITAL MARKETS

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SEC central clearing rule changes

Determining the right Treasury market clearing access model for your firm

Ready for Next

U.S. Treasury market participants have had more than seven months to digest the Securities and Exchange Commission's (SEC) December 2023 rule adoption announcement that will require most Treasury cash and repo trades to be cleared through a Covered Clearing Agency (CCA).

With only about 30% of the current Treasury repo market[1] — and less than 15% of the Treasury cash market — currently cleared,[2] the move to mandatory central clearing for the majority of trading activity represents a significant shift for both buy- and sell-side market participants.

The Fixed Income Clearing Corporation (FICC), which currently is the only CCA to clear Treasury trades, sits at the nexus of this transformation.

Since the beginning of the year, the FICC has reviewed its clearing service with the stated goal of facilitating access for all eligible secondary market transactions.

There's evidence that the market is already warming to clearing Treasury transactions. The FICC reported as of June 2024, its Treasury clearing business stood at more than $7.5 trillion in average daily volume.[3] In addition, the FICC has stated it anticipates clearing will add about $4 trillion a day in average daily volume to that current number.[4]

CHANGES AND CLARIFICATIONS

In the first half of 2024, the FICC released proposed rule changes in March and June. Market participants now have sufficient big-picture information to initiate the process of deciding which of the FICC's models they will use to either access, or provide access to, this CCA.

The June 2024 proposal amended rules, redefined terms and clarified definitions around areas such as membership qualifications, trade submission requirements and "eligible secondary market transactions." Most importantly, it provided sufficient guidance on the primary clearing access channels, the sponsored and agent clearing models (ACM).

As it's likely that the FICC's proposals will be adopted with little or no changes, firms should assess their overall strategy pertaining to access models, operations, margin, finance, regulatory reporting and technological impacts. Even firms that have successfully navigated the transition from bilateral settlement to central counterparty clearing in other asset classes will face challenges.

It may be helpful to consider the following questions:

- Which access model (sponsored or ACM) are you considering utilizing to access FICC? Which access model are your clients requesting or are you considering offering?
- Will this model span across your affiliates and other legal entities?
- Do you participate in "done away" trading activity?
- Does your firm currently trade Treasuries with sponsored members?
- Does your current process support the collection and segregation of margin to meet the new FICC requirements?
- What systems (if any) do you leverage to connect with the FICC today?
- Can your current operational process support daily computation of 15c3-3 reporting?
- Are you looking to subscribe to additional CCAs like CME Group and the Intercontinental Exchange (ICE)?

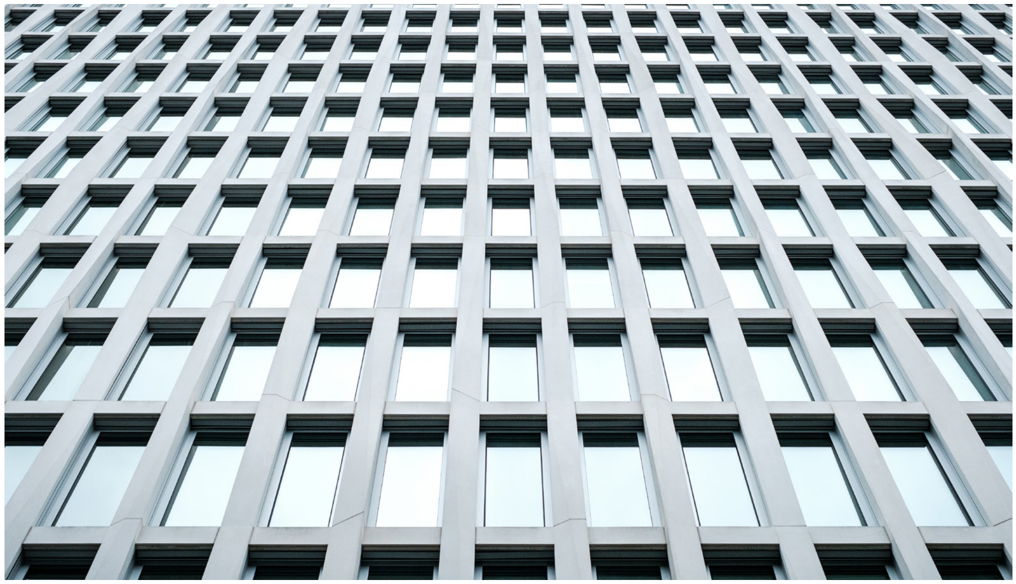
EXCLUSIONS APPLY

Rules often come with exemptions and Treasury clearing is no exception.

