IDTA

April 16, 2019

<u>SUBMITTED VIA E-MAIL</u>

Christian Sabella
Deputy Director, Division of Trading and Markets
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: <u>File No. SR-FICC-2018-013</u>; Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change to Expand Sponsoring Member Eligibility in the Government Securities Division Rulebook and Make Other Changes

Dear Mr. Sabella:

The Independent Dealer and Trader Association ("IDTA")[1] has reviewed the Securities and Exchange Commission's ("Commission") approval order of the Fixed Income Clearing Corporation's ("FICC") proposed rule change to expand the Sponsored Membership Program.[2] While the Commission made an effort to address some of the IDTA's comments,[3] the responses do not address the crux of our concern. That is, the expanded Sponsored Membership Program is likely to increase systemic concentration risk in the market generally, and to FICC in particular. We hope to use this letter to establish a dialogue with you and to encourage you to monitor the effects of the program and address any adverse consequences that may occur.

The subtext of the approval order is that the Sponsored Membership Program, by expanding access to certain non-bank FICC members (i.e., "Category 2 Sponsoring Members"), can only benefit the repo market. However, the reliance on this element of the proposed rule change suggests that the Commission failed to adequately consider how the ability of a

[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 SEC, the Treasury Department, and the Federal Reserve Bank of New York. The IDTA is composed of nine organizations registered as broker-dealers or futures commission merchants (or affiliates of such organizations) that are not affiliated with a bank holding company. A list of current IDTA membership can be viewed at https://www.idtassoc.com/.

[2] Securities Exchange Act Release No. 34-85470 (Mar. 29, 2019), 84 Fed. Reg. 13328 (Apr. 4, 2019) ("Approval Order"), *available at* https://www.govinfo.gov/content/pkg/FR-2019-04-04/pdf/2019-06527.pdf.

[3] Letter from James Tabacchi, Chairman, Independent Dealer and Trade Association, dated January 22, 2019, to Brent J. Fields, Secretary, Commission, *available at* https://www.sec.gov/comments/sr-ficc-2018-013/srficc2018013-4844303-177209.pdf.

Sponsoring Member to net positions of its Sponsored Members – even those positions that are not directly facing the Sponsoring Member – can lead to dramatic increases in concentration. Thus, it is not surprising to the IDTA that early reports of the expanded Sponsored Membership Program highlight its use by *J.P. Morgan*.[4] Before the rule change, any activity by a Category 1 Sponsoring Member's Sponsored Members could only be netted if the activity was directly offset by other positions with Sponsored Members or by trades novated to FICC within the Sponsoring Member. With the rule change, that same Category 1 Sponsoring Member and its non-bank broker-dealer affiliates can net repo activity among all of their Sponsored Members regardless of who they traded with, including other FICC Netting Members away from the Category 1 Sponsoring Member or any of its affiliates. This increases settlement risk exposures to FICC at the same time as it reduces the Sponsoring Member's Individual Total Amount, the maximum CCLF funding obligation, which was actually designed to address liquidity risks.

The Commission seems to acknowledge this risk, but somehow believes that it can be managed entirely through margin (or that the effects of such increased concentration are irrelevant).[5] The IDTA reminds the Commission that margin has not always proven sufficient. One simply has to look to the numerous revisions of the margin system, including the rapid implementation of Margin Proxy in April 2017,[6] and the complete overhaul of the Required Fund Deposit calculation in January 2018.[7] There also was the creation of the Capped Contingency Liquidity Facility ("CCLF") in November 2017.[8] As you know, the CCLF was created to address the liquidity risks to FICC in the event of a default of a Netting Member or family of affiliated Netting Members to which FICC has the largest exposure ("Cover 1 Liquidity Requirement"). In approving the CCLF, the Commission acknowledged the inadequacy of margin as a means of addressing risks to FICC when it stated:

> In the event of a Netting Member default, which itself could deplete the relevant portion of the clearing fund, FICC's resultant liquidity needs could alone exceed the amount available in the [Government Securities Division] clearing fund. In

[4] *See, e.g.*, *Expanded DTCC Sponsored Service Gains Immediate Traction in Evolution of the Treasury Market*, DEPOSITORY TRUST & CLEARING CORPORATION ("DTCC") (Apr. 4, 2019), http://www.dtcc.com/news/2019/april/04/expanded-dtcc-sponsored-service-gains-immediate-traction-in-evolution-of-the-treasury-market; Joe Parsons, *JP Morgan Clears First Repo Under New DTCC Sponsor Programme*, THE TRADE (Apr. 5, 2019), https://www.thetradenews.com/jp-morgan-clears-first-repo-new-dtcc-sponsor-programme/.

