

Mandatory Clearing of Eligible Treasury Securities Transaction Resources:

Executive Summary

On December 13, 2023, the SEC adopted [final rule amendments to Rule 17ad-22\(e\)\(18\)](#) that require U.S. Treasury securities clearing agencies (currently, the Fixed Income Clearing Corporation (“FICC”)) to propose clearing rule changes that will implement mandatory clearing of eligible secondary market Treasury securities transactions to which a clearing member is a counterparty and provide appropriate means to facilitate access to clearing services of all eligible secondary market Treasury securities transactions, including those of indirect clearing participants.

The implementation of the mandatory clearing of clearing members’ eligible secondary market Treasury securities transactions will depend on FICC to propose new rules. FICC’s proposed clearing rules are expected to include new risk management rules, margin, customer protection and expansion of access to clearing for non-clearing members. The new rules will change the existing market structure and practices. Treasury market participants will be required to adjust their trading practices, operations, legal documentations and/or technological systems (depending on their types, activity in the market and clearing model), in order to comply with the SEC’s and FICC’s rules regarding mandatory clearing, net capital, margin, segregation, clearing access models and account structures.

In a [whitepaper](#) published by FICC, FICC indicated its plan to establish 15c3-3 account structure that is similar to the “LSOC” approach used in the cleared swaps space. While we are waiting for FICC to file the first set of proposed rule changes with the SEC regarding margin and clearing access models by March 16, here are important things to consider:

What Transactions Are Required to Be Submitted for Clearing

Treasury securities transactions falling within the definition of a “Eligible Secondary Market Transaction” are required to be submitted for clearing. Eligible Secondary Market Transactions are:

- (i) Treasury repo and reverse repo transactions if one of the counterparties is a clearing member.
- (ii) Cash purchases and sales of Treasury securities between a clearing member and:
 - Any counterparty if the clearing member (A) brings together multiple buyers and sellers using a trading facility (such as a limit order book) and (B) is a counterparty to both the buyer and seller in two separate transactions (such cash transactions, “IDB Transactions”), and
 - a registered broker-dealer, a government securities broker or a government securities dealer.

Note that the final rules do not include cash purchases and sales of Treasury securities between a direct participant and a hedge fund and cash purchases and sales between a direct participant and a leverage account with a broker-dealer, a government securities broker or a government securities dealer in the definition of “Eligible Secondary Market Transactions”, as proposed.

Transactions Excluded from the Eligible Secondary Market Transactions

Eligible Secondary Market Transactions do not include Treasury securities transactions in which one counterparty is a central bank, sovereign entity, international financial institution, or natural person; Treasury repo or reverse repo transactions where one counterparty is a clearing organization or a state/local government; and Treasury repo or reverse repo transactions between a clearing member and its affiliate so long as the affiliate submits all of its other Treasury repo and reverse repo transactions for clearing.

Issues Particular to Certain Treasury Market Participants

1. Registered Investment Companies ("RICs")

Despite commenters urging the SEC to exclude RICs' transactions in Treasury securities from the definition of "Eligible Secondary Market Transactions", the SEC declined to do so. Instead, RICs' repo and reverse repo transactions with a clearing member are Eligible Secondary Market Transactions subject to mandatory clearing. However, a cash purchase and sale of Treasury securities between a RIC and a clearing member would not be an Eligible Secondary Market Transaction unless it is an IDB Transaction (i.e., executed on an IDB's platform where the IDB is a clearing member and is both the buyer and seller in two separate transactions).

