SUNTHAY

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December 27, 2022

VIA ELECTRONIC SUBMISSION

Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

**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**

Ladies and Gentlemen:

Sunthay GRX LLC ("Sunthay")[1] appreciates the opportunity to submit this letter to the U.S. Securities and Exchange Commission ("SEC") on its proposal to amend the standards applicable to covered clearing agencies ("CCAs") for U.S. Treasury securities ("Treasuries") to require that such CCAs have written policies and procedures reasonably designed to require that direct participants submit certain secondary market transactions in Treasuries for clearing (the "Proposed Rule").[2]

The SEC proposes to amend Rule 17Ad-22(e)(18) under the Securities and Exchange Act (the "Exchange Act") to require CCAs to adopt written policies and procedures to require direct participants to submit for clearing (i) repurchase and reverse repurchase transactions (collectively, "repos") as to which one of the "counterparties" is a direct participant of a CCA ("Covered Repos"); (ii) any purchases and sales entered into by a direct participant bringing together multiple buyers and sellers using a trading facility and acting as principal; and (iii) any purchase and sales between a direct participant and a counterparty that falls within

1 Sunthay's parent company, Sunthay Holdings, LLC, is collaborating with highly regarded firms that support the smooth functioning of financial markets to develop solutions to improve their efficiency and resilience. Sunthay Holdings' principals are industry veterans with extensive experience with financial markets, particularly secured funding markets.

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, 87 Fed. Reg 64610 (October 25, 2022) (the "Proposed Rule"), available here.

one of several other categories. As a broker-dealer that has developed a structure to facilitate repos that would be entered into primarily by non-CCA members, but guaranteed by financial institutions that generally would be CCA direct participants, Sunthay's interest is primarily in the portion of the Proposed Rule that addresses Covered Repos (prong (i) above) and the focus of our comments is on the proposed clearing requirement for such Covered Repos.

Sunthay supports the clearing of Treasury repos that are entered into by a CCA direct participant as buyer or seller. More broadly, Sunthay supports the SEC's objectives of increasing liquidity in the Treasury market, reducing systemic risk and promoting the aims of all-to-all trading[3] and we believe an appropriately tailored final rule can materially further those goals.[4] At the same time, we note that it is critical to the further development of this important market that any rule that attempts to further these objectives through market centralization be balanced with the SEC's longstanding goals of permitting competition and promoting market innovation.[5] In this regard, we note that as drafted, the Proposed Rule would require direct counterparties to transactions in the secondary market for Treasuries that also are full members of CCAs to submit their eligible transactions for clearing.[6] As we read the Proposed Rule, repo transactions between entities that are not members in a CCA (except insofar as they may be "sponsored members" or "indirect participants" for the limited purpose of having access to cleared repo through a "direct participant" or "sponsoring member"), but the performance of which may be guaranteed or otherwise credit enhanced by a full member in a CCA, would not be required to be submitted for clearing. We believe that to be an appropriate result that correctly

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3 All-to-all trading is a term used to describe a wide range of trading protocols that would enable any market participants to trade directly with any other market participant. The level of intermediation across all-to-all trading protocols ranges from fully-intermediated Alternative Trading Systems, fully decentralized technology-based solutions to partially intermediated structures, such as Sunthay's.

4 We also support improved transparency for the Treasury repo market and note the recent expansion of Trade Reporting and Compliance Engine ("TRACE") reporting requirements and the U.S. Department of the Treasury's efforts to collect additional data with respect to bilateral repurchase and reverse repurchase transactions in the Treasury markets and generally support expanded collection of trade data through TRACE and other forms of regulatory reporting as an appropriate means to increase transparency in the Treasury market. See, Order Approving a Proposed Rule Change To Amend FINRA Rule 6730 (Transaction Reporting) To Enhance TRACE Reporting Obligations for U.S. Treasury Securities, 87 Fed. Reg. 54579 (Sept. 6, 2022), available here; Notice Seeking Public Comment on Additional Transparency for Secondary Market Transactions of Treasury Securities, 87 Fed. Reg. 38259 (June 27, 2022), available here.

5 *See, e.g.*, Securities and Exchange Commission, Our Goals, available here.

6 Proposed Rule at 64620.

balances the SEC's objectives and that facilitates liquidity and mitigation of systemic risk better than a broader rule would for the reasons we discuss below.