[5] *See* Approval Order, *supra* note 2, at 13331 ("[A]lthough the greater activity in a Sponsoring Member Account would likely increase the exposure to FICC from a Netting Member default, FICC would help account for this risk by individually margining each Sponsored Member.").

[6] Securities Exchange Act Release No. 34-80484 (Apr. 19, 2017), 82 Fed. Reg. 19136 (Apr. 25, 2017), *available at* https://www.govinfo.gov/content/pkg/FR-2017-04-25/pdf/2017-08282.pdf ("Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Establish Effective Date of Government Securities Division Margin Proxy Rule Changes").

[7] Securities Exchange Act Release No. 34-82588 (Jan. 26, 2018), 83 Fed. Reg. 4687 (Feb. 1, 2018), *available at* https://www.govinfo.gov/content/pkg/FR-2018-02-01/pdf/2018-01949.pdf.

[8] Securities Exchange Act Release No. 34-82090 (Nov. 15, 2017), 82 Fed. Reg. 55427 (Nov. 21, 2017) ("CCLF Approval"), *available at* https://www.govinfo.gov/content/pkg/FR-2017-11-21/pdf/2017-25145.pdf.

addition, the composition of the clearing fund, including the cash component, varies over time in a manner not related to FICC's liquidity risk exposures.[9]

The extent to which the Commission believes that risks from increased concentration from the Sponsored Membership Program can be managed by margin and/or the CCLF require further re-examination. Focusing on the CCLF, the IDTA believes that the dramatic increase in the peak CCLF requirement reflects the growing risks to FICC from further concentration of repo activity in the largest firms. The increase in FICC's combined Cover 1 Liquidity Requirement and Liquidity Buffer – from $56 billion in June 2017 to $115 billion in April 2019 – is illustrative:

Date	**Total Liquidity Requirement**
6/30/2017	$55,549,545,605
12/31/2017	$54,730,864,493
5/15/2018	$58,332,336,416
11/14/2018	$57,585,081,573
12/31/2018	$90,099,846,657
4/8/2019	$114,522,898,038

Such increases are contrary to what was understood when the CCLF was adopted. At the time, FICC represented that the program was structured to "incentivize" Netting Members to manage their liquidity needs and thereby limit FICC's Historical Cover 1 Liquidity Requirement.[10] Since then, not only has its top line liquidity requirement grown in absolute terms, but FICC has determined that the Liquidity Buffer, initially set at 20 percent,[11] is no longer adequate. On January 24, 2019, FICC announced it was raising the Liquidity Buffer to 30 percent, the top end of the range per the rule filing.[12] The Commission should be carefully monitoring this situation.[13]

The collateral consequences of the spike in FICC's Cover 1 Liquidity Requirement, which were in motion even before the increased concentration risks from the expanded Sponsored Membership Program, have the potential to intensify as smaller firms take greater measures to reduce their CCLF exposure. At the time it was adopted, the Commission found that the CCLF did not impose any unnecessary or inappropriate burden on competition, in part because of the tiered approach to allocating CCLF liabilities:

[9] *Id.* at 55435.

[10] *Id.* at 55433 n120.

[11] *Id.* at 55429.

[12] *Government Securities Division's Capped Contingency Liquidity Facility® (CCLF®) – Changes to the Liquidity Buffer and Look-Back Period - Effective as of February 8, 2019*, DTCC (Jan. 24, 2019), http://www.dtcc.com/Globals/PDFs/2019/January/24/GOV578-19.

[13] The IDTA also notes that there does not appear to be any rule-based constraint on FICC's ability to further increase the Liquidity Percentage. *See* FICC Government Securities Division Rulebook at Rule 1 (definition of "Liquidity Percentage").

> The Commission believes these features of the proposal address concerns that the CCLF would force smaller Netting Members to subsidize the "outsized liquidity risks" posed by the largest Netting Members. Additionally, by placing higher CCLF obligations on Netting Members that present greater liquidity needs, the proposal also addresses the concerns that the CCLF does nothing to limit the growth of FICC's liquidity requirements.[14]

But as FICC's Cover 1 Liquidity Requirement steadily increases, the burdens faced by Netting Members who exceed the $15 billion liquidity threshold increase in a manner disproportional to the risks they present to FICC. When the CCLF was first adopted, each time a Netting Member exceeded the $15 billion threshold, its supplemental CCLF obligation increased by $15 million. Today, with the significantly larger Cover 1 Liquidity Requirement of over $90 billion, each incident of a breach of the liquidity threshold increases a firm's supplemental CCLF obligation by just under $35 million (or an increase of 125%). The incremental costs to Netting Members from this top line growth of liquidity risk to FICC is intensifying concentration risks, as firms manage their books to avoid the punitive and disproportionate effects from breaching the liquidity threshold.[15] Instead of acknowledging the ways in which the CCLF is not working as intended using data readily available to the staff, the Commission doubled down by using the CCLF as part of its rationale for approving the expanded Sponsored Membership Program.[16]

