# US Treasury central clearing and settlement transformation—Examining key implementation requirements

How will the adoption of the SEC's Final Rule impact your firm's operations and strategic transformation objectives?

**The SEC adopts regulatory amendments to enhance risk management practices and facilitate centralized clearing of US Treasury security transactions.**

## Background

On December 13, 2023, the Securities and Exchange Commission (SEC) approved new regulations under the Securities Exchange Act of 1934, revising the standards for covered clearing agencies (CCAs) and requiring centralized clearing of eligible US Treasury securities transactions.

The regulatory update was largely driven by several significant market disruptions in the $26 trillion US Treasury market throughout the last decade—most recently the "dash-for-cash" during the COVID-19 pandemic, which resulted in a sharp decline in Treasury prices and required a liquidity injection from the Federal Reserve to mitigate systemic risk and global implications.[1]

As noted by the SEC, the US Treasury market serves as the cornerstone for much of the US capital markets, yet the underlying clearing and settlement model requires a considerable overhaul:

> Having such a significant portion of Treasury markets uncleared—70 to 80 percent of the Treasury funding market and at least 80 percent of the cash markets—increases system wide risk.[2]

Therefore, the migration from bilateral to centralized clearing, both for cash and repos, is a critical step towards enhanced liquidity and reduced systemic risk.

## Purpose

The Final Rule's amendments aim to enhance the regulatory standards for CCAs in the US Treasury market. Specifically, key objectives and targets of the regulatory updates include:[4]

1. **Systemic risk reduction/market stabilization:** CCAs must establish written policies and procedures, requiring all eligible secondary market US Treasury security transactions to be centrally cleared, thereby reducing counterparty risk.
2. **Risk management enhancement:** Updates to CCA standards regarding netting and margin practices; mandate the separate calculation, collection, and holding of margin for transactions submitted on behalf of indirect participants versus direct participants.
3. **Broker-dealer customer protection updates:** Amendments to the Broker-Dealer Customer Protection Rule enable customer margin required and on deposit at CCAs for US Treasuries to be included as a debit in the customer reserve formula, subject to certain conditions.

These objectives aim to standardize and strengthen the US Treasury market, enabling a safer and more transparent trading environment for market participants.

*Implementation of the SEC's Final Rule aims to bolster market liquidity, enhance investors' protection, and reduce systemic risk within the Treasury market.*

[1] SEC statement: The Treasury Market: Improving Transparency and Stability
[2] SEC press release: SEC Adopts Rules to Improve Risk Management in Clearance and Settlement and Facilitate Additional Central Clearing for the U.S. Treasury Market
[3] At present, Fixed Income Clearing Corporation (FICC) is the sole CCA for UST securities transactions
[4] SEC Final Rule: 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

# Summary of the Final Rule: Understanding the key regulatory amendments

## Key roles

**Covered clearing agency (CCA)**

Acts as an intermediary between buyers and sellers (and vice versa) in a transaction, mitigating counterparty risk; provides clearing and settlement services[1]

**Direct Participant**

Member firm authorized to directly engage with a CCA for the purposes of clearing and settling transactions (e.g., broker-dealers, banks, etc.)[1]

**Indirect Participant**

Firm that accesses the CCA's payment, clearing, and settlement facilities through a Direct Participant (e.g., customers, etc.)[1]

## Key regulatory provisions:[2]

Key regulatory amendments in the Final Rule require CCAs providing central counterparty services for US Treasuries to comply with the following amendments:

### Mandatory clearing and access requirements

**Amendment to Rule 17ad-22(e)(18)(iv)[3]**

Mandates that US Treasury securities CCAs establish, implement, maintain, and enforce written policies and procedures that are designed to be risk-based, objective, and made available to the public. Policies and procedures are mandates to:

- Establish policies requiring Direct Participants to submit all eligible secondary market transactions in US Treasuries for clearance and settlement
- Identify and monitor participants' submission of transactions for clearing
- Ensure appropriate means to facilitate access to clearance and settlement services, including for indirect participants.

