Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

December 4, 2023

Via Electronic Mail: rule-comments@sec.gov

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Proposed Rules Regarding 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 No. S7-23-22; RIN 3235–AN09

Dear Ms. Countryman:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") on the above-captioned proposed rule ("**Proposed Rule**").[2] This letter supplements comments the MFA previously submitted on the Proposed Rule on December 21, 2022 ("**December Comment Letter**").[3]

The U.S. Treasury markets are the largest and most liquid markets in the world. Treasuries are both the primary debt instrument for the U.S. government and a foundation of the global financial system. The resilience of these markets is critical to financial stability and economic prosperity, and the diversity of participants in the market fuels its resilience. While there is more work to be done to improve the resiliency and efficiency of the Treasury markets, it is critical that policymakers do not blindly tinker with its underpinnings before understanding the

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[1] MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Proposed Rules Regarding 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) ("**Proposing Release**"), *available at*: https://www.govinfo.gov/content/pkg/FR-2022-10-25/pdf/2022-20288.pdf.

[3] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (Dec. 21, 2022), available at: https://www.sec.gov/comments/s7-23-22/s72322-20153289-320728.pdf.

consequences of significant modifications. As has long been true, Treasury market structure is better when it is modified thoughtfully and incrementally, minimizing as much as possible negative, unintended impacts to liquidity and efficiency while maximizing resilience.[4]

MFA supports the Commission's intent to strengthen the U.S. Treasury markets by modernizing market architecture to account for the significant increase in the size of the market over the last several years and to mitigate the vulnerabilities in market functioning highlighted by recent market events.[5] For example, we support the Commission's proposed amendments to increase operational transparency, system integrity, and regulatory oversight of alternative trading systems ("**ATSs**") that trade government securities or repurchase and reverse repurchase agreements ("**repos**") on government securities,[6] as well as regulatory proposals to increase both regulatory and post-trade transparency in the Treasury markets.[7] We further support the development of voluntary central clearing in the dealer-to-customer segment of the Treasury markets for both secondary cash market transactions and repos.[8] Provided the market infrastructure is more fully developed (as discussed below), we believe expanded central clearing will enhance market resiliency, lead to greater market transparency and liquidity, and reduce credit and operational risks. It also will benefit investors and market participants by allowing them to more efficiently deploy resources and capital by netting offsetting transactions and have access to market-wide protections provided by a clearinghouse's default management framework.

While we support the goal of increasing central clearing, we believe the benefits of central clearing will be undermined if the Commission rushes forward with a clearing mandate

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[4] *See* MFA, *Role of Alternative Asset Managers in the Treasury Markets* (Nov. 2023), available at: https://www.managedfunds.org/wp-content/uploads/2023/11/MFA-Treasury-Markets-Primer.pdf (attached as Appendix to this letter).

[5] *See, e.g.*, MFA, *2022 Market Structure Recommendations: Promoting Fair, Efficient, and Transparent Markets* (April 2022), available at: https://www.managedfunds.org/wp-content/uploads/2022/04/MFA-Market-Structure-Recommendations.pdf.

[6] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Vanessa Countryman, Secretary, SEC (Apr. 18, 2022), available at: https://www.sec.gov/comments/s7-02-22/s70222-20123993-280134.pdf.

[7] *See* Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Brian Smith, Deputy Assistant Secretary for Federal Finance, Department of the Treasury (Aug. 26, 2022), available at: https://www.managedfunds.org/wp-content/uploads/2022/09/MFA-Comment-Letter-Treasury-RFI-as-submitted-on-8.26.22.pdf (supporting additional post-trade transparency of data regarding secondary market transactions of Treasury securities); Letter from Jennifer W. Han, Executive Vice President, Chief Counsel & Head of Global Regulatory Affairs, MFA, to Michael Passante, Chief Counsel, Office of Financial Research, U.S. Department of the Treasury (Mar. 10, 2023), available at: https://www.managedfunds.org/wp-content/uploads/2023/03/Final-MFA-Comment-Letter-on-OFR-Proposal-on-Repo-Transparency-As-submitted-on-3.10.23-.pdf (expressing support for improving data collections in the repo marekt by regulators to help them identify and monitor risks to financial stability).

