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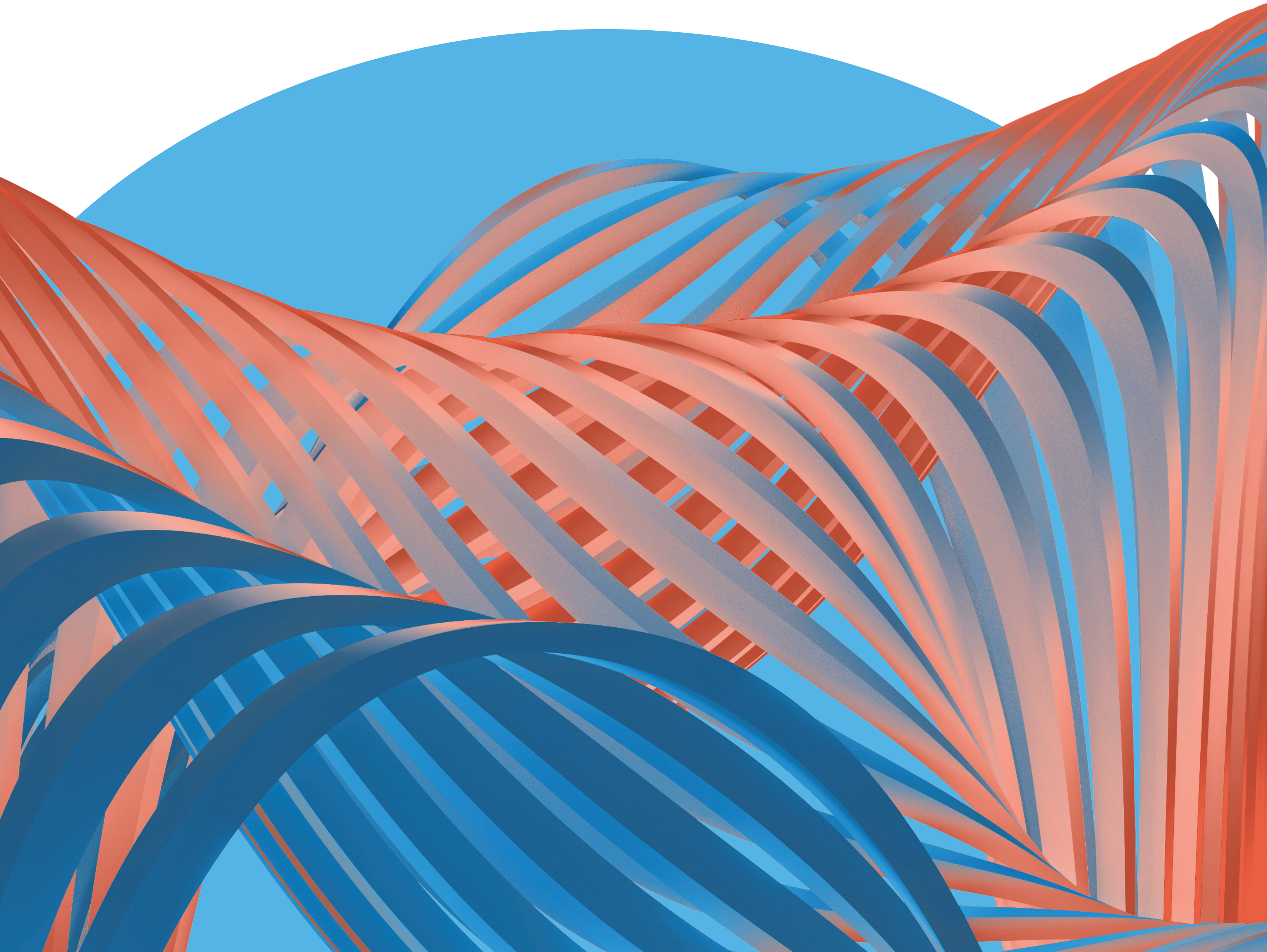
MAKING THE U.S. TREASURY MARKET SAFER FOR ALL PARTICIPANTS:

How FICC's Open Access Model Promotes Central Clearing

A WHITE PAPER TO THE INDUSTRY



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INTRODUCTION

The Fixed Income Clearing Corporation (FICC) subsidiary of The Depository Trust and Clearing Corporation (DTCC) applauds the recommendations of the Treasury Markets Practice Group[1], the G-30[2], the Brookings Institution[3], staff of the Federal Reserve Bank of New York[4] and the Futures Industry Association Principal Trading Group[5] for greater adoption of central clearing in the U.S. Treasury market.