Requiring RICs' repo and reverse repo transactions to be cleared raises compliance issues with respect to the custody requirements under 17(f) of the Investment Company Act of 1940, as amended (the "40 Act") and Rule 17f-4 thereunder, which require RICs to maintain their securities in a bank or a company which is a member of a national securities exchange or to deposit its securities in a securities depository. The SEC declined to opine on whether FICC is a securities depository and clarified that the final rules do not require RICs to post margin at FICC; nonetheless, in order to facilitate the posting of margin at FICC by RICs, the SEC states in the adopting release that, for a period of five years, if a RIC posts cash or securities at FICC for the purposes of meeting FICC's margin requirements in connection with the RIC's participation in the FICC's sponsored program, it would not provide a basis for enforcement action under Section 17(f) of the 40 Act, as long as:

- FICC withdraws the margin only upon the RIC's default;
- The margin is not commingled with, and is kept separate from, FICC's assets;
- FICC segregates on its books and records the RIC's margin and identifies a value of margin in its books and records as being attributable to the RIC;
- The entity FICC uses to custody the margin is an eligible fund custodian under section 17(f) of the 40 Act and rules thereunder;
- The margin is not subject to loss mutualization or allocation;
- The margin is not used by FICC for any purpose other than in connection with the RIC's default;
- The RIC receives quarterly statements of accounts concerning the margin provided in connection with Eligible Secondary Market Transactions showing, at a minimum, the name of the account, asset movements during the quarter, and quarter-end positions; and

- The account into which a RIC's margin is deposited is governed by a contract by and among the RIC, its sponsoring member, and FICC providing for an arrangement consistent with the above (collectively, the "FICC registered fund margin framework")

The SEC states that the five-year period is intended to give FICC time to develop and file proposed rule changes to facilitate a RIC's ability to post margin at FICC in a manner consistent with the FICC registered fund margin framework.

Similarly, the SEC also adopted a five-year no-action position to allow a RIC to use a member of a national securities exchange as a sponsoring member that receives and posts margin to FICC on behalf of the RIC. Such five-year no-action position provides that, if a RIC's cash and/or securities are placed and maintained with a sponsoring member that is a member of a national securities exchange, solely in connection with facilitating the posting of margin to FICC on behalf of a registered fund in connection with the registered fund's participation in the FICC's Sponsored Program, it would not provide the basis for an enforcement action against a registered fund under Section 17(f) of the 1940 Act so long as:

- the fund complies with Rule 17f-1(a), (b)(5), and (d), and
- the contract between the RIC and the member of the national securities exchange provides for the following:
 - The margin provided by a RIC is not commingled with, and is kept separate from, the sponsoring member's assets;
 - The sponsoring member segregates on its books and records the margin provided by a RIC (or series thereof, as applicable), and identifies a value of margin in its books and records as being attributable to the registered fund;
 - The RIC's provision of margin is consistent with the FICC registered fund margin framework; and
 - The sponsoring member does not hold RIC's assets that exceed the amount that is required to be deposited as margin to FICC with respect to the RIC's outstanding Eligible Secondary Market Transactions.

In addition, SEC agrees with commenters that FICC would need to implement additional rules regarding record keeping and protection of margin and will consider rule changes filed by FICC that are expected to derive from the demands of and discussions with its clearing members and other market participants.

2. Futures Commission Merchants ("FCMs")

FCMs also face challenges with respect to their Eligible Secondary Market Transactions subject to mandatory clearing. Commenters urged the SEC to exclude FCMs' Treasury securities transactions from the mandatory clearing requirement for two reasons. First, imposing mandatory clearing on FCMs would interpose FICC to be a counterparty through novation, but a clearing agency such as FICC would not be a permitted counterparty for permitted investments under the CFTC rules. Second, FCMs' ability to post margin at FICC would depend on FICC's margin account structure being designed to be consistent with the CEA requirements and CFTC rules.

The SEC declined to exclude FCMs' repo/reverse repo transactions from the definition of "Eligible secondary Market Transactions", stating that there is no requirement for an FCM to post margin directly to FICC and the final rules do not require FCMs to use a particular type of model that would make an FCM a counterparty to FICC. The SEC stated that an FCM could access FICC's clearing services through a prime broker or correspondent clearing model, in which an FCM would essentially "give up" its transaction to a direct participant for submission without becoming a counterparty to the FICC.

Amendment to Rule 15c3-3

In connection with the above, the SEC also amended Rule 15c3-3a to permit margin posted to FICC for U.S. Treasury securities to be included by broker-dealers as a debit in the reserve formulas for customer accounts and proprietary accounts of broker-dealers, subject to certain conditions.