[8] *See* MFA, *2022 Market Structure Recommendations*, *supra* note 5.

before addressing the shortcomings in the existing clearing ecosystem. To this end, we recommend the Commission carefully consider whether the clearing ecosystem is sufficiently developed to warrant a clearing mandate and how it proposes to sequence the rollout of any clearing mandate. As explained below (and supported by our December Comment Letter), we recommend the Commission proceed in the following way:

- Begin by expanding the availability of central clearing for customers and making certain other essential changes to the clearing ecosystem, including facilitating cross-margining for customer trades, *before* mandating clearing for any segment of the U.S. Treasury markets; and

- Then, to the extent the Commission moves forward with a clearing mandate, appropriately phase in the mandate, starting with those market segments where the benefits of central clearing are most significant and existing market infrastructure is best able to support more central clearing, but at a minimum do not begin by imposing a mandate in the dealer-customer market, as doing so would economically disadvantage the buy-side.

In the following, we discuss these recommendations in more detail.

I. The Commission should improve the Treasury clearing ecosystem before mandating central clearing

There has been a trend toward increased clearing of repo transactions on a voluntary basis in recent years, indicating an increased market acceptance of, and comfort with, clearing these transactions even absent a mandate.[9] However, there are certain necessary enhancements that must be made before the Commission moves forward with a clearing mandate.

First, all Treasury market participants must have commercially reasonable and efficient methods of accessing clearing, and in particular a viable "done away" client clearing model must be developed.[10] The rules of the Fixed Income Clearing Corporation ("**FICC**")[11] (and clearing member practices) must ensure that an indirect participant of FICC can consolidate the clearing of its portfolio in one or a small number of direct participants by having a direct participant offering customer clearing accept transactions executed by the indirect participant with third-party executing firms. FICC's rules are not currently structured this way today, with the result

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[9] Proposing Release at 64622; Group of Thirty Report, *supra* note 9, at 10 ("[A] higher and growing share of Treasury repos are centrally cleared, with recent growth in the share principally attributable to the expansion by FICC of its sponsored repo service, which enables money funds, hedge funds, and other entities that are not members of FICC to centrally clear their repos through sponsors that are FICC members.").

[10] "Done away" transactions are entered into by indirect participants of a clearing house for which the counterparty is not the direct participant that is providing access to the clearing house.

[11] At present, FICC is the only clearing house that provides central counterparty services for cash and repo transactions in the U.S. Treasury securities market.

that indirect participants may be prevented by their clearing firms from clearing these "done-away" transactions.

The Proposal does not adequately ensure the availability of done away clearing models. To address this deficiency, the Commission should require FICC to prohibit certain anti-competitive practices that limit access to clearing, including the forced bundling of clearing services and executions. The Commission should ensure FICC's rules require direct participants not to condition clearing services on executing with only that firm, so that indirect participants can consolidate the clearing of their portfolios in one or a small number of direct participants.[12]

Second, indirect participants of FICC should have the ability (although not the obligation) to fund the margin obligations of the direct participant clearing on its behalf. In those instances, FICC must be required to separate initial margin from default fund requirements that can be subject to loss mutualization. Today FICC does *not* separate customer margin from the clearing member's default fund obligation. This is a gap that must be addressed before a clearing mandate is imposed.

Third, the Commission should ensure FICC offers (and obtains regulatory approval for) cross-margining of customer transactions. Cross-margining would lower costs for market participants by allowing them to calculate risk-based margin requirements across correlated positions cleared at different clearinghouses (*e.g.*, a cash transaction at FICC and a futures transaction at CME). Cross-margining is currently only available to direct members of FICC (not customers of direct members, *i.e.*, indirect participants at FICC). Therefore, the Commission should ensure indirect participants also can take into account offsetting positions when calculating margin requirements, as otherwise clearing costs will be disproportionately high for buy-side market participants and market efficiency will be impaired.