The Federal Reserve and foreign governments hold approximately 60% of the Treasury market.* Both cash and repo transactions involving these counterparties will be exempt from mandatory clearing. To elaborate, an SEC fact sheet on Treasury clearing stated that this exemption applies to trades in which, "... one counterparty is a central bank, a sovereign entity, an international financial institution, or a natural person."**

Repo trades in which one counterparty is a state or local government won't need to be cleared either. Inter-affiliate repo transactions entered into between a direct participant and an affiliated counterparty are another exemption. When one of the counterparties is either a U.S. CCA, a clearing organization or foreign central counterparty, no clearing is required for that repo trade.

*Treliant, "Understanding the Treasury clearing reforms," February 20, 2024, accessed July 2, 2024.
** https://www.sec.gov/files/34-99149-fact-sheet.pdf

BIG DECISIONS AHEAD

Even market participants who have been clearing cash Treasury and repo trades for several years have important decisions to make, which will have an impact on the future shape of their Treasury business.

DIRECT PARTICIPANTS' CHOICE

An old American Express advertising slogan stated that, "Membership has its privileges." When it comes to clearing at the FICC, that continues to be true. Any financial institution that wants to directly access the FICC's clearing services will still need to be a member.

Although current FICC members clearly have a head start in terms of adapting their Treasury business to mandatory clearing, it won't be business as usual.

Broker-dealers should be aware of sponsoring member rule changes that are designed to simplify this status. For example, the FICC has proposed eliminating the differentiation between bank sponsoring members (category 1) and other netting members (category 2) with the current category 2 requirements applying to all netting members that wish to sponsor indirect market participants.

As a starting point, this is an opportunity to evaluate what type of membership makes sense for their Treasury business and the new market opportunities ahead. Banks and broker-dealers that are currently netting members – limited to clearing trades with other netting members – may wish to evaluate additional access models. They may decide to provide sponsoring model access, ACM model access or both. That would give them the ability to capitalize on the market opportunity with indirect market participants.

Regardless of membership type, direct members should take a hard look at their current capacity and infrastructure to see if it's capable of handling the increased clearing volume. An April 2024 article noted that, "Dealers have also warned that they lack the capacity to sponsor every client that trades with them to clear at FICC."[5]

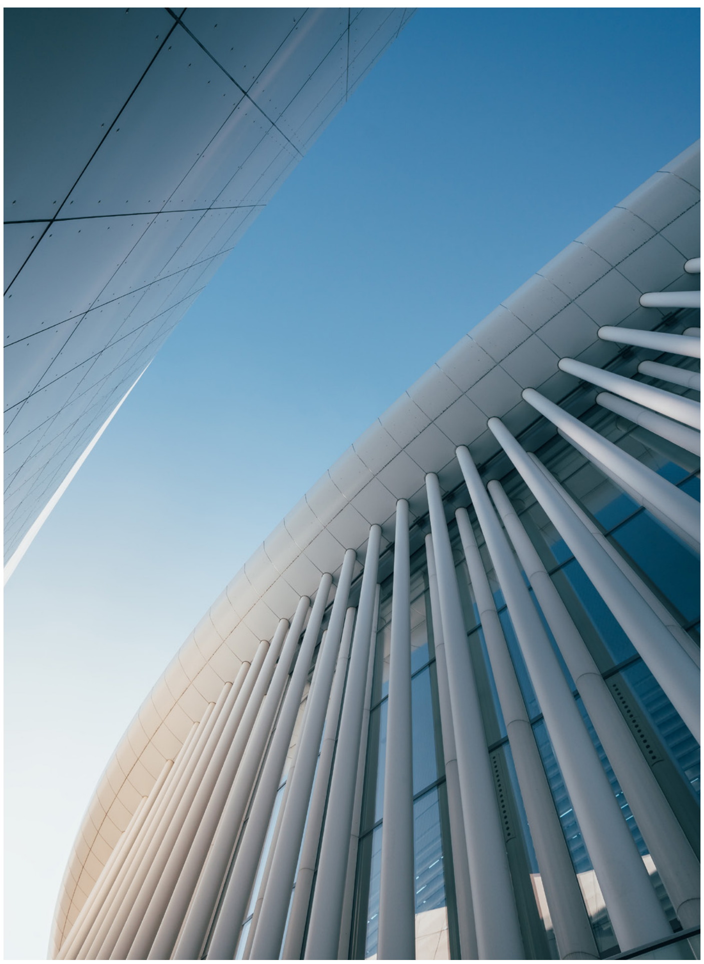
In addition to access models and clearing capacity, firms will also need to consider the impact of these changes on legal documentation and their pricing structure. They should also begin the process of evaluating their existing Treasury trading workflow for cleared trades to evaluate any potential pain points created by mandatory clearing.