In other respects, the Commission's approval order discounted the potential negative effects from increased concentration with speculative or conclusory statements of how the expanded pool of Sponsoring Members would benefit the U.S. repo market:

- "[I]ncreased trading activity through the expanded Sponsored Membership [P]rogram *could help* (i) lower the risk of diminished liquidity in the U.S. repo market . . . (ii) protect against fire sale risk . . . and (iii) decrease settlement and operational risk . . .";[17] and

- "By expanding the types of entities that are eligible to participate and thereby benefit from FICC's guaranteed settlement, novation, and independent risk management, the proposal would help mitigate the risk of a large-scale exit by such firms from the U.S. repo market in a stress scenario and, thus, help lower the risk of a liquidity drain in such a scenario."[18]

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[14] CCLF Approval, *supra* note 9, at 55438.

[15] Though outside the scope of this letter, the fact that the liquidity threshold is a static $15 billion, while the Cover 1 Liquidity Requirement has more than doubled, may evidence a fundamental flaw in the design of the CCLF. While much was made of incentives to reduce liquidity risk to FICC, the CCLF does not appear to adequately constrain the risks presented by its largest members.

[16] Approval Order, *supra* note 2, at 1331-32 (finding no competitive burden imposed by the proposed changes based on the Commission's "belief" that FICC "appropriately sought to mitigate the relative burdens on Netting Members" through implementation of the CCLF).

[17] *Id.* at 13330 (emphasis added).

[18] *Id.* at 13331. The reference to "expanding the types of entities" here is misguided inasmuch as the rule change only permits additional FICC members to allow access to central clearing. No evidence has been presented showing that allowing additional firms to be Sponsoring Members will expand the universe of money market funds accessing FICC.

However, neither FICC nor the Commission provided any evidence or reasoned basis for these assertions. As you know, in a proposed rule change, the "burden to demonstrate that a proposed rule change is consistent with the [Securities Exchange Act of 1934] and the rules and regulations issued thereunder . . . is on the self-regulatory organization that proposed the rule change."[19]

In the one instance where the Commission referenced data in support of its approval order, it cited the "exponential growth" of money market funds into FICC when the Sponsored Membership Program was first adopted.[20] Yet, in citing this data, neither the Commission nor FICC explained how the program benefitted the repo market. Rather, FICC characterized the benefits of this growth as increasing the *income* of firms that participate in the Sponsored Membership Program.[21] Increasing the income of FICC members who are banks is not a standard for approving a rule change under Section 17A of the Securities Exchange Act of 1934.

Despite these serious deficiencies in the reasoning underlying the approval order, the Commission still has the opportunity – and, in fact, has the responsibility – to ensure that the rule change does not further impair the repo market. The recent dislocations in the market that took place during year-end[22] show signs of deterioration in the liquidity of the repo market and symptoms that will be exacerbated by increased concentration. The Commission is in a position to root out the cause (or causes) by looking more closely at FICC's new rules, including the expanded Sponsored Membership Program. Careful oversight of FICC and a corresponding analysis of the effects of the Sponsored Membership Program will mitigate and alleviate any adverse consequences of the program's expansion.

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[19] 17 C.F.R. 201.700(b)(3).

[20] Approval Order, *supra* note 2, at 1331 ("[P]rior expansion of the Sponsored Membership [P]rogram provides insight into the likely effect of future expansions of the program. Specifically, prior expansion has led to exponential growth in incremental cash investment in FICC.").

[21] Letter from Murray Pozmanter, Managing Director, DTCC, dated February 4, 2019, to Brent J. Fields, Secretary, Commission, at 8, *available at* https://www.sec.gov/comments/sr-ficc-2018-013/srficc2018013-4872522-177408.pdf.

[22] *See* Alex Harris, *Eye-Popping Surge in Repo Rate Blamed on Rules Instead of Funding Stress*, BLOOMBERG (Jan. 2, 2019), https://www.bloomberg.com/news/articles/2019-01-02/eye-popping-repo-surge-blamed-on-rules-instead-of-funding-stress.

The IDTA thanks the Commission for considering our comments. Should you have any questions, please contact me at [redacted] or [redacted].

Sincerely,

James Tabacchi
Chairman
Independent Dealer and Trader Association

CC: Jeffrey S. Mooney, Associate Director, SEC Division of Trading and Markets
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