Fourth, certain FICC clearing models do not extend FICC's guarantee of settlement to indirect participants. Before a mandate becomes effective, the Commission should ensure indirect participants benefit from the clearinghouse's guarantee of settlement. This is not the case, for example, with FICC's correspondent and prime brokerage clearing models. Those models do not afford indirect participants the full benefits of central clearing because settlement of the transactions they clear through those models remains dependent upon the direct participant, with the result that indirect participants do not face FICC directly.

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[12] The CFTC addressed a similar issue when adopting rules regarding mandatory clearing in the swaps market. *See* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21278 (Apr. 9, 2012), available at: https://www.govinfo.gov/content/pkg/FR-2012-04-09/pdf/2012-7477.pdf (adopting rules prohibiting, among other things, a derivatives clearing organization from requiring as a condition of accepting a swap for clearing that an FCM enter into an arrangement with a customer that discloses to the FCM the identity of a customer's original executing counterparty or limits the number of counterparties with whom a customer may enter into trades).

Finally, the Commission should consider other regulatory changes to improve the economics and viability of clearing before a mandate becomes effective. These could include, among others:

- Evaluating changes to Exchange Act Rule 15c3-3a to determine whether further changes are necessary or appropriate to further reduce costs for broker-dealer net capital calculations;
- Conducting a holistic review of FICC rules to ensure fair access for all market participants (both direct participants and indirect participants);
- Enhancing transparency of FICC's margining and default management frameworks;
- Coordinating with global regulators.

II. The Commission should phase in any clearing mandate in a measured and appropriate manner

We believe that only after the Commission expands the accessibility and availability of central clearing and makes certain other essential changes to the clearing ecosystem, as described above, should it consider mandating clearing for any segment of the U.S. Treasury markets. However, if the Commission is determined to move forward with a clearing mandate, it is critical that the Commission phase in the mandate in a measured and appropriate manner, minimizing as much as possible negative, unintended impacts to liquidity and efficiency while maximizing resilience.

To begin with, as explained in the December Comment Letter, it is critical that the Commission phase in a clearing mandate by market segment. A clearing mandate should initially focus on those market segments where the benefits of central clearing are most significant and existing market infrastructure is best able to support more central clearing. We believe the Commission should focus first on bilateral repo and reverse repo transactions (other than the triparty repo market),[13] where the benefits of central clearing are most significant and existing market infrastructure is best able to support more central clearing. ***Most importantly, the Commission should not apply the clearing mandate to the cash market at this time, as the costs are likely to be significant and outweigh any potential benefits.*** Cash transactions do not present the same extent of counterparty credit risk as repo transactions, which means that a

[13] Triparty repo transactions do not give rise to the same counterparty credit risk as bilateral repo transactions. With respect to bilateral repos, the counterparties to the trade remain exposed to each other's credit risk throughout the life of a transaction; in the case of triparty repos, such credit risk is mitigated by the collateral-and settlement-facilitating role played by BNY Mellon. Furthermore, BNY Mellon is subject to prudential regulation, which provides an additional layer of oversight over these transactions and arrangements that is not present with respect to bilateral repos. For this reason, central clearing is more likely to have a significant risk mitigating effect with respect to bilateral repos.

principal benefit of central clearing—counterparty credit risk mitigation—is significantly less evident in these markets.[14]

Furthermore, to the extent the Commission determines to move forward with a clearing mandate for cash transactions, ***the Commission should not impose a mandate in the dealer-to-customer market, as doing so would economically disadvantage the buy-side for several reasons***.[15]

First, as discussed above, there is a lack of cross-margining available to customers of direct participants of FICC. This creates an uneven playing field for customers.

Second, in the cash market context, the Proposed Rule would limit clearing requirements to certain market participants (including hedge funds) and certain trading facilities. To justify singling out hedge funds in the Proposed Rule, the Commission notes several episodes in the U.S. Treasury markets—including the "flash rally" of 2014, the U.S. Treasury repo market stress of September 2019, and the COVID–19 shock of March 2020—as raising questions regarding the U.S. Treasury markets' continued capacity to absorb shocks and what factors may be limiting the resilience of the U.S. Treasury markets under stress.[16] In particular, the Commission points to the purported role of hedge funds in the U.S. Treasury markets with respect to the March 2020 market events and stated that "FSOC observed that hedge funds were among the three largest types of sellers of Treasury securities, materially contributing to the Treasury market disruption during this period, although not as its sole cause."[17]

In fact, FSOC noted it was actually large-scale sales of U.S. Treasury securities by foreign investors (principally foreign official institutions) that more directly contributed to the March turmoil, noting that "foreign investors are estimated to have sold a record amount of more than $400 billion of Treasury securities in March [2020]."[18] Furthermore, mutual funds sold in exceptionally large volumes during this time frame, totaling almost $200 billion in the first quarter of 2020, as these funds monetized their most liquid asset holdings to prepare for potential

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[14] Furthermore, the indirect clearing models that are most commonly offered in the cash market context—correspondent and prime brokerage clearing—do not result in meaningful netting or risk management benefits when one counterparty is not a direct participant.

[15] We also note that ransomware attacks are typically targeted at dealers within the markets, as opposed customers of dealers, which is not surprising given the critical role that dealers play in the Treasury markets. *See*, *e.g.*, Financial Times, "Ransomware attack on ICBC disrupts trades in US Treasury market" (Nov. 9, 2023), available at: https://www.ft.com/content/8dd2446b-c8da-4854-9edc-bf841069ccb8.

[16] *See* Proposal at 61614.

[17] *See id.* at 64624 (citing FSOC Statement on Nonbank Financial Intermediation (Feb. 4, 2022), available at: https://home.treasury.gov/news/press-releases/jy0587).

[18] *See* Federal Reserve Board, Financial Stability Report (Nov. 2020) at 34, available at: https://www.federalrforeigneserve.gov/publications/files/financial-stability-report-20201109.pdf.

redemptions and rebalance their portfolios.[19] By contrast, FSOC noted that hedge funds reduced their cash Treasury positions by only about $35 billion in the first quarter of 2020, noting that the "evidence that large-scale deleveraging of hedge fund Treasury positions was the primary driver of the turmoil **remains weak**."[20] (emphasis added).

Despite the fact that hedge funds were involved in a significantly smaller proportion of the sell-off in March 2020, the two largest categories of participants in the Treasury markets—foreign central banks/sovereign entities and mutual funds—would not be subject to the proposed clearing mandate for cash transactions (and foreign central banks/sovereign entities are also not subject to the proposed repo clearing mandate).[21] Instead, the Proposed Rule requires one segment of market participants—hedge funds—to centrally clear their cash transactions. This creates an uneven playing field that will subject hedge funds to much higher costs than other market participants. This uneven application of clearing requirements will result in undesirable competitive disparities and market distortions across different types of buy-side firms. As a result, we believe the Proposal's disparate treatment of market participants will only provide the appearance of a solution, while in fact creating unjustified, discriminatory treatment of market participants and creating more market fragility by supporting and even mandating an anticompetitive clearing regime. The Commission will end up doing one of two things: either decrease liquidity in the Treasury markets, at a time when there is an increased need for market participation, or push the activities it wants to regulate to market participants that do not have to comply with the clearing mandate. By shifting market activities from one market participant to another, the clearing mandate will fail to mitigate perceived risks in the markets—its reason for being proposed.

Accordingly, to the extent the Commission has identified impediments to clearing by different types of market participants, it is critical that, before imposing a clearing mandate, the Commission understand how FICC's access models address and accommodate the unique requirements applicable to different market participants. If the Commission fails to address these regulatory constraints prior to imposing a clearing mandate, it may create competitive disparities and will likely result in a reduction of liquidity in the Treasury market or push activity to market participants not subject to the clearing mandate.

Third, because cash transactions pose significantly less settlement risk than repos, there is much less potential for such trades to ever present financial stability concerns. Furthermore, any

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[19] *See* Lorie K. Logan, Executive Vice President, Federal Reserve Bank of New Yori, "Treasury Market Liquidity and Early Lessons from the Pandemic Shock" (Oct. 23, 2020), available at: https://www.newyorkfed.org/newsevents/speeches/2020/log201023 (citing Yiming Ma, Kairong Xiao and Yao Zen, *Mutual Fund Liquidity Transformation and Reverse Flight to Liquidity* (July 2020), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3640861).

[20] *Id.* at 35.

