December 27, 2022

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

Re: 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)

Dear Ms. Countryman:

We appreciate the opportunity to provide comments to the Securities and Exchange Commission (the "Commission") on its proposal to increase central clearing of secondary market transactions in Treasury securities and to improve the operation and oversight of clearing agencies (the "Proposal").[1] We have consistently advocated for modernizing Treasury market structure, including by expanding central clearing, increasing public transparency, and rationalizing trading venue oversight.[2] Our response to this Proposal is informed by the market experience of two separate and distinct businesses – Citadel Securities, a leading global market maker, and Citadel, a leading global alternative investment firm. Both businesses already clear material volumes of Treasury securities transactions, and believe that a market-wide transition to central clearing will result in a more efficient, robust and resilient Treasury market.

Overview

If implemented thoughtfully, increased central clearing of Treasury cash and repurchase ("repo") transactions will reduce systemic risk and meaningfully improve counterparty risk management, market liquidity, and resiliency. A market-wide clearing requirement can optimize dealer balance sheet utilization, reduce credit and operational risk, enhance competition, and foster innovation in trading protocols. All of these benefits of central clearing are well documented in academic research, and have been realized by market participants in other asset classes that have similarly transitioned to central clearing, including the interest rate swaps market.

Reforms to expand central clearing in the Treasury market, in conjunction with reforms to ensure open and fair access to clearing agencies, are warranted to enhance overall market liquidity and

[1] 87 Fed. Reg. 64610 (Oct. 25, 2022).

[2] *See generally*, Citadel Response to the Request for Information on Additional Transparency for Secondary Market Transactions of Treasury Securities (Aug. 31, 2022) available at https://www.regulations.gov/comment/TREAS-DO-2022-0012-0028; Heath P. Tarbert, Chief Legal Officer, Citadel Securities, "Strengthening the Treasury Market," COLUM. BUS. L. REV (Jan. 28, 2022) available at https://doi.org/10.52214/cblr.v2021i3.9111; Citadel Response to the Request for Information on the Evolution of U.S. Treasury Market Structure (Apr. 22, 2016) available at https://www.regulations.gov/comment/TREAS-DO-2015-0013-0045; Remarks by Ken Griffin at the 2015 Roundtable on Treasury Markets and Debt Management (Nov. 20, 2015) available at https://home.treasury.gov/system/files/276/11-20-2015-Ken-Griffin-Treasury-Roundtable-Remarks.pdf.

resiliency. The Treasury market has dramatically increased in size over the last 15 years, from $4.5 trillion in 2007 to nearly $24 trillion today, and is expected to reach $40 trillion by 2032.[3] In addition, the Federal Reserve has announced plans to meaningfully reduce its portfolio of nearly $9 trillion of Treasury securities, resulting in an even greater supply of securities that market participants will need to absorb.[4] Yet, we have already seen evidence of capacity constraints and liquidity challenges in the Treasury market.[5] It is therefore critical that the regulatory framework and market structure evolve to ensure that the Treasury market continues to fulfill its vital role in the efficient funding of the U.S. government, and remains the most credible and relied-upon benchmark in the world, contributing to price discovery and the efficient allocation of capital across virtually every other asset class.

To realize the benefits associated with central clearing, any clearing requirement must capture a broad cross-section of the market. Accordingly, we recommend the Commission consider more closely aligning the scope of the clearing requirement for cash transactions with the proposed market-wide clearing requirement for repos. In light of its objectives, the Commission lacks a rational basis to only apply a clearing requirement in the cash market to a limited subset of dealer-to-customer transactions (i.e. those executed with hedge funds or leveraged accounts). As discussed in more detail below, proceeding in this manner would be counterproductive, and undermine the Commission's stated objectives of enhancing overall market resiliency.

Additionally, before a market-wide central clearing requirement goes into effect, all market participants must be able to efficiently access central clearing, including indirectly through customer clearing offerings. We appreciate that the Commission has proposed requiring Treasury clearing agencies to establish policies and procedures to ensure access to clearing by indirect participants. However, the Commission should revise the Proposal to expressly prohibit certain practices, such as forced bundling of execution and clearing services, that can stifle competition and impede access to central clearing.

Section I of this letter discusses the benefits of market-wide central clearing. Section II recommends refinements to the scope of the Commission's proposed clearing requirement. Section III details the importance of ensuring fair access for indirect participants. Finally, section IV of this letter highlights inconsistencies between this Proposal and the Commission's separate proposal to inappropriately re-classify certain buy-side market participants as "dealers."