### Eligible secondary market transactions

**Amendment to Rule 17ad-22(a)[3]**

Eligible secondary market transactions in US Treasury securities that are subject to clearing and settlement requirements include:

- Repurchase (repo) and reverse repo agreements where one counterparty is a Direct Participant (certain exclusions apply)
- Purchase and sale transactions between any counterparty and a Direct Participant, if the Direct Participant is utilizing a trading facility and is a counterparty for both buyer and seller in two separate transactions
- Purchase and sales between a Direct Participant and a registered broker-dealer, government securities broker, or government securities dealer except where one counterparty is a central bank, sovereign entity, an international financial institution, or a natural person.

### Margin segregation for house versus customer/clearing and settlement access

**Amendment to Rule 17ad-22(e)(6)(i)[3]**

Requires CCAs to establish, implement, maintain, and enforce written policies and procedures in regard to the calculation, collection, and holding margin amounts from a direct participant for its proprietary US Treasury securities positions, separately and independently from margin posted by an Indirect Participant (prohibiting house and customer netting)

**Amendment to Rule 17ad-22(e)(18)(iv)(C)[3]**

Requires CCAs to establish, implement, maintain, and enforce written policies and procedures for clearing and settlement of eligible secondary market US Treasury transactions, including those of Indirect Participants

### Broker-dealer customer protection

**Amendment to Rule 15c3-3a[3]**

Permits broker-dealers to include margin required and on deposit at CCAs for US Treasuries as a debit in the customer reserve formula, subject to certain conditions

[1] SEC Final Rule: 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
[2] Select snapshot of key regulatory requirements, not an exhaustive, and is subject to change based on additional regulatory updates
[3] KPMG LLP: U.S. Treasury Securities Clearing Agency Standards: SEC Final Rule

# Navigating operational challenges across your firm's value chain

As firms prepare for changes in the US Treasury market, they should consider allocating additional resources for a thorough impact assessment, in an effort to address the following key challenges across the end-to-end processing lifecycle.

## Key processing pain points:[1]

| Challenge | KPMG observation | Market implementation challenge |
|---|---|---|
| **Designing a clearing model strategy** | Strategic design of the future-state clearing model and related considerations for access to CCA is time consuming and costly—especially if indirect/sponsored members aspire to become direct/sponsoring members. | **Determining the most appropriate model**<br>Conducting thorough analysis to determining the best suited model for your organization—Direct (sponsoring) versus Indirect (sponsored or agent)—organizations will be required to adopt/enhance usage of FICC's clearing models considering membership needs, relative costs, etc. |
| **Defining a methodology to identify transactions requiring central clearing** | Firms must establish their evaluation criteria to determine which transactions will be impacted by the Final Rule and will require central clearing (accounting for transactional exemptions such as sovereign entities, central banks, international financial institutions, etc.). | **Defining comprehensive methodology for identifying transactions eligible and required for central clearing**<br>Conduct an evaluation of transactions and counterparties likely to be impacted by the Final Rule, requiring central clearing. |
| **Updating margin and reserve calculations** | Amendments to broker-dealer customer protection rules (e.g., Rule 15c3-3) require modifications to includable amounts in the customer reserve formula. Further, margin is required to be calculated, collected, and maintained separately for Direct and Indirect participants. | **Interpreting and implementing margin and collateral requirements**<br>Assessing the impact of margin and collateral requirements on collateral management processes, margin requirement calculations, and service agreements with CCA. |
| **Upgrading complex architecture** | Many firms have complex, internal architecture with intricate logic sets that support their collateral and inventory management, margining, and customer segregation operations. | **Addressing modifications to existing proprietary infrastructure—especially on collateral and inventory management processes**<br>Systems and applications supporting FICC trading will need to be enhanced/built to accommodate required clearing changes. |
| **Facilitating data sourcing and quality control** | Many organizations struggle with issues related to the accurate sourcing of data; validating the true golden source of data and QA/QC considerations/protocols continue to remain critical dependencies. | **Identifying data sourcing enhancements/ change mapping/tracking**<br>Due to anticipated changes in transaction flow, messaging, supporting instructions, and other critical data elements, a technology uplift is likely required for data sourcing to ensure position and transactional reporting is accurate and timely. |
| **Reviewing and renegotiating contract/ documentation** | There is a significant volume of highly negotiated documentation (especially for buy-side firms) and a lack of industry-wide standardization of client agreements. | **Identifying and repapering large volumes of in-scope client contracts/ documentation**<br>Evaluating and reassessing legacy documentation that requires renegotiation (e.g., client service contracts/agreements etc.) and drafting agreement of new legal documentation may be significant and can potentially be time-consuming and costly. |