[21] The Proposed Rule excludes foreign central banks, foreign sovereign entities, and international financial institutions from the scope of the mandatory clearing requirement with respect to both repo and cash transactions.

perceived concerns with hedge funds and "basis trading,"[22] would be better addressed through expanding repo clearing, not by mandating clearing of cash transactions.[23] In this regard, we note that dealers, including banks, determine overall collateralization requirements for the basis trade by looking at a hedge fund's exposure in the aggregate, factoring in both initial margin posted with respect to the futures leg and the haircuts applied to the repo leg. Low haircuts on repos are often driven by netting and cross-product margining, where a dealer estimates and collects margin for their risk exposure over all trades and exposures in a hedge fund's portfolio. Netting and cross-product margining significantly contribute to the appearance of low repo haircuts hedge funds often obtain on their repo borrowing in the context of basis trading and shows why this practice can be sound from a risk-management perspective.[24]

Finally, before mandating clearing, the Commission should ensure that FICC has adequate time to make improvements to its clearing model, policies, and procedures. We believe two years is the minimum amount of time necessary to address the issues raised above. Also, before moving to the next phase of any mandate, the Commission should solicit feedback from market participants regarding the state of FICC's product offerings and the viability of moving to a mandate. Then, the Commission should implement the bilateral repo clearing mandate 18 months following FICC's implementation of required changes and the solicitation of market participant feedback.

[22] The basis trade is the buying of a Treasury and the subsequent selling of a Treasury future matching the characteristics of the already purchased Treasury. The price of a Treasury future exceeds the price of the Treasury due to the high demand for the futures. This difference in price is known as the "basis."

[23] *See* MFA, *Role of Alternative Asset Managers in the Treasury Markets*, *supra* note 4.

[24] For example, in a typical basis trade arrangement, a fund might finance the underlying bond through a low or zero haircut repo because the risk is sufficiently offset with its corresponding futures exposure (which is typically margined at 1% to 9%, depending on maturity). Therefore, looking at one piece of a connected trade in a silo does not give an accurate representation of the actual collateralization level and risk management practices. *See id.*

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We appreciate the opportunity to provide our comments to the Commission regarding the Proposed Rule, and we would be pleased to meet with the Commission and its staff to discuss our comments. If the staff has questions or comments, please do not hesitate to call Matthew Daigler, Vice President & Senior Counsel, or the undersigned, at (202) 730-2600, with any questions regarding this letter.

Very truly yours,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
The Hon. Mark T. Uyeda, SEC Commissioner
The Hon. Jaime Lizárraga, SEC Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets

Appendix

MFA, Role of Alternative Asset Managers in the Treasury Markets (Nov. 2023)

MFA on Treasury Market Structure

State of the Treasury Markets

The U.S. Treasury markets are the largest and most liquid government bond markets in the world. Treasuries are both the primary debt instrument for the U.S. government and a foundation of the global financial system. The Treasury markets' liquidity and depth limit volatility and provide stability. The markets are comprised of a large and diverse pool of market participants who buy, sell, and hold the bonds. The resilience of these markets is critical to financial stability and economic prosperity. The diversity of participants in the market fuels its resilience.

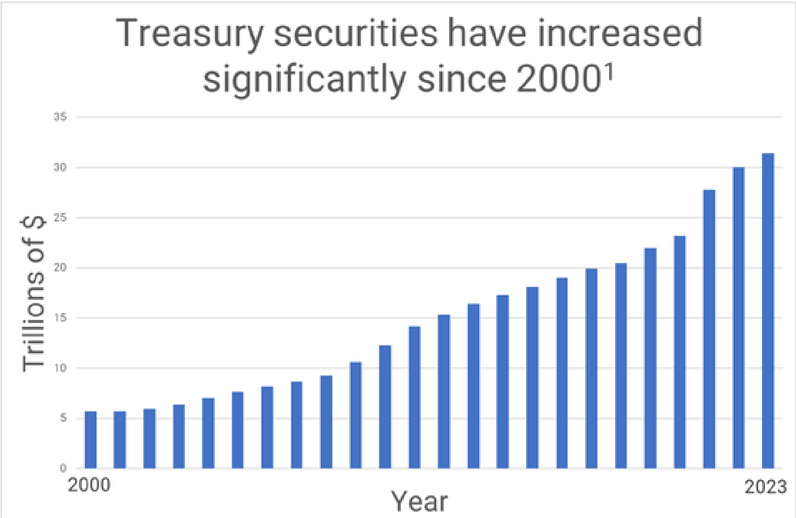
To enhance the resiliency and efficiency of the Treasury markets, it is critical that policymakers do not radically change the market structure before understanding the consequences of significant modifications. Treasury market structure is enhanced with thoughtful and gradual modifications that minimize any negative, unintended impacts to liquidity and efficiency, while maximizing participation and resilience.

