Via Electronic Submission (www.regulations.gov)

U.S. Securities and Exchange Commission
Washington, DC

Re: Notice Seeking Public Comment on SR-FICC-2017-002
Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Designation of Longer Period for Commission Action on Proposed Rule Change to Implement the Capped Contingency Liquidity Facility in the Government Securities Division Rulebook

To whom it may concern:

The signatories listed below appreciates the opportunity to respond to the U.S. Securities and Exchange Commission ("SEC") and submit comments regarding rules change to Implement the Capped Contingency Liquidity Facility in the Government Securities Division Rulebook.

Background:

Registered clearing agencies that perform central counterparty services are required to maintain sufficient financial resources to withstand a default by the largest participant family to which the clearing agency has exposure in "extreme but plausible conditions." See SEA Rule 17Ad-22(b)(3). In light of this requirement, the Government Securities Division ("GSD") of the Fixed Income Clearing Corporation[1] ("FICC") has proposed a rule change to establish the creation of a Capped Contingent Liquidity Facility (CCLF) that would require solvent members of the GSD to fund the portfolio of a failed participant family during the liquidation process of that participant family.[2]

We we are very mindful of the regulatory concern that financial institutions are able to withstand a period of diminished liquidity and market downturn. Certainly it would be impossible for the lessons of the last great financial crisis to be disregarded. Nonetheless, that does not mean that every response that is motivated by a reaction to the financial crisis is one that is for the better. Certain reactions, whether judged individually or cumulatively, may have unintended negative consequences, perhaps material ones. It is our collective concern that the CCLF proposal is one such proposal that has the very real possibility of doing harm.

In addition, simply as a matter of law, the signatories believe that the scenario that the CCLF is intended to address is not, in fact, "plausible," as required by the rule. That is

[1] The Fixed Income Clearing Corporation (FICC), a subsidiary of The Depository Trust & Clearing Corporation (DTCC), is composed of the Government Securities Division (GSD) and the Mortgage-Backed Securities Division (MBSD). The GSD is responsible for the clearing of U.S. Treasury and agency securities.

[2] The establish of the CCLF is not intended to address market risk in ordinary market conditions, as the current margining models that GSD are sufficient in this regard.

because the CCLF treats U.S. government securities as ordinary "risky" assets, when they are not. U.S. government securities are, *per se*, riskless assets, from a credit standpoint. This means that at a time of financial crisis, money will inherently **flow into** U.S. government securities, not out of such securities. It is the very definition of a financial "crisis" that market participants are seeking to diminish risk; *i.e.,* seeking to move their assets into governments. It is inherently contradictory to posit a financial crisis, and yet posit that investors are seeking to move assets away from U.S. governments.

Summary:

The signatories to this letter, all of whom are either members of GSD or market participants, request that the SEC not approve the establishment of the CCLF in the form proposed. The GSD is required to consider how to maintain its financial resources in the event of a large member default, during "extreme but **plausible** conditions." (Emphasis supplied.) GSD's rule proposal fails on its face because it has given no evidence that the market conditions that it supposes are remotely plausible. As the FICC concedes in its rule proposal, there was no shortage of liquidity in the U.S. government securities markets during the financial crisis because U.S. Treasury securities are a "risk-free" instrument which investors seek out during a time of crisis. The FICC does not suggest that there exists any plausible market condition in which the CCLF, certainly one of the size proposed by the FICC, would be necessary.

That the FICC has not demonstrated any justification for the CCLF is obviously problematic. But the more serious problem is the damage that would be done by the rule proposal. FICC acknowledges that it has been informed by its "smaller clearing members" that they may be forced by the rule change either to withdraw from the clearing business or to terminate their membership with the FICC. In this regard, FICC's only response is to state that it "values" its members and "does not wish to force" them to exit the FICC. It is obvious in this response that FICC does in fact expect that its rule change will force firms to exit the GSD and perhaps the business of clearing government securities. However, GSD makes no attempt to quantify the costs of its CCLF to members, the number of firms that may exit the GSD, or the general reduction in facilities available to clear government securities.

