Submitted Via Email

September 1, 2023

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

RE: **Release No. 34-95763; File No. S7-23-22; Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule with Respect to U.S. Treasury Securities Fund Advisers**

Dear Ms. Countryman:

On behalf of the Independent Dealers and Trader Association ("IDTA"), I respectfully request that the attached White Paper relating to the Securities and Exchange Commission's ("SEC") Proposed Rule for 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 Number S7-23-22) be included in the comment letter file of the proposed rule as a supplemental comment letter to the IDTA's letter filed on December 27, 2022 (attached to this email transmittal).

The IDTA has distributed this White Paper to Commissioners' offices and key staff of the Commission The members of the IDTA met with Commission staff and were asked whether this White Paper should be included in the Comment Letter file. We agreed that it should. This letter is a follow up to those discussions and an official request that it be included in the Comment Letter file.

While this White Paper is entirely consistent with the Comment letter filed by the IDTA in December, it goes into much great detail on the issues discussed, and, importantly, also lays out specific ways in which the concepts expressed in the IDTA original comment letter can be

efficiently implemented by the SEC to ensure that the implementation of these reforms to the U.S. Treasury Securities market do not result in a market that is less competitive, particularly for smaller and middle market Treasury and Repo dealers. Furthermore, these specific recommendations will also protect against over concentration of risk in the Treasury Market that could increase systemic risk and narrow liquidity to only the largest, systemically important institutions.

It is the view of the IDTA that before finalizing the proposed rule, it is imperative that the final rule and the preamble to the rule address the recommendations outlined in the IDTA White Paper. All of these recommendations are directly related to the proposed rule and its appropriate implementation.

Thank you for your attention to this matter.

Sincerely,

James Tabacchi, South Street Securities LLC
Chairman, Independent Dealer and Trader Association

cc: Honorable Gary Gensler, Chairman
Honorable Hester M. Peirce, Commissioner
Honorable Caroline A. Crenshaw, Commissioner
Honorable Mark T. Uyeda, Commissioner
Honorable Jaime Lizarraga, Commissioner

Haoxiang Zhu, Director, Division of Trading and Markets
Jessica Wachter, Chief Economist & Director, Division of Economic Risk Analysis

Attachments

IDTA White Paper
IDTA December 27, 2022 Comment letter

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 clearing[3] 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 Act[6] 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 2019[9] 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 IDTA[10] 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.

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[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

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[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).

was less than $5 billion, the firm was considered a "Category 2 Sponsoring 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

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[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

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[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

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[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/IDTA+-+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.

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[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

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[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 FRBNY[33] 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

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[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 dealers[42] 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 reinstituting 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 bi-laterally 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.

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[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.

December 27, 2022

SUBMITTED VIA AGENCY WEBSITE

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

Re: Release No. 34-95763; File No. S7-23-22; Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule with Respect to U.S. Treasury Securities Fund Advisers

Dear Ms. Countryman:

The Independent Dealer and Trader Association ("IDTA")[1] appreciates the opportunity to respond to the U.S. Securities and Exchange Commission ("Commission" or "SEC") proposed rule to increase the number of centrally cleared transactions (the "Proposed Rule").[2] The IDTA was founded on the principals of promoting resilient, liquid, safe and competitive U.S. Treasury and repurchase agreement ("Repo") markets. That is not only critical to the U.S. Treasury and U.S. taxpayer to ensure the lowest cost of borrowing, but such goals are essential given the importance of these markets, in particular the Repo market, to the functionality of national and global markets as well as for the implementation of U.S. monetary policy. U.S. Treasury securities also serve as the primary benchmark for the rest of the fixed income markets and the Repo market

[1] The IDTA was formed to create a forum for independent dealers and traders to discuss and consider the impact of market operational issues on their industry sector and to advocate for constructive solutions that promote the liquidity and efficiency of capital markets. The objective of the IDTA is to form an interactive line of communication with regulators and other relevant policy makers, with particular emphasis on the Securities and Exchange Commission, the Treasury Department, and the Federal Reserve Bank of New York. The IDTA is composed of six organizations registered as broker-dealers or futures commission merchants (or affiliates of such organizations) that are not affiliated with a bank holding company. For additional information, visit IDTA's web site: www.idtassoc.com.