## I. Current State of Market; Guaranteed Repos

### A. Overview of Matched Book Model

Currently, end users seeking to obtain or borrow cash or securities participate in the Treasury repo market primarily through a matched book trading model, though "sponsored repo" cleared through FICC has also become somewhat common. Under the matched book model, an end user that may be a supplier of finance (*e.g.*, a money market fund seeking to lend cash on a secured basis) would enter into a repo with a financial intermediary, such as a bank or broker dealer, who then would enter into an offsetting repo with another end user with a corresponding financing need (*e.g.*, a fund looking to finance its Treasuries inventory by borrowing against those Treasuries). Facilitating repo on a matched book basis can be attractive to a financial intermediary, because it does not have to source either the cash or securities that serve as collateral from its own inventory; rather, it acts as a conduit that passes through funds and securities by acting as a counterparty to back-to-back trades.

Although the matched book model is sometimes described as "riskless," financial intermediaries operating under this model remain exposed to the credit of each of their end user counterparties as they are contractually responsible for performing to individual end users. Financial intermediaries, may also be required to use their own funds in various circumstances, for example where margin settlement timing is mismatched. In consideration of its centralized role and the fact that it serves as the primary credit counterparty, the financial intermediary may profit from the spread between the borrowing and lending rates on each side of a matched pair of transactions.

The matched book model offers certain advantages to the marketplace, most importantly that end users can look to the intermediary (typically a well-established financial institution) as the primary credit risk, rather than to other end users. Notably, however, this traditional model also poses distinct disadvantages, as most recently evidenced by the events of the 2007-2008 financial crisis. Under this model, a single effective financing requires two distinct transactions, one between an end user and the intermediary, and an offsetting transaction between the intermediary and other end user. This doubling of transactions increases frictional costs, operational risk and system-wide leverage.[7] Second, by requiring the intermediary to take on credit risk to each of the end users, and vice versa, the model concentrates credit risk with the intermediary and increases the likelihood of contagion in the event of an intermediary failure.

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[7] Each repo transaction executed by a cash borrower (reverse repurchase transaction for the cash lender) results in the creation of a liability on the balance sheet of the cash borrower.

B. Central Clearing as a Solution

Central clearing, and in particular central clearing through "sponsored" repo, mitigates certain of the disadvantages of matched book repo. Under a central clearing model such as the Fixed Income Clearing Corporation's ("FICC") service, CCA members may submit trades between each other, or between a member and a "sponsored" non-member, *e.g.*, an indirect participant. Upon acceptance of a trade for clearing by the CCA, the CCA steps into the middle by becoming the repo buyer to the original repo seller and vice versa. However, the sponsoring member essentially guarantees the obligations of its sponsored counterparty, effectively retaining its original credit risk exposure to the counterparty it has sponsored.

By inserting a CCA into the middle of each trade between end users and their financial intermediaries, clearing centralizes credit risk with a single market institution, which would be subject to enhanced supervision and regulation. Further, by facilitating balance sheet netting by clearinghouse members, central clearing may reduce leverage within financial intermediaries (with respect to each set of matched trades between the financial intermediary and an end user).[8]

However, though it standardizes contracts, central clearing does not decrease the overall number of transactions in the market (in fact the novation process doubles the number of transactions yet again) and as such has a mixed impact on operational risk. Moreover, although central clearing could decrease leverage at certain financial intermediaries, sponsored central clearing does not decrease the amount of leverage or credit exposure in the system as a whole. Instead it moves some of that leverage and credit risk to the clearinghouse while also leaving the sponsor bank or broker-dealer with exposure to its original counterparty. Finally, although central clearing addresses to some extent credit concentration risk at financial intermediaries (often times systemically important banks and broker-dealers), central clearing also increases credit concentration in a central counterparty (the clearinghouse).[9]

C. Guaranteed Repo as a Solution

Sunthay has developed a repo solution based on a new model we refer to as guaranteed repo ("Guaranteed Repo"). Pursuant to the Guaranteed Repo model, end

[8] Under U.S. GAAP, a firm is only permitted to offset payables and receivables in connection with a repo with the same counterparty. *See* FASB Interpretation No. 41. Central clearing facilitates this type of netting because the financial intermediary only faces the central counterparty post-novation. Netting is also permitted for purposes of supplementary leverage ratio calculations under substantially similar standards as FIN 41.

