

How does the new Treasury clearing rule affect custodians and buy-side participants?



The SEC (Securities and Exchange Commission of the USA) has approved a new rule requiring most of the U.S. Treasury Securities transactions, including repo's, reverse repo's and tri-party repo to be cleared through a central clearing agency (CCA). Currently the FICC (Fixed Income Clearing Corporation) is the main CCA utilized for Treasury clearing and netting (novation).

Other CCA's are entering the market as alternatives to FICC such as ICE Credit Clear (ICC) and the Chicago Mercantile Exchange (CME). Although most of the material spoken and published has been focused on the sell side, there are significant implications and changes associated with buy side transactions.

The SEC's original proposal included all cash transactions (Outright Buys and Sells), however they amended the original plan with a few exceptions, to exclude buying and holding US Treasuries often engaged in by buy side participants such as, customers of custodians (institutional investors), asset managers hedge funds, money market funds, etc.

The original mandated timelines associated with this change were December 31, 2025, for cash transactions and June 30 2026 for repo clearing. The SEC has since moved these dates forward one year to December 31, 2026 for cash and June 30, 2027 for repo, after considerable pushback from the industry participants and Securities Industry and Financial Markets Association (SIFMA).

As previously mentioned, most of the dialogue has been on the sell side, but how does this affect the custodians and buy side participants even though buy and hold cash transactions are exempt under most circumstances. Firstly, any bank acting as a custodian for active traders such as a treasury desk of a bank that engages in frequently buying

and selling of cash US Treasuries must submit their trades to a CCA such as FICC for matching and netting purposes. Additionally, any underlying customers of a custodian that engages in repo, reverse repo or tri-party repo activity must also submit their trades to the CCA, for example the FICC. This rule also applies to non-US domicile banks and broker dealers engaging in US Treasuries.

How is this accomplished from a custodial point of view?

There are 3 ways to accomplish this:

1. Direct CCA membership

The custodian has a direct relationship with the CCA (FICC). Deliveries and receive messages are submitted to the FICC for comparison and netting by the custodian and novated (netted) delivery/receive messages are received from the CCA (FICC) to the custodian (the direct CCA (FICC) member).

The custodian as a direct member will take complete control of the executed buy/sell, repo/reverse transaction after execution and submit it to the CCA(FICC) for comparison and netting. The custodian as a direct member will segregate these trades from any proprietary activity to calculate whatever margin is required from the CCA (FