December 27, 2022

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

Re: Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rules With Respect to U.S. Treasury Securities

The undersigned firms[1] appreciate the opportunity to submit this letter to the Securities and Exchange Commission ("SEC") in response to the proposal regarding central clearing in the U.S. Treasury market (the "Proposal").[2] These firms trade their own capital in a variety of asset classes including equities, foreign exchange, commodities and fixed income and are a critical source of liquidity in these markets. We are strongly supportive of efforts by the official sector to increase transparency, liquidity and resiliency in the Treasury market.

I. The Benefits of Central Clearing

We believe that as the FIA Principal Traders Group detailed in their white paper,[3] transitioning more trading activity in U.S. Treasuries (both cash and repo) to central clearing will lead to significant benefits, including alleviating balance sheet constraints, reducing credit and operational risk, and facilitating more liquidity providers and trading protocols. Importantly, academic research has substantiated these benefits.[4]

[1] These firms include: ARB Trading Group LP; Citadel Securities; DRW Holdings, LLC; Eagle Seven LLC; Geneva Trading USA, LLC; Hard Eight Futures, LLC; Hudson River Trading LLC; IMC Trading; Jump Trading Group; Kore Trading LLC; Optiver; Quantlab Financial, LLC; WH Trading LLC; and XR Trading LLC.

[2] 87 FR 64610 (Oct. 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/34-95763.pdf.

[3] Clearing a Path to a More Resilient Treasury Market," FIA PTG (July 2021), available at: https://www.fia.org/sites/default/files/2021-07/FIA-PTG_Paper_Resilient%20Treasury%20Market_FINAL.pdf.

[4] *See, e.g.,* All-to-All Trading in the U.S. Treasury Market," Federal Reserve Bank of New York Staff Report No. 1036 (Oct. 2022), available at: https://www.newyorkfed.org/research/staff_reports/sr1036; Darrell Duffie, "Still the World's Safe Haven? -- Redesigning the U.S. Treasury Market After the COVID- 19 Crisis," Hutchins Center Working Paper Number 62, Brookings Institution (June 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf; "Enhancing Liquidity of the U.S. Treasury Market Under Stress," Hutchins Center Working Paper Number 72, Brookings Institution (Dec. 2020), available at: https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf; "Mandatory Central Clearing for U.S. Treasuries and U.S. Treasury Repos," Program on International Financial Systems (November 2021), available at: https://www.pifsinternational.org/wp-content/uploads/2022/08/PIFS-Mandatory-Central-Clearing-for-U.S.-Treasury-Markets-11.11.2021.pdf; Michael Fleming and Frank Keane, "The Netting Efficiencies of Marketwide Central Clearing," Federal Reserve Bank of New York Staff Report (April 2021), available at: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf; "U.S. Treasury Markets: Steps Toward Increased Resilience," Group of Thirty (July 2021), available at: https://group30.org/images/uploads/publications/G30_U.S_._Treasury_Markets-_Steps_Toward_Increased_Resilience__1.pdf.

While these benefits appear to be broadly acknowledged for repo transactions, some have asserted that similar benefits should not be expected to result from clearing more cash Treasury transactions, as regulatory capital benefits may be smaller and bilateral netting may already be occurring.[5] In response, we note the following:

- There is little doubt that, directionally, the Proposal will have a positive effect on balance sheet constraints for cash Treasury trading activity.[6] First, the ***multilateral*** netting achieved through central clearing will decrease balance sheet exposures more than any uncleared ***bilateral*** netting that is already occurring, reductions that flow through to regulatory capital calculations. Second, the multilateral netting achieved through central clearing significantly reduces gross settlement obligations (unlike bilateral netting for accounting purposes), meaning that central clearing will dramatically reduce settlement fails, which will also lower capital costs and help to alleviate balance sheet constraints (particularly during periods of volatility).[7]

- The trading-related benefits that flow from central clearing are particularly relevant for cash Treasuries. For example, central clearing will enable more liquidity providers to interact directly with market participants for cash transactions that are not executed on an order book (e.g., on-the-runs executed by market participants on RFQ platforms and most off-the-run transactions). At the moment, without central clearing, counterparty credit risk considerations typically limit the number of executing counterparties that market participants can interact with. In addition, all-to-all order books already exist for on-the-run cash instruments, and central clearing should allow more market participants to participate on these venues (which may be an important option during periods of volatility).[8]

- As noted in the Proposal, clearing a broader set of cash Treasury transactions should be expected to increase the resiliency of relevant clearing agencies, including with respect to risk management and default management. In particular, transitioning cash transactions executed by a broader set of counterparties into clearing will provide the clearing agency with more insight regarding current trading activity and market dynamics, and will diversify the user base and the types of portfolios being cleared.

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[5] "No clear gain: banks question SEC's Treasuries clearing plan," Risk.net (Nov. 8, 2022), available at: https://www.risk.net/regulation/7955059/no-clear-gain-banks-question-secs-treasuries-clearing-plan.

[6] Fleming, Michael and Frank Keane (April 2021) at page 2, available at: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr964.pdf.

[7] *Id.*

[8] "All-to-All Trading in the U.S. Treasury Market," Federal Reserve Bank of New York Staff Report No. 1036 (Oct. 2022), available at: https://www.newyorkfed.org/research/staff_reports/sr1036. Other research finds that even a small share of all-to-all trading in a market results in a more competitive trading environment, improving liquidity, and lowering the cost of trading. Hendershott, T., D. Livdan, and N. Schurhoff, 2021, "All-to-All Liquidity in Corporate Bonds." Swiss Finance Institute Research Paper Series.

As a result, we strongly support the Proposal to transition more cash and repo trading activity into central clearing. However, it is important to note, that even with broader central clearing, we expect that primary dealers will continue to be of central importance.[9] Instead of dramatically changing market structure, this Proposal is designed to provide more capacity for current liquidity providers, while also establishing the conditions necessary for more liquidity providers to participate and new trading protocols to develop. Given that the Treasury market continues to increase in size, growing from $4.5 trillion in 2007 to more than $23 trillion today (and expected to reach $40 trillion by 2032), it is critically important to find solutions that can facilitate overall risk transfer, particularly during periods of volatility, instead of continuing to rely solely on the balance sheets of a small group of liquidity providers.

II. How to Achieve the Benefits of Central Clearing

To achieve the benefits detailed above, we support the Proposal to implement a clearing mandate for certain repo and cash transactions ***(subject to the conditions below)***.

A clearing mandate has several important advantages compared to voluntary incentives, including:

- **Efficient Transition of Liquidity**. A clearing mandate provides for an orderly transition of liquidity pursuant to a defined timeline. This eliminates first-mover disadvantages and clients are provided with the necessary confidence that there will be sufficient cleared liquidity to properly risk manage their positions.

- **Availability of Client Clearing Offerings**. A clearing mandate encourages client clearing service providers to support the available clearing agency offerings. Due to associated costs, client clearing service providers may not prioritize offering client clearing solutions for non-mandated instruments despite client interest in voluntary clearing.

- **Resolving Legal and Operational Hurdles**. A clearing mandate establishes a firm deadline for clients to enter into a clearing relationship and test the associated operational workflows.

We are not aware of a market-wide transition to central clearing occurring in any asset class without a clearing mandate (even where voluntary clearing offerings are available).

Necessary Conditions

In order to support a clearing mandate for either repo or cash transactions, we view the following two conditions as essential:

1. The clearing mandate must be market-wide.

[9] See the interest rate swaps market, for example, following a similar transition to central clearing.

The benefits of central clearing detailed above will only materialize if a market-wide mandate is implemented. For example, the netting benefits associated with transitioning only proprietary trading firm ("PTF") transactions into central clearing are much smaller, given the substantial netting that already occurs directly with inter-dealer brokers ("IDBs").[10] In addition, the trading-related benefits of central clearing will only accrue to market participants if their transactions are covered by the proposed mandate. Finally, clearing agency resiliency will be negatively impacted if only one segment of the market is cleared.[11] For these reasons, other asset classes have specifically rejected clearing mandates targeted at only limited market segments.

As such, we support the proposed scope of the repo clearing mandate and would encourage the Commission to broaden the scope of the proposed mandate for cash transactions such that it more closely replicates the repo clearing mandate.

2. An agency (i.e., "done-away") client clearing model must be available in practice, proven by material volumes cleared.

As noted in the Proposal, most market participants (including PTFs, private funds, asset managers, pensions, insurance companies, and money market funds) access central clearing as an indirect participant, due to the eligibility requirements, operational complexity, and default management responsibilities associated with direct clearing agency membership. Therefore, before implementing a clearing mandate for either repo or cash transactions, it is absolutely essential that a clearing agency offer a client clearing model that can support a market-wide clearing mandate for indirect participants.

