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VIA E-MAIL RULE-COMMENTS@SEC.GOV

December 28, 2022

Ms. Vanessa Countryman
Secretary
US 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 Rule with Respect to U.S. Treasury Securities (File No. S7-23-22)

Dear Ladies and Gentlemen:

Federated Hermes, Inc. and its subsidiaries ("Federated Hermes")[1] submit this comment letter to the U.S. Securities and Exchange Commission (the "Commission" or the "SEC") regarding the Commission's proposal to require a Treasury covered clearing agency (CCA) to have policies and procedures that require, subject to certain exceptions, its direct participants to submit for clearing and settlement "eligible secondary market [Treasury] transactions" (the "Proposal")[2]. Eligible secondary market transactions would include repurchase agreements where the purchased securities for such repurchase agreement are Treasury securities ("Treasury repurchase agreements"). The Proposal also requires certain categories of market participants to centrally clear secondary market cash transactions in Treasury securities ("cash Treasury transactions"). Federated Hermes, on behalf of its underlying advisory clients, has substantial experience in the repurchase agreement market including repurchase agreements that are cleared through a CCA[3]. Many of Federated Hermes sponsored investment products for which it transacts in repurchase agreements are money market funds that are registered under the Investment Company Act of 1940 ("1940 Act") and therefore subject to Rule 2a-7 under the 1940 Act (a "2a-7 Fund"). Money

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[1] Federated Hermes, Inc. (NYSE: FHI) is a global leader in active, responsible investment management, with $624.4 billion in assets under management as of September 30, 2022. We deliver investment solutions that help investors target a broad range of outcomes and provide equity, fixed-income, alternative/private markets, multi-asset and liquidity management strategies to more than 11,000 institutions and intermediaries worldwide. Our clients include corporations, government entities, insurance companies, foundations and endowments, banks and broker-dealers.

[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, Sec. & Exch. Comm'n, Exchange Act Release No. 34-95763 (Sept. 14, 2022), 87 Fed. Reg. 64610 (Oct. 25, 2022), available at: https://www.sec.gov/rules/proposed/2022/34-95763.pdf.*

[3] On September 30, 2022, Federated Hermes had invested, on behalf of its advisory accounts, approximately $206 billion in repurchase agreements of which $163 billion was invested in Treasury repurchase agreements.

market funds, particularly government money market funds, hold trillions of dollars of Treasury securities and, along with all investment companies, held the third most Treasury securities after foreign and international investors and the Federal Reserve in March 2022.[4] As an industry leader, Federated Hermes' had invested in its liquidity products, on behalf of its clients, approximately $232 billion in Treasury securities as of September 30, 2022, of which $163 billion was invested in Treasury repurchase agreements.

Federated Hermes supports a strong, stable and liquid market for Treasury securities. However, for the reasons set forth below Federated Hermes opposes the Commission's proposed clearing mandate that would require direct participants to a CCA to clear their Treasury repurchase agreements. Federated Hermes also opposes a clearing mandate for cash Treasury transactions but supports the exclusion of 2a-7 funds from the proposed cash Treasury transactions mandate. If the Commission proceeds with a clearing mandate for repurchase agreements the Commission should ensure that any clearing market structure would continue to enable Government and Treasury 2a-7 Funds to meet the definition of "collateralized fully" under the 1940 Act and therefore be eligible to be a "government money market fund" under Rule 2a-7. Additionally, a clearing mandate for Treasury repurchase agreements could have adverse consequences for 2a-7 Funds that are rated by a rating agency by causing them to change their portfolio holdings in order to maintain their credit ratings. Such a mandate could also adversely affect certain state and local government investment pools as their authorizing statutes may not permit them to engage in centrally cleared repurchase agreements. Lastly, we do not feel that any mandate should include securities lending involving the lending of Treasury securities as that market is fundamentally different from the Treasury repurchase agreement market. Although we agree with the Investment Company Institute that the best course is to continue with the development of central clearing on a voluntary basis, if the Commission nevertheless determines to adopt a central clearing mandate, we respectfully request the Commission take into account the concerns outlined below.

