SECURITIES LENDING COUNCIL

December 23, 2022

Via Electronic Submission

Ms. Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-23-22
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

Dear Ms. Countryman:

The Securities Lending Council (the "RMA Council") of the Risk Management Association (the "RMA")[1] appreciates the opportunity to submit this letter to the Securities and Exchange Commission (the "Commission") on behalf of the numerous members of the RMA that participate in the industry as securities lending agents ("Lending Agents"), including some of the largest U.S. custody banks and asset managers. This letter addresses the Commission's proposed 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 (the "Proposed Rule")[2].

The Commission proposes to amend the standards applicable to covered clearing agencies (each, a "CCA") for U.S. Treasury ("Treasury") securities to require that each such CCA establish, implement, maintain and enforce written policies and procedures reasonably designed to require that every direct participant of a CCA submit for clearance and settlement all "*eligible secondary market transactions*" ("ESMT") in Treasury securities to which such direct participant is a

1 The RMA Council acts as a liaison for RMA member institutions involved in agency lending functions within the securities lending industry by providing products and services, including hosting several forums, conferences and training programs annually and sharing aggregate composite securities lending market data free of charge.

2 *See* 87 Fed. Reg. 64,610 (Oct. 25, 2022).

counterparty. In addition, the Commission proposes amendments to the Covered Clearing Agency Standards[3] related to risk management. When proposing the Covered Clearing Agency Standards, the Commission explained that "[a]ppropriate minimum operational, legal, and capital requirements for membership that are maintained and enforced through the supervisory practices of a clearing agency help to ensure all members will be reasonably capable of meeting their various obligations to the clearing agency in stressed market conditions and upon member default."[4] Together, according to the Commission, these requirements are designed to protect investors, reduce risk, and increase operational efficiency.

If the Proposed Rule is adopted, Treasury repurchase transactions entered into with direct participants by Lending Agents on behalf of certain beneficial owner lenders ("Beneficial Owners") for the purpose of investing cash collateral received from borrowers under securities lending transactions would need to be cleared through a CCA. If the Proposed Rule is revised by expanding the definition of "*eligible secondary market transaction*" to include Treasury securities lending transactions, then Lending Agents will be required to clear those transactions it enters into with a participant of the CCA through the CCA.

Recognizing the importance, globally, of the $23.7 trillion US Treasury market[5], the RMA Council supports the Commission's policy objective of enhancing the safety and operational efficiency of this market (particularly in times of stress[6]) and appreciates the Commission's request for comment on the Proposed Rule. In this comment letter, the RMA Council addresses only the three questions related to clearance of Treasury securities lending transactions (including some discussion of the impact on the cash reinvestment activities of Beneficial Owners mentioned above), posed by the Commission in bullet point 7 of Section 5 of Article III(A) of the Proposed Rule.

1. Should securities lending transactions in which Treasuries are borrowed or loaned be included in the definition of ESMT in Proposed Rule 17Ad-22(a)?

2. Would the decision to exclude such Treasury securities lending transactions from the definition of ESMT create opportunities for "gaming or evasion" of requirements of Proposed Rule 17Ad-22(e)(18)(iv)(A)?

3. Are there economic or other distinctions that mitigate against including Treasury securities lending transactions in the definition of ESMT?

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[3] Covered Clearing Agency Standards Adopting Release, Exchange Act Release No. 78961 (Sep. 28, 2016), 81 FR 70786, 70839 (Oct. 13, 2016).

[4] CCA Standards Proposing Release, supra note 7, 79 FR at 29552; see also CCA Standards Adopting Release, supra note 25, 81 FR at 70839.

[5] US Treasury Securities Statistics - SIFMA - US Treasury Securities Statistics - SIFMA (as of November, 2022).

[6] *See* 87 Fed. Reg. at 64,612.

I. Background and General Considerations

A. Agency Securities Lending

Agency securities lending is a well-established, safe and sound activity that supports global capital markets activities and facilitates trade settlement. By effectively increasing the supply of securities available for these and other market activities, securities lending improves global market liquidity and enhances price discovery.[7] Beneficial Owners, the lenders in securities lending transactions, largely consist of institutions such as public and private pension funds, mutual funds, ERISA (as defined below) plans, endowment funds of not-for-profit institutions, insurance companies, investment funds, and other similar entities or funds into which such entities invest. Most Beneficial Owners are not direct participants in CCAs. Borrowers in securities lending transactions largely consist of broker-dealers, banks, and other financial institutions and, in contrast, are often direct participants in CCAs.