2023 Treasury Markets: Diversity of Participation is Key

Since 2000, the supply of Treasuries has grown significantly to support the expanding U.S government debt. Preserving robust participation by a diverse group of market participants is essential to ensuring that demand keeps up with supply and that government funding costs are kept as low as possible, as that debt continues to expand.

Treasury market participants:

- Foreign entities
- Mutual funds
- Depository institutions
- State & local governments
- Hedge funds
- Private & public pensions
- Insurance companies
- U.S. savings bonds



[1] Data from U.S. Treasury, Monthly Statement of the Public Debt reports, total debt outstanding in January of each year

How Trading Treasuries Works

The primary market is where investors buy newly issued bonds directly from the U.S. Department of Treasury at auction. The secondary market is where investors buy and sell Treasuries that have previously been issued. Both markers are critical to the functioning of the U.S. economy as well as the global financial system.

Hedge Funds' Role in Treasury Markets

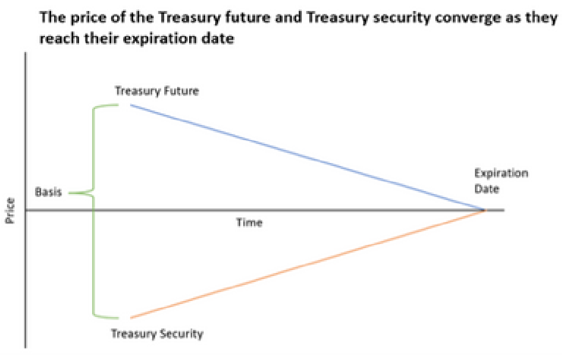
Hedge funds are one of many active participants in the Treasury markets. Hedge funds transact in Treasuries as part of their investment, trading, hedging, and cash management activities. One example that has received outsized attention, but is not always well understood, is the cash-futures "basis trade."

The basis trade refers to a position established through the sale of a Treasury futures contract and the purchase of a Treasury bond that is deliverable under the futures contract. An array of market participants–not just hedge funds–participate in the basis trade. The basis trade is not unique to the Treasury futures market–rather, it is a regular feature of nearly all futures markets.

A Treasury futures contract is an agreement to buy or sell Treasury securities at a specific price and date in the future. Many investors—such as mutual funds and pension funds—increasingly rely on Treasury futures as an efficient way to obtain exposure to Treasuries in their portfolios while maximizing their allocation to other higher-yielding assets, such as corporate bonds.

For every buyer of a futures contract, there needs to be a seller—and the supply and demand for futures is what determines their price. High demand for Treasury futures relative to supply leads to a pricing discrepancy, where the futures contract trades at a premium to the underlying bond. This pricing discrepancy—or "basis"—provides an arbitrage opportunity for market participants who can sell the future and buy an underlying deliverable cash Treasury. At the expiry date of the futures contract, the prices converge making the trade profitable for the seller of the future contract.

The Fed found that hedge funds were not the primary driver of the March 2020 Treasury market volatility.[3] In March 2020, foreign investors sold $400 billion of Treasuries, mutual funds sold over $200 billion,[4] and hedge funds sold only $35 billion.



Some hedge funds act as sellers of the Treasury futures and buyers of the bonds. Their participation in the Treasury markets narrows the price dislocation between the futures contract and the underlying Treasury bond, enhances overall efficiency and liquidity in the markets, and helps lower the cost of government debt issuance by creating demand for U.S. Treasuries.