The Commission Should Not Apply a Treasury Repurchase Agreement Clearing Mandate to 2a-7 Funds

Repurchase agreements are a primary investment for 2a-7 Funds, with Treasury repurchase agreements making up a significant portion of Treasury and other Government 2a-7 Funds. Federated Hermes engages in Treasury repurchase transactions with different settlement characteristics, to include bilateral, tri-party, and more recently, sponsored cleared transactions. As demonstrated by its use of sponsored cleared repo at a CCA, Federated Hermes has found that central clearing of Treasury repurchase agreements may offer benefits, primarily through access to additional collateral supply. With the ability to transact with the same counterparty across

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[4] As of December 22, 2022, government money market funds (including both retail and institutional) had assets of $3,955.18 billion, of which $1,314.602 billion was from Treasury repurchase agreements. Press Release, *Money Market Fund Assets*, INV. CO. INST. (last visited Dec. 23, 2022), https://www.ici.org/research/stats/mmf. Government money market funds are defined as money market funds that invest 99.5% or more of their total assets in very liquid investments, namely, cash, government securities, and/or repurchase agreements that are collateralized fully with government securities. SEC. & EXCH. COMM'N, MONEY MARKET FUNDS (last visited Dec. 23, 2022), https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-5. *See also* VIKTORIA BAKLANOVA, ISAAC KUZNITS, TREVOR TATUM, MONEY MARKET FUNDS IN THE TREASURY MARKET, SEC. & EXCH. COMM'N 2 (Sept. 1, 2022), *available at* https://www.sec.gov/files/mmfs-treasury-market-090122.pdf.

different settlement platforms, Federated Hermes usage of sponsored repo in its 2a-7 Funds has varied over changing market environments. For the additional reasons set forth below the ability to transact in Treasury repurchase agreements across a variety of clearing and settlement platforms allows the 2a-7 Funds to be invested in a manner that is in the best interests of its shareholders.

The Proposal identified the avoidance of potentially disorderly defaults in the Treasury repurchase agreement market as a potential benefit of central clearing of Treasury repurchase agreements. However, much planning and tools have been developed that seek to avoid a disorderly default in repurchase agreement markets. For example, the SEC issued guidance in the aftermath of the 2008 financial crisis for 2a-7 Funds to develop and adopt policies and procedures to facilitate the orderly liquidation of collateral in the event of a failed repurchase agreement counterparty[5]. To Federated Hermes knowledge, neither the Commission nor its Staff have indicated that the plans that have been developed in response to the guidance are inadequate. Additionally, the likely insolvency regimes for the major repurchase agreement participants allow the receiver (e.g., the Federal Deposit Insurance Corporation or the Securities Investor Protection Corporation) to transfer or wind down repurchase agreements in an orderly manner.

The Proposal also claims that it would further the prompt and accurate clearance and settlement of U.S. Treasury securities, although it does not cite any circumstance in which parties have encountered difficulties in clearing and settling repurchase agreements. The Proposal does not take into account the significant changes to the clearance of tri-party repurchase agreements implemented after the 2008 financial crisis.[6] As the Proposal acknowledges, the clearing bank handles the settlement of tri-party repurchase agreements through its collateral allocation systems and such process has resulted in a well-functioning process that already operates under severe time constraints. We have also not observed any difficulty in clearing and settling Treasury repurchase agreements on a bilateral basis. These repurchase agreements are settled on a same-day, delivery-versus-payment, basis. Federated Hermes gives instructions for the settlement of these repurchase agreements as soon as they are confirmed, so settlement generally is completed as rapidly as possible.

Another potential benefit identified by the Commission in the Proposal is to enhance regulatory visibility in the Treasury markets. However, 2a-7 Funds are already subject to robust reporting requirements that identify the counterparty to a repurchase agreement, the market value of the underlying collateral to that transaction, and the terms of the trade including rate and maturity[7]. Such detailed disclosure gives regulatory authorities the ability to view exposures easily and regularly[8]. A mandate for central clearing of Treasury repurchase agreement transactions ignores

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[5] *See* SEC. & EXCH. COMM'N, DIV. OF INV. MGMT GUIDANCE UPDATE: COUNTERPARTY RISK MANAGEMENT PRACTICES WITH RESPECT TO TRI-PARTY REPURCHASE AGREEMENTS (July 2013), *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-03.pdf

[6] *See* FED. RESERVE BANK OF N.Y., TASK FORCE ON TRI-PARTY REPO INFRASTRUCTURE, FINAL REPORT (Feb. 15, 2012), *available at* https://www.newyorkfed.org/medialibrary/microsites/tripartyrepo/pdf/report_120215.pdf.