FICC whole-heartedly agrees with this diverse array of market participants, regulators and scholars that increased central clearing would provide numerous benefits to the U.S. Treasury market, including:

- **Reducing counterparty credit risk** by replacing the original parties to each trade with a central counterparty (CCP) that is subject to comprehensive regulation.
- **Reducing settlement risk** by netting across all CCP members so that each member has a single delivery or payment obligation.
- **Limiting the ability of sudden market movements to cause a default** by collecting margin twice daily (or more frequently as needed) through standardized processing.
- **Reducing the risk of market disorder and fire sales** by centralizing responsibility for liquidating a defaulting member's positions in a single organization.
- **Enhancing market access and increasing market liquidity** by reducing the capital needed to engage in U.S. Treasury market activity.
- **Enhancing the ability of smaller banks and independent dealers to compete** through direct CCP membership.

In addition to these benefits, FICC believes that increased clearing would improve financial stability by providing greater transparency. Currently, FICC does not have visibility into its members' uncleared U.S. Treasury market activity. This lack of access obscures the market risks (such as concentrated positions, crowded trades, and inadequate margin) of a significant segment of the market. However, to the extent such trades were moved into clearing, that would provide FICC with greater visibility as to both its members' exposures and, more generally, the risk exposure of these currently uncleared U.S. Treasury trades.

In light of the broad consensus on the benefits of increased central clearing of U.S. Treasury transactions, the focus should now turn from ***whether*** to adopt a clearing mandate to ***how*** to implement such a mandate, including, among other questions, whether the cleared U.S Treasury market ought to more closely resemble the cleared swaps market before a U.S. Treasury clearing mandate is implemented.

Although the recent transition of a portion of the swaps market to central clearing may well provide policy makers with some lessons for a U.S. Treasury clearing mandate, we think it is important to consider the significant differences between the U.S. Treasury and swaps markets. Among other things, a number of market participants who do not engage in the swaps market are critical liquidity providers to the U.S. Treasury market, and the systemic risk mitigation objectives of a clearing mandate could not be achieved if those market participants could not effectively

1 See Treasury Markets Practice Group (TMPG), White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury Securities, July 2019.

2 See Group of 30 (G-30), U.S. Treasury Markets: Steps Toward Increased Resilience, July 2021.

3 See Liang & Parkinson, Brookings Institution, Enhancing Liquidity of the U.S. Treasury Market Under Stress, December 2020.

4 See Fleming & Keane, Federal Reserve Bank of New York Staff Reports, no. 964, The Netting Efficiencies of Marketwide Central Clearing, April 2021.

5 See Futures Industry Association (FIA) Principal Traders Group (PTG), Clearing a Path to a More Resilient Treasury Market, July 2021.

access clearing. In addition, the methods of execution in the markets are very different. Most notably, in contrast to the over-the-counter swaps market where trades are frequently executed on a fully-disclosed basis, a substantial portion of U.S. Treasury trades are executed on a fully anonymous basis through inter-dealer brokers (IDBs). This anonymity is comparable to that available on securities and futures exchanges and very much limits the ability of clearing members to influence their clients' counterparties or trading decisions. As a result, were policy makers to remake the U.S. Treasury market in the image of the cleared swaps market, they might risk cutting off access to critical market participants in order to solve for problems that do not exist.

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In our view, FICC's long-standing "open-access" approach to central clearing provides the flexibility necessary to allow a wide variety of market participants to access central clearing, while also ensuring impartiality and fairness. In Section II, we provide some background on the U.S. Treasury market and how it compares to the swaps market. In Section III, we suggest that policy makers bear in mind not only these differences, but also the fact that clearing and trading are separate functions and should be part of separate policy dialogues. We then discuss FICC's open-access approach to clearing in Section IV and why we are concerned that converting that flexible model into a singular approach based on the cleared swaps market would cut off market access and reduce liquidity without providing meaningful benefits. Finally, we conclude in Section V with some final recommendations and next steps.