[1] Select sample of key pain points and is not representative of an exhaustive list and is subject to change based on any updates to the regulatory requirements.

# Navigating operational challenges across your firm's value chain (continued)

## Key processing pain points (continued):[1]

| Challenge | KPMG observation | Market implementation challenge |
|---|---|---|
| **Coordination with third-party/vendor applications, data, and workflows** | There is a large dependency on multiple vendors for various process and data-related activities (especially for smaller sell-side firms as well as a large portion of buy-side firms). | **Performing a detailed vendor analysis**<br>Vendor management and agreements highlighting areas requiring enrichment/ clarification/additional documentation work in concert with updated workflows defining operating model enhancements. |
| **Implementing and supporting a new operating model** | Incremental costs include, but are not limited to, investments in technology infrastructure, to accommodate clearing mandate enhancements, and also include increased cost from CCA and/ or sponsoring firms (e.g., initial margin, capital requirements, fees, etc.). | **Assessing the increased cost due to anticipated increases in transaction cost and associated capital needs**<br>Market participants that have historically underutilized central clearing may see increases in transaction costs, required initial margin, and capital requirements. |
| **Updating regulatory reporting and governance protocols** | Additional regulatory reporting obligations require cross-functional updates to standard operating procedures (SOPs), desktop procedures, key performance indicators (KPIs), key risk indicators (KRIs), and automated reporting processes, etc. | **Reviewing and recalibrating functional and systematic regulatory reporting/ governance updates**<br>Market participants will need to assess their end-to-end processing lifecycle to define areas requiring functional and systematic updates. |
| **Evaluating accounting implications** | The new Agent Clearing Service being offered by the FICC has downstream implications in that clients transacting on a "Done-Away" or "Done-With" basis will need to evaluate if an agent clearing member (ACM) is acting as a principal or agent. | **Assessing the downstream accounting implementations, as a result of the new FICC clearing service**<br>Concluding on if an ACM is a principal or agent will impact how the ACM reports a client's repo transactions on the balance sheet. |

*A wide-ranging impact assessment is the first step towards the development of a robust and resilient transformation roadmap.*


[1] Select sample of key pain points, not representative of an exhaustive list, and subject to change based on any updates to the regulatory requirements

## Regulatory reporting: Assessing the Final Rule's downstream implications

When examining the regulatory reporting requirements, market participants should perform a wide-ranging assessment to determine how rule changes will impact their firm's unique operating model. One of the amendments to the Final Rule enables market participants to classify the margin required and on deposit at a clearing agency for US Treasury securities as a debit in the customer reserve formula. Inclusion of this debit could result in the broker-dealer freeing up cash and/or qualified securities, which could be utilized to fulfill the clearing agency's margin requirements. These amendments may also impose specific requirements on covered CCAs handling US Treasury securities. Specifically, the requirements would require CCAs to implement policies to mandate that participants; clear eligible secondary market transactions; calculate, collect, and maintain separate margin accounts for direct and indirect participants, and ensure universal access to clearance and settlement services. The provisions seek to enhance the safety and efficiency of Treasury securities trading and reduce the potential for market destabilization caused by a single participant's failure.

### Regulatory spotlight:

| | Key themes | Industry considerations[1,2] |
|---|---|---|
| **Margin and reserve calculations** | **"Collect gross/deliver gross" booking model** | Market participants have expressed some concerns regarding the amendments to Rule 15c3-3, pertaining to the "collect gross/deliver gross" booking model, which requires individual segregation. |
| | | To comply, Direct Participants would be subject to significant margin requirements for nonsegregated accounts, which could increase capital constraints. |
| | **Reserve Formula treatment** | Market participants have requested additional guidance on the Customer Reserve Formula treatment of includable debits and credits if the broker-dealer posts cash in lieu of pledging customer assets. |
| | | Currently, the industry has a mixed view on treatment of includable amounts as compared to other clearing corporation deposits. |
| **Clearing model strategy** | **Drafting processing protocols for direct clearing and settlement** | CCAs are required to implement policies and procedures that mandate Direct Participants to submit certain eligible secondary market transactions for clearing. |
| | | CCAs must ensure that policies and procedures are set to calculate, collect, and hold margin for proprietary transactions of Direct Participants separately from transactions submitted on behalf of Indirect Participants. |
| | | CCAs are obliged to establish policies and procedures to provide access to clearance and settlement services for all eligible secondary market transactions, including those involving Indirect Participants. |
| | **Updates to policies and procedures** | On an annual basis, CCAs must review policies and procedures relating to clearance and settlement services for eligible secondary market transactions. |
| | | CCAs must be prepared for compliance by March 31, 2025, with full compliance from Direct Participants required by December 31, 2025 and June 30, 2026, for cash and repo transactions, respectively. |
| **Future-state operating model** | **External consultation** | Clearing agencies and Direct Participants may elect to engage with third-party vendors to deepen their understanding of the Final Rule and implications for their firm's unique business model. |
| | **Data-driven impact assessment** | Market participants are encouraged to perform a data-driven impact assessment and proactive evaluations of key processes to address critical knowledge gaps. |
| | | Robust impact assessments should be accompanied by a cost reduction model and a plan for process reengineering, where applicable. |

*Based on forthcoming guidance from the SEC, broker-dealers will be able to better determine treatment of related balances under SEA Rule 15c3-3.*

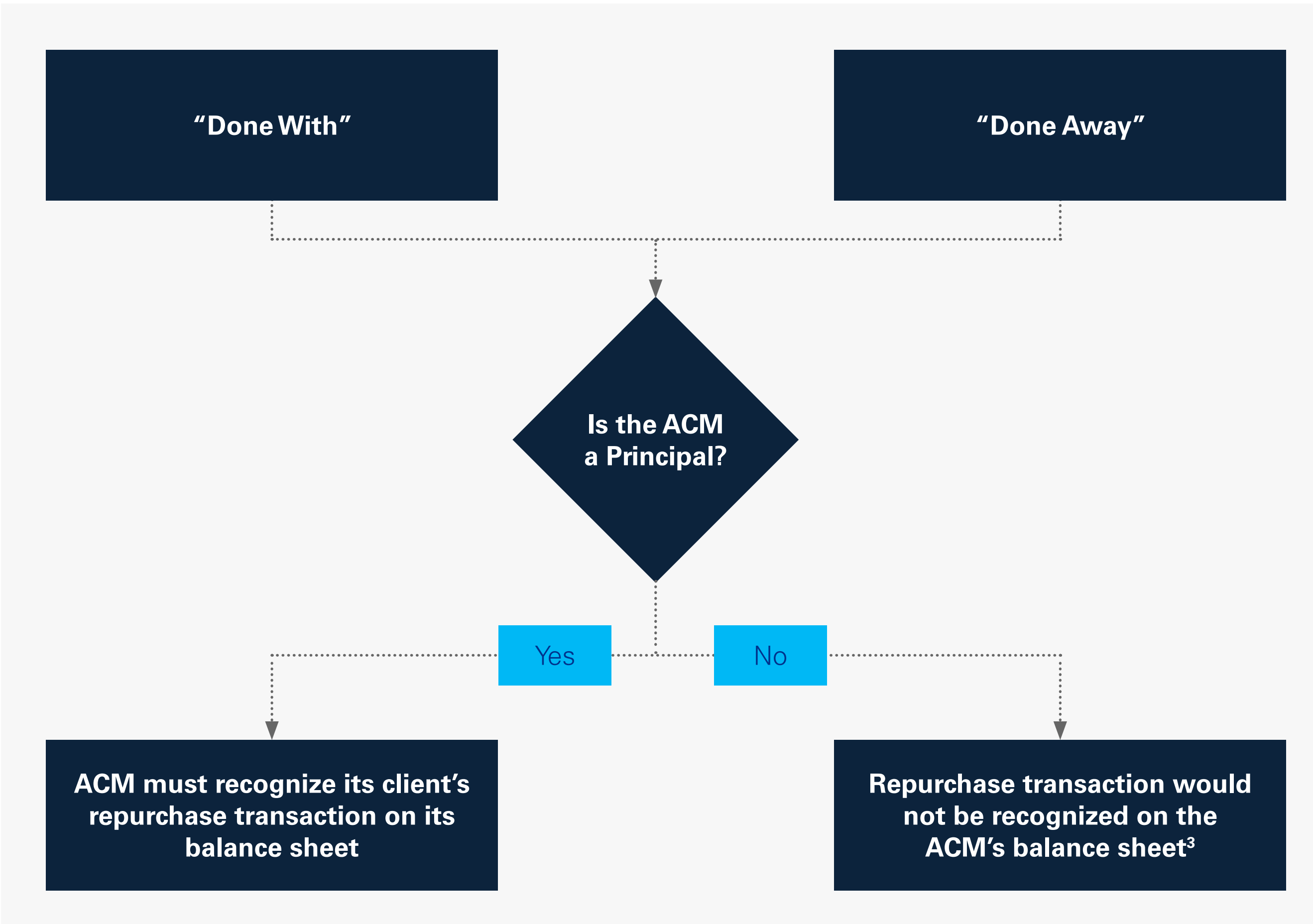
[1] Final Rule: Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities
[2] Proposed Rule: Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities

# Accounting: Assessing the Final Rule's downstream implications

As part of the implementation of the SEC's Final Rule, the FICC has proposed changes to the Government Securities Division Rulebook (see SEC Release No. 34-99817[1]), including introducing an Agent Clearing Service. As discussed on page 6 of the Depository Trust & Clearing Corporation's (DTCC) "The U.S. Treasury Clearing Mandate: An Industry Pulse Check,"[2] the changes would provide clients with indirect access to clearing on both a "Done-Away" basis, which represents transactions that are executed by an indirect participant with a counterparty other than its clearing intermediary (ACM) and on a "Done-With" basis, which represents transactions that are executed between an indirect participant and its ACM.

## Accounting spotlight:

**Preliminary future-state processing flow**




In determining whether it is acting as a principal or agent, an ACM should carefully consider the accounting literature and discuss the accounting requirements with its accounting advise and independent auditors. Because the definition of a principal versus an agent is also a legal concept, an ACM may also need to consult with legal counsel and consider the necessity of obtaining a legal opinion to support its accounting conclusion. We expect that there will be ongoing industry discussion of this matter as ACMs further develop their accounting analysis of the proposed clearing rules.

*ACMs will need to determine if they are a principal or agent for accounting purposes, driving whether a balance sheet gross-up is required.*

[1] SEC Release No. 34-99817
[2] DTCC's "The U.S. Treasury Clearing Mandate: An Industry Pulse Check"
[3] If acting as an agent, there would be no gross-up of assets and liabilities associated with the transactions.

# Exploring opportunities for strategic assessment and recalibration

Given the cross-functional scope and complexity of the required changes, firms should consider creating an internal working group (IWG)[1] with representation from Stock Borrow-Loan (SBL), Operations, Tech, Risk, Compliance, Regulatory Reporting, Governance, and Data and Vendor Management, among others. In doing so, the IWG will proactively address questions related to resource allocation, funding, and their initial impact assessment.

As a next step, consider reviewing the below implementation guidelines with your firm's stakeholders:

| | Anticipated implementation complexity | Key implementation considerations[2] |
|---|---|---|
| **Clearing model strategy** | Medium | **Assess existing clearing model challenges**—evaluate the efficacy of the firm's existing clearing model structure and key pain points<br>**Design an optimized clearing model**—develop a strategy for restructuring the clearing model to align with a direct (sponsoring) or indirect (sponsored or agent) approach; assess the projected implementation costs and return on investment |
| **Methodology to identify transactions requiring central clearing** | Medium | **Design a methodology for transaction vetting**—define criteria for identifying and evaluating transactions that will be impacted by the Final Rule<br>**Define transactions required for central clearance**—perform a thorough assessment, detailing transactions eligible for central clearance |
| **Margin and reserve calculations** | High | **Develop a thorough understanding of the regulatory amendments**—review the updated margin and collateral requirements<br>**Perform an impact assessment**—analyze the impact of the rules and changes to the existing tech stack, supporting processes, calculations, and SLAs |
| **Complex architecture** | High | **Evaluate the impact of clearing changes to the technical architecture**—develop a baseline impact assessment for systems and applications supporting FICC trading (e.g., batch jobs, etc.)<br>**Design a technical optimization roadmap**—develop a robust directory of technical enhancements and build requirements, associated with timelines, and key dependencies |
| **Data sourcing and quality** | Medium | **Define future-state data transmission requirements**—review the updated position and transaction reporting requirements and service level agreements (SLAs)<br>**Develop an implementation roadmap**—identify key updates and data mapping requirements across processes, workflows, and systems to align to future-state protocols and SLAs |
| **Contract documentation review and renegotiation** | Low | **Define in-scope client contracts**—identify relevant contracts/documents for review and renegotiation<br>**Draft updates to existing settlement contracts**—evaluate legacy contracts' terms/conditions, draft proposed updates, and renegotiate with clients |
| **Third-party/vendor applications, data, and workflow** | Medium | **Identify impact to vendors' workflows**—review existing service agreements to evaluate areas requiring an update or renegotiation<br>**Align on the implementation requirements**—communicate change requirements to vendors; align on the design, build, testing, and implementation phases and associated timelines |
| **Implementing and supporting a new operating model** | High | **Perform a financial cost assessment**—develop a transformation and operating cost projection model, detailing expense categories and ranges<br>**Evaluate the impact on margin reserves and capital requirements**—create a financial projection model for updated margin and capital requirements |

**Anticipated implementation complexity:** High Medium Low

[1] Additionally, market participants should consider joining industry working groups (e.g., SIFMA, etc.) to stay abreast of the latest industry developments.

[2] Select sample of suggested implementation considerations is not representative of an exhaustive list and is subject to change based on your Firm's unique operating model.

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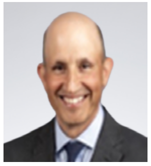

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# How KPMG LLP can help

## Operations and tech

**Wide-ranging impact assessment**
Defining and mapping your firm's cross-functional process flows—resulting in a robust gap analysis, list of process reengineering opportunities, and a baseline implementation cost assessment, etc.

**Change management support**
Assessing, effecting, and managing the required changes across people, process, technology, and data—resulting in thorough test scripts, accelerated test execution, smart automation validated test results, recalibrated KPIs and KRIs, and more.

## Accounting

**Accounting evaluation**
Evaluating the "Done With" and "Done Away" models utilized by your firm and assessing principal versus agent considerations—resulting in a robust assessment of the accounting treatment required under US generally accepted accounting principles (GAAP) and/or International Financial Reporting Standards (IFRS).

**Documentation—approach and conclusions**
Documenting the model(s) utilized by your firm and the associated principal versus agent considerations—resulting in detailed and well-defined documentation as it relates to how your firm should account for both "Done With" and "Done Away" trades under GAAP and/or IFRS.

## Regulatory reporting

**Scoping and gap assessment**
Determining the scope and nature of potential impact to rule conformance, regulatory operations, financial reporting, and internal controls over compliance—resulting in a detailed gap assessment and process enhancements required for compliance with SEC regulations.

**Implementation support**
Managing and guiding your firm through the change process—resulting in the implementation of industry-leading practices based on your specific business profile, operational challenges, and regulatory obligations.

**Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.**

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