[7] Sec. & Exch. Comm'n, Form N-MFP, Items C.7 and C.8, https://www.sec.gov/files/formn-mfp.pdf.

[8] Tri-party repo reform efforts that were undertaken following the financial crisis of 2008 has also substantial improved transparency in the tri-party repo market. As part of such reform efforts the Federal Reserve Bank of New York disclosures detailed information on the tri-party repurchase agreement market. FED. RESERVE BANK OF N.Y., TRI-PARTY/GCF REPO (last visited Dec. 23, 2022), *available at* https://www.newyorkfed.org/data-and-statistics/data-visualization/tri-party-repo/index.html

the meaningful improvements in the transparency of large portions of the Treasury repurchase agreement market. The Commission could, in lieu of a clearing mandate, focus on filling in any perceived transparency gaps.

A mandate for central clearing of Treasury repurchase agreements would result in less investment flexibility for shareholders of 2a-7 Funds while imposing material costs on the Funds without clearly demonstrated benefits for Treasury market liquidity. Regulators have communicated their concerns about the opaque nature of the bilateral repurchase agreement market. However, Rule 2a-7 requires 2a-7 Funds to take action to mitigate risks in all types of repurchase agreement transactions[9]. The requirement for the 2a-7 Fund to make a minimal credit determination on a repurchase agreement counterparty, irrespective of the nature of the underlying securities, mitigates the risk that a 2a-7 Fund relies too heavily on the underlying Treasury securities in its credit evaluation. Even though not required by Rule 2a-7, Federated Hermes has historically limited the exposure of its 2a-7 Funds to a repurchase agreement counterparty based on this credit determination. Imposition of a central clearing mandate would force us to choose between accepting a substantial concentration of risk with a CCA and taking steps to diversify that risk by gaining exposure to counterparties that are not CCA direct participants or diversifying its investments away from repurchase agreements. Therefore, the mandate could indirectly force changes in the portfolio composition of 2a-7 Funds which could implicate the liquidity and risk characteristics of such funds.

A mandate for Treasury repurchase agreement clearing would also reduce the flexibility that 2a-7 Funds have with respect to the management of their cash flows and have the potential to significantly impede the movement of cash throughout the financial markets. For example, bilateral repurchase agreements can settle earlier in the day on the repurchase date which permits the 2a-7 Fund to have access to their funds earlier in order to manage fund redemption requests or to fund other investments. Moving to a single cleared Treasury repurchase agreement mandate would standardize the settlement time to later in the day and therefore likely have an impact on the flow of funds throughout the financial system. Conversely 2a-7 Funds can rely on tri-party repurchase agreements to facilitate the late day investment of cash. A clearing mandate would likely move the settlement to earlier on the purchase date, which would make the investment of late day cash flows more challenging for 2a-7 Funds. Therefore, the ability to utilize bilateral, tri-party and cleared repurchase agreements by 2a-7 Funds are important tools that 2a-7 Funds use to manage cash flows in a fund, and any clearing mandate which restricts such flexibility will adversely affect 2a-7 Funds and their shareholders.

The costs of a Treasury repurchase agreement clearing mandate would be significant for 2a-7 Funds. There are significant operational, technological, personnel and legal costs incurred in entering into a sponsored arrangement with a sponsoring member. The operational and legal arrangements governing the sponsored arrangement are much more complex and onerous than

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[9] In order to qualify as a Government Money Market Fund under Rule 2a-7 a fund must invest 99.5 percent or more in cash, government securities, and/or repurchase agreements that are "collateralized fully". One of the requirements to be "collateralized fully" is that the value of the securities collateralizing the repurchase agreement is, and remains for the term of the repurchase agreement, at least equal to the repurchase price for the repurchase agreement transaction. *See* 17 C.F.R. § 270.5b-3(c)(1)(i). This requirement leads to more conservative margining practices for 2a-7 Funds for Treasury repurchase agreement transactions than may be the case for other Treasury repurchase agreement market participants.

traditional bilateral or tri-party relationships. Additionally, the direct costs of clearing with a CCA, while directly borne by the sponsoring member, are likely passed along to the 2a-7 funds in the form of lower rates than may otherwise be available in the marketplace. Federated Hermes recognizes that the Commission may consider 2a-7 Fund participation in a Treasury repurchase agreement clearing mandate as desirable in order to address the perceived risks posed by other market participants, but urges the Commission to consider carefully whether the benefits of a clearing mandate would outweigh these costs on 2a-7 Funds and their shareholders. Additionally, the Commission should consider that the imposition of a clearing mandate would likely disincentivize investment and innovation in the repurchase agreement market by market participants.