[9] To the extent the central counterparty requires a partner custodian or other financial services vendor, *e.g.*, as with FICC's sponsored service, the central counterparty also increases hidden concentration risks because the central counterparty becomes dependent on a single vendor to provide critical services.

users trade directly with each other, in Sunthay's case using standardized documentation and technology support providing for efficient bilateral execution and third-party monitoring of settlement. To preserve the credit advantages of the matched book model, the Guaranteed Repo model contemplates a third-party financial intermediary guaranteeing the performance of any end user that is borrowing cash (*i.e.*, any repo seller). However, it is not considered necessary to guarantee the obligations of a lender (*i.e.*, a repo buyer), which is generally a strong credit counterparty such as a money market mutual fund. As such, Guaranteed Repo offers an alternative solution with somewhat different characteristics and advantages compared to central clearing.

First, Guaranteed Repo does not require anybody to step into the middle of trades between the natural buyer and seller and, in fact decreases intermediation by contrast to clearing. As such, it decreases leverage in a manner different than clearing by taking the original intermediary out of the middle and does so both at financial intermediaries and generally. Second, Guaranteed Repo diffuses credit risk at the start rather than centralizing it in the clearinghouse and mutualizing it. Even though the intermediary bank still guarantees the performance of borrower end users, this guaranteed model diffuses credit risk because the buyer and seller look to each other for performance of the contract in the first instance and would continue to perform to each other under the terms of their trade independent of any issues at a guarantor bank. Only in the event of a "double default" by both the seller and the guarantor, would the buyer to a Guaranteed Repo be forced to exercise default remedies and close out. By contrast, in the matched book and central clearing models, the end users would look to the intermediary (either a bank/broker-dealer or central counterparty) for all performance and would not have contractual privity with each other. In the event of an intermediary default, all counterparties to the intermediary on both sides would be forced to close-out potentially creating fire sales. By virtue of the decreased leverage and reduced credit concentration facilitated by Guaranteed Repo (by virtue of the dual default mechanism embedded in the structure), the Guaranteed Repo model also has the effect of reducing the systemic importance of the guaranteeing bank, reducing the risk of contagion.

## II. Guaranteed Repo Addresses the SEC's Goals

### A. Guaranteed Repos Decrease Leverage

As described above, the matched book model both increases leverage at financial intermediaries (typically banks and broker-dealers) and system-wide leverage, while central clearing partially transfers leverage from financial intermediaries to a clearinghouse, with limited impact on system-wide leverage. Compared to the matched book and central clearing models, the Guaranteed Repo model has a balance sheet-relieving impact on financial intermediaries and clearinghouses because the financial intermediary is no longer a counterparty to any repo. In fact, the leverage reduction produced by the model for financial intermediaries is superior to the clearing alternative. It also has the added benefit of materially reducing system-wide leverage by reducing the number of transactions relative to matched book trading by half and reducing the number of transactions relative to clearing by four. Because neither banks nor any other intermediary (such as a clearinghouse) is exposed as principal to the party on either side of the guaranteed transactions, repos entered into under the Guaranteed Repo model would not impact any credit intermediary's balance sheet unless the guaranteed party were to default and the guarantor were to step into its shoes. By becoming a secondary (rather than primary) obligor, leverage is reduced. As described further below, the reduction in leverage has significant benefits for market liquidity and systemic risk.

### B. Guaranteed Repos Have the Potential to Increase Treasury Market Liquidity

SEC Chair Gary Gensler and other policymakers have long emphasized the importance of robust liquidity in the Treasury market.[10] In particular, the Proposed Rule is motivated in part by notable disruptions in the Treasury markets involving dramatic increases in market price volatility or sharp decreases in available liquidity.[11] These concerns have led to broader efforts by the official sector to enhance the liquidity of the Treasury market.[12]

As described in Section I above, the matched book model requires the intermediary to deploy its own balance sheet to facilitate financing trades. Particularly for financial intermediaries that are subject to regulatory capital constraints, that requirement can have the effect of significantly discouraging these participants from facilitating trades, or only doing so at rates significantly above ordinary course market clearing levels. Guaranteed repo mitigates that constraint by taking financial intermediaries out of the center of each transaction. As the SEC noted with respect to the potential benefits of central clearing, this increased bank balance sheet capacity

[10] Gary Gensler, "The Beatles and the Treasury Market": Remarks Before the U.S. Treasury Market Conference, Securities and Exchange Commission (Nov. 16, 2022) ("Gensler Remarks") ("When you maximize the competitiveness, liquidity, and resiliency of the $24 trillion Treasury market, that lowers the cost of financing and helps American taxpayers save money. It helps the central bank administer monetary policy. It also helps the fluid functioning of our financial system, as Treasuries are the foundation of the capital markets."), available here; Inter-Agency Working Group for Treasury Market Surveillance ("IAWG"), Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report 22 (Nov. 8, 2021) ("IAWG Nov. 2021 Report") (proposing "resilient and elastic liquidity" as the first guiding principle for the Treasury market), available here.