Lending Agents act as intermediaries in securities lending programs by facilitating, on behalf of Beneficial Owners, the negotiation of loans of securities to borrowers that have been approved both by the Lending Agent and the respective Beneficial Owners. Securities are generally lent pursuant to (i) a securities lending authorization agreement between the Beneficial Owner and the Lending Agent, and (ii) a securities loan agreement between the borrower and the Lending Agent as agent for the Beneficial Owner. Under these agreements, the borrower provides collateral to the Beneficial Owner (generally, through its Lending Agent) that equals or exceeds the value of the loaned securities, usually by 2% to 12% (margin), depending upon the characteristics of the loaned securities, the collateral, and the creditworthiness of the borrower. The loaned securities and collateral are then marked-to-market daily to ensure the value of the collateral consistently meets the requisite value of the loaned securities. Because Lending Agents typically provide Beneficial Owners with indemnification against borrower credit risk and/or reinvestment risk, agency lending by capital-regulated banks is capital intensive. It is this indemnification of the

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[7] Securities lenders use agency securities lending services provided by Lending Agents in order to obtain additional incremental revenue from their portfolios of securities. Agency securities lending activities developed initially as an outgrowth of Lending Agents' custody and related activities, and have long been regulated, examined and treated by regulators as traditional banking services. *See, e.g.*, Securities Lending, Federal Financial Institutions Examination Council, Supervisory Policy (1985) (addressing appropriate regulatory guidelines for the growing securities lending industry); Letter from J. Virgil Mattingly, General Counsel, Board, William F. Kroener, General Counsel, Federal Deposit Insurance Corporation, and Julie L. Williams, General Counsel, Office of the Comptroller of the Currency, to the Securities and Exchange Commission (Dec. 10, 2002) (indicating that interagency guidelines "ensure that banks conduct their securities lending activities in a safe and sound manner and consistent with sound business practices, investor protection considerations and applicable law"); Bank of England, Securities Lending and Repo Committee, Securities Borrowing and Lending Code of Guidance (July 2009) (describing how securities lending transactions are regulated both under UK regulations and EU directives), *available at* http://www.bankofengland.co.uk/markets/Documents/gilts/stockborrowing.pdf; Directive 2004/39/EC, of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF.

borrower's performance that also implicates risk weighted asset ("RWA") considerations against which Lending Agents are required to hold capital.

B. Beneficial Owners' Use of Cash Collateral

The collateral transferred by the borrower to the Beneficial Owner can consist of cash or high-quality securities (in the U.S. market, those securities are typically Treasuries). The Beneficial Owner will often invest cash collateral (including into Treasury repurchase transactions) to earn a return and pay expenses, including the borrower rebate fee and the Lending Agent fee. Beneficial Owners use the remaining yield to augment their revenue. Without this incremental revenue it is unlikely that Beneficial Owners would participate in the securities lending market at all.

II. Specific Recommendations

A. Should securities lending transactions in which Treasury securities are borrowed or loaned be included in the definition of ESMT in Proposed Rule 17Ad-22(a)?

The Proposed Rule would require CCAs to establish written policies and procedures requiring direct participants to submit all ESMTs to which they are counterparties to clearance and settlement. The proposal defines an ESMT in Treasury securities to include:

- Repurchase agreements and reverse repurchase agreements (collectively "repo" transactions) in which one of the counterparties is a direct participant;
- Any purchases and sales entered into by a direct participant if the direct participant (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; and
- Any purchases and sales of Treasuries between a direct participant and a counterparty that is a registered broker-dealer, government securities dealer, or government securities broker, a hedge fund, or an account at a registered broker-dealer, government securities dealer, or government securities broker where such account may borrow an amount in excess of one-half of the value of the account or may have gross notional exposure of the transactions in the account that is more than twice the value of the account.[8]

The Commission asks whether Treasury securities lending transactions should also be included in the list of ESMTs. For the reasons discussed below, it is the considered view of the RMA Council that Treasury securities lending transactions should not be so included.

[8] *See* 87 Fed. Reg. at 64,641.