However, the difference in price between the future and the Treasury is small. To make the trade economically viable, hedge funds often use leverage, buying Treasuries

[3] Board of Governors of the Federal Reserve System, Financial Stability Report – November 2020
[4] Federal Reserve Bank of New York, "Treasury Market Liquidity and Early Lessons from the Pandemic Shock", October 23, 2020

in the cash market and then funding their purchases with banks by making use of the repo market. Hedge funds are constrained in how much leverage they can utilize, in part because the futures contracts they are shorting against their Treasury longs have significant initial margin requirements. For banks, the repo trade's credit risk is generally very small, since banks are typically clear of the futures contract as well.

The basis trade benefits the Treasury market by:

- Increasing liquidity;
- Dampening volatility;
- Reducing bid-ask spreads;
- Lowering the cost of government borrowing; and
- Helping pensions and other buyers of futures optimize their allocation of capital.

Collateralization of the Basis Trade

The amount of collateral posted in connection with the basis trade includes both margin posted on the futures leg of the trade and any haircuts on the repo transaction used to finance the cash leg of the trade.

The futures leg of the trade is over-collateralized. The Chicago Mercantile Exchange (CME) margins the short futures position as an outright directional position, and does not account for the underlying cash Treasury being held against it.

Recently, there has been focus on the seeming existence of zero haircut repo financing. This narrow focus overlooks the fact that repo financing is provided under master netting agreements where a dealer/prime broker recognizes that its client has a netted package of a Treasury future and a cash Treasury. If the dealer had to close out the client's full position, it would have recourse to the excess margin posted on the futures leg.

CME operates both an exchange and a clearinghouse, which are regulated by the CFTC. The CME's margin methodology is subject to robust requirements and approved by regulators.

In October, in the annual Financial Stability Report, the Federal Reserve wrote that concerns about risk in the basis trade are being "mitigated by tighter financing terms applied to hedge funds by dealer counterparties over the past several quarters."[5]

Dealers, including banks, decide margin levels in the basis trade by looking at a hedge fund's exposure in aggregate. Low haircuts on repos are often driven by netting and cross-product margining, where a dealer estimates and collects margin for their risk exposure over all trades and exposures in a hedge fund's portfolio. Netting and cross-product margining significantly contribute to the low repo haircuts hedge funds often obtain on their repo borrowing in the context of the basis trade and shows why this practice is sound from a risk-management perspective.

Some policymakers have floated the idea of implementing a minimum haircut on bilateral uncleared repo in order to limit the use of leverage in the basis trade. Counterparty banks—through their own risk management protocols—determine margin requirements on hedge fund financing

[5] Board of Governors of the Federal Reserve System, Financial Stability Report – October 2023

arrangements. Bank regulators work with banks to ensure appropriate counterparty and collateral risk management. It is important to understand that implementing leverage limits is not without cost, and therefore should be done with great care. Unintended consequences for the Treasury markets include:

- Raising the cost of government borrowing;
- Increasing volatility;
- Widening bid-ask spreads; and
- Reducing liquidity.

> *"[Most] funds already satisfy the collateral requirement and, in our analysis, do not need additional capital to support existing borrowing…. [Imposing leverage limits] may affect the size and volatility of spreads among related instruments in Treasury cash and derivatives markets, as well as market liquidity conditions in those markets."* [6]
>
> **– U.S. Federal Reserve**

0% Haircuts is a Misnomer: Some policymakers have noted and criticized a perceived practice of providing a lending arrangement with a 0% haircut. This assertion is a misunderstanding of the margining practices between funds and banks. For example, in a typical basis trade arrangement, a fund might finance the underlying bond through a low or zero haircut repo because the risk is sufficiently offset with its corresponding futures exposure (which is typically margined at 1% to 9%, depending on maturity). Therefore, looking at one piece of a connected trade in a silo does not give an accurate representation of the actual collateralization level and risk management practices.