[11] Proposed Rule at 64653–55.

[12] *See, e.g.,* IAWG Nov. 2021 Report at 1.

"could enhance [banks'] capacity to make markets during normal times and stress events," and could "increase funding capacity to the market."[13]

### C. Guaranteed Repos Reduce Systemic Risk

Given the important and centralized role of the Treasury markets in the global financial system, policymakers have rightfully expressed concern regarding the risk of contagion associated with a single market participant being unable to meet its obligations.[14] As such, the Proposed Rule aims to "mitigate the potential for a single market participant's failure to destabilize other market participants or the financial system more broadly."[15]

Although central clearing has the potential to reduce systemic risk, we note that it is not without countervailing costs and risks. The IAWG Nov. 2021 report correctly points out there are residual risks associated with increased central clearing, most notably because rather than diffusing risk, risk becomes "concentrated at a single systemically important institution" that is heavily risk managed.[16] In addition, though clearinghouses are designed to mutualize risk, increased central clearing may increase the risk related to the distress or failure of one or more financial intermediaries that are members in various ways. For example, under the sponsored repo model at FICC (the only registered clearing agency in the Treasury market), indirect participants (or sponsored members) are dependent on direct participants (or sponsoring members) to interface with FICC by guaranteeing the indirect participant's obligations to the CCA.[17] For regulatory or other reasons, indirect participants may therefore need to post collateral that is held at the direct participant rather than passed through to the CCA which could then become trapped in the event of a direct participant's insolvency. FICC Rules also provide that if a direct participant is insolvent, all of the trades sponsored by the direct participant are liquidated and FICC "shall terminate the membership of all of the insolvent's [*sic*] Sponsored Members unless they are the Sponsored Members of another Sponsoring Member."[18] As a result, the failure of a single direct participant could create additional stress by effectively disrupting indirect participant's financing and

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13 *Id.* at 64662.

14 *Id.* at 64662; Gensler Remarks (The Proposed Rule "would help address the potential contagion risk that could flow through to the markets if a hedge fund or levered fund were unable to deliver on a transaction.").

15 Proposed Rule at 64612.

16 IAWG Nov. 2021 Report at 31.

17 *Id.* at 64616–17.

18 Fixed Income Clearing Corporation, Government Securities Division Rulebook 117 (effective November 21, 2022), available here.

eliminating the ability of indirect participants to access the Treasury market, at least until such time as they find new sponsors.[19]

By facilitating trading directly between end users, the Guaranteed Repo model reduces systemic risk by construction, while at the same time addressing many of the residual risks associated with the central clearing model, particularly those that result from the failure of a single market participant.[20] In particular, by requiring a near-simultaneous double default (by an end user and its guarantor) before an end user is forced to close out a trade (a potential cause for a "fire sale" of collateral that could exacerbate market stress), Guaranteed Repos reduce the risk of the failure of one financial intermediary affecting other participants and the broader market. And because the default of the end user is unlikely to be very closely correlated with the default of the guarantor (as it would be in a sponsored cleared model), an end user's default is unlikely to result in contagion.

Moreover, Guaranteed Repos also reduce system-wide leverage, which economic literature has long identified as a significant risk factor in financial crises.[21] In contrast to matched book trading or clearing (including central clearing models), pursuant to which both end users and intermediaries leverage the underlying collateral for cash, the Guaranteed Repo model only requires the "true" cash borrower end users to leverage its balance sheet, with the guarantor bank taking an off-balance-sheet, secondary role.

Finally, as discussed in Section I above, Guaranteed Repos reduce the operational complexity and associated costs in the Treasury repo market by reducing the number of trades relative to matched book or cleared repo. By removing the number of transactions and settlements required in connection with the provision of credit, Guaranteed Repos reduce complexity risk (which also has the benefit of incentivizing greater activity in the market, consistent with the SEC's goals of increased market liquidity).