[2] Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities, 87 Fed. Reg. 64610 (Oct. 25, 2022), *available at* https://www.govinfo.gov/content/pkg/FR-2022-10-25/pdf/2022-20288.pdf (hereinafter "Proposed Rule").

is the basis of the Secured Overnight Financing Rate (SOFR) Data. It is with those indisputable prerequisites that the IDTA has in the past spoken out about policies that will promote the efficiency, fairness, safety, competitiveness and liquidity of the Treasury and Repo markets. The IDTA has analyzed the Proposed Rule and welcomes the opportunity to provide the SEC comments on these proposed rules.

For the purposes of the Proposed Rule and the comments provided, the IDTA would like to clarify the terminology used to describe certain transactions. The Proposed Rule suggests that bilateral trades are uncleared, however, they are cleared, but not *centrally* cleared. In those instances where the Proposed Rule references only a "clearing" requirement, it should be noted that this is a requirement for transactions to be *centrally* cleared.

I. INTRODUCTION & SUMMARY

Clearing and settlement of financial market transactions is an essential element of safe and efficient financial markets in managing the risk that a trade defaults or fails to settle. Proper margining by the counterparties provides such protection. The actual process of clearing and settlement will vary by the type of transaction. Transactions in equities differ from fixed income, commodities and currency cash transactions. Similarly, cash transactions differ from derivatives and financing transactions.

Within the U.S. government securities markets (Treasury securities and Repos), trades between dealers who are members of the Fixed Income Clearing Corporation ("FICC") are centrally cleared on a *net* basis at the FICC. FICC is the only Treasury market central counter party ("CCP") currently registered with the SEC. IDTA member firms are all members of FICC. The role of a CCP is essentially to become the buyer to every seller and the seller to every buyer, and to properly margin each trade to ensure that the clearinghouse has sufficient resources to settle any failed trades or absorb the failure of a member of the clearinghouse.

Dealer to customer/institutional counterparty trades are generally bilateral between the parties where the counterparties utilize the services of various clearing and custody banks and the Fedwire Securities Service ("Fedwire") operated by the Federal Reserve Banks. In the case of members of the IDTA, their "customer" is an institutional counterparty. Trades intermediated by Interdealer Brokers ("IDB") may be centrally cleared, if the IDB is a member of FICC, or bilaterally cleared through a clearing bank and the Federal Reserve's system Fedwire, or through a hybrid approach. There are also bilateral transactions that are centrally cleared, which Depository Trust and Clearing Corporation ("DTCC")/FICC refers to as the Prime Broker Model.[3] The Prime Broker Model is a dealer-to-institutional counterparty bilateral trade that is given up to FICC as opposed to the bilateral trade being between the dealers and the customer. Although unclear, in the Proposed Rule, this type of trade seems to potentially fit into the policies articulated in the proposed amendments to Rule 15c3-3.[4] However, because the margin in such institutional transactions is assessed through a haircut, as opposed to a separate customer account, the debit

[3] Depository Trust & Clearing Corporation, *How To Access Treasury Clearing as an Indirect Participant* https://www.dtcc.com/USTclearing/how-to-access-treasury-clearing-as-an-indirect-participant.
[4] Proposed Rule at 64637.

provides little substantive relief from the effect of gross margining. As will be explained below, this prioritizes the need to address the issues related to an important and unfortunate aspect of the FICC Sponsorship program, referred to as the Excess Capital Premium ("ECP") charge, that creates a material limitation affecting small and middle market broker dealers' ability to access the Sponsorship program.

Aside from its size and importance to the overall U.S. and global financial systems, another unique hallmark of the Treasury market is the diversity of participants on the sell-side and buy-side. The above examples of the various methods that trades get cleared and settled reflect the need to accommodate the variety of transactions and participants.

While the IDTA believes in the important role that central clearing can play in financial markets, converting the U.S. Treasury and Repo markets completely over to central clearing is a significant and material change that should be considered carefully. The U.S. Treasury and Repo markets are not and should not be confused with the pre-Dodd Frank[5] swaps market. The pre-Dodd Frank swaps market was an unregulated and uncleared market involving less liquid and unique transactions that by their very nature, represented materially different risks of default and failure than the U.S. Treasury and Repo markets.

Supporting central clearing in principal cannot be the basis for imposing a mandate. Before any move toward a central clearing mandate, the SEC and other appropriate government agencies (e.g. U.S. Treasury, Federal Reserve Board of Governors) must conduct more data-based research on how such a policy change will affect the Treasury and Repo markets. In particular, that research must ensure that a move toward central clearing enhances, and does not constrict, liquidity; increases, and does not decrease, competition in the market; and lowers, and does not raise, concentration of risk in the market. The cost of central clearing for dealer to institutional counterparty trades under the Proposed Rule, when compared with alternative clearing methods currently utilized, could materially change the economics of a transaction for institutional investors, which would then negatively affect both liquidity and competition. These risks need to be understood before imposing such a mandate.

Any changes meshing this large market with its diversity of participants in the Treasury market with a regulatory mandate for central clearing will lead to unintended consequences that must be fully understood and avoided, particularly if they could increase the cost of borrowing for the U.S. government, increase concentration of risk in the largest systemically important institutions, and reduce competition, making it harder for smaller and middle market broker dealers to meaningfully participate in this important market.

Before a rule is finalized, it is critically important that all of these issues are analyzed based on data analysis and review. If approved, any implementation plan should be phased and supported by data reviewed by the Interagency Working Group and most specifically the Treasury, the Federal Reserve Board of Governors and the Federal Reserve Bank of New York ("FRBNY"), as those agencies are most closely involved in the Treasury and Repo markets from a debt management perspective, and regarding financial stability and monetary policy. Analyzing this

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203.

data should also include input from a broad array of market participants including institutional investors.

II. IDTA COMMENTS ON PROPOSED RULES

a. Increased Transaction Costs and Margin Requirements

Under the Proposed Rule, FICC would calculate, collect, and hold margin for positions of a direct participant separate from those customers or other indirect participants that are sponsored into the clearing agency.[6] The IDTA is very concerned about how the Proposed Rule will affect the cost and overall economics of dealer to institutional counterparty Repo transactions as a result of additional clearing costs of transacting through FICC and the increase in margin requirements due to mandated central clearing. The ultimate effect of these increased costs can be expected to negatively affect liquidity in the Treasury and Repo markets.

Increased Transaction Costs: It is critical for the Commission to better understand the cost difference between current bilateral trades that are cleared through Bank of New York Mellon (BONYM) and the Fedwire, and an identical transaction that must be centrally cleared. This cost across a volume of trades is borne by the clients. The cost of a bilateral trade clearing through Bank of New York Mellon versus FICC is more than doubled. While this may vary across the IDTA membership, IDTA members are currently paying BONYM about $3.00 for a Fedwire ticket. If, instead, the transaction was centrally cleared through FICC, the cost would exceed $7.00. This is because FICC imposes intraday and end-of-day position management charges, among other charges, making it materially cost prohibitive to transact with FICC and thereby increasing the cost of trading to the end customer.

Increased Margin Requirements: The Proposed Rule imposes a fundamental shift from a system of margining the net position of a member's activity to a system based on gross margin of each individual customer/institutional counterparty of a member. Under the current structure, each dealer executes Repo transactions with their counterparties and in the clearing process, in conjunction with a clearing bank and Fedwire, charges each counterparty margin and effectively nets customer risk internally. The Proposed Rule would require customers to be margined individually and would require FICC to collect margin even where a members' overall customer position is netted. This exponentially increases the margin requirement on all those involved in the U.S. Treasury market. Clients (institutional investors) will be forced to bear a cost burden, which, as mentioned above, changes the economics of the transactions, and which will affect liquidity in the Treasury market and translate into higher costs for the U.S. Treasury to finance its debt. This is a liquidity issue, as the economics of the transactions influence whether a market participant will less inclined to engage in the transactions, reducing liquidity in the Treasury and Repo markets.

In addition, as mentioned earlier, members of FICC have a special margin surcharge if their margin requirement is greater than their capital (the ECP charge). The effect of the application of this ECP on the smaller, independent broker dealers is material. For a broker-dealer operating its

[6] Proposed Rule at 64634.

own business, it is certainly a valid way to limit leverage, however, the ultimate effect of the ECP is exacerbated when customer/institutional counterparty margin is included in the calculation, and the surcharge punitively prevents smaller independent broker-dealers from sponsoring institutional counterparties/customers.

This method of gross margin is utilized currently by FICC under the Sponsored Model. Today, the FICC sponsorship program has 30 sponsoring members and 1900 sponsored members. The volume of sponsored transactions is dominated by the largest banks.[7] Margin is not standard, meaning some banks charge the same margin that they charge in the prime brokerage accounts (i.e. financing the difference themselves), some charge the FICC margin, and others charge a two percent flat rate. The largest firms (defined under the Sponsorship program as firms with $5 billion or more of capital) have essentially unlimited capacity to sponsor counterparties trades. The combination of gross margining and ECP currently in use under the Sponsored Model, and what is prescribed in the Proposed Rule, effectively prevents smaller and middle market broker dealers from materially participating in the Treasury market.

To illustrate the effect of the Proposed Rule's margin approach combined with the FICC ECP rule on members' capital requirements, and on the members' ability to continue to intermediate the U.S. Treasury market, see the below chart. An average middle market firm can currently be operating with $250 million of Net Capital and managing its FICC VAR to be at or below its Net Capital (Scenario 1 or 2 below). Under the Proposed Rule, a member can easily fall into Scenarios 3, 4, or 5—or even worse—without changing its business. Due to the new gross margin requirement, a firm that had a FICC VAR of $200-250 million can easily see its VAR increase to $300-500 million. Even without ECP coming into the equation this is a problem for these firms and will require them to pass on significantly more margin to their customers. However, bringing ECP into the equation exponentially and materially increases the members' FICC margin requirement beyond the actual $300-500 million margin requirement. As illustrated below, this same member operating comfortably currently with $250 million of Net Capital, can end up with a margin requirement of 2-5 times of its current requirement and as high as a $1 billion margin requirement.

[7] Depository Trust & Clearing Corporation, Daily Transactional Data on GSD Sponsored Service (Apr. 22, 2020), https://www.dtcc.com/dtcc-connection/articles/2020/april/22/daily-transactional-data-on-gsd-sponsored-service-now-available.

Scenario	1	2	3	4	5
Net Capital	250,000,000	250,000,000	250,000,000	250,000,000	250,000,000
FICC VAR	200,000,000	250,000,000	300,000,000	400,000,000	500,000,000
Excess VAR over Net Capital	-	-	50,000,000	150,000,000	250,000,000
VAR/Net Capital	0.80	1.00	1.20	1.60	2.00
Excess Capital Premium (ECP)	**-**	**-**	**60,000,000**	**240,000,000**	**500,000,000**
Total VAR Charge	200,000,000	250,000,000	360,000,000	640,000,000	1,000,000,000
VAR in excess of Net Capital	-	-	110,000,000	390,000,000	750,000,000
Multiple of net capital	-	-	0.44	1.56	3.00

The result of this aspect of the Proposed Rule (and the current Sponsorship program) will make it extremely difficult for smaller and middle-market broker dealers to compete with the largest global banks that have unlimited capital and are able to significantly reduce and even eliminate haircuts on trades. With less competition from a wider array of broker dealers, costs to investors will be subject to the will of those systemically important financial institutions. If the goal is to have competitive and diverse liquid markets, the Proposed Rule must be changed to ensure that the punitive and cumulative effect of gross margining and that the ECP does not excessively burden smaller, middle-market broker dealers and their institutional investor customers.

Proposed Options to Participate in Central Clearing: The below chart is indicative of the IDTA's understanding of the different models for Central Clearing that are being considered at present to meet the requirements of the Proposed Rule.

	Margin Netting	**ECP Charge**	**15c3-3 Relief**	**Need to be a Prime Broker**
Sponsored Model	No	Yes	Yes	No
Prime Broker Model	Yes, for customers (not proprietary)	Yes	No	?

As detailed above, under the Sponsored Model, there would be a gross margin requirement by customer/institutional counterparty and the ECP charge would greatly limit the ability of smaller middle-market broker dealers from participating in this market. While 15c3-3 relief is

being provided and is helpful to the market in general, due to the nature of smaller, independent broker dealers' business acting as intermediaries, it does not change anything for them as they may not currently be subject to reserve calculations.

Under the Prime Broker model, which is a give up arrangement, it is unclear if smaller middle-market broker dealers would be able to participate in this model because of the following questions:

- Would the dealer need to register as a prime broker? This would be a lengthy and costly process for middle market broker dealers.
- Even if a firm does not need to be a Prime Broker, it is unclear how this model would work for smaller independent broker dealers. Currently smaller independent broker dealers act as counterparties to their institutional customers. Under the Prime Broker Model, they would not be a counterparty, rather, the customer would trade directly with the third party and the trade would be given up to smaller independent broker dealer for clearing.
- There is also a question regarding the ability to rehypothecate collateral under the Prime Broker Model.[8] It is the IDTA's understanding that under this model, the dealer would not get a 15c3-3 offset for rehypothecating collateral. How would this apply to smaller and middle-market independent broker dealers that are not currently subject to reserve calculation requirements.

The Proposed rule lacks clarity on these important issues that will materially affect the practical accessibility of the Sponsorship program by smaller and middle market independent broker dealers. Any final rule must be unambiguous that registered clearing agencies need to review policies, like the ECP, to ensure they don't reduce the ability of smaller firms to competitively access the Sponsorship program under the rule.

b. Impact on Competition

Increasing the number of centrally cleared transactions does not sufficiently account for the rising concerns surrounding competitiveness and liquidity in the marketplace. Leveling the playing field among firms is paramount. However, the largest institutions have natural advantages, as well as advantages by virtue of current SEC approved FICC rules that have disproportionately disadvantaged smaller and middle-market broker dealers. This disparity could worsen depending how the Proposed Rule is implemented, if adopted. For example, smaller and middle-market broker dealers have had to shrink their business models as a result of the aforementioned ECP charge that is imposed on such dealers. As previously noted, under the current structure, the ECP is a charge imposed on member firms when their required deposit exceeds its excess net capital. While the ECP charge aims to mitigate default risk that a member could pose, the charge results in small and middle-market dealers being competitively disadvantaged against large institutions.

The need to ensure an adequate competitive environment for small and middle-market independent broker dealers in the Treasury and Repo markets has been the subject of important academic research. In December 2020 two then-former officials of the Federal Reserve Board of Governors (Nellie Liang and Pat Parkinson) wrote in a Brookings Institution research paper about

[8] Proposed Rule at 64645.

liquidity in the Treasury markets that "broader central clearing through a central counterparty clearinghouse (CCP) would increase the supply of liquidity by the largest bank affiliate dealers by easing constraints because bank capital and leverage requirements recognize the risk reduction from multilateral net of centrally cleared trades. The rules of the CCP should be designed to enhance the ability of smaller bank and independent dealers to compete and not further increase the dominant positions of the largest dealers."[9]

Liang and Parkinson added, "To be sure, central clearing raises concerns about concentrations of risk in CCPs and in clearing firms, so expanded clearing would make their regulation even more important."[10]

Consistent with this concern, in 2021, data released by the FRBNY demonstrates the level of concentration in the Repo markets.[11]

As a Whole, Inter-Dealer Activity is not Concentrated

	FICC DVP + GCF Repo		FICC DVP		GCF Repo	
	Top 5 Share (Percent)	Top 10 Share (Percent)	Top 5 Share (Percent)	Top 10 Share (Percent)	Top 5 Share (Percent)	Top 10 Share (Percent)
Cash-lenders	44.2	63.6	45.2	64.8	77.2	95.9
Cash-borrowers	40.2	56.7	41.2	57.5	80.7	95.9
Net-positions	28.4	42.0	28.6	42.0	64.5	85.6

Source: Authors' calculations based on confidential daily data from the OFR repo collection for 2020.

In order to ensure diverse and liquid markets, firms representing all key segments of the market must participate on a level playing field. Small and middle-market dealers should be encouraged to increase their participation in FICC. Nonetheless, FICC rules that are well intended to protect the clearinghouse if a systemically important institution were to fail, in actuality have impaired the ability of smaller and middle-market independent broker dealers to compete. The largest financial institutions have unlimited authority to sponsor clients directly into FICC while middle-market firms must adhere to formulaic limits based on their capital and risk and the application of the ECP. Furthermore, in 2017, FICC established the Capped Contingency Liquidity Facility ("CCLF") obligations, with the objective of maintaining sufficient liquid resources to settle all outstanding transactions of a defaulting FICC member. The CCLF requires all Tier 1 netting member firms to have in place a liquidity plan to provide FICC with financing options should a systematically important financial institution ("SIFI") default. The size and cost

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[9] Nellie Liang and 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.
[10] *Id*.
[11] Federal Reserve Bank of New York, *How Competitive are U.S. Treasury Repo Markets?* (Feb. 18, 2021), https://libertystreeteconomics.newyorkfed.org/2021/02/how-competitive-are-us-treasury-repo-markets/.

of a firm's liquidity plan is tied not only to its own exposure at FICC, but also to the maximum exposure of the largest SIFI banks. IDTA members have reduced their portfolios as part of their CCLF liquidity plans. At the same time, SIFIs have increased the size of their portfolios, and correspondingly, the very risk that the CCLF was designed to reduce.

The IDTA urges the Commission to further review and analyze the effect of the Proposed Rule on competitiveness in the U.S. Treasury and Repo markets. Not doing so would be inconsistent with President Biden's Executive Order on Competition ("Executive Order"), which requires regulators to ensure that current and proposed rules enhance, not hinder, competition in the markets they oversee.[12] The Executive Order utilizes a "whole-of-government approach" to address excessive concentration, abuses of market power, unfair competition, and the effects of monopoly.[13] More specifically, the SEC is identified as one of the agencies whose rules must seek to resist consolidation and promote competition, "including the market entry of new competitors.[14]

Failure to do so could result in the market share of the largest banks continuing to grow—both increasing concentration of risk in the market and reducing competitiveness by increasing barriers for smaller and middle market firms. With less competition investors and counterparties could face less robust pricing as a result.

c. FICC Credit Approval

The IDTA believes that relinquishing control of credit approval to a single entity, FICC, poses a significant problem. Particularly, with all transactions going through FICC and where margin requirements can be changed at any time. Every firm has a different appetites and quantitative and qualitative perspectives as it relates to credit analysis. Such perspectives are part of the professional services and expertise that well-run firms offer. Centralization of the credit analysis and approval, is a one size fits all policy for a very multi-faceted issue. By inserting FICC into the center of the credit approval process, firms lose their ability to apply their deeply informed market views. The ability of IDTA members to differentiate themselves in the market is therefore removed by inserting FICC into the process. Small and middle-market dealers and their clients comprise an important and necessary tier of liquidity, which only grows in importance with the increasing financing needs of the U.S. government and the consumer housing market. Disrupting the traditional market-maker role of a broker dealer in these institutional markets will disproportionately affect middle-market institutional broker-dealers who exist to provide sell-side services to institutional investors that choose not to solely trade through the largest banks. Credit analysis and pricing credit risk are fundamental to those services.

III. TREASURY AND TREASURY REPO MARKET LIQUIDITY

As articulated above related to the effect of the Proposed Rule as a result of the higher cost of central clearing, the IDTA has serious concerns about the effect of the Proposed Rule on liquidity in the Treasury and Treasury Repo markets. This is driven primarily by the cost of the

[12] Exec. Order No. 14036, 86 Fed. Reg. 36987 (July 14, 2021).
[13] *Id*.
[14] *Id*. at 36989.

transactions, and the impact on competition. Within the Economic Analysis sections of the Proposed Rule there is a statement concluding that the Proposed Rule will have a positive impact on liquidity.[15] However, the analysis does little to support such a conclusion. Sole reliance on data from the FRBNY on transactions that are currently centrally cleared only reveals a part of the picture. It is critical to acknowledge and understand how a central clearing mandate will affect the economics of bilaterally cleared transactions that make up a material part of the Repo market. It is undeniable that if, as demonstrated above, the costs of the transactions increase, the economics of the transaction are affected and counterparties may be less willing to execute the trade. If counterparties' willingness to transact declines as a result of the additional costs of central clearing, liquidity in the market can reasonably expected to be adversely affected.

Another important issue that could materially affect liquidity in the Treasury cash and Repo markets, appears to the IDTA as, hopefully, an unintended consequence of the Proposed Rule is the effect that a central clearing mandate will have on state and local governments. IDTA members work extensively with state and local governments on a variety of cash and financing transactions. Investment policies and, *in several circumstances under state statute,* require 102% collateralization from their financial institutions. Central clearing of such trades will trigger a problematic level of margin that could create a conflict with a state or local government's investment policies and, worse, state law. If a firm is receiving cash from states and novating over to FICC, that firm is required to give states and municipalities a haircut. FICC will also charge an additional haircut, which becomes margin punitive. This doubles the collateral that is required and minimizes capital efficiency. This would reasonably affect the economics of the transaction and the level of activity by that state or local government in the Treasury and Repo markets.

Additionally, it is important to appreciate that states and localities are governed by the statute of their state. New York state law and rules of the New York Department of Financial Services are not in a position to govern the investment policies of other states. States will be forced out of the Treasury Repo market to other transactions as a result of the additional costs and conflicts with their investment policies or state law. With such disruption, those transactions may carry additional risks for the state and local governments and also negatively affect liquidity in the Treasury and Repo markets.

IV. CONCLUSION

A one-size-fits-all rulemaking could lead to unprecedented consequences for the markets. Smaller and middle-market independent broker dealers play an important role in providing diversity of liquidity in the market. They are also depended upon to provide critical liquidity during volatile times, such as September 2019 and during the height of the COVID crisis in March 2020 when the largest systemically important institutions were not able to provide such liquidity.[16] Therefore, the Proposed Rule should be amended to unambiguously remove the barriers to entry

[15] Proposed Rule at 64662.

[16] Anbil, Sriya, Alyssa Anderson, and Zeynep Senyuz, *What Happened in Money Markets in September 2019?*, FEDS Notes, Board of Governors of the Federal Reserve System (Feb. 27, 2020), *available at* https://doi.org/10.17016/2380-7172.2527.

and competition that have been described in this Comment Letter. In order to reduce systemic risk in the Treasury and Repo markets, there must be greater diversity of market participants.

While conceptually, increasing the number of centrally cleared transactions on its own, can lessen certain counterparty risk, before mandating central clearing, it is absolutely critical to conduct data-supported research on how such a mandate would affect liquidity, costs and competitiveness of the market. Furthermore, how such a policy is implemented is critically important not only to lessening risk in the market, but also to ensuring that such policies result in more, not less, competition and less, not more, concentration of risk in the market.

Other issues must be reviewed before finalizing and implementing the proposed rules, for example, the single point of failure created by central clearing. Any concentration of risk is compounded by the concentration risk by just one of these large systemically important financial institutions. Concentration of risk is also, by definition, anti-competitive, and thus inconsistent with the goals of Dodd–Frank Wall Street Reform and Consumer Protection Act.

Clearinghouse rules can directly affect the competitiveness of the markets. Rules that provide a competitive advantage to the largest, systemically important institutions through the application of well-intended, but one-size-fits-all policies will both increase concentration risk in the market and narrow diversity of liquidity in the U.S. Treasury market at a time when more diverse liquidity is needed. Furthermore, such policies make it increasingly harder for small and independent broker dealers to compete. Until there is greater clarity on the impact of mandatory central clearing, and until the SEC proposed rules on clearinghouse governance and conflicts of interests are finalized, it is difficult to assess how a central clearing mandate would be implemented.

It must be fully recognized that it will take significant time to conduct adequate data-driven research on a central clearing mandate. There also must be sufficient lead time and coordination with other regulators (i.e., the Interagency Working Group, certain state regulators) to understand more fully how such a wile would affect the Treasury and Repo markets. Finally, the Commission must recognize that the operational and technology issues related to expanding central clearing in the Treasury and Repo markets require time. This is particularly true given that DTCC is currently implementing a major technology project to shorten the settlement cycle to T+1.

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The Proposed Rule has significant implications for all market participants. As previously noted, we urge the Commission to consider how the Proposed Rule will shift the current market structure and further inhibit competition. The IDTA thanks the Commission for considering our comments. Should you have any questions, please contact our outside regulatory counsel, Micah Green at Steptoe & Johnson LLP at mgreen@steptoe.com.

Sincerely,

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