A NEW (-ISH) WAY TO PROVIDE ACCESS

The ACM is a refresh of the FICC's current correspondent clearing/prime brokerage services. The FICC has referred to this approach as a "Futures commission merchant (FCM)-style clearing capabilities for Treasury cash activity and Treasury repo activity."[6]

An important distinction between the ACM and sponsorship models that deserves consideration is how the FICC views the indirect participant.

In the ACM world, the CCA only has a relationship with its ACM member. The member is thus responsible for managing all aspects of the clearing process with the FICC and the executing firm customer. As stated in its proposed rule change, "The FICC has no obligation to the customers but deals directly with the agent clearing members in all respects."[7]



MARGIN CALCULATIONS

There are significant changes ahead for how the FICC holds margin — and how members post it.

The FICC has been collecting margin for sponsorship program trades with no requirements on which counterparty the funds came from. Often it was the sponsoring member who would put down the entire margin amount.

Going forward, FICC will continue to gather margin from its member entities. With the newly introduced access models, they will also be able to collect margin from sponsored members and/or customers of executing firms, facilitated through the segregated access provision.

This change means that any FICC members, who until now haven't collected margin from sponsored member counterparties, will now need to establish a two-way process to track and exchange margin. Since only the FICC member is responsible for posting the margin, a broker-dealer could, of course, continue to post margin for their firm as well as for their indirect participant customer. But with increased clearing volume, this courtesy could become prohibitively expensive.

Netting members need to consider the difference in how the two access models treat margins.

Under the sponsorship program, margin requirements are calculated on a gross basis. In the ACM world, margins are calculated on a net basis. For those firms active in the cash and futures Treasury markets, cross margining is a significant consideration.

COMPARE AND CONTRAST

The following chart shows some of the important, high-level differences between the two access models that netting members can offer indirect participants (sponsored members and executing firm customers).

	ACM Member	Sponsoring Member
Qualifications	A netting member that has established a relationship with an executing firm customer in accordance with the proposed rules.	A netting member that meets the requirements to be a sponsoring member.
Trade execution	Permitted but not required to act as the pre-novation counterparty to their executing firm customer.	Permitted but not required to act as the pre-novation counterparty to their own sponsored member.
Trade submission	Acts as the processing agent for their executing firm customer and submits their side of the trade to the FICC.	Acts as the processing agent for their sponsored member and submits their side of the trade to the FICC.
Financial considerations	Responsible for any losses associated with their ACM omnibus account through which executing firm customer trades are processed. Responsible for all FICC fees resulting from executing firm customer trades.	Responsible for any losses associated with their sponsoring member omnibus account. Responsible for all FICC fees resulting from sponsored member trades.
Posting margin	Members are responsible for posting margin associated with their executing firm customers' trades.	Members are responsible for posting margin associated with activity in either their netting member or sponsoring member omnibus account.
Margin calculation	Gross or net margining with other trades in the ACM omnibus account.	Gross margining with no offsets between positions of different sponsored members.
Reporting	Receives real-time trade status messages and clearing trade reports.	Receives real-time trade status messages and clearing trade reports.

Source: DTCC, Client clearing model comparison, 2024.

INDIRECT ACCESS PERSPECTIVE

On the other side of the trade sits the netting member's customer, the indirect participant. These are primarily buy-side firms, such as asset managers and hedge funds. They are facing the same access model decisions as their FICC netting member counterparties. However, their clearing access path is relatively simple in comparison to the sell side's.

Some buy-side firms already clear some or even all of their Treasury trades. They do this for a number of reasons, such as to comply with their internal risk management policy or with parameters around trading size and frequency.

The current universe of FICC sponsored members consists of approximately 2,400 mutual fund companies, hedge funds and principal trading firms[8], reflecting a broad range of size, investment strategies and trading level activity. The sponsored membership role will certainly grow, though not all indirect participants may choose the sponsorship access approach. Some may opt in for the ACM approach, especially if they are familiar with this model through other trading activity.

One proposed change that will make it more attractive for these firms to become sponsored members is the elimination of the requirement that a sponsored member be a qualified institutional buyer. To be considered a qualified institutional buyer, a firm must own or manage $100 million of securities.

The way that the FICC labels the indirect participants in the two models provides some insight into how the CCA distinguishes between them. In the sponsored access model, the buy-side customer is a sponsored member while the indirect participant in an ACM clearing transaction is an executing firm customer.