1. **Negative Impact on Beneficial Owners.** As the Commission has pointed out, there is currently only one CCA for Treasury securities: the Fixed Income Clearing Corporation ("FICC"), which has limited, though growing, exposure to, and experience with, central clearing of Treasury securities. FICC does not maintain a default or guarantee fund; it requires its members to post initial margin to a clearing fund and to participate in the Capped Contingency Liquidity Facility® ("CCLF") to secure their obligations and the obligations of their customers. The CCLF, which comprises one of the largest costs of clearing at FICC today, is an additional liquidity resource designed to provide FICC, in the event of the default of a member, with a committed liquidity resource to meet its cash settlement obligations if its liquidity resources were to be insufficient to satisfy its payment obligations to non-defaulting members.[9] If FICC is required to establish policies and procedures requiring Treasury securities lending transactions to be cleared, then Beneficial Owners will be required to post initial margin.[10]

Certain classes of Beneficial Owners, such as registered investment companies, entities subject to the Employee Retirement Income Security Act ("ERISA")[11] and state pension funds, are required by law, regulation, or their own organizational documents or policies, to receive initial levels of collateral in an amount equal to or greater than the value of the securities loaned. Currently, in the FICC cleared repo market, the sponsoring member may provide any excess collateral required by its sponsored client as well as any FICC required default fund contributions. If Treasury securities lending transactions were to be added to the definition of ESMT and Beneficial Owners expected Lending Agents to provide excess collateral and clearing fund contributions, Lending Agents would be subject to additional capital and liquidity costs. As noted, given the thin margins on agency lending of Treasury securities, Lending Agents may well choose to cease intermediating these transactions. This does not appear to be an effective solution.

If, on the other hand, the Proposed Rule were to be amended such that it resulted in a model where excess collateral and clearing fund contributions were to be paid by the Beneficial Owner (if permitted), Beneficial Owners that are not permitted to be collateralized at less than 100% of the market value of the securities loaned would either need to cease lending Treasury securities, or require additional initial margin from borrowers. This might put these Beneficial Owners at a competitive disadvantage to other Beneficial Owners who are not so constrained. However, even those Beneficial Owners who do not face such constraints may choose to require additional initial margin for the protection it provides. This, of course, would serve to limit the disadvantage of those constrained Beneficial Owners and level the playing field. Alternatively, FICC could seek to amend its program and policies to require borrowers to provide additional initial margin to cover FICC's exposure to Beneficial Owners.

As discussed in this letter, due to the razor thin spreads on Treasury securities lending transactions, any additional capital or liquidity costs to Lending Agents, or requirements for additional margin or clearing fund contributions could result in these transactions not making

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9 *See* 82 Fed. Reg. at 31356.

10 *See* 87 Fed. Reg. at 64,610.

11 *See, e.g.* Prohibited Transaction Exemption 2006-16.

economic sense for any party. Given the current economics of agency Treasury securities lending, the RMA Council suggests that it would be prudent for the Commission to further study this market to understand the viability of requiring these transactions to be cleared and the markets' ability to withstand such a requirement.

If FICC amends its rules to require Beneficial Owners to post collateral as initial margin and such collateral could be used under FICC's rules to mutualize losses within FICC's program, then certain Beneficial Owners, including mutual funds, would be prohibited from participating either as a matter of law, if they are not permitted to share in the loss provision of a counterparty default,[12] or as a practical matter, if they are not operationally able to provide or receive such excess collateral.[13] The loss of these market participants could lead to decreased liquidity in the Treasury markets.

Extension of the Proposed Rule to include Treasury securities lending transactions (in addition to Treasury repurchase transactions) would concentrate all of the counterparty risk associated with these transactions with a single CCA. In determining whether to adopt the Proposed Rule, the RMA Council urges the Commission to carefully consider that any disruption or failure of this single CCA, whether financial, operational, or technological, would almost certainly harm Beneficial Owners, Lending Agents, borrowers, the capital markets, and ultimately, the global financial system as a whole. Instead, the Commission should consider the other reforms that have been proposed to strengthen the Treasury market, bearing in mind that studies referenced in the Proposed Rule all reflect that further research is required to confirm that the benefits of central clearing of Treasury transactions outweigh the costs.[14]

Despite the belief that the availability of a CCA reduces risk, most Beneficial Owners and Lending Agents participating in Treasury securities lending transactions will view the loss of initial margin, the concentrated counterparty risk, and the program requirement to be margined by FICC, on a twice daily basis as increasing their risk, generally. This could result in these Beneficial Owners being prohibited by their own regulation from engaging in Treasury securities lending transactions, or choosing not to engage in these transactions, thereby both reducing returns they may earn for their investors and removing liquidity from the Treasury market.

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12 See Section 17(d). Rule 17d-1 and Section 2(a)(3)(E).

13 For these reasons, many mutual funds only engage in tri-party, rather than bilateral, repurchase transactions where the security is held in safekeeping by a third-party custodian, rather than by either of the parties participating in the bilateral repurchase transaction. Under tri-party repurchase transactions where the mutual fund is the buyer (a cash provider), if the value of the securities the mutual fund has purchased under the repurchase transaction increases, the tri-party custodian will return such increased value of the securities to the seller (a securities provider), rather than requiring the mutual fund cash provider to deliver additional cash to the securities provider.