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[3] *See* U.S. Treasury Securities Statistics, SIFMA, available at https://www.sifma.org/resources/research/us-treasury-securities-statistics/ ; Budget and Economic Data, at Table 1-1, CBO, available at https://www.cbo.gov/data/budget-economic-data#1.

[4] *See* Katherine Greifeld, "The Weekly Fix: Financial Conditions are Easing. Maybe that's Ok," Bloomberg (June 3, 2022), available at https://www.bloomberg.com/news/newsletters/2022-06-03/the-weekly-fix-financial-conditions-are-easing-maybe-that-s-ok.

[5] *See e.g.,* Financial Stability Report, Board of Governors of the Federal Reserve System (Nov. 4, 2022), available at https://www.federalreserve.gov/publications/files/financial-stability-report-20221104.pdf; Matt Grossman & Sam Goldfarb, "Rocky Treasury-Market Trading Rattles Wall Street," Wall St. J. (Oct. 30, 2022) (reporting that "The ranks of traders ready to buy and sell Treasuries are shrinking[,] individual trades are moving prices more[,] Treasury securities with similar characteristics are trading at larger-than-normal price differences[, and] major players, including the big banks and asset managers that have long been significant buyers, are in retreat) available at https://www.wsj.com/articles/rocky-treasury-market-trading-rattles-wall-street-11667086782; "Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report," Inter-Agency Working Group for Treasury Market Surveillance (Nov. 8, 2021) available at https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf.

I. Benefits of Increased Central Clearing

Transitioning more trading activity in Treasuries (both cash and repo) to central clearing will lead to significant benefits, as detailed below.

A. Clearing Optimizes Balance Sheet Utilization and Reduces Settlement Failures.

Central clearing of transactions nets down gross exposures across participants, reducing open exposures and settlement obligations.[6] Academic research finds that the netting and balance sheet benefits of central clearing would be substantial.[7]

While market participants often focus on the extent to which cleared repo will optimize balance sheet utilization, multilateral netting of cash transactions will also positively impact dealer balance sheets. There is little doubt that, directionally, the Proposal will have a positive effect on balance sheet constraints for cash Treasury trading activity,[8] as multilateral netting reduces both gross settlement obligations (unlike bilateral netting for accounting purposes) and settlement fails. Research estimates that central clearing of all Treasury trades would have lowered dealers' daily gross settlement obligations by roughly $330 billion (or approximately 60%) in the weeks immediately preceding and following the March 2020 market volatility, and nearly $800 billion (approximately 70%) when trading was at its highest.[9] In turn, central clearing could have reduced settlement fails by nearly 75% over a 5-month period from January to May of 2020, which would have also contributed to greater resiliency and intermediation capacity.[10]

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[6] We also note that further automating intra-day netting practices at the clearing agency will serve to reduce outstanding settlement obligations.

[7] *See, e.g.,* Nellie Liang & Pat Parkinson, "Enhancing Liquidity of the U.S. Treasury Market Under Stress," Brookings (Dec. 16, 2020) available at https://www.brookings.edu/wp-content/uploads/2020/12/WP72_Liang-Parkinson.pdf; Darrell Duffie, Still the World's Safe Haven?, Brookings (June 2020) (explaining how expanded central clearing would allow increased netting of dealers' trades, reducing the commitment of dealers' balance sheets needed to maintain liquid markets) available at https://www.brookings.edu/wp-content/uploads/2020/05/WP62_Duffie_v2.pdf; Marta Chaffee & Sam Schulhofer-Wohl, "Chicago Fed Insights: Is a Treasury Clearing Mandate the Path to Increased Central Clearing?", Federal Reserve Bank of Chicago (June 23, 2021) ("increased netting might free up space on dealers' balance sheets for additional trades that could help keep the market liquid") available at https://www.chicagofed.org/publications/blogs/chicago-fed-insights/2021/treasury-clearing-mandate; and Viktoria Baklanova et. al., "Benefits and Risks of Central Clearing in the Repo Market," Office of Financial Research (Mar. 9, 2017) available at https://www.financialresearch.gov/briefs/files/OFRBr_2017_04_clearing agency-for-Repos.pdf.

[8] Michael Fleming & Frank Keane, "The Netting Efficiencies of Marketwide Central Clearing." Federal Reserve Bank of New York, Staff Report No. 964, Federal Reserve Bank of New York (April 2021) available at https://www.newyorkfed.org/research/staff_reports/sr964.

[9] *Id*.

[10] *See also* Duffie, *supra* note 7 (presenting evidence that Treasury fails rose less in March 2020 for trades that were centrally cleared than for all trades involving primary dealers, suggesting that central clearing reduces daisy-chain fails).