Limitations of the Current FICC Client Clearing Models

Unfortunately, the Fixed Income Clearing Corporation ("FICC") does not currently offer a client clearing model that can support a market-wide clearing mandate for either repo or cash transactions. To explain why, we consider the three client clearing models offered by FICC today – Correspondent Clearing, Prime Broker Clearing, and Sponsored Clearing:

- **Correspondent Clearing and Prime Broker Clearing Are Not the Solution**. Under both the Correspondent Clearing and Prime Broker Clearing models, clients do not directly benefit from the clearing agency's guarantee of settlement.[12] This means that, in the event

[10] *Supra* note 6 at page 28.

[11] As a general matter, in the current market structure, (i) market participants interface with dealers, (ii) dealers internalize these orders to the extent possible, and (iii) the remainder is hedged in the inter-dealer segment of the market, meaning this segment of the market contains the most difficult-to-trade transactions. A clearing agency will benefit from clearing a diverse cross-section of market-wide activity.

[12] *See* Externalities in Securities Clearing and Settlement: Should Securities CCPs Clear Trades for Everyone?, Schulhofer-Wohl, Sam (March 2021) at page 10, available at: https://www.chicagofed.org/publications/policy-discussion-papers/2021/2021-02. *See also* "Making the U.S. Treasury Market Safer for all Participants: How FICC's Open Access Model Promotes Central Clearing," DTCC (October 2021), available at: https://www.dtcc.com/-/media/Files/Downloads/WhitePapers/Making-the-Treasury-Market-Safer-for-all-Participants.pdf ("**Second FICC White Paper**").

the client's clearing member defaults, the client is largely in the same position as it would have been if the trade was not cleared and is likely to be less protected than under a model where the clearing agency's guarantee of settlement extends to the client. As a result, many market participants may be uncomfortable using the Correspondent Clearing or Prime Broker Clearing models, and therefore additional access models are required. We also note that, based on our understanding, relatively few repo transactions are cleared through these models.

- **Sponsored Clearing is Limited by the Market Structure Allowed Under FICC Rules**. While the clearing agency's guarantee of settlement extends to clients under the Sponsored Clearing model, current FICC rules permit their clearing members to decline to clear "done-away" trades (meaning that a clearing member will only clear transactions that are executed with that same clearing member). This model effectively permits clearing members to compel clients to bundle execution and clearing in order to have access to central clearing. Perhaps unsurprisingly, this is exactly what is happening in practice today – sponsoring clearing members are not clearing transactions executed with third parties for either repo or cash transactions. This creates a number of costs for clients that result in the model being unable to support a market-wide clearing mandate, including:

    - Clients have to establish a separate clearing relationship with each executing counterparty. This significantly increases costs, as the client must negotiate several clearing relationships, pay associated clearing fees to each clearing member (which may include account minimums), sacrifice netting and margin efficiencies as their portfolio is divided across multiple clearing members, and navigate the operational complexity of this type of multi-clearing member setup.

    - In the event a client's clearing member defaults, porting positions to another clearing member would not be an option under the sponsored clearing model since currently no clearing member accepts transactions executed with a third party. As a result, clients lose a key protection typically offered by central clearing in the event of a clearing member default.

    - Clients would also sacrifice the key trading-related benefits of central clearing, as the universe of executing counterparties would remain limited since clients would be unable to interact with liquidity providers that do not also offer clearing services. In addition, many clients would remain unable to participate on all-to-all order books, as they would be unable to clear transactions executed with anyone other than those liquidity providers that they established a clearing relationship with.

For the above reasons, there is broad consensus across market participants that an agency client clearing model (i.e., one that clears "done-away" transactions executed with third parties) is necessary to support a market-wide clearing mandate for either repo or cash transactions.

The Proposal Does Not Effectively Address the Issue

The Proposal acknowledges that the client clearing access models at FICC "need to be revisited,"[13] but only requires that FICC implement policies and procedures "reasonably designed to, as applicable, ensure that it has appropriate means to facilitate access to the clearance and settlement services of all eligible secondary market transactions in U.S. Treasury securities, including those of indirect participants."[14] This requirement is insufficient to ensure that an agency (or "done-away") client clearing model exists in practice, which is necessary to support a market-wide clearing mandate for either repo or cash transactions.

