

MEMORANDUM

June 27, 2023

TO: File No. S7-23-22

FROM: Robert Fisher
Office of Commissioner Mark T. Uyeda

RE: Meeting with Representatives of the Independent Dealer Trader Association (IDTA)

On June 27, 2023, Commissioner Mark T. Uyeda's counsel, Robert Fisher, and SEC Scholar Intern Jakell Larson had a meeting with IDTA. The attendees met both in-person and by phone. The IDTA representatives in attendance consisted of:

- Jim Tabacchi, South Street Securities
- Brent Posner, Marex
- Philip Vandermause, Aardvark Securities
- Lara Hernandez, Mirae Asset Securities
- Micah S. Green, Steptoe & Johnson, LLP
- Sophia Breggia, Steptoe & Johnson, LLP

Among other matters, the participants discussed the IDTA's comment letter filed in connection with the 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 Fund Advisers. The attendees also discussed a related "White Paper" by the IDTA (June 2023), which is included as an attachment, and is entitled "After COVID-19, a Banking Crisis, and the Uncertainty of Raising the Debt Ceiling: How to Expand the SEC's Proposed Treasury and Repo Market Central Clearing Mandate to Enable Broader Reforms for Greater Treasury Market Financial Stability".

Attachment.



INDEPENDENT DEALER TRADER ASSOCIATION

**After COVID-19, a Banking Crisis, and the Uncertainty of Raising the Debt Ceiling:
How to Expand the SEC’s Proposed Treasury and Repo Market Central Clearing Mandate
to Enable Broader Reforms for Greater Treasury Market Financial Stability**

A White Paper by the Independent Dealer and Trader Association (“IDTA”)

June 2023

I. Executive Summary

The Independent Dealers and Traders Association (“IDTA”) is an association of middle market and minority-owned registered broker dealers that are active in the Treasury market. Specifically, the IDTA believes market reforms must occur in a manner that will broaden meaningful participation and competition, and that policy makers must undertake implementation of such efforts comprehensively, providing equal footing for large, small and medium sized broker dealers, rather than incrementally.

The IDTA applauds the Securities and Exchange Commission (“SEC”) and SEC Chairman Gensler’s call for broad reforms in the U.S. Treasury and Agency mortgage-backed securities (“MBS”) markets. However, the IDTA believes such market reforms must delve deeper than currently outlined, including through engagement with regulatory bodies such as the U.S. Treasury, the Federal Reserve, the SEC, and the Federal Deposit Insurance Corporation (“FDIC”), to avoid the type of “quick fix” scenario that has plagued past reforms.

As currently proposed, the SEC’s Treasury Central Clearing Mandate (the “Central Clearing Mandate”) would result in more risk concentration among the largest banks, making it more difficult for smaller dealers to compete. The IDTA believes the goal of the Central Clearing Mandate is and should be exactly the opposite. The SEC’s Central Clearing Mandate proposal will have such consequences due to a bias in the current central clearing process of the Fixed Income Clearing Corporation (“FICC”), which limits the capacity to clear based on the size, defined by capital, of the clearing member as opposed to quality of the underlying collateral of the trade. This bias discriminates against all but the largest financial institutions. The Central Clearing Mandate, as currently proposed, would exacerbate this bias, as it will lead to significantly more volume of trades being cleared through FICC’s Sponsored Program, where the bias against smaller firms is most profound.

The IDTA recognizes the importance of FICC measuring and managing its risks to ensure that the market can operate smoothly, particularly in times of stress in the market or with any clearing member. The following is a list of proposed reforms that are necessary to couple with a Central

Clearing Mandate in order to mitigate concentration risk among systemically important institutions, remove the current bias in the clearing system, and increase competition in the Treasury and repo markets and, most importantly, strengthen FICC's ability to manage clearing system risk.

- Most notably, to replace the current bias against all but the largest institutions, establish standardized repo minimum haircut requirements for FICC members to charge their clients, with rehypothecation rights. Such a reform will increase first loss protection of FICC while minimizing or eliminating the need for the current Excess Capital Premium (“ECP”), and will prevent member firms from acquiring a predatory competitive advantage, which has become more common place, by not requiring haircuts for those members’ clients. Additionally, standardized haircuts are an effective limit on the leverage of unregulated entities such as hedge funds.
- Approving a common margining program for FICC, where members participating in the Mortgage-Backed Securities Division (“MBSD”) or Government Securities Division (“GSD”) of FICC, or the Chicago Mercantile Exchange (“CME”), which are designed to hedge interest rate exposure, are accounted for properly in terms of offsetting positions.
- Increasing the reliance of FICC’s Capped Contingent Liquidity Facility (“CCLF”) on the largest banks, which are the entities that represent FICC’s potential systemic liquidity risk, rather than requiring smaller and middle-market FICC participants to bear the burden of those costs.
- As proposed in a 2021 publication by the Group of Thirty (“G30”), there should be broader access to the Standing Repo Facility (“SRF”).¹ The IDTA recommends that this specifically include any Tier 1 netting FICC member, and that FICC also have access to the SRF.²
- Requiring Money Market Funds (“MMFs”) to look to the rating of the collateral, the short tenure of the transactions, the custodian banks, and FICC when choosing counterparties for repo transactions in U.S. government securities. Transactions should not be limited only to counterparties rated by the two largest rating agencies.
- Making banks’ financial condition more transparent by limiting Hold to Maturity (“HTM”) portfolios to the total amount of insured deposits only, which will ensure that the securities actually can be held to maturity.

¹ See Group of Thirty, U.S. Treasury Markets: Steps Toward Increased Resilience, (July 2021), available at https://group30.org/images/uploads/publications/G30_U.S._.Treasury_Markets-Steps_Toward_Increased_Resilience__1.pdf.

² G30 also proposed that FICC have access to the SRF in their 2021 publication. *See id.*

- The Treasury and the Federal Reserve must strive to encourage more firms to become bank or non-bank Primary Dealers.
- Creating an exception for state and municipalities to continue participating bi-laterally in the liquidity flows of the U.S. Treasury market.

The SEC’s recent proposal to mandate Treasury and repo central clearing³ could, if finalized comprehensively, provide a unique opportunity to level the competitive playing field throughout the market. Competition generates liquidity, a lower funding cost for taxpayers, and a more stable financial system with less moral hazard. Conversely, if the Central Clearing Mandate proposal is finalized and implemented inappropriately, it could further reduce competition and increase the concentration of risk among the largest SIFI banks.

Given the current and ongoing banking crisis, the IDTA believes that it is important for regulators to methodically plan a comprehensive Treasury market overhaul. The goal of such reforms should be to increase long-term market resiliency fostered through competition and transparency, as well as the creation of a broader and more diversified market of intermediaries. Importantly, regulators should avoid a “quick fix” that could result in more risk concentration within a single point of failure.

II. Background

The U.S. Treasury market began in 1776 with the issuance of Continental securities to finance the Revolutionary War. Shortly thereafter, this market underwent considerable change with the enactment of the Funding Act of 1790.⁴ The Funding Act became law only because of a dinner in the famous “room where it happened” between Alexander Hamilton, Thomas Jefferson, and James Madison.⁵ The initial goal for Jefferson and Madison was to move the young nation’s capital from New York to an area close to Virginia. However, the government also needed a stable government funding structure. In exchange for support for the Funding Act, it was agreed the capital location would be moved. Since the Funding Act, all securities issued by the Treasury have been backed by the full faith and credit of the U.S. government.

The moral of the story? Sometimes the best decisions for the financial markets are packaged together with other reforms.

As the 19th century financial system grew, the nation created the Federal Reserve to manage monetary policy, and Treasury securities became the premier investment for institutions, individuals, and sovereign governments. Historically, the primary market for Treasury securities was built around broker dealers and banks that are designated by the Federal Reserve Bank of

³ 17 C.F.R. § 240 (2022), Release No. 34-95763; File No. S7-23-22

⁴ See An Act Making Provision for the Payment of the Debt of the United States, 1st Cong. (1970).

⁵ See Jack Rakove, *The Compromise of 1790*, available at <https://billofrightsinstitute.org/essays/the-compromise-of-1790>.

New York (“FRBNY”) as Primary Dealers. The secondary market has always had a wide variety of participants.

Today, the U.S. Treasury market is the largest and most liquid financial market in the world and remains an investment with no measurable credit risk. Treasury securities are the most utilized collateral for repurchase agreement (“repo”) transactions, which are critical for providing liquidity to the U.S. and global financial markets.

Regulation of the Treasury market has evolved to address problems in the market requiring attention. The Government Securities Act⁶ was enacted in 1986 in response to a number of crises, including the Penn Square Bank failure, Drysdale, and a variety of small broker dealer bankruptcies, providing regulators with oversight of the market. The Government Securities Act was amended in 1993 in response to an auction bid rigging scandal involving Solomon Brothers, one of the market’s largest Primary Dealers.⁷ The amendments required greater price transparency, sales practice reforms, and large position reporting.⁸ Most recently, volatile repo rates in September 2019⁹ and liquidity concerns during the COVID-19 crisis in March 2020 led to currently pending proposals for increased market oversight. However, new regulatory developments must find a balance between the need for oversight, regulation, and transparency, while also preserving the efficiency and liquidity of the Treasury and repo markets.

Independent and minority-owned broker-dealers face regulatory bias and institutional barriers in the Treasury and repo markets. While Systemically Important Financial Institutions (“SIFI banks”) play an important role in the U.S. Treasury market, independent and minority-owned dealers are needed to achieve diversity and resilience of liquidity provision. The IDTA looks forward to market reforms that restore a competitive balance among all participants.

Over the past ten years, many new rules and regulations that were intended to make the market more resilient and diversified have driven business to large SIFI banks. Because government institutions and regulators receive most of their feedback directly from those banks, the IDTA¹⁰ was created as a voice for the small and mid-sized financial institutions, which are also active participants in the Treasury and repo markets.

The IDTA seeks to promote a competitive marketplace, including through:

- New regulations that ensure a more competitive marketplace for all broker dealers, rather than a highly concentrated market that is excessively reliant on the largest systemically important banks; and

⁶ Pub. L. No 99-571, 100 Stat. 3208 (1986).

⁷ Pub. L. No. 103-202, 107 Stat. 2344 (1993).

⁸ *See id.*

⁹ *See* Sriya Anbil et. al., *What Happened in Money Markets in September 2019?*, FED. RESERVE (Feb. 27, 2020), <https://www.federalreserve.gov/econres/notes/feds-notes/what-happened-in-money-markets-in-september-2019-20200227.html>.

¹⁰ *See generally* INDEP. DEALER & TRADER ASS’N, <https://www.idtassoc.com/> (last visited May 2, 2023).

- Easing the barriers to market entry, thus attracting more competition and private capital to the market to effect broader and more diverse Treasury liquidity flows.

III. SEC Treasury Central Clearing Mandate Proposal

The IDTA submitted a comment letter in December 2022 in response to the SEC Treasury Central Clearing Mandate proposal.¹¹

The IDTA comment letter outlined several potential adverse consequences that should be addressed prior to implementation of the Central Clearing Mandate. Those issues include:

1. Increased transaction costs;
2. Increased capital and margin (i.e., haircut) requirements;
3. Increased concentration of risk among the largest SIFI banks;
4. Increased anti-competitive advantages for the largest SIFI banks and a bias against middle market and smaller firms, particularly in the FICC Sponsored Program due to the material limitations created by the ECP and CCLF;
5. Potential for disruption of supply of liquidity from diverse areas of the Treasury market.

There are benefits of central clearing of Treasury securities and repos. However, there are also inherent costs that will be borne by both sell side and buy side market participants that must be considered and addressed when implementing such policy. For example, increased transactions costs can be managed through additional volumes flowing through FICC's automated processing systems, because in a systemic operation if volume increases multiple times, cost does not increase the same number of times.

The need for additional capital requirements can be obviated through standardized repo haircuts with rehypothecation rights. This will standardize the credit decision system wide and drive the decision to be dependent on the value of the best collateral in the world, while also inherently balancing the competitive landscape. Once the competitive landscape is back in balance, concentration risk will decrease.

The U.S. Treasury repo market is vast with many diverse participants, from banks and dealers to corporate treasurers, insurance companies, pension funds, state and municipalities, among other, all looking to put short term cash to work in the safest most secure investment. Many participants invest in the bi-lateral repo market with regional and mid-market dealers utilizing a tri-party bank custodian. Since most states and municipalities use Master Repo Agreements ("MRAs") based on local state law by statute, they would be unable to sign a New York law based repo agreements to clear through a Treasury Central Clearing Mandate at FICC. This is just one example of a potential disruption of flows in this vast and diverse market.

¹¹ See Indep. Dealer & Trader Ass'n, Comment Letter on Proposed Rule on 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 (Dec. 27, 2022), <https://www.sec.gov/comments/s7-23-22/s72322-20153762-321517.pdf>.

As discussed further in the sections that follow, in addition to raising the above issues, the IDTA proposes a series of potential solutions that may be implemented through broader, more thoughtful market reforms.

IV. Requiring FICC Members to Charge Standardized Repo Haircuts

As explained above and below, the current FICC method of managing risk is based on the size of its member firms. Rather than relying on capital, which is a complex construct based on complex GAAP accounting, FICC should instead require its members to charge their clients a minimum standardized repo haircut. The billions of required haircuts would fortify FICC's first loss position and minimize FICC's reliance on the underwriting skills of the sponsoring institution. Standardized haircuts for FICC member clients would level the competitive playing field by ensuring that the largest member institutions do not predatorially reduce or eliminate haircuts to accumulate market share and obtain a competitive advantage over smaller competitors.

Standardized haircuts in this context would also effectuate a standard level of capital required of non-regulated buy side firms (i.e. hedge funds), thus capping their leverage, something regulators have wanted to do for some time.

The IDTA believes that standardized haircuts will foster greater competition in the market and provide FICC greater tools for its critical role measuring and managing risks than the ECP. Furthermore, since it is widely anticipated that the Central Clearing Mandate will significantly expand the FICC Sponsored Program, a standardized haircut is much better policy than the current limitations in the rules governing Sponsoring Members with less than \$5 billion in capital.

Discussion

The FICC Sponsored Program is very attractive to the largest institutions because such banks will receive further balance sheet netting reductions from using the FICC's Sponsored Program as a "quick" first step in implementing a Central Clearing Mandate.¹²

Under the SEC's Central Clearing Proposal, the largest firms, as currently defined in the GSD Rulebook as being firms with at least \$5 billion in capital,¹³ enjoy unlimited netting opportunities as a Category 1 Sponsoring Member in the FICC Sponsored Program. In fact, when the Sponsored Program was designed in 2004, only the largest banks could qualify as a Sponsor.¹⁴ Eventually, eligibility to become a Sponsoring entity was broadened, however, if a firm's capital was less than \$5 billion, the firm was considered a "Category 2 Sponsoring

¹² See *Sponsored Service Fact Sheet*, DTCC (2018), available at <https://www.dtcc.com/-/media/Files/Downloads/Clearing-Services/FICC/GOV/Sponsored-Membership-Fact-Sheet.pdf>.

¹³ See FICC, Government Securities Division Rulebook: Rule 3A.

¹⁴ See Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of a Proposed Rule Change Relating to Establishing a Sponsored Membership Program, 70 Fed. Reg. 25129 (May 12, 2005).

Member.”¹⁵ Category 2 Sponsoring Members had their sponsored activity capped, as was described in a contemporaneous publication by the Depository Trust and Clearing Corporation in the following way: “FICC will limit [Category 2 Sponsoring Members’] sponsored activity through a cap, which will be based on the aggregate VaR exposure a firm presents versus the level of capital they maintain. To the extent that their VaR exposure exceeds their net capital, FICC will stop accepting additional sponsored activity until the VaR exposure is reduced or the capital is increased.”¹⁶ So even if the Sponsoring Member has the ability to post the additional margin, as a result of the above, they are only permitted to trade directly for themselves and not permitted to submit any more customer trades.

These limits have been implemented in a manner that require the Sponsoring Member to represent their VaR as “the sum of the VaR Charges for all of the Sponsored Members whose activity is represented in the Sponsoring member”...account. The effect of this aggregation of the Sponsored customers’ VaR combined with the effect of the ECP has made the Sponsored program, for all practical purposes, inaccessible to anything but the largest Sponsoring Members.¹⁷

Since, the effect of mandated central clearing is expected to materially increase volumes in the Sponsored Program, smaller broker dealers’ inaccessibility to this market, as described above, will have a profoundly negative effect on competitiveness in the repo market. Since the ECP does not practically affect the largest firms, without additional reforms changing or replacing the ECP as proscribed in this White Paper, the result of the SEC Central Clearing Proposal will simply be that the bigger institutions will grow larger, and the smaller institutions will be shut out of competition for pricing and market share, further narrowing the market and increasing concentration of risk in the largest firms.

The Sponsored Program was a creative solution to provide additional capacity to the U.S. Treasury repo market, which requires balance sheet capacity to accommodate the growing Treasury market. The Sponsored Program allows FICC members to post a moderate amount of additional margin at FICC when that same member “sponsors” (underwrites the credit) of a non-participant financing into FICC. The additional margin posted at FICC by the sponsor is not a Generally Accepted Accounting Principles (“GAAP”) charge against capital, as margin is still owned by the posting institution. Participants with over \$5 billion in capital that invest in Treasury securities that they post as margin against a sponsor will not incur a net capital charge and will show the same capital on a GAAP basis, but will see balance sheet netting because they are netting their customers’ assets.¹⁸ This is an example of the lack of accounting transparency and a competitive disadvantage for all but the largest, SIFI banks. On a credit basis, the absolute capital position of participants, while important, is only a portion of the evaluation of the credit

¹⁵ See DTCC Connection Staff, *FICCS Is Transforming the Repo Market*, DTCC (Apr. 1, 2019), available at <https://www.dtcc.com/dtcc-connection/articles/2019/april/01/ficc-is-transforming-the-repo-market>.

¹⁶ *Id.*

¹⁷ See FICC, Government Securities Division Rulebook: Rule 3A, Section 10 and Rule 4, Section 1b

¹⁸ See *id.* For additional information, see bank Form 10-K section referencing off-balance sheet lending activities.

worthiness of large sponsor banks. FICC would have to understand all of the risks dependent on that sponsor's capital position.¹⁹

V. Common Margining

Turbulent markets create large variations in FICC margin requirements, and appropriately so. One way to minimize these large variations is by allowing participants who have offset positions with prudent hedging to get full credit for their risk management efforts. The IDTA notes that FICC has been prudently working on just such offsetting position reporting capability between its subsidiaries, GSD and MBSD, as well as between FICC and the CME. In the latter case, members participating in both clearinghouses would be able to offset their risk. The IDTA believes it is absolutely critical that both these efforts are completed before any Central Clearing Mandate is implemented.

VI. Changes to FICC's Capped Contingent Liquidity Fund

The Capped Contingency Liquidity Facility ("CCLF") was conceptually designed to require FICC to maintain contingent liquidity lines to respond if its largest participant failed, leaving FICC with substantial amounts of securities needing to be financed during an orderly liquidation. Since FICC is a cooperative owned by its members the liquidity risk is "mutualized," or spread among all members. However, if the risk being mutualized is the failure of one of the largest systemically important financial institutions, mutualizing those risks across the entire universe of FICC members shifts the burden from the largest institutions to their smaller competitors. Mutualization has become an even larger issue for the smaller institutions because of the sustained growth of the largest FICC members since CCLF's inception in 2017. As the largest SIFI bank grows larger and passes even more volume through FICC, the mutualized portion of FICC's total liquidity risk will force ever more punitive costs onto independent mid-market dealers. Also, subsequent to the creation of the CCLF, the largest SIFI institutions now have access to the Standing Repo Facility, as discussed further below, which provides access of additional liquidity to a prescribed group of acceptable participants - not currently including independent dealers.

As noted above, absent changes to the proposed Central Clearing Mandate and the adoptions of the other reforms in this paper, the IDTA strongly believes that the result will be a material increase in concentration risk in the Treasury and repo markets among the largest systemically important institutions. Concentration risk is a risk that every central clearing counterparty ("CCP") must actively manage due to potential consequences of the failure of a systemically important institution. Recently, the Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions issued a paper entitled "Margin Dynamics in Centrally Cleared

¹⁹ Notably, Silicon Valley Bank ("SVB") had almost \$21 billion of capital before producing one of the swiftest failures in banking history

Commodities Markets in 2022.”²⁰ In the paper’s conclusion, it was noted that while margin requirements are highly dependent on underlying market volatility, margin models should also consider concentration risk to ensure that CCPs can manage the additional liquidation risk posed by such large positions.²¹

There is a certain and consequential irony if the current Central Clearing Mandate proposal makes it harder for smaller firms to compete with the largest financial institutions. As a result of that increased concentration risk in the market, there will be an increased burden of the CCLF that could force smaller participants to reduce their market activity to offset those higher contingent funding costs. The even more ironic consequence of this cycle is that independent broker-dealers may have to borrow cash from the large banks to meet their CCLF contribution to cover the cost of a potential large bank default, further facilitating the biggest banks to grow bigger still...and the cycle will continue unabated.

Disparately, in the current consumer banking environment, the FDIC intends to pass a significant portion of the cost of bank failures to the largest banks. This is reflective of an understanding, as well as a statutory requirement,²² that community and smaller regional banks are important to the consumer markets they serve. The same principle applies to regional and independent dealers providing critical liquidity flows in the U.S. Treasury and repo markets.

VII. Standing Repo Facility

In July 2021, the Federal Reserve announced the creation of the Standing Repo Facility (“SRF”) to set a ceiling on repo rates.²³ At the time, independent broker-dealers, Tier 1 netting members of FICC, and active participants in the Treasury and repo markets argued for, and reasonably expected, access to the SRF, in the same way the Reverse-Repo Facility (“RRP”) is open to many market participants.²⁴ Scholars from the Brookings Institution and G30 also called for access to the SRF to extend beyond depository institutions.²⁵ The Federal Reserve initially

²⁰ “Margin Dynamics in Centrally Cleared Commodities Markets in 2022,” Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions (BCBS-CPMI-IOSCO), May 23, 2023.

<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD735.pdf>

²¹ *Id* at page 21.

²² See 12 U.S.C. 1817.

²³ See *Standing Repurchase Agreement (repo) Facility*, FEDERAL RESERVE (July 28, 2021),

<https://www.federalreserve.gov/monetarypolicy/standing-overnight-repurchase-agreement-facility.htm>.

²⁴ See Indep. Dealer & Trader Ass’n, White Paper on the Repo Market Affecting U.S. Treasury and Agency MBS (Dec. 6, 2019),

<https://static1.squarespace.com/static/5ad0d0abda02bc52f0ad4922/t/5dea7fb6af08dd44e68f48cc/1575649207172/ID+TA+-+White+Paper+%2812.6.19%29-c2.pdf>; see also *Reverse Repo Counterparties*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/markets/rrp_counterparties.

²⁵ See Nellie Liang & Pat Parkinson, *Enhancing Liquidity of the US Treasury Market Under Stress*, Brookings Institution 3 (Dec. 16, 2020) https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf.

At the time of this writing Nellie Liang is the Under Secretary for Domestic Finance at the U.S. Treasury. See also Group of Thirty, *U.S. Treasury Markets: Steps Toward Increased Resilience*, (July 2021), available at https://group30.org/images/uploads/publications/G30_U.S._Treasury_Markets-Steps_Toward_Increased_Resilience_1.pdf.

opened the SRF program only to Primary Dealers.²⁶ While access has been extended to depository institutions that are not Primary Dealers, independent and minority-owned non-bank broker dealers still do not have access.²⁷

The SRF was not used over the past two years because repo rates traded at the bottom of the Federal Reserve's fed funds target range. However, IDTA members believe that as high Treasury issuance and balance sheet runoff continue, repo rates will eventually move to the top of the range and the SRF will be used similarly to how the RRP is used today.

Furthermore, when the market needs access to the SRF on a quarter-end or month-end, when rate pressure peaks, bank affiliated Primary Dealers (which include 22 out of 24 existing Primary Dealers)²⁸ have balance sheet constraints. The non-bank independent broker-dealers fill the need when the largest banks pull back capacity to generate more favorable leverage ratios for quarter end. Giving independent broker dealers access to the SRF will avert potential funding bottlenecks in the future, as occurred in September 2019.²⁹ As a solution, the SRF should be open to all Tier 1 netting members of FICC, understanding that additional regulatory review might be required.³⁰

VIII. Money Market Fund (“MMF”) Liquidity Expansion

MMFs are only permitted to execute repo transactions with counterparties that are rated by one of the top rating agencies, a benefit typically accessible to only larger participants due to the prohibitive cost of obtaining and maintaining a rating from the top tier rating agencies. Thus, independent dealers that are non-rated or rated by an agency other than the top two are precluded from dealing with the MMFs.

Repo transactions with MMFs are over collateralized with U.S. government securities, short in tenure, and held by a AA+ tri-party custodian bank. Therefore, these transactions are extremely low risk. Rating restrictions leave independent broker-dealers unable to intermediate in this segment of the market, which further increases concentration at the large banks and limits MMF liquidity and pricing options. The consequences are clear each month-end when banks shrink their balance sheets and the MMFs are forced to move cash to the Federal Reserve's RRP facility.

²⁶ See Jonnelle Marte, *Fed establishes standing repo facilities to support money markets* (July 28, 2021), <https://www.reuters.com/article/us-usa-fed-standing-repo/fed-establishes-standing-repo-facilities-to-support-money-markets-idUSKBN2EY2OS>.

²⁷ See *FAQs: Standing Repo Facility*, FED. RESERVE BANK OF N.Y. (Mar. 22, 2023), <https://www.newyorkfed.org/markets/repo-agreement-ops-faq>.

²⁸ See *Primary Dealers*, FED. RESERVE BANK OF N.Y., <https://www.newyorkfed.org/markets/primarydealers>.

²⁹ See Sriya Anbil et. al., *What Happened in Money Markets in September 2019?*, FED. RESERVE (Feb. 27, 2020), <https://www.federalreserve.gov/econres/notes/feds-notes/what-happened-in-money-markets-in-september-2019-20200227.html>.

³⁰ See this recommendation in Group of Thirty, *U.S. Treasury Markets: Steps Toward Increased Resilience*, (July 2021), available at https://group30.org/images/uploads/publications/G30_U.S._Treasury_Markets-Steps_Toward_Increased_Resilience_1.pdf.

MMFs will be better served by having additional liquidity sources for their repo cash investments.³¹ Allowing MMFs to execute repo transactions with dealers that are not rated by one of the top two rating agencies could even have the added benefit of releasing some cash in the Federal Reserve's RRP facility. The MMFs should be allowed to look to structure of the transaction including the over collateralized Treasury collateral, the tri-party custodian bank and its rules of engagement, and, when transacting as a Sponsored Member, the credit worthiness of FICC itself, when choosing which counterparties to transact with.

IX. Accounting Transparency

In addition to capital and balance sheet differences between posting margin versus netting of assets and liabilities, as discussed above, another notable accounting issue is accounting for security positions in Held to Maturity ("HTM") portfolios. If Silicon Valley Bank ("SVB") had been required to be a member of FICC through a Central Clearing Mandate, SVB's failure would have further burdened FICC's risk models and CCLF requirements. This could have caused additional midday margin calls, further burdening participant firms. While it is speculative to assume SVB's membership and subsequent failure could have had a contagion effect on other FICC members, the possibility cannot be ruled out.

It is not rational to expect FICC to understand the total credit risk of every sponsoring participant introducing sponsored firms. These global SIFI institutions have proven to be historically difficult to understand and are growing more complex by the day. If SIFI banks become larger participants in a single point of failure CCP like FICC, an extraordinary amount of credit review may be required. Notably, this issue emphasizes the importance of relying on the strength of the collateral using standardized haircuts to accumulate a sizeable first loss position rather than on a participant's capital.

Still, the IDTA believes a review of HTM accounting rules is pertinent. While HTM accounting was appropriate for securities positions at banks in the past, limits on its use now appear warranted. Previously, HTM securities were financed by what was referred to as "core deposits." These were deposits with a long-term track record of being extremely stable and rarely withdrawn; especially after the formation of the FDIC and deposit insurance.³² However, in today's electronic age, tens of billions of deposits can move away from a bank with the click of a button. HTM accounts at financial institutions should be measured first against insured deposits. It is important to understand and ensure that HTM securities can be held to maturity, which may not be possible if they were funded with uninsured deposits. Additionally, insured deposits are not the only source of stable funding, as certain equity and long-term debt could also qualify, and

³¹ Note the wide gap between the tri-party index and the general collateral repo rate during the last week of March. The spread ranged between 8 to 15 basis points. This generates outsized profits at large banks which it only exists because the competition is limited.

³² See Ashley Kilroy, *Understanding Core Deposits*, SOFI LEARN (Aug. 5, 2022), <https://www.sofi.com/learn/content/what-is-a-core-deposit/>.

where HTM securities are pledged at the discount window, that window can also be a stable source of contingent funding.

If there are insured deposits above loan balances, they could cover some specific security assets, like a portfolio reserve for discount window borrowings or other unlikely long-term events. All other security positions should be Marked to Market (“MTM”), especially for members of FICC and their affiliates. The IDTA believes more transparency is better than less in MTM accounting.

X. Primary Dealership Members

Primary Dealers play an important role in Treasury debt management and Federal Reserve monetary policy. They are officially designated by the FRBNY³³ and must demonstrate a record of financial strength and a commitment to help ensure demand for Treasury issuance.³⁴

Historically, the list of Primary Dealers was dominated by the largest banks and non-bank broker dealers. Since the Financial Crisis of 2008, the industry consolidated and most Primary Dealers are now a part of bank holding companies.³⁵ However, there remain many non-bank affiliated, independent and minority-owned broker-dealers that are active and important participants in the Treasury and repo markets, but which are not Primary Dealers.³⁶

The number of Primary Dealers has decreased over the past 35 years.³⁷ Ironically, during that same time, the amount of U.S. Treasury debt increased nearly twelve-fold.³⁸ In 1988, the amount of Treasury securities outstanding was \$2.6 trillion, and the high water-mark of Primary Dealers reached 46.³⁹ Today, there is \$31 trillion of U.S. Treasury debt outstanding and there are only 24 Primary Dealers—48% lower than in 1988.⁴⁰ Arguably, the lack of diversification in the number of intermediaries in the U.S. Treasury market contributed to the “flash crashes” of October 2014 and February 2021.

The U.S. Treasury and the FRBNY should expand the Primary Dealer program to include more “non-bank” registered broker dealers. This will help ensure a broader range of diverse and

³³ See *id.*

³⁴ See *Primary Dealers*, FED. RESERVE BANK OF N.Y., <https://www.newyorkfed.org/markets/primarydealers>.

³⁵ See Eric S. Rosengren, *Risk of Financial Runs – Implications for Financial Stability* (Apr. 17, 2013), <https://www.bostonfed.org/news-and-events/speeches/risk-of-financial-runs-ndash-implications-for-financial-stability.aspx>.

³⁶ See *Historical Primary Dealers Lists*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/medialibrary/media/markets/Dealer_Lists_1960_to_2014.xls.

³⁷ See *id.*

³⁸ See *Historical Debt Outstanding*, FISCALDATA.TREASURY.GOV, <https://fiscaldata.treasury.gov/datasets/historical-debt-outstanding/historical-debt-outstanding> (last updated Oct. 4, 2022).

³⁹ See *id.*; see also *Historical Primary Dealers Lists*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/medialibrary/media/markets/Dealer_Lists_1960_to_2014.xls.

⁴⁰ See *Historical Debt Outstanding*, TREASURY.GOV, <https://fiscaldata.treasury.gov/datasets/historical-debt-outstanding/historical-debt-outstanding> (last updated Oct. 4, 2022); *Historical Primary Dealers Lists*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/medialibrary/media/markets/Dealer_Lists_1960_to_2014.xls.

competitive participants in both the primary and secondary markets to always maintain more consistent and deeper liquidity.

To continue to attract private capital into the U.S. Treasury market, the IDTA suggests that the Treasury and the FRBNY reinstate the category of “aspiring dealer.” This will provide greater diversity and breadth of market participants. For decades, there was a group of “aspiring dealers” that did not all meet the requirements to achieve designation by FRBNY, but could demonstrate sound creditworthiness, among other qualifications, enough to be recognized as an aspiring dealer.⁴¹ In 1992, all Primary Dealers were required to maintain at least a one percent share of total customer activity, which was difficult to meet for aspiring dealers⁴² and when the FRBNY eliminated the market share requirement they concluded that there was no longer a need for an “aspiring dealers” category.⁴³ In the years since the elimination of the category, the market became less diverse and the number of Primary Dealers decreased. In 1992 there were 39 Primary Dealers and today there are only 24.⁴⁴ Increasing the number of Primary Dealers and reinstating the aspiring dealer category would improve liquidity and competition in the market.

XI. Conclusion

There are significant competitive advantages that SIFI banks will receive, to the detriment of smaller and middle market dealers, if Treasury market reforms are implemented as a “quick fix” by utilizing the current Sponsored Program with no corresponding amendments to the Program. The SEC pending Central Clearing Mandate proposal, as currently proposed and understood, makes the Treasury and repo markets more concentrated and less competitive. Though generally supportive of the implementation of central clearing, the IDTA believes that the suggestions described above and summarized below will enhance the current SEC Central Clearing Mandate proposal, and help to better accomplish the SEC’s goals of creating a more stable market and reducing market risk.

Proposed Reforms:

- To change the discriminatory bias in the current measure of risk being based on the size of the clearing member and not the quality of the collateral in the transaction, replace the current ECP with a standardized industry repo haircut requirement, so all FICC members are obligated to charge clients standard haircuts. This will not only help ensure a more competitive environment across markets, but within the FICC sponsored program specifically. Furthermore, that competition will ensure that the result of increased central

⁴¹ See U.S. GAO, Rep. to the Cong., U.S. Government Securities: An Examination of Views Expressed About Access to Brokers’ Services 15 (Dec. 1987).

⁴² See Fed. Reserve Bank of N.Y., Operating Policy: Administration of Relationships with Primary Dealers (Jan. 22, 1992), https://www.newyorkfed.org/markets/pridealers_policies_920122.html.

⁴³ See *Historical Primary Dealers Lists*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/medialibrary/media/markets/Dealer_Lists_1960_to_2014.xls.

⁴⁴ See *id.*

clearing does not result in greater concentration of risk among the largest systemically important institutions.

- Approve a common margining program for FICC, where members participating in the MBSD and GSD (FICC) of the Depository Trust and Clearing Corporation (“DTCC”), and the CME can offset their obligations across FICC. It is imperative that this happen prior to implementation of a Clearing Mandate.
- Make CCLF more dependent on the largest banks that create the liquidation risk, rather than disproportionately burdening smaller middle-market dealers.
- The Standing Repo Facility should be open to any Tier 1 netting FICC member.
- Money Market Funds should look to the rating of the collateral, the short tenure transaction, the custodian banks, and FICC when involving repo transactions in U.S. government securities, and not limit transactions to solely institutions that the major rating agencies rate.
- Limit the use of HTM accounting by banks.
- The Treasury and the FRBNY should consider a broader array of bank and non-bank affiliated broker dealers as Primary Dealers, and consider re-introducing the aspiring primary dealer category
- FICC should create an exception for state and municipalities to continue participating bilaterally in the liquidity flows of the U.S. Treasury market. Notably, a similar exception is an alternative that has been in place for Europe, the Middle East and Africa (“EMEA”) transactions with positive results.⁴⁵

The solutions discussed in this paper give regulators the necessary blueprint to create more stable and competitive Treasury and repo markets for the long term and a safe and well managed clearing system.

Sometimes the best decisions for the financial markets are packaged together with other reforms.

⁴⁵ See UK EMIR, FIN. CONDUCT AUTHORITY (May 23, 2016, last updated Jan. 10, 2023), available at <https://www.fca.org.uk/markets/uk-emir>.