COMPARISON OF THE U.S. TREASURY MARKET TO THE CLEARED SWAPS MARKET

There are several critical differences between the U.S. Treasury and cleared swaps markets, including differing histories, market participants, methods of execution and clearing arrangements. It is imperative that any clearing mandate or associated requirements take due account of these differences.

Evolution of Clearing

Central clearing in the U.S. Treasury market evolved organically over the past four decades as the industry sought to improve the safety and soundness of the market, streamline the processes for clearance and settlement of U.S. government securities transactions and mitigate the risks associated with the failure of one or more major firms.[6] This is in stark contrast to the swaps market, where central clearing was not widely adopted until the 2008-2009 financial crisis prompted members of the G-20 to shift a portion of an almost entirely uncleared, over-the-counter market into central clearing to address concerns regarding the interconnectedness of market participants and the systemic risk of contagious (knock-on) defaults that could spread from one counterparty to others.[7]

6 See DTCC White Paper, More Clearing, Less Risk: Increasing Centrally Cleared Activity in the U.S. Treasury Cash Market, May 2021.

7 See ISDA Research Note, Evolution of the OTC Derivatives Markets Since the Financial Crisis, p.13. January 2021.

FICC's predecessor, the Government Securities Clearing Corporation (GSCC), was established in 1986 as an industry utility. FICC is a wholly owned subsidiary of DTCC. DTCC is a user-owned market infrastructure, with the mission to promote the safety and soundness of the global financial markets by clearing and settling transactions. Consistent with that goal, DTCC's Board of Directors represents a diverse array of market participants and self-regulatory organizations. Of DTCC's 22 directors, 14 represent clearing agency members, including buy-side end-users, sell-side dealers and clearing banks; four are non-participant directors; two are designated by DTCC's preferred shareholders, ICE and FINRA; and two are DTCC's Non-Executive Chairman and its President and Chief Executive Officer. This organizational structure is designed to ensure that DTCC (and its subsidiaries) act not based on profit or the preferences of the major dealers, but rather in a manner that reflects the views of its various stakeholders and promotes fair, orderly and efficient markets.

> There are several critical differences between the U.S. Treasury and cleared swaps markets, including differing histories, market participants, methods of execution and clearing arrangements. Any clearing mandate or associated requirements must take account of these differences.

For nearly forty years, FICC and GSCC have provided trade matching, novation, risk management, netting and settlement services for a wide variety of trades in U.S. government debt securities, including primary market U.S. Treasury auction purchases, secondary market purchases and sales of U. S. Treasury securities executed bilaterally or on anonymous IDB platforms, delivery-versus-payment (DVP) repurchase transactions executed bilaterally or on anonymous IDB platforms, tri-party style General Collateral Finance repurchase transactions (GCF Repo®) executed by dealers on anonymous IDB platforms, and, most recently, tri-party-style General Collateral (GC) repurchase transactions executed bilaterally between dealers and their clients. Over time, in response to market needs and demands, FICC has expanded the scope of activity that it clears and the entities it admits as members, including most recently admitting a number of buy-side firms as limited members through its Sponsored Service.

By contrast, many participants in the swaps market had not embraced central clearing prior to implementation of the G-20 market reforms through Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act and related rule makings by the U.S. Commodity Futures Trading Commission (CFTC) and the SEC. In designing its regulatory mandate to centrally clear swaps subject to its jurisdiction, the CFTC took guidance from the manner in which listed derivatives, including interest rate futures and options on interest rate futures, had centrally cleared for over 100 years.[8] The listed futures market has been and continues to be primarily traded anonymously on exchanges and centrally cleared through a "give up" style clearing model where the clearing member of the derivatives clearing organization (DCO), referred to as a futures commission merchant (FCM), does not typically transact with the clients for whom it provides central clearing services. Rather, FCMs simply underwrite their clients' exposures to the DCO in exchange for a fee, and the client executes through a separate executing broker.