14 *See* 87 Fed. Reg. at 64,654 referencing studies by Darrell Duffie, Nellie Liang, and Pat Parkinson.

2. **Costs of Central Clearing; Infrastructure.** Securities lending generally requires economies of scale to be profitable, and even marginal increases in cost may drive supply-side liquidity out of the market – particularly in the market for general collateral (like Treasury securities) where the margins are exceedingly narrow -- unless cost increases due to additional margin requirements can be offset by increased fees. As reflected above, Treasuries, when used as loaned securities in the securities lending market, are typically considered to be general collateral. Accordingly, their potential to attract high fees from borrowers is limited. The imposition on Treasury securities lending transactions of additional fees related to clearing contribution requirements (from, for example, the requirement to make deposits into the clearing fund or the CCLF), and margin requirements, as well as the operational complexities necessary for clearing, may tip the balance for institutional investors away from securities lending, causing them to remove those Treasury securities from availability for securities lending market transactions. As of the second quarter of 2022, RMA data showed just under $2 trillion of Treasuries as lendable assets, with just under $660 billion on loan, globally. RMA composite figures are compiled using responses of 13 member institutions, including the largest providers of agency securities lending services. Of those loans, over $265 billion of Treasury securities were on loan against cash collateral. It is commonly understood that the spreads on Treasury securities are less than the spreads on equities and corporate bonds. As Treasury securities lending transactions are low risk, low spread transactions, requiring them to be cleared through FICC would impose additional costs and margin, which could cause some Treasury securities lending transactions to become economically unviable for Beneficial Owners and/or Lending Agents. Fewer Treasury securities lending transactions could lead to reduced liquidity in the overall Treasury market.

The RMA Council would also like to highlight that if the Commission were to adopt the Proposed Rule as stated, there is a not insignificant risk that some Beneficial Owners could be driven from the Treasury securities lending market due to the requirement that Treasury repurchase transactions be cleared. As discussed above, Beneficial Owners often invest the cash collateral received from borrowers in securities lending transactions into Treasury repurchase transactions. In these repurchase transactions, the Beneficial Owner is the buyer of the Treasury securities (the cash provider). Because, under the Proposed Rule, certain Beneficial Owners (such as sovereign states and central banks) will be exempt from the CCA requirements, while other Beneficial Owners (such as institutional investors) will not be exempt, implementation of the Proposed Rule will likely lead to bifurcation of Agent Lenders' cash collateral reinvestment programs where such cash is invested in Treasury repurchase transactions. Due to this bifurcation, some Beneficial Owners will incur increased clearing and margin costs, while others will not. There is a risk that clearing requirements will increase program expenses for affected Beneficial Owners, driving them out of the Treasury securities lending market. If, for whatever reason, Lending Agents are not able to pass increased clearing costs on to relevant Beneficial Owners, then the yields from the investment of cash collateral in Treasury repurchase transactions may no longer support the cost of the transactions, which would have a negative impact on Beneficial Owners' revenue and the liquidity of the Treasury market. The RMA Council respectfully believes that the Commission did not intend to capture the reinvestment into Treasury repurchase transactions by Beneficial Owners of cash collateral received from borrowers in Treasury securities lending transactions and requests that the Commission further study the impact of the Proposed Rule on agency securities lending before taking any further steps related to such required clearing.

B. <u>If securities lending transactions in which Treasury securities are borrowed or loaned are not included in the definition of ESMT, would that increase the opportunities for gaming or evasion of the Proposed Rule?</u>

1. **Difference in Purposes of Transactions**. While the economic effect of a repurchase transaction may appear to be similar to that of a securities lending transaction (i.e., the exchange of securities and collateral), these transactions are typically entered into for different commercial purposes and pose different risks. In securities lending transactions, which are typically driven by borrower demand, the borrower is interested in borrowing a particular security for the economic characteristics of that particular security (e.g., to cover a short position). For Beneficial Owners, securities lending transactions are used for generating incremental income on their idle securities portfolios (alpha). Lending Agents typically provide Beneficial Owners with a guarantee against borrower default and occasionally against risks related to cash collateral reinvestment. Repurchase transactions, on the other hand, are predominantly used by the repo seller (securities provider) to satisfy a financing or leverage need and are used by the repo buyer (cash provider) to invest cash on a secured basis. Given that the Commission has not undertaken a thorough analysis of how these differences might affect the costs and benefits and capital consequences to Agent Lenders of a Treasury securities lending central clearing requirement, the RMA Council recommends that the Commission not apply a central clearing requirement to any securities lending transactions.