Current indirect participants should anticipate that the margining changes the FICC plans to implement to comply with the SEC will add to their clearing expenses. Due to the anticipated increase in clearing volume, a netting member is more likely to ask a customer to provide them with their share of the margin under the segregated construct and guideline.

ALTERNATIVE VENUES

The size and opportunity for clearing Treasuries is also why the FICC may not be participants' only CCA option for much longer. With the U.S. national debt on track to exceed $50 trillion in 2034, Treasury issuance will continue to grow to finance government spending.

Competition might ease some of the clearing cost increases that market participants are facing.

CME Group was the first exchange to announce its plans to enter the Treasury clearing arena. With an average daily trading volume of $645 billion in 2023, its Treasury futures market is 111% larger than the cash market reported by TRACE.[9]

The day after the CME announcement, the London Clearing House said it was considering expanding into the Treasury market clearing. However, the organization has been quiet about any potential plans since then.

The Intercontinental Exchange (ICE) has also said that it will offer Treasury clearing through its existing clearing house, ICE Clear Credit.

IDENTIFYING RESOURCES

Broadridge has worked closely with a growing number of Treasury clearing participants both from a consulting and product perspective. We have seen how this market and our clients' needs have evolved. So, we are well positioned to assist existing and new participants, both buy and sell side, successfully navigate this transition. Clients are expressing concerns with the stringent timeframes; however, we are marching under the guise that the SEC will remain firm with the timelines.

CHANGE MANAGEMENT

While the move to clearing represents a significant structural shift in the Treasury market, nearly all participants have relationships with at least one CCA, albeit for a different asset class. Market participants that are completely new to Treasury market clearing can draw on that experience as they start to examine their Treasury trading practices and workflows.

A cross-functional team that represents areas that are most affected by this regulatory change — trading, finance, operations and technology — is a classic change management starting point. These stakeholders can begin monitoring and assessing the impact of clearing rule changes and definitions on your business.

Once armed with that information, they can begin to make recommendations that will form key decisions. For example, should they move forward with one access model versus another – or perhaps both?

As is the case with any significant regulatory change, policies, procedures and paperwork will need to be updated to ensure a smooth transition and regulatory compliance.

OPPORTUNITY AWAITS

While the number of to-dos and ambitious timeline may make the move to Treasury clearing feel overwhelming, this shift in market structure also offers firms a business opportunity. The FICC has estimated that the number of intermediary-indirect participants relationships across all its current access models which it supports to more than double to approximately 7,000. That's a significant opportunity for broker-dealers who wish to grow that book of business. A recent FICC white paper reported that, based on surveyed participants' outlook that the margin value of their sponsoring omnibus accounts would grow by $27 billion, many FICC members do intend to increase indirect clearing activity through current and new sponsored members.[10]

Regardless of whether you fall into that camp or not, with less than 18 months until mandatory clearing commences for Treasury securities, now is the time to start analyzing what this means for your firm. As you start to assess your firm's readiness, one of your goals is to answer the question, "Which access model or models is right for us and our Treasury business?"

If your firm finds itself struggling with the decision regarding which access model to pursue, your firm might benefit from working with a third-party with deep Treasury market experience that can provide a holistic perspective and guide you through the three phases of implementation.

As more details unfold, we are finalizing and finessing our product and service offerings to help our clients successfully migrate to a cleared Treasury market.

At Broadridge, we are not only here to help, we are here to help your business thrive in this new market structure.

Footnotes

1 https://www.dtcc.com/news/2024/march/12/dtccs-ficc-treasury-clearing-volumes-grow-31-percent

2 https://www.sec.gov/newsroom/speeches-statements/gensler-statement-treasury-clearing-121323#_ftn4

3 https://www.dtcc.com/-/media/WhitePapers/Treasury-Clearing-Mandate.pdf

4 https://www.dtcc.com/news/2024/march/12/dtccs-ficc-treasury-clearing-volumes-grow-31-percent

5 Risk.net, "FICC takes flak over Treasury clearing proposal," April 22, 2024.

6 DTTC, "FICC-GSD FAQ," 2024, accessed June 19, 2024.

7 DTTC, GSD access models: Facilitating greater access to clearance and settlement of eligible secondary market transactions in U.S. Treasury Securities," March 4, 2024, p. 4.

8 https://www.dtcc.com/client-center/ficc-gov-directories

9 CME Group, "Interest rate futures & options: Trading and liquidity review for full-year 2023," January 2024, p. 20.

10 DTCC, "The U.S. Treasury clearing mandate: An industry pulse check," July 2024, p.5 and p. 8.

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