If the SEC proceeds with a clearing mandate for Treasury repurchase agreements, it should exclude tri-party repurchase agreements from such a mandate. The Proposal acknowledges that "[c]ollateral posted to the triparty platform generally cannot be repledged outside the platform, thereby protecting against settlement fails.[10]" This restriction on rehypothecation of the Treasury securities underlying the repurchase agreement significantly reduces settlement risk as there should be no meaningful risk that the 2a-7 Fund would not deliver the Treasury securities on the repurchase date. This leaves the only significant source of settlement risk as the nonpayment of the repurchase price by the counterparty to the repurchase agreement[11]. However, in Federated Hermes' experience this nonpayment rarely occurs and when it has it has been attributable to operational risk, rather than credit risk. Therefore, in Federated Hermes' view there would be very little settlement risk being mitigated by subjecting tri-party repurchase agreements to a clearing mandate.

The Cash Treasury Clearing Mandate Should Not be Applied to 2a-7 Funds

We agree with the exclusion of registered investment companies, including 2a-7 Funds, from the Cash Treasury Clearing Mandate. Applying this mandate to 2a-7 Funds would yield minimal benefits while potentially imposing significant costs on 2a-7 Funds. Federated Hermes' 2a-7 Funds do not normally utilize leverage in the cash purchase of Treasury securities. Rather Federated Hermes' 2a-7 Funds and other 1940 Act funds sponsored by Federated Hermes are generally investing in Treasury securities on a long-term basis or are using them to hedge risks, for capital protection or for diversifying the risk in their investment portfolios. These strategies are generally not linked to other leveraged strategies and therefore there is minimal contagion risk evident in these transactions. The costs of such a mandate would be significant as Federated Hermes currently does not clear cash Treasury transactions and therefore would need to establish the technological, operational and legal frameworks that are necessary to support such a clearing mandate. Therefore, any anticipated benefits of 2a-7 Funds, as well as other 1940 Act funds, clearing their cash Treasury purchases would be vastly outweighed by the costs and burdens associated with such a mandate.

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[10] Proposed Rule, 87 Fed. Reg. at 64,617 n.65 and accompanying text.

[11] Under the current clearing model the "start-leg" of the repurchase agreement transaction is settled bilaterally so a clearing mandate would not help avoid a settlement failure at this stage of the transaction.

If the Commission Adopts Treasury Repurchase Agreement Clearing Mandate the Commission Should Ensure Continued Compliance with the Investment Company Act of 1940

If a Treasury repurchase agreement clearing mandate is adopted the Commission should ensure that 2a-7 Funds and, more broadly, 1940 Act Funds can continue to comply with the 1940 Act with respect to their cleared Treasury repurchase agreement transactions. As noted above, it is critical for Treasury and other Government 2a-7 Funds that Treasury repurchase agreements continue to be able to meet the definition of a "collateralized fully" repurchase agreement under Rule 5b-3 so they remain permissible investments for Treasury and other government money market funds.[12] A key requirement to be "collateralized fully" is that the collateral is maintained at the 2a-7 Fund's custodian. In order to meet this requirement, Federated Hermes' 2a-7 Funds currently take possession of the purchased Treasury securities at the 2a-7 Funds' primary custodian or at the 2a-7 Fund's account at the tri-party custodian[13], depending on the settlement of the cleared Treasury repurchase agreement. This possession of purchased Treasury securities is integral to compliance with Rule 5b-3's "collateralized fully' definition and therefore should be maintained as a feature of any sponsored repurchase agreement offered by a CCA[14]. The ability of a 2a-7 Fund or other 1940 Act Fund to meet the requirements of "collateralized fully" is also needed in order to achieve "look through" treatment for certain diversification requirements imposed under the 1940 Act and Internal Revenue Code.[15]

In Federated Hermes' experience the sponsoring member and sponsored member relationship is highly negotiated through documentation that sets forth the respective parties' rights and responsibilities. As part of such negotiation, Federated Hermes seeks to ensure that the arrangement enables the cleared Treasury repurchase agreements to meet the "collateralized fully" requirements. We are concerned that if the clearing mandate for Treasury repurchase agreements is adopted the mandate will enhance the bargaining position of the sponsoring members. If 2a-7 Funds can only engage in repurchase agreements with FICC members through sponsored member arrangements, sponsoring members are more likely to adopt a "take-it-or-leave-it" posture with respect to their sponsored member agreements. Even if 2a-7 Funds can still convince sponsoring members to accept provisions necessary to comply with the "collateralized fully" requirements, a mandate may still compel 2a-7 Funds to accept other risks amenable to negotiation in a more competitive market.