B. Clearing Enhances Competition by Enabling Seamless Access to a Greater Array of Trading Counterparties and Fosters Innovation in Trading Protocols.

Central clearing replaces an interconnected web of bilateral counterparty credit exposures with a well-regulated clearing agency. By substituting the clearing agency as counterparty, market participants can focus on achieving better execution outcomes by trading with a broader range of counterparties. This can also "enhance the ability of smaller bank and independent dealers to compete with the incumbent bank dealers,"[11] providing more sources of liquidity during periods of market stress.

Central clearing is also a necessary condition for further evolution in trading protocols, including the growth of all-to-all trading. Enabling end investors to utilize all available trading protocols will enhance liquidity and price discovery, particularly since end investors hold the majority of outstanding Treasury securities. The emergence of all-to-all trading in the dealer-to-customer market may serve as an important complement to existing trading protocols,[12] and research demonstrates that it can help make markets more resilient during periods of volatility by providing an alternative source of liquidity in the event dealer intermediation capacity is constrained.[13] For example, research suggests that the all-to-all structure of the Treasury futures market is one reason why liquidity was more resilient than in the on-the-run cash market in March 2020.[14]

The trading-related benefits that flow from central clearing are particularly relevant for the cash market where it is more likely that greater competition among liquidity providers will emerge, and liquid all-to-all order books already exist for on-the-run instruments. Central clearing should allow more customers to diversify execution counterparties and trading protocols (which may be particularly important during periods of volatility).[15]

C. Central Clearing Enhances Financial Stability and Market Resiliency.

The benefits described above will meaningfully enhance financial stability and market resiliency. Clearing agencies establish and enforce standardized risk management and default management

[11] Liang & Parkinson, *supra* note 7.

[12] Notably, academic research analyzing the introduction of an all-to-all trading protocol in the corporate bond market found that transaction costs decreased after the protocol was introduced. *See* Terrence Hendershott, Dmitry Livdan, Norman Schurhoff, "All-to-All Liquidity in Corporate Bonds," Swiss Finance Institute Research Papers (Oct. 10, 2021) available at https://ssrn.com/abstract=3895270. *See also* research covering the interest rate swaps market. Evangelos Benos, Richard Payne & Michalis Vasios, "Centralized Trading, Transparency, and Interest Rate Swap Liquidity: Evidence from the Implementation of the Dodd-Frank Act" (Dec 3, 2018) available at https://doi.org/10.1017/S0022109018001527.

[13] *See* Alain Chaboud et. al., "All-to-All Trading in the U.S. Treasury Market," FRBNY (Oct. 2022) available at https://www.newyorkfed.org/research/staff_reports/sr1036.

[14] Dobrislav Dobrev & Andrew Meldrum, "What Do Quoted Spreads Tell Us About Machine Trading at Times of Market Stress? Evidence from Treasury and FX Markets during the COVID-19-Related Market Turmoil in March 2020," FEDS Notes (Sep. 25, 2020) available at https://www.federalreserve.gov/econres/notes/feds-notes/what-do-quoted-spreads-tell-us-about-machine-trading-market-stress-march-2020-accessible-20200925.htm.

[15] *Id*.

requirements, including margin collection and guaranty fund contributions, for member portfolios.[16] Clearing agencies operate in accordance with an ongoing set of regulatory requirements and responsibilities, including with respect to financial resources, stress testing, and model back testing. In addition, clearing agencies facilitate multilateral netting and compression, which increases efficiency with respect to collateral management and trade reconciliation, and provides market participants with increased transparency around end-of-day pricing. All of these factors serve to distinguish the risk management of cleared positions from uncleared positions and increase overall market resiliency.

II. Recommended Refinements to the Scope of the Clearing Requirement

In light of the benefits detailed above, we support the Commission's efforts to expand central clearing in the Treasury market through a clearing requirement. A market-wide clearing requirement will foster a more orderly industry transition pursuant to a clear implementation timeline. It will also incentivize client clearing service providers to invest in expanding their offerings to compete for clearing client transaction volumes (and may even incentivize new entrants in the clearing agency landscape). While there are costs associated with a clearing requirement, we expect them to be outweighed by the benefits of a more competitive, resilient, and efficient trading and clearing environment.