We believe that it is very like that the rule proposal, if adopted, will have a material negative effect on the government securities markets in ordinary conditions. Perhaps even more significantly, the rule proposal, if implemented in its proposed form, will likely materially increase market concentration, decrease market competition, and increase the credit exposure of the FICC to its largest participant families, as smaller participants exit the GSD. This will increase the relative exposure to which the GSD is subject from its largest members. Further, given that there is now only one private bank that clears the great portion of transactions in U.S. government securities (Bank of New York), it is simply not realistic to believe that BONY could take up the slack for FICC if FICC were to choose to "limit" its risk by refusing to clear trades.

Discussion:

As we have stated above, FICC is required to develop liquidity facility that takes account of extreme but plausible conditions. In terms of a model for what such conditions might be, we can look to the market crash of 2008 that included the Lehman default. During the 2008 credit crisis,

the repo markets for FICC members trading in U.S. governments and agencies were liquid and functioned well. In fact, there was actually a scarcity in U.S. Treasury and agency collateral, which is to be expected given that during a time of financial crisis there is a demand for "risk-free" instruments. We also note that the rules adopted under Dodd-Frank have, since the financial crisis, materially reduced the risk of systemically significant financial institutions. Finally, we note that one of the mandates is for the Federal Reserve Bank ("FRB") is to ensure ample liquidity in the US Treasury markets. In short, FICC needs to explain why the conditions that it posits as justifying the CCLF are plausible, because they do not appear to be.

What are the conditions that the FICC is purporting to plan for?

- The largest FICC member firm instantaneously defaults with no prior warning.
- Repo markets in US Treasuries are impaired during the liquidation process, notwithstanding the evidence of the 2008 crisis
- The Fed is not accepting U.S. Treasuries or any other U.S. Government debt as collateral in order to promote liquidity, notwithstanding that this would be contrary to the central mission of the Fed

As we have seen in the case during the credit crisis where we had a major counterparty default, Lehman Brothers, there was a flight to quality and major players such as money market funds, insurance companies, trust banks, etc... were all looking for US Treasuries. There was a scarcity of US Treasuries. The idea that the repo markets would be impaired and FICC will be unable to repo out US Treasuries during the liquidation process seems implausible.

Because the conditions posited by FICC are so implausible, we believe that it is appropriate to look at the much more plausible, in fact likely, negative unintended consequences of the CCLF:

- CCLF will increase costs to FICC members of clearing through the FICC.
  - The current cleared FICC repo marketplace is highly efficient and it allows FICC to assess the risk of each member and margin that risk accordingly based on the risk to FICC. The risk assessment models that the FICC uses is time proven and no member can be outside of 99% confidence of its calculated risk. In addition there is a midday margin call based on the member's mid-day position.
  - Increasing costs to FICC members will result in their reducing the balance sheets devoted to the government securities market by making less funding of positions in U.S. government securities available to market participants. To the extent that less funding (or purchasing power) is available for the U.S. government securities markets, the price that the U.S. government must pay to fund its debt must rise which ultimately increases the cost to the U.S. taxpayer.
  - Increasing the costs of clearing through the FICC will impel firms to move away from central clearing to bilateral transactions, which may be somewhat less efficient, but will be materially less expensive. The use of bilateral repo lines which will reduce efficiency in the market place and will also weaken the FICC ability to monitor the member's risk.

Given that the support of central clearing was intended to be a primary purpose of Dodd-Frank, it is an odd result that the rules adopted pursuant to Dodd-Frank would in fact serve to discourage central clearing by imposing excessive costs based on concerns of a scenario that is not merely implausible, but is one that other provisions of Dodd-Frank are meant to prevent.

- CCLF will increase costs to customers of FICC members
  - The increased costs that would be created by the CCLF, and thus imposed on participants in the government securities markets, will be based on the gross size of a market participant's positions, rather than on the risk of the positions. Put differently, this means that investors that run hedged or arbitraged books in government securities (for example, long one maturity and short another) will be hit much harder than those that take absolute positions.
  - Increasing costs to hedged traders is likely to have materially negative effects on the market. It is the hedge traders who are essential for establishing the yield curve from which the off the run curve in U.S. government securities are priced. When the curve goes out of whack is the activities of the hedge traders that bring the curve back into line, which establishes highly efficient pricing in government securities and gives investors' confidence, such as large asset managers, in the value of the securities that they may own or trade. In addition these firms are active at the auctions which will reduce liquidity on new issue issuance.
  - Discouraging participation by hedge traders in the market has the potential to increase market breaks. For example, the "Joint Staff Report" on the break in the U.S. Treasury Market on October 15, 2014, reported that, during the period of the break, (i) proprietary traders remained the dominant participants in the market, producing high trading volumes and **continuing to provide liquidity**, (ii) while bank dealers provided less liquidity by widening their spreads and withdrawing offers from the market. In short, the costs imposed by the CCLF will increase the likelihood, and likely severity, of market breaks by unduly penalizing the hedge traders whose activities are most likely to maintain the smooth functioning of the market.
- The CCLF is anticompetitive. Small and mid-sized FICC member firms will be hardest hit and will either reduce FICC participation or give up their membership.
  - If one is looking for an analog to how the increase in clearing costs will affect market participants, one can readily look to the market for cleared futures. Since Dodd-Frank, the number of firms that can clear financial futures; i.e., FCMs has been reduced by more than half, almost certainly driven in good part by regulatory burdens. There is no reason to believe that FICC participation would not also be materially impacted.
  - FICC has indicated in our discussions that stated that at quarter ends the large global banks bring their balance sheets down and the mid-size and small firms ordinarily fill that gap providing liquidity to the markets. Without participation by those firms, prices in the U.S. government securities markets will become more discontinuous.

- Driving small and medium firms from the market will increase "too big to fail exposure".

- The CCLF moves the risk from FICC to the only other clearing bank, Bank of New York ("BONY").
  - In case of a default by a major firm, FICC will not take in certain deliveries of securities. The only effect of this would be to move the entire risk of clearing government securities from the FICC to BONY, which is currently the only major bank clearing government securities as JP Morgan has left the market. We do not believe that BONY should be put in a position to absorb this risk and it is not clear that it would be able to do so.

- There is only a limited amount of liquidity available in the market as a whole. To state the obvious, liquidity cannot be infinite. By requiring that so much liquidity be allocated to the U.S. government securities markets—the market that has the least real need for artificial liquidity support—the FICC would be effectively draining the liquidity available for other markets.

- Another way of putting this is that the CCLF is based on the premise that the market for U.S. government securities is like that for other securities. That is not the case; in fact, the government securities market is in many ways the opposite of other markets. When risk is high, investors want to move out of other securities and into U.S. governments that are viewed as risk-free. Conversely, when risk is low, investors are more likely to move into riskier securities. Treating government securities as "just like" other securities and requiring the same level of liquidity funding simply misses the whole point: governments are not like other securities. In fact, our regulatory structure provides numerous exemptions to government securities, because it recognizes that they are not just like other securities.

  By mandating that there be excessive and unneeded funding for governments in times of market stress, the CCLF will reduce available funding in ordinary times, increase the likelihood of market breaks as hedge investors withdraw from the market which is funding is not likely to be needed as investors seek to acquire governments to reduce risk, inconsistent with other regulatory treatment for U.S. Treasuries. We agree that for other asset classes all FMU CCP should have adequate liquidity facilities to support the liquidation of defaulting member's assets. There are many rules that exempt US Treasuries from the rules as they are a special asset class and important to the functioning of the US Government. CCLF should be one of them.