Rating Agency Implications

Certain of the 2a-7 Funds sponsored by Federated Hermes are rated by one or more Nationally Recognized Statistical Rating Organizations (NRSROs), often reflecting end-user requirements. NRSROs typically establish exposure limits that a rated money market fund may have to any particular CCA. As the Proposal notes the FICC is currently the only CCA clearing Treasury

[12] *See* 17 C.F.R. § 270.2a-7(a)(14) for the definition of a government money market fund.
[13] The tri-party custodian has also been appointed as a qualified custodian of the 2a-7 Funds.
[14] Having control of the collateral also facilitates compliance with another requirement of the collateralized fully definition which is that the 2a-7 Fund has a perfected security interest in the collateral. *See* 17 C.F.R. § 270.5b-3(c)(1)(ii).
[15] Look through treatment would permit invests in Treasury repurchase agreements to be deemed to be investments in the Treasury securities themselves for purposes of various issuer diversification requirements.

securities, so adoption of the Proposal should be expected to significantly increase the exposure of 2a-7 Funds to the FICC. This could adversely affect the credit rating of such 2a-7 Funds.
It is not unusual for some types of 2a-7 Funds to have 50% or greater of their assets invested in Treasury repurchase agreements. If the Proposed Rule is adopted, these 2a-7 Funds may be incentivized, in order to maintain their credit rating, to diversify their concentration of credit risk. Such diversification of credit risk could cause the 2a-7 Fund to take on market and liquidity risk by purchasing securities with various maturities in lieu of overnight repurchase agreements. In addition, the concentration of risk to a CCA could, independently of rating requirements, incent a 2a-7 Fund to diversify its credit exposure in order to ensure that it has sufficient access to liquidity in the event of a force majeure or other event at the CCA.

State & Local Government Pools

The Commission should not apply a Treasury repurchase agreement clearing mandate to state and local governments. Repurchase agreements are an integral part of an investment program of state and local governments. State and local government investment policies are derived from authorizing statutes and ordinances. Most state authorizing statutes and local ordinances follow a "legal list" approach by which general categories of investments are specified as permissible investments. In defining repurchase agreements as a permissible investment, most state statutes and local ordinances define repurchase agreements using model language provided by the Government Finance Officers Association, which in general terms explains repurchase agreements as the sale by a bank or dealer of a government security with the simultaneous agreement to repurchase the security on a later date. As a CCA may not be a bank or dealer, centrally cleared repurchase agreements may not comply with these statutes or ordinances. State statutes and local ordinances are silent as to the novation of a repurchase agreement (a requirement of the FICC's multilateral netting and settlement process), and it is unreasonable to expect that state courts or attorneys general would interpret authorizing statutes and ordinances to implicitly approve the novation of a repurchase agreement. Sponsored cleared repurchase agreements present a myriad of other issues that, like novation, may only be resolved by amendment of the authorizing statute or ordinance through the action of an applicable legislative body. Given the substantial amount of time and effort it would take for states and municipalities to fashion and pass amendments necessary to harmonize existing statutes or ordinances to the structure of sponsored cleared repurchase agreements, it would be more reasonable and safer for the markets to exempt state and local governments from the requirement.

Securities Lending

The Commission requests comment on whether the Treasury clearing mandate should be applicable to securities lending transactions where a Treasury security is the subject of the loan. Federated Hermes participates in a securities lending program and periodically lends Treasury securities in its advisory accounts through such program. However, we do not believe that such securities lending transactions should be included within a clearing mandate. Securities lending transactions are subject to different market infrastructure than repurchase agreements and such infrastructure and processes has not been adapted to facilitate cleared securities lending transactions as a robust clearing market has not existed for securities loans.

Please do not hesitate to contact me if you would like to discuss this letter or have additional questions.

Best regards,

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