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SEC Tackles Treasury Market Risk With New Clearing Mandate

By **Law360 Staff**

Law360 (December 13, 2023, 8:40 PM EST) -- The U.S. Securities and Exchange Commission on Wednesday finalized rules to require central clearing for a broader set of U.S. Treasury securities transactions in a bid to reduce systemic risk in the $26 trillion market**,** though some have raised concerns as to whether the move could introduce new risks.

The vote at an SEC meeting came in on a 4-1 split, with Republican Commissioner Hester Peirce declining to support the measure. The new rules will require hedge funds and other trading firms to centrally clear certain secondary market transactions in Treasuries, including repurchase and reverse repurchase agreements.

This involves sending trades to a clearinghouse in which counterparties post margin to guarantee a trade's execution in order to prevent a default. For U.S. Treasuries, the chief clearing agency is currently the Fixed Income Clearing Corp., a subsidiary of the Depository Trust & Clearing Corp.

SEC Chair Gary Gensler said the new rules will help curb risk in a critical corner of the securities market that largely does not undergo central clearing. He cited data that says as much as 80% of repurchase and reverse repurchase transactions, or repos, in U.S. Treasuries are not centrally cleared, and that an even larger volume of cash Treasury transactions aren't centrally cleared.

"The $26 trillion Treasury market — the deepest, most liquid market in the world — is the base upon which so much of our capital markets are built," Gensler said in a statement. "I am pleased to support these rules because they will help to make the Treasury market more efficient, competitive, and resilient."

The rules were proposed in September 2022 following years of change in the marketplace that led to fewer transactions being subject to central clearing, including the rise of principal trading firms and hedge funds that don't clear their trades. Gensler on Wednesday noted that the volume of repo transactions "has grown significantly in the last few years," with daily transaction volumes being in the range of $4 trillion a day as of the second half of last year.

On top of the marketplace changes, regulators have pointed to events in recent years, including a September 2019 spike in the Treasury repurchase market and the volatility at the start of the coronavirus pandemic in March 2020, as a sign stronger guardrails are needed.

The new clearing requirements apply to all eligible secondary market transactions, unless the counterparty is a state or local government or another clearing organization or the repurchase agreement is a transaction between affiliates, the SEC said.

Other updates include how margin is handled. Under the final measure, firms won't be able to net their customers' positions against their own proprietary positions when posting margin in the clearinghouse, Gensler said. "This will better protect customers as well as the clearinghouse itself," he said.

But the final rules will also allow broker-dealers to post customer margin that they collect to the clearinghouse, Gensler said. "Allowing such rehypothecation helps both protect customers and free up broker-dealers' resources," he said, adding that this is similar to how margining operates in the swaps, options and derivatives markets.

With respect to monitoring for systemic risk, central clearing could help by giving regulators insight into how much risk and leverage is embedded in Wall Street's Treasuries holdings, noted Stephen Evans, chief investment officer of Pave Finance Inc.

"If most of these transactions are cleared through a central entity, then there will be greater clarity on risks taken and the types of actions that central banks could take that might cause disruptions. This would be another mechanism that is intended to mitigate systemic risks," Evans said in an email.

Peirce, the sole dissenting vote at Wednesday's meeting, said the SEC's approach to the final rule could actually create new challenges, and said she would have taken a more incremental approach to central clearing as a result.

She noted that many public commenters raised concerns that moving straight to mandatory clearing could disrupt the markets, for instance by potentially impacting liquidity or transaction costs. They also had concerns about whether the Fixed Income Clearing Corp. and its sponsoring members have the ability to support additional clearing.

She warned that the SEC is committing itself to mandatory clearing "with no brakes or off-ramps in the event the market takes a bad turn."

"With this final rule, the Commission insists that the market move toward clearing on autopilot, with no clear means of seizing the wheel if things go awry," Peirce said.

Morgan Lewis Bockius LLP partners Ignacio Sandoval and Penny Christophorou noted some of these concerns, as well.

"Today's rules are in many ways meant to address systemic risk in the Treasury markets," Sandoval and Christophorou said in an email. "However, there are concerns that these collective reforms may be too soon and too fast such that systemic risk may be reduced — not as a result of these reforms — but as a result of potentially less liquidity as market participants reassess their roles in the market and operational delays associated in getting these reforms implemented."

There could be dissent elsewhere. In an email, Jay Gould, special counsel at Baker Botts, noted that the new rules require brokers to compute net cash positions that carrying brokers owe on a daily as opposed to weekly basis.

But if one of these brokers were to fail financially, it would cause "substantial disruption" in the market and hurt customers of other brokers that have funds and securities with the failed broker, he said.

"We will see whether the industry attempts to block this rule amendment as being 'arbitrary and capricious' and a violation of the Administrative Procedure Act, a strategy that the industry has used to vacate other recent SEC rulemaking activity," Gould said.

The final rule will be implemented over the next two-and-a-half years, Gensler said, with clearinghouses set to propose and adopt rules on customer clearing in the next 15 months. Following that, eligible cash trades will be required to be centrally cleared by the end of 2025, and repos to be centrally cleared by mid-2026.

Gould called this timeline and process an interesting facet of the final rule. "Because clearing agencies are self-regulatory organizations that will likely need to propose their own rules to be consistent with this SEC rule, the SEC will need to approve these new SRO rules before they can take effect," he said.