- FRB takes in cash from money market funds through its reverse repo program which has been increased to up to $2 trillion and allowing FMU CCP to place its customer cash with them and paying the bank reserve rate has effectively made the FRB a dealer in competition with the street. This has drained cash providers from the marketplace and in time of crisis we believe those cash providers will increase these deposits with the FRB.

Conclusion:

The CCLF as proposed by the FICC is intended to deal with a problem that does not exist; *i.e.*, it posits a state of the market that is not plausible. In a time of market crisis, investors flee risky

securities and crowd into governments. This behavior is both common-sensical and evidence of its truth is amply provided by the actual conduct of market participants following the failure of Lehman Brothers.

That the CCLF will serve no purpose in a crisis should be argument enough against its imposition. However, the far more significant issues are the problems and costs of the CCLF in ordinary times. These are in summary as follows:

- The CCLF will drive smaller and mid-sized firms from FICC membership, increasing market concentration.

- The CCLF will impel firms to move from central clearing to bilateral transactions (shadow banking).

- The CCLF will reduce funding available for the government securities markets, which will reduce demand and raise the cost to the government of funding the deficit.

- The CCLF will drive hedge traders from the market, which will decrease liquidity, making the yield curve more discontinuous, and increasing the likelihood of market breaks.

Given the importance of the market for U.S. government securities, and the potential impact that the FICC's proposed changes could have on that market, we urge that a study be conducted of the costs and benefits of the FICC proposal. Such a study should not be confined to the narrow question of whether the rule change might provide the FICC with more liquidity but should take account of the U.S. markets as a whole. Ideally, the participants in the study would include a broad range of regulators that have an interest in the continuing strength of the U.S. governments markets, including, in addition to the SEC, the U.S. Department of the Treasury and the other regulators that participated in the study of the 2014 market break. Among the questions that the study might consider as to the CCLF are the following:

- Will CCLF reduce the number of firms that clear U.S. governments through FICC and, if so, how many firms will leave the FICC?

- As to those firms that remain clearing members of the FICC, will CCLF reduce the volume of business that they clear with the FICC, and, if so, how great will be the reduction in volume?

- In light of the answers to the above two questions, will the CCLF increase market concentration, and if so, how much? Will such increased concentration, exacerbate concerns as to "too big to fail"?

- Will the CCLF impel firms to move away from central clearing towards bilateral clearing relationships (shadow banking)?

- To the extent that there is a diminution of involvement by clearing firms in the U.S. governments market, how will that affect market participants? Will different classes of

market participants be differently affected, particularly participants that engage in hedge transactions in high notional amounts that result in low risk exposures?

- If hedge participants exit or reduce participation in the U.S. governments market, will that have a negative effect on pricing so that the yield curve becomes discontinuous and government securities become difficult to price?

- Will any discontinuity in pricing have a negative effect on the auction for U.S. government securities?

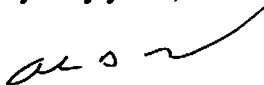
- Is the result of the CCLF to drive transactions to BONY is a time of a market break? If so, is that a stress that BONY (as the only primary triparty clearing bank remaining in the market) able to bear? How does risk at BONY affect the Federal Reserve?

- Perhaps most significantly, do all these changes result in the U.S. government having to pay a higher rate to borrow and materially raise the costs of funding the government's debt which ultimately increases the cost to the U.S. taxpayer?

In summary, the signatories hope that the SEC will not approve the adoption of the CCLF without far more detailed consideration of its impacts in light of the damage it will do to the market for U.S. government securities and the resulting costs to U.S. taxpayers. The signatories of this letter are available to meet to discuss the direct impact of the CCLF on their individual activities and the potential effects of the CCLF on the market as a whole.

If you have any questions with respect to this letter, please contact either Alan Levy, Managing Director of the Industrial and Commercial Bank of China Financial Services LLC, or Steven Lofchie, of Cadwalader, Wickersham & Taft.

Very truly yours,



Alan Levy
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