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[19] In addition, central clearing is not cost free. Indeed we understand that the cost to a clearing member in developing the systems, documentation and operations to act as a "sponsoring member" can be substantial. As such, we would submit that there is non-negligible risk that requiring full members of a CCA to clear their repos with non-members through providing sponsored membership could drive certain smaller providers of matched book repo financing out of the marketplace, potentially <u>decreasing</u> liquidity.

[20] Proposed Rule at 64627.

[21] Dell'Ariccia, Giovanni, Ehsan Ebrahimy, Deniz Igan and Damien Puy. 2018. "Discerning Good from Bad Credit Booms: The Role of Construction." IMF Staff Discussion Note, International Monetary Fund; Korinek, Anton, and Alp Simsek. 2016. "Liquidity Trap and Excessive Leverage." American Economic Review 106 (3): 699–738; Schularick, Moritz, and Alan M. Taylor. 2012. "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles, and Financial Crises, 1870-2008." American Economic Review 102 (2): 1029–61.

### D. Guaranteed Repos Promote All-to-All Trading Aims

The SEC also believes that the Proposed Rule "could support movement toward all-to-all trading . . . which would further improve market structure and resiliency."[22] The IAWG Nov. 2022 report, which defines all-to-all trading as "a form of trading that, in concept, allows any participant in a financial market to trade with any other market participant," states that increased all-to-all trading may increase liquidity in the Treasury market by "increasing the number and diversity of potential counterparties to a trade or reshaping the competition among them."[23] The report goes on to highlight additional potential benefits of all-to-all trading, including increased transparency (of executable and executed prices), and lowering barriers to entry for new liquidity providers. Similarly, Federal Reserve staff note that all-to-all trading may allow Treasury market participants to continue trading while intermediaries are facing stress.[24] To the extent that all-to-all trading would allow the Treasury market to continue to function while an intermediary is facing stress, all-to-all trading could reduce contagion risk in the Treasury market.

The Proposed Rule mentions that certain central clearing models could in the future promote all-to-all trading, though we note that sponsored repo still generally starts with a repo with a financial intermediary that is a FICC full member. Guaranteed Repos, by design, achieves aims of all-to-all trading, because the fundamental concept is to allow end users to trade directly with each other with only a one-sided guaranty by a financial intermediary. Indeed, the Guaranteed Repo model is designed to increase the diversity of counterparties to repo trades, increase price discovery and lower barriers to entry for end users that other end-user counterparties may have been reluctant to trade with directly.

## III. Guaranteed Repos Are Not Appropriate for Sponsored Clearing

Sunthay envisions that end users who use Guaranteed Repos typically would not be members of a CCA. As such, the Proposed Rule would not apply to these transactions. While CCA full members would guarantee the performance of end users in a Guaranteed Repo these guarantors would not be counterparties to Treasury repos, and thus the Proposed Rule would not require a Guaranteed Repo to be submitted for central clearing.

We note that requiring Guaranteed Repos to be centrally cleared would fundamentally change the terms of a trade by imposing obligations not originally

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22 *Id.* at 64628.

23 IAWG, Enhancing the Resilience of the U.S. Treasury Market: 2022 Staff Progress Report 4 (Nov. 10, 2022) ("IAWG Nov. 2022 Report"), available here.

24 Alain Chaboud, et al, All-to-All Trading in the U.S. Treasury Market, Federal Reserve Bank of New York Staff Reports 10 (Oct. 2022), available here.

bargained for. Because non-members of a CCA must be sponsored by a full member in order to interface with a CCA as an indirect participant, requiring Guaranteed Repos to be centrally cleared would require both of the end users party to a Guaranteed Repo to be sponsored by a CCA member. This would require the sponsor bank to effectively guaranty the obligations of both parties to the central clearinghouse when it had only bargained to guaranty the obligations of the borrower. In addition to violating the terms of the agreed deal between the parties, this would unnecessarily introduce new banking system exposure to the repo transaction.

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In sum, Guaranteed Repo offers similar liquidity-enhancing and systemic risk-reducing benefits to central clearing models, while addressing some of the residual risks associated with those models. We support the currently contemplated scope of the Proposed Rule which would not require the clearing of Guaranteed Repos (not otherwise entered into between two full members of a CCA).

Thank you for considering these comments. Please feel free to contact the undersigned at [redacted] with any questions.

Best regards,

Shiv Rao
Chairman
Sunthay Holdings, LLC.