Implementation Timeline

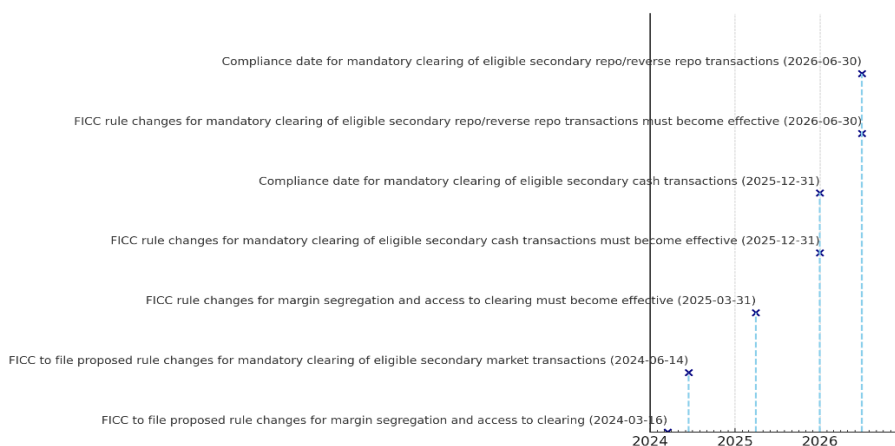
The SEC contemplates a staged implementation of the mandatory clearing of eligible secondary Treasury securities transactions over the course of two and a half years.

First, regarding separation of house and customer margin and access to clearing, FICC is required to file proposed rule changes and/or advance notices by March 16, 2024 and the proposed rule changes must be effective by March 31, 2025.

Regarding the requirements to clear eligible secondary transactions in Treasury securities, FICC is required to file proposed rule changes to implement mandatory clearing of eligible secondary transactions within 150 days following January 16, 2024 and must have the proposed rules regarding mandatory clearing of eligible secondary cash transactions be effective by December 31, 2025 and have the rules regarding mandatory clearing of eligible secondary repo transactions be effective by June 30, 2026.

Compliance by FICC clearing members with mandatory clearing of secondary cash and repo transactions would not be required until December 31, 2025 and June 30, 2026.

The following diagram illustrates the staged implementation of the mandatory clearing of eligible secondary Treasury securities transactions over two and a half years from the adoption of the final rules:



Important Update and Assistance

As stated above, the implementation of the mandatory clearing of clearing members' secondary market trades will depend on FICC to propose new rules. It remains to be seen how FICC will design its new rules to require, monitor and enforce eligible secondary Treasury securities transactions to be submitted for clearing and how FICC's new rules will facilitate access to clearing by indirect participants.

We are actively monitoring FICC's proposed rule change filing with the SEC and will provide updates and help you engage with FICC. Although the SRO rule filing process under section 19(b) of the Exchange Act and Rule 19b-4 thereunder allows the public to submit comment, because the Exchange Act and the SEC final rules on mandatory clearing impose deadlines on the effective date of the FICC rules, it is critical for market participants to discuss their particular issues with FICC as soon as possible. FICC has been collecting feedback from market participants since the SEC proposed the rules to mandate clearing of eligible secondary Treasury securities transactions and expansion of access to clearing.

If you would like to receive updates on FICC's proposed rule change regarding margin segregation, clearing access models, and mandatory clearing of eligible secondary cash and repo transactions, please contact us by clicking [here](#).

If you would like to receive our Regulatory Recap Newsletter, please contact us by clicking [here](#).

If you would like to receive updates on both the FICC's proposed rule changes and our Newsletter, please contact us by clicking [here](#).

If you have questions about the SEC's new mandatory clearing rules or need assistance with implementation of clearing of secondary Treasury transactions and compliance with the SEC's and FICC's requirements, please contact:

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About Wenchi Hu, PLLC

We are a law firm with SEC regulatory expertise. Wenchi Hu was a senior staff and the head of clearing agency supervision at the SEC's Division of Trading and Markets and Marc Leibert was a staff in clearing agency supervision at the SEC's Division of Trading and Markets. Each of us has more than two decades' experiences in financial markets and services. Visit us at www.hulaw.us.