Market Participants

As a general matter, the U.S. Treasury market encompasses a more diverse, more heavily regulated array of end users than those that typically participate in the derivatives market. For example, money market mutual funds subject to SEC Rule 2a-7 (MMFs) are critically important cash providers in the U.S. Treasury repo market and also actively participate in the cash U.S. Treasury market, but do not generally participate in the cleared derivatives market. MMFs often face limitations that are not applicable to participants in the cleared derivatives market, including tight

8 The first futures clearing organization was established in 1883 to clear CBOT contracts. See US Futures Trading and Regulation Before the Creation of the CFTC.

regulatory and operational restrictions on use of funds that can restrict their ability to pay fees to clearing members, post margin, satisfy liquidity requirements and participate in loss mutualization. In addition, mutual funds not subject to SEC Rule 2a-7, pension plans and other institutions that participate in the cleared derivatives market face operational or legal constraints, such as custodial requirements, in the context of the securities markets that are generally not relevant to their activity in the cleared derivatives market. In many cases, this is because these institutions benefit from certain exemptions (e.g., allowing them to custody positions and margin at FCMs) in the cleared derivatives market that do not apply in the U.S. Treasury market.

Methods of Execution and Clearing Arrangements

Like the listed futures market, a substantial portion of U.S. Treasury cash and repo transactions has, for decades, been executed anonymously, just on IDB platforms, rather than exchanges. When a contracting party in the U.S. Treasury market executes a trade on an IDB platform, it sees only the IDB, not the "other side" of the trade, much like a buyer or seller on an exchange knows only that it has executed a trade on the exchange, not who the contracting counterparty is. However, market participants also sometimes elect to execute U.S. Treasury cash and repo transactions bilaterally on a fully disclosed basis. Both dealers facing other dealers and clients facing their dealers may choose to execute trades in this manner for a variety of reasons, including internal treasury or operational requirements and regulatory constraints of the sort noted above.

Trade execution occurs away from FICC because FICC is a post-trade infrastructure. Unlike many DCOs, FICC does not have a vertically integrated proprietary exchange. Rather, FICC offers an open-access model in which it accepts for clearing eligible transactions executed by its members through multiple trading modalities. As a post-trade infrastructure, FICC has never dictated how its members execute U.S Treasury transactions submitted for central clearing, so long as each counterparty to the transaction is either an FICC full-service or limited member.

THE DIFFERENCES BETWEEN CLEARING AND TRADING

In our view, trading and clearing are separate functions and should be part of separate policy dialogues. In addition, the regulator(s) responsible for these markets, rather than the CCPs, should be the ones to promulgate any regulations regarding trading practices. We note that, in this particular respect, the U.S. Treasury and cleared swaps markets are similar, as neither clearing agencies nor DCOs generally impose requirements on members' trading practices. Rather, it was the CFTC that promulgated conflict-of-interest regulations for the cleared swaps market.[9]

Under the Government Securities Act of 1986[10] and Government Securities Act Amendments of 1993[11], several agencies are responsible for regulating the U.S. Treasury securities market and its participants, including the Department of Treasury, the SEC, FINRA and the banking agencies. FICC believes these regulators, not FICC, should decide whether to impose trading practice requirements on the cleared U.S. Treasury market similar to those the CFTC imposed on the cleared swaps market.

Moreover, any dialogue regarding trading or clearing practices should take account of the long history of the U.S. Treasury market as well as its differences with the cleared swaps market. Indeed, when the CFTC adopted cleared swaps conflict-of-interest rules that prohibit an FCM from limiting or requiring disclosure of its client's

9 See 17 C.F.R. §1.71(d) and 23.605(d), 77 Fed. Reg. 20128 (April 3, 2012), available at cftc.gov; see also FIA PTG, supra note 5, p.8-9.

10 Pub. L. 99-571, 100 Stat. 3208 (1986).

11 Pub. L. 103-202, 107 Stat. 2344 (1993).

counterparties and require an FCM to implement independence requirements for its clearing unit from the business trading unit of its affiliated swap dealer, it emphasized the history of the futures market and how central clearing through a "give up" style clearing model had served that market well.[12]

> The U.S. Treasury market is different from the swaps market as well as the futures market. In the U.S. Treasury market, market participants have greater optionality with respect to execution; they can execute trades anonymously through an IDB or transact on a bilateral, fully disclosed basis.

As noted above, however, the U.S. Treasury market is different from the swaps market as well as the futures market. In the U.S. Treasury market, market participants have greater optionality with respect to execution; they can execute trades anonymously through an IDB or transact on a bilateral, fully disclosed basis. In many cases, clients prefer to bundle their clearing and trading relationships so as to avoid the need to pay fees for clearing services separate from execution-related costs. Such fees can be problematic for MMFs or other institutions that are subject to stringent treasury, operational or regulatory limitations.