To understand why the Proposal is insufficient, we note that FICC has asserted that the Sponsored Clearing model already permits clearing members to clear "done-away" transactions.[15] Therefore, according to this line of argument, there is little more for the clearing agency to do, and the rest is up to market participants to sort out. Unfortunately, this line of argument ignores that FICC sponsoring clearing members are only permitted to compel clients to bundle execution and clearing because FICC rules allow the practice. As further evidence that an FICC-specific issue exists, the same firms that serve as FICC sponsoring clearing members provide full-service "done-away" clearing offerings in every other asset class that is centrally cleared, including equities, options, futures, and swaps. There is nothing unique about the Treasury market that explains why no clearing member is currently clearing "done-away" transactions at FICC.

In addition, we note there is no legitimate justification from a clearing member perspective for refusing to clear "done-away" transactions. In fact, in response to similar attempts to limit access to swaps clearing, the Commodity Futures Trading Commission ("CFTC") affirmatively prohibited disclosing the identity of the client's executing counterparty to its clearing member, finding that:

> *(1)* ***disclosure of a customer's original executing counterparty could have potentially anticompetitive effects*** *[emphasis added], (2) limiting the number of counterparties would hurt the customer's access to the best price as well as general market liquidity, (3) restricting the size of trades with particular counterparties also would hurt the customer's access to the best price as well as general market liquidity, and (4) restrictions on the number of counterparties and on the size of trades with them would slow down acceptance for clearing.*[16]

Necessary Enhancements to the Proposal

Instead of proposing a vague requirement for clearing agencies to implement "policies and procedures," the Commission should address client access directly by requiring registered clearing agencies to prohibit anti-competitive practices. This should include prohibiting clearing members

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[13] Proposal at 64635.

[14] *Id.*

[15] *See* Second FICC White Paper.

[16] 77 FR 21278 (Apr. 9, 2012) at 21280, available at: https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2012-7477a.pdf.

from compelling clients to bundle execution and clearing (rather than leaving it up to clearing members to set their own access standards).[17]

The Commission has clear statutory authority to implement such a requirement.

- First, since a clearing requirement cannot be implemented in the Treasury market unless the Commission ensures that both direct and indirect participants have a way to access a clearing agency, the two topics are inseparable and the Commission can rely on the statutory authority underlying the clearing requirement in order to address related access issues, including promoting the prompt and accurate clearance and settlement of Treasury securities.[18]

- Second, Section 17A of the Exchange Act grants the Commission broad authority to improve access and competitive practices at a clearing agency. For example, the Commission has the authority to adopt rules for clearing agencies that are "necessary or appropriate in the public interest" or "otherwise in furtherance of the purposes of this chapter."[19] These purposes of Section 17A include maintaining "fair competition among brokers and dealers"[20] and scrutinizing clearing agency rules to ensure they do not "permit unfair discrimination [. . .] among participants in the use of the clearing agency"[21] and do not "impose any burden on competition not necessary or appropriate."[22]

  As noted above (and acknowledged by the CFTC), there is no legitimate justification from a clearing member perspective for refusing to clear transactions executed with specific counterparties, as all cleared trades face the clearing agency. Prohibiting these practices will allow broker-dealers to fairly compete with respect to trade execution in the Treasury market, as clients will be able to interact with a broader range of counterparties. In addition, this will help to ensure indirect participants are not unfairly discriminated against when attempting to establish clearing arrangements but also preserve execution counterparty flexibility. Finally, to the extent the proposed clearing requirement is determined to be "necessary or appropriate in the public interest," then the same is clearly true for access-related rules that facilitate the implementation of such a clearing requirement.

We note that any such prohibition could still allow bundling of clearing and execution services where requested by the client (due to regulatory requirements or otherwise). In particular, FICC has asserted that certain market participants may be required to use bundled execution and clearing

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[17] For example, a clearing agency should not permit its clearing members to condition or tie the provision of clearing services to the provision of trading services (by the clearing member or its affiliates).

[18] Proposal at 64626.

[19] 15 U.S.C. 78q-1(d)(1).

[20] 15 U.S.C. 78q-1(a)(2)(A).

[21] 15 U.S.C. 78q-1(b)(3)(F).

