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SEC Adopts Treasury Clearing Rules

Regulatory & Compliance on **January 3, 2024**

On December 13, 2023, the Securities and Exchange Commission ("SEC") adopted new rules that will have the effect of requiring central clearing of a broad range of cash transactions and repurchase transactions in U.S. treasury securities ("U.S. Treasuries"). [1] The new rules will require covered clearing agencies ("CCAs")[2] to adopt policies and procedures requiring their direct participants to clear all "eligible secondary market transactions" in U.S. Treasuries. Almost all repurchase and reverse repurchase transactions in U.S. Treasuries (collectively "repos") entered into by funds or institutional investors are done with direct participants of a CCA resulting in most repos being submitted to the CCA for clearing. Among other changes, the new rules also require a CCA to hold margin for its direct participants' proprietary trades separate from margin for customer transactions.[3] The SEC has stated that the new rules are intended to increase the safety and efficiency of trading in U.S. Treasuries, reduce costs, and mitigate the potential for a single market participant's failure to destabilize other market participants or the financial system.

What Treasury Transactions are Required to be Cleared?

All "eligible secondary market transactions" in U.S. Treasuries where one of the parties to the transaction is a direct participant in a CCA must be submitted for clearing. Direct participants are entities that are members of a CCA such as banks and broker-dealers. Entities that rely on a direct participant to clear and settle their U.S. Treasury transactions with covered clearing agencies (e.g., money market funds, asset managers, institutional investors, and smaller banks or broker-dealers) are generally considered to be customers of the CCA member and not direct participants themselves.

Eligible secondary market transactions in U.S. Treasuries include:

- Repos collateralized by U.S. Treasury securities where a CCA member is a party to the agreement.

- Cash purchases or sales between a CCA member that is an interdealer broker (someone who “brings together multiple buyers and sellers using a trading facility (such as a limit order book) and is a counterparty to both the buyer and seller in two separate transactions”) and any counterparty.
- Cash purchases or sales between a CCA member and a registered broker-dealer, government securities dealer or government securities broker.

Of note, following comments from industry participants on the original rule proposal in 2022, the SEC did not include cash purchases or sales with hedge funds or leveraged accounts in the final definition of “eligible secondary market transaction.”

Eligible secondary market transactions do **not** include:

- Initial sales of U.S. Treasuries.
- Repos between a direct participant and an affiliate (subject to certain conditions). While inter-affiliate repos are excluded from the clearing mandate, affiliates of direct participants are required to clear all repos.
- Repos between a direct participant and a CCA providing clearing services or a derivatives clearing organization.
- Repos between a direct participant and a state or local government or agency (but not state pensions or retirement plans).
- Repos or any cash purchase or sale transaction in U.S. Treasuries between a direct participant and a central bank, sovereign entity, international financial institution or a natural person.

Margin for Cleared Transactions

The new rules also impact how margin, with respect to transactions in U.S. Treasuries, is collected, held, and accounted for. CCAs will be required to segregate customer margin from the margin posted by direct participants for their proprietary trades. The new rules also amend Rule 15c3-3a to allow broker-dealers to include any margin that is required and on deposit at a CTA to be included as a debit in the customer reserve formula. This will have the effect of allowing broker-dealers to use the margin collected from customers to satisfy the customers' margin requirements with respect to cleared transactions in U.S. treasuries. Previously, broker-dealers used proprietary funds to finance customer margin, increasing costs to customers. With respect to the clearing model, the SEC declined to require CCAs to adopt the "legally segregated, operationally comingled" model currently used by derivatives clearinghouses. The SEC noted that CCAs do not currently provide this type of segregation and that customer positions in cash securities and listed options would be eligible for protection under SIPA. Cleared transactions will be subject to mandatory margin requirements and CCA mandated margin haircuts. Finally, the SEC restated the importance of risk management standards that are applied uniformly and objectively to all market participants.

When do these Rules Become Effective?

The SEC is adopting different compliance dates for different aspects of the new rules. CCAs will be required to comply with the segregation of customer margin, access to the clearing house, and customer protection rules by March 31, 2025. Cash market transactions in U.S. Treasuries will be required to be cleared beginning December 31, 2025, while repos will be subject to clearing beginning June 30, 2026.

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[1] *See* 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 *available at* https://www.sec.gov/rules/2022/09/standards-covered-clearing-agencies-us-treasury-securities-and-application-broker#34-99149.

[2] Currently the Fixed Income Clearing Corporation is the only CCA that clears U.S. Treasuries and Treasury repurchase transactions.

[3] The new rule also requires a CCA to ensure it has appropriate means to facilitate access to clearance and settlement of the eligible secondary market transactions in U.S. Treasury securities and makes changes to the reserve formula in the customer protection rule.

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