2. **Anti-Evasion Powers**. If the Commission is concerned that market participants may choose to structure Treasury repurchase transactions as Treasury securities lending transactions in an effort to evade the clearing requirements of the proposal, the RMA Council respectfully submits that the Commission is always able to rely on its general anti-evasion authority.

C. <u>Are there economic or other distinctions that mitigate against including Treasury securities lending transactions in the definition of an ESMT?</u>

Impact on Lending Agents' Capital Requirements. In a traditional securities lending transaction, it is the Lending Agent's guaranty of a borrower's performance to Beneficial Owners that implicates RWA considerations under the Basel III capital rules. On one hand, if Treasury securities lending transactions are required to be cleared through FICC, then Lending Agents would view FICC (and not the borrower) as the counterparty to the transaction. That would most likely have a beneficial impact on the amount of capital Lending Agents would need to hold in relation to the Treasury securities lending transaction because a securities loan with FICC as the central counterparty warrants more beneficial RWA treatment under Basel III (2%) than the same loan to a traditional borrower (20% for banks and 100% for broker dealers). On the other hand, because Lending Agents as participant members of FICC would be required to guarantee the performance of their Beneficial Owners, the Lending Agents would be required to evaluate their RWA exposure with respect to each such Beneficial Owner. For certain classes of Beneficial Owners (such as mutual funds, insurance companies, and ERISA plans), Lending Agents would likely have to hold capital equal to 100% of the calculated exposure at default ("EAD").[15] This would result in a material increase in capital costs for Lending Agents and would have a chilling effect on the lending of Treasury securities as Lending Agents would need to either price securities lending transactions executed for different Beneficial Owners based on their RWA treatment (e.g. central banks versus institutional investors) or stop lending on behalf of Beneficial Owners with unfavorable RWA treatment.

Equally, if a Lending Agent does not currently perform a close out netting analysis in respect of its Beneficial Owners, the requirement to provide a guaranty to FICC would mean that the Lending Agent (or the industry) would need to incur substantial costs to obtain favorable netting opinions in respect of each Beneficial Owner client type. If the Lending Agent is unable to receive favorable netting opinions for certain types of Beneficial Owners, such as state pension plans, then the Lending Agent may either be required to cease lending on behalf of these Beneficial Owner entity types or become an unsecured creditor of those Beneficial Owners in the event of their insolvency. Based on the nature and capital of the Lending Agent, this could result in smaller entities being squeezed out of the Treasury securities lending market altogether.

III. Conclusion

We appreciate the opportunity to provide these comments and would be happy to engage in a more comprehensive dialog with the Commission. We believe that achieving effective and efficient reform requires healthy and robust collaboration between regulators and market participants.

Sincerely,

Fran Garritt | Mark Whipple

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[15] *See* Appendix A.

APPENDIX A

RWA is calculated by multiplying the EAD by the counterparty risk weight. For example, a loan from a Lending Agent on behalf of a Beneficial Owner (that is a mutual fund) of $100 of 10-year Treasury securities against $102 in cash collateral from a borrower (that is a bank) would be subject to the following treatment:

> EAD = ($100 * by (1 + .04)) minus $102, where 4% is the haircut for a Treasury security with a maturity in excess of 5 years and there is a 0% haircut for cash.
>
> EAD = $2

If the borrower is a bank, it has a risk weight of 20% so the RWA will be $2 multiplied by 20% or $0.40.

If the borrower is a broker dealer, it has a risk weight of 100% so the RWA will be $2 multiplied by 100% or $2.00.

If the securities lending transaction is cleared by a CCA, the CCA has a risk weight of 2% so the RWA will be $2 multiplied by 2% or $0.04; however, the excess collateral would be reversed so the calculation would be as follows:

> EAD = ($100 * (1 + .04)) – $98 = 6%
>
> RWA = $6 *.02 = $0.12

However, under the CCA model, the Lending Agent must guarantee the performance of the beneficial owner, which in many cases (i.e. mutual funds) will have a 100% risk weight. The EAD on this leg of the transaction will be the same as the loan directly to the borrower (that is a bank); therefore;

> RWA = $2 *100%, or $2

Thus, the total RWA incurred by the Lending Agent would be $2.12 in a cleared transaction compared to $0.40 in an uncleared transaction in the case of a loan to a bank and $2.00 in the case of a loan to a broker dealer.