[22] 15 U.S.C. 78q-1(b)(3)(I).

services due to regulatory constraints.[23] It may also be appropriate for the Commission to consider a safe harbor under §17(f) of the Investment Company Act in order to allow money market funds ("MMFs") and registered investment companies ("RICs") to custody margin with a broker-dealer clearing member of FICC, similar to Rule 17f-6 which applies to futures commission merchant clearing members.

To the extent the Commission elects to retain the Proposal's current approach, we recommend several enhancements:

- First, similar to the CFTC, the Commission should specifically acknowledge that a clearing member requiring a market participant to disclose its original executing counterparty could have potentially anti-competitive effects. As a result, to the extent a clearing agency elects not to prohibit such a practice, the clearing agency must, at a minimum, (i) specify in its rules the instances in which such a practice is permitted, and (ii) provide supporting rationale explaining why permitting such a practice is consistent with the Exchange Act.

- Second, in connection with demonstrating that it has appropriate means to facilitate access to clearance and settlement services for all eligible secondary market Treasury transactions, the clearing agency should be required to show that material client volumes are successfully being cleared. For example, minimal cash transactions are currently being cleared through FICC's Sponsored Clearing offering, suggesting that refinements are necessary in order to facilitate broader access.

- Third, the Commission (with other members of the official sector) should host public roundtables or other forums in order to track progress of the steps needed to support a market-wide clearing mandate for repo and cash transactions, including access-related issues.

III. Other FICC Enhancements

We support the proposed amendments to the broker-dealer customer protection rule to facilitate clearing members using margin posted by clients to fund clearing agency margin requirements for client positions. However, in addition to the conditions for relief set forth in the Proposal, in no event should margin posted for client positions be available for use as part of a clearing agency's default waterfall. At the moment, we understand that FICC commingles margin requirements and guaranty fund contributions, meaning that posted margin can be used for loss mutualization purposes. There should be separate calls for initial margin ("IM"), variation margin ("VM"), and guaranty fund, with margin posted for client positions (both IM and VM) specifically excluded from the default waterfall. We note this change may facilitate a broader range of clients posting margin (see the discussion around MMFs and RICs above), as the potential for loss mutualization is removed.

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[23] Second FICC White Paper at page 7.

In addition to the clearing agency enhancements set forth in the Proposal, we recommend the Commission also address cross-margining to ensure a level playing field between direct and indirect members. We have noted that, in contrast to direct members, clients are not permitted to cross-margin positions cleared at FICC with futures positions cleared at CME Group under FICC's current cross-margining framework. This significantly increases clearing costs for clients (depending on the trading strategies involved), discouraging clearing and creating an unlevel playing field between direct members and clients at FICC. While we appreciate FICC's acknowledgement of the issue and willingness to "engage with the industry and regulators regarding how best to extend those margining efficiencies to customers,"[24] we have yet to see meaningful progress or a definitive timeline for resolving this issue.

IV. Intersection with the Commission's Dealer Proposal

This Proposal is designed to enhance market integrity, resiliency, and transparency in the Treasury market. However, the Commission has simultaneously put forward multiple proposals designed to achieve these objectives without considering how these various proposals interact with each other. For example, the asserted benefits associated with significantly amending the definition of a "dealer" under Commission regulation so as to require additional firms to register may not be accurate to the extent there is a broad clearing requirement for repo and cash Treasury transactions. At a minimum, we request the Commission re-open the comment period for related proposals impacting the Treasury market in order to enable market participants to consider the cumulative impact and to meaningfully comment on the costs and benefits of the entire package of proposals.

V. Conclusion

Finally, we urge the Commission to ensure the benefits of central clearing justify the costs. To the extent a clearing member offers client clearing services, the pricing for those services should be fair and equitable across market participants. Pricing should be based on the economics of offering clearing services and not as a barrier to entry. Similar principles should apply to FICC.

Respectfully,

ARB Trading Group LP

Citadel Securities

DRW Holdings, LLC

Eagle Seven LLC

Geneva Trading USA, LLC

Hard Eight Futures, LLC

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[24] Second FICC White Paper at page 6.

Hudson River Trading LLC

IMC Trading

Jump Trading Group

Kore Trading LLC

Optiver

Quantlab Financial, LLC

WH Trading LLC

XR Trading LLC

cc: Gary Gensler, Chair
Hester M. Peirce, Commissioner
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