Further, as has been noted by the Federal Reserve, in the event of selling pressure, funds have unencumbered cash, or dry powder.[7]

Treasury Market Transparency and Risk Management

Comprehensive information about transactions in the cash, futures, and repo markets is already reported to regulators. To the extent these data sets need to be further enriched to better understand market dynamics or perform market oversight, this should be prioritized. Currently:

- All cash transactions are reported to FINRA through its TRACE system;
- All futures market activity is conducted on exchanges subject to CFTC oversight;
- For all centrally cleared repos, data is collected through OFR's cleared repo collection; and
- For the non-centrally cleared tri-party repo market, the Bank of New York Mellon serves as the tri-party custodian and transaction-level data is collected under the supervisory authority of the Federal Reserve Board.

[6] Board of Governors of the Federal Reserve System, Hedge Fund Treasury Exposures, Repo, and Margining

[7] Ibid

In addition, hedge fund managers provide data and information to the SEC about their investment strategies and their use of leverage through Form PF. This provides regulators with the information to properly assess risk in the financial system.

The information provided to regulators in Form PF Includes:

- Fund size
- Investor Type
- Investor concentration
- Liquidity
- Fund performance
- Strategy
- Counterparty exposure
- Use of trading and clearing mechanisms

In addition to SEC oversight, hedge funds and their bank counterparties use sophisticated risk management. Collateral, margin, and haircuts are determined by minimum legal requirements, the customer's credit risk, and other business relationships the customer maintains with the bank. Minimum legal margin requirements are set by the banks' prudential regulators and can be revised, as needed.

Enhancing Treasury Markets

The size of the Treasury markets has quadrupled in the last 15 years and is expected to continue growing. It is important to modernize the market architecture to meet evolving market dynamics. But policymakers should do so in a way that is gradual, thoughtful, data-driven, and, above all, based on the first-order principle of "Do No Harm."

To enhance Treasury market resiliency, policymakers need to modernize market structure. MFA supports specific proposals to bolster Treasury market structure including by:

- Improving data collection by adding customer legal entity identifiers (LEIs) and a clearing arrangement indicator to TRACE for cash trades;
- Requiring reporting of repo and reverse repo transactions to a central depository (such as the OFR recently proposed);
- Expanding the use of voluntary central clearing in the dealer-to-customer segment of the Treasury market for both secondary cash market transactions and repos;
- Requiring clearing members of FICC (the only clearing agency for Treasury securities) to accept transactions executed by their customers with third-party executing firms ("done away" trades);
- Providing for segregation of customer margin at FICC; and
- Introducing cross-margining for end-users for Treasury futures and cash Treasury transactions.

Expanding central clearing solutions has the potential to:

- Enhance market resiliency, transparency, and liquidity while reducing credit and operational risks;
- Benefit investors and market participants by allowing them to more efficiently deploy capital by netting offsetting transactions and providing access to market-wide protections provided by a clearinghouse's default management framework; and
- Help facilitate the development of all-to-all trading in Treasuries.

Avoid Harmful Proposals

Recent proposals from the SEC will create negative, unintended consequences for investors and the markets:

Dealer Proposal: The SEC's proposal to expand the scope of who is a "dealer" under the Exchange Act would capture a large number of private funds and their advisers. These market participants are already subject to Commission registration, examination, and significant reporting requirements. Many private funds, as a result of the SEC's dealer proposal, will be forced to curtail their participation in the U.S. Treasury markets. This will:

- Reduce liquidity;
- Impair price discovery; and
- Increase the cost of capital for companies and the U.S. government.

Treasury Clearing Proposal: The SEC's proposal to mandate clearing in the U.S. Treasury markets before the clearing ecosystem to support customer clearing is developed would be counter-productive. In addition, the rationale for repo clearing and cash clearing differs significantly, and the rationale for only targeting hedge funds with a cash clearing mandate is problematic. Unless the implementation details and timeline are appropriately designed and staggered, it could:

- Decrease market efficiency and resiliency;
- Make it more difficult and expensive for investors to transact; and
- Increase market concentration and risk.

Data-Driven Updates of Treasury Market Structure is Needed as Markets Evolve

The Treasury markets underpin the U.S. economy as well as the global financial system. As the market continues to grow and evolve, so too must the underlying market structure. Making data-driven, gradual changes will ensure a continued diversity of market participation—including the important role played by hedge funds. This approach, in turn, will maximize liquidity and resiliency and avoid negative, unintended consequences.