We disagree, however, with the proposed scope of the clearing requirement for cash transactions, which focuses on transactions with hedge funds, leveraged accounts, and inter-dealer brokers. This approach would leave much of the cash market outside of the clearing requirement, including transactions with MMFs, mutual funds, pension funds, insurance companies, and foreign official institutions, even though the Commission recognizes that these participants are significant holders of Treasuries.[17] In doing so, the Proposal will increase costs for a specific subset of market participants, thereby putting them at a competitive disadvantage, while failing to deliver the envisaged market-wide benefits associated with central clearing. Indeed, leaving a significant portion of trading activity outside of the clearing requirement will materially reduce the associated multilateral netting benefits, impair the risk management practices of clearing agencies, and hinder the evolution in trading protocols that can be expected from a market-wide clearing requirement.[18]

As such, we recommend the Commission align the scope of the clearing requirement for cash transactions with the proposed market-wide clearing requirement for repos, subject to certain limited exceptions for investors that trade *de minimis* volumes.[19]

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[16] "Mandatory Central Clearing for U.S. Treasuries and U.S. Treasury Repos," Program on International Financial Systems (Nov. 2021), available at https://www.pifsinternational.org/wp-content/uploads/2022/08/PIFS-Mandatory-Central-Clearing-for-U.S.-Treasury-Markets-11.11.2021.pdf.

[17] For example, the Commission notes that money market mutual funds held $1.8 trillion of cash Treasuries and mutual funds held an additional $1.5 trillion as of the end of the first quarter of 2022. Proposal at 64660.

[18] We also note that specifically targeting inter-dealer brokers may increase the costs of trading on all-to-all order books relative to trading bilaterally or through electronic RFQ systems, thereby hindering the growth of all-to-all trading.

[19] We note the Commission could consider the exceptions granted in other asset classes with clearing requirements, such as OTC derivatives.

With respect to the proposed clearing requirement for repos, we recommend that the Commission exclude triparty repos at this stage given that triparty repos typically employ different operational workflows and market infrastructure, and may include both Treasury and non-Treasury securities as collateral.

III. Fair Access for Indirect Participants

In order to realize the benefits of market-wide central clearing, market participants must be able to access central clearing in a cost-efficient and operationally-efficient manner. As noted in the Proposal, becoming a direct member of a clearing agency is not viable for many market participants due to the eligibility requirements and default management responsibilities associated with direct clearing agency membership.[20] Instead, the vast majority of market participants should be expected to access central clearing through an indirect client clearing model, such as the Sponsored Clearing, Correspondent Clearing, or Prime Broker Clearing models offered by the Fixed Income Clearing Corporation ("FICC").

In particular, a "done-away" client clearing model (whereby a client may access clearing regardless of the identity of the original executing counterparty), is necessary to support a market-wide clearing requirement for both repo and cash transactions. Otherwise, a client would have to establish a clearing relationship with each of its executing counterparties, which increases costs and bifurcates portfolios. While current FICC rules may permit clearing members to clear done-away transactions, the clearing agency does not prohibit direct clearing members from compelling clients to bundle execution and clearing services (meaning that, in practice, a clearing member will only clear transactions that are executed with that same clearing member).

The Commission recognizes these concerns, but fails to adequately address them, proposing only that Treasury clearing agencies establish policies and procedures that "permit fair and open access by direct, and, where relevant, indirect participants and other financial market utilities."[21] However, FICC purports that its current offerings already provide fair and open access to clearing, and that the decision to offer done-away clearing rests solely on its members.[22] These assertions are misguided, and the Commission is justified in taking stronger action.

A clearing member should be agnostic about with whom (i.e. the executing counterparty) a trade is executed, as the counterparty of a cleared trade is the clearing agency, not the original executing counterparty. Without a coherent risk-based reason for doing so, a clearing member should not limit a customer's choice of execution counterparties, thereby limiting competition and access to liquidity.[23]

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[20] Proposal at 64635.

[21] *Id.*

[22] Making the U.S. Treasury Market Safer for all Participants: How FICC's Open Access Model Promotes Central Clearing," DTCC (October 2021) ("Second FICC Whitepaper") ("Each of FICC's client clearing models can also support an arrangement where, after execution, the transaction is effectively "given up" to a clearing member that is different from the trading counterparty."), available at https://www.dtcc.com/-/media/Files/Downloads/WhitePapers/Making-the-Treasury-Market-Safer-for-all-Participants.pdf

[23] We note that, for legal or regulatory reasons, certain markets participants may prefer bundling executing and clearing services and this should be permitted to occur (just not compelled by clearing members).

In response to similar attempts to limit access to swaps clearing, the CFTC affirmatively prohibited disclosure of the identity of the client's executing counterparty to its clearing member, finding that "disclosure of a customer's original executing counterparty could have potentially anticompetitive effects."[24]

The Commission should address client access directly by requiring registered clearing agencies to prohibit anti-competitive practices and to mitigate potential conflicts of interest. This should include prohibiting clearing members from compelling clients to bundle execution and clearing (rather than leaving it up to clearing members to set their own access standards).