We note that, when the SEC, which has experience regulating markets that are much more similar to the U.S. Treasury market than the cleared swaps market, considered whether to adopt trading market restrictions of the sort described above in connection with its security-based swap regulations, it declined to do so. Rather than dictating that market participants follow a specific business model for their cleared security-based swaps activity, the SEC instead opted to address potential conflicts of interest through the imposition of disclosure requirements on security-based swap dealers and major security-based swap participants.[13] We think a similar approach is likely more appropriate for the U.S. Treasury market than engrafting on it requirements from a cleared swaps market with a very different profile and history.

FICC'S OPEN ACCESS APPROACH TO CLIENT CLEARING IN THE U.S. TREASURY MARKET AND THE CHALLENGES WITH A SINGLE CLIENT CLEARING MODEL

FICC's open access approach to client clearing is designed to promote the availability of central clearing services to the diverse array of participants in the U.S. Treasury market. FICC offers a variety of client clearing models for U.S. Treasury cash and repo transactions, including correspondent clearing, prime broker clearing and Sponsored clearing (via FICC's Sponsored Service), to allow market participants to select the model that best addresses their needs.

Similar to the cleared swaps model, in FICC's correspondent clearing and prime brokerage clearing models, the client does not have a legal relationship with FICC. FICC only has central counterparty obligations to the correspondent clearer or prime broker itself, as applicable, who is an FICC member. In light of this, FICC net margins the activity in

12 77 Fed. Reg. 21278, 21280 (April 9, 2012), available at https://www.govinfo.gov/content/pkg/FR-2012-04-09/pdf/2012-7477.pdf. ("The Commission notes that cleared futures markets have operated for decades without any need for the types of provisions prohibited by the rules. Similarly, trades executed over-the-counter ('OTC') have been successfully cleared by CME and ICE on behalf of customers for approximately ten years without such provisions.")

13 See SEC, Release No. 34-77617, Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants. By contrast, the SEC did impose conflict of interest obligations on brokers and dealers when it adopted Regulation Best Interest: The Broker-Dealer Standard of Conduct ("Reg Best Interest"). SEC, Release No. 34-86031, Reg Best Interest, 84 FR 33318 (July 2019). Specifically, and among other things, Reg Best Interest requires brokers and dealers to establish, maintain, and enforce written policies and procedures reasonably designed to identify and at a minimum disclose, or eliminate, all conflicts of interest associated with its recommendations to customers. 17 C.F.R. §240.15l–1(a)(2)(iii).

the accounts of correspondent clearers and prime brokers, respectively.

Sponsored Members participating in FICC's Sponsored Service, on the other hand, are members of FICC's Government Securities Division (GSD) and upon novation of their U.S. Treasury transactions, FICC becomes obligated to such Sponsored Members. Recognizing that its central counterparty and guarantor obligations run to Sponsored Members as well as their Sponsoring Members, FICC gross margins Sponsored Member activity in order to ensure it is able to perform to individual Sponsored Members even in the event of their Sponsoring Member's default. FICC's gross margining of Sponsored Members means that FICC would be able to cross-margin Sponsored Member trades with customer-level listed derivatives transactions cleared at CME Clearing or another DCO, so long as the relevant regulators approved such a cross-margining arrangement. FICC agrees with those who have argued that such customer-level cross-margining would facilitate central clearing, as it would more closely tie margin requirements to the risk of the relevant transactions. FICC is currently proposing to enhance its existing cross-margining capabilities with CME Clearing to improve margin efficiencies for common full-service members with respect to their proprietary positions, which proposal is subject to regulatory approval. As a next step to that effort, FICC welcomes the opportunity to engage with the industry and regulators regarding how best to extend those margining efficiencies to customers.

While designed and developed at different times for different original use cases, each of FICC's client clearing models can support both U.S. Treasury cash and repo transactions executed by a client either bilaterally or on an anonymous IDB platform.

While designed and developed at different times for different original use cases, each of FICC's client clearing models can support both U.S. Treasury cash and repo transactions executed by a client either bilaterally or on an anonymous IDB platform. Each of FICC's client clearing models can also support an arrangement where, after execution, the transaction is effectively "given up" to a clearing member that is different from the trading counterparty. Notably, the vast majority of the $80bn plus of activity that we observe clearing and settling daily through FICC's correspondent clearing and prime broker clearing models follows this "give-up" model, where the clearing member is simply underwriting the risk of its client to FICC for transactions executed between the client and a third-party market participant that is either itself a FICC clearing member or a client of another FICC clearing member. FICC also provides each clearing member with the ability to establish separate GSD accounts in order to segregate its client clearing business from any proprietary trading activities of the same member firm.

FICC today supports locked in trading relationships and welcomes the opportunity to discuss with interested market participants implementing locked in trade submission for U.S. Treasury activity executed on anonymous platforms and cleared through a "give-up" style client clearing arrangement similar to the processes DTCC has in place today in the cleared equities market.

That said, FICC does not limit the ability of a member to be both a client's counterparty and the client's clearing member. In our view, any such limitations would threaten to shut out from the market important liquidity providers, while providing minimal benefits to the market. A host of considerations factor into whether and how a client and its clearing member access central clearing for U.S. Treasury cash and repo transactions through FICC, including:

- the business models and objectives of the client and its clearing member;
- the total costs of clearing to the clearing member and whether the client is willing and/or capable of reimbursing the clearing member for those costs; and
- how much value the client and the clearing member would derive from having the client become a Sponsored Member and face off directly against FICC as its post-novation counterparty.

In certain cases, these factors will lead a client to becoming a Sponsored Member and enter into transactions strictly with its Sponsoring Members. Indeed, this is the only practical way for MMFs and many other heavily regulated buy-side participants in the U.S. Treasury market to access central clearing. These institutions elect to become Sponsored Members and trade exclusively with their Sponsoring Members, who are compensated for the costs of clearing their clients' activity via their ability to make a spread on such trading activity. Based on FICC's conversations with these MMFs and other market participants, it is not pressure from dealers that leads MMFs to adopt this model. Rather, many MMFs are represented by large money managers that have significant negotiating power, especially considering the substantial number of dealers that now operate as Sponsoring Members. Instead, MMFs elect to access clearing in this manner because any other kind of clearing arrangement, including any "give up" style clearing model, would likely require these firms to pay clearing fees that they are not permitted to pay and require that they post margin and satisfy mark-to-market and liquidity commitments, which would be challenging, if not impossible, for them from a regulatory and/or operational perspective.

Accordingly, prohibiting this model of clearing would not serve to increase access and fairness in the market, but, rather, would shut out an important segment of the market, with detrimental effects for those buy-side participants and the liquidity of the market more generally. Similar measures to restrict the types of clearing arrangements that market participants are permitted to adopt may have knock-on effects that were not present in the swaps space considering the significant differences between the U.S. Treasury and swaps markets.

FICC Clearing Access Options

Client Capabilities	Full Service Member	Sponsored Member	Prime Broker Clearing	Correspondent Clearing
Faces FICC	Yes	Yes	No	No
Position Netting	All	Net By Client	Across Clients	Across Clients
Margin	Net	Net By Client	Across Clients	Across Clients
IDB Access	Yes	Yes	Yes	Yes
"Give-Up" Execution	N/A	Yes	Yes	Yes

FINAL RECOMMENDATIONS AND NEXT STEPS

FICC believes that it is well-positioned to support increased central clearing in the U.S. Treasury market given its open-access approach to central clearing. FICC has developed this approach over the course of four decades to provide the diverse array of U.S. Treasury market participants with the flexibility necessary to access central clearing on their preferred terms and in a manner that meets their needs.

We plan to continue our work with the industry to ensure that all firms looking to access clearing either on a voluntary, or potentially mandatory, basis can do so in an impartial and fair way.

In connection with its discussions regarding the potential expansion of central clearing in the U.S. Treasury market, FICC frequently hears from its broker-dealer members that in order to facilitate client clearing in scale to a large swath of Treasury market participants that relief is likely needed to allow them to include as debit items in the Reserve Formula set forth into SEC Rule 15c3-3 margin deposits that they collect from their clients and then onward post to FICC in order to satisfy Clearing Fund margin requirements associated with client activity. FICC would welcome the opportunity to explore with the SEC how this relief could be operationalized if it were granted.

As we have done in the past, we intend to use this paper to engage with clients, regulators and other stakeholders to discuss these topics which should remain a focus area for the industry. We actively encourage you to share your thoughts and participate in the ongoing dialogue that we are looking to foster. To become an active part of this industry conversation or to obtain more information on any of the material presented in this paper, input can be provided to:

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