Such a rule would be well within the Commission's statutory authority. Section 17A(a)(2) of the Exchange Act directs the Commission to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions, having regard for, among others, the public interest and the maintenance of fair competition among brokers and dealers.[25] Separately, Section 17A(d)(1) of the Exchange Act provides the Commission with broad authority to adopt rules as necessary or appropriate in the public interest or otherwise in furtherance of the purpose of the Exchange Act, including the maintenance of fair competition among brokers and dealers.

Clearly addressing indirect access and clearing member conflicts of interest is necessary to maintain "fair competition among brokers and dealers."[26] Prohibiting clearing members from tying execution and clearing will allow for fair competition across all broker-dealers with respect to trade execution in the Treasury market, as this will allow clients to interact with a broader range of counterparties (as opposed to only being able to transact with their clearing firm). We note that the Commission relied on this same statutory authority when proposing a clearing requirement for Treasury securities.[27] Since, in practice, a clearing requirement cannot be implemented in the Treasury market unless the Commission ensures that indirect participants have a viable way to access clearing, it follows that the Commission should be able to rely on the same statutory authority to address access-related issues that could prevent the prompt clearance and settlement of transactions.

Addressing anti-competitive practices and conflicts of interests is also consistent with prior Commission action under Section 17A of the Exchange Act. This past August, the Commission proposed rules under this same authority that would impose specific governance requirements and mitigate conflicts of interest.[28] In that proposal, the Commission stated it was informed by its prior experience in adopting Regulation MC, where it exercised its authority to prevent participant conflicts of interest from influencing a clearing agency to limit access, including by "restricting indirect access by controlling the ability of non-participants to enter into correspondent clearing arrangements."[29] The Commission further noted that addressing these conflicts was appropriate because "the resulting

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[24] *Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management*, 77 Fed. Reg. 21278 (Apr. 9, 2012).

[25] Exchange Act Section 17A(a)(2)(A).

[26] Exchange Act Section 17A(a)(2)(A).

[27] Proposal at 64678.

[28] Clearing Agency Governance and Conflicts of Interest, 87 Fed. Reg. 51812 (Aug. 23, 2022).

[29] *Id.* at 51816.

conflicts of interest could limit the benefits of a … clearing agency in the securities market to indirect participants."[30]

IV. Reevaluating the Commission's Dealer Proposal

Finally, we request the Commission reevaluate its proposal to dramatically rewrite the definition of the term "dealer" (the "Dealer Proposal") in light of this Proposal.[31] Many market participants have detailed how the Dealer Proposal will have profound negative effects for Treasury market liquidity, resiliency, and efficiency by compelling some of the largest customers by holdings to reduce their investment, trading, and hedging activities.[32] The Commission's purported justifications for the Dealer Proposal are even weaker for market participants that are centrally clearing their cash and repo activity, as contemplated by this Proposal.

At a minimum, the Commission should reevaluate the economic analysis of the Dealer Proposal and re-open the public comment period. This is necessary for market participants to meaningfully comment on the cumulative impact of these inter-related proposals for overall Treasury market functioning.

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We have been a longstanding advocate for measures to enhance the efficiency, liquidity, and resiliency of the Treasury market, including expanding central clearing. As demonstrated by experience in other asset classes and academic research, market-wide clearing with fair and open access should be expected to improve market liquidity and resiliency. We urge the Commission to continue to prioritize these reforms.

Please feel free to contact the undersigned with any questions regarding these comments.

Respectfully,

/s/ Stephen John Berger
Managing Director
Global Head of Government & Regulatory Policy

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[30] *Id.*

[31] *Further Definition of ''As a Part of a Regular Business'' in the Definition of Dealer and Government Securities Dealer*, 87 Fed. Reg. 23054 (Apr. 18, 2022).

[32] We note that market participants have overwhelmingly opposed the Dealer Proposal and raised serious concerns regarding the potential negative impact it will have on Treasury market functioning. *See* Audrey Blater, "Examining the SEC's U.S. Treasury Nonbank Dealer Registration Proposal, Coalition Greenwhich (Sept. 20, 2022) ("According to the comment log, the ratio of nays and yays was 30:1, prompting investors to wonder who exactly this rule is intended for") available at https://www.greenwich.com/market-structure-technology/examining-sec-us-treasury-nonbank-dealer-registration-proposal; *see also* Letter from Stephen John Berger, Managing Director, Global Head of Government & Regulatory Policy, Citadel to Vanessa A. Countryman, Secretary, Securities and Exchange Commission (June 7, 2022) available at https://www.sec.gov/comments/s7-12-22/s71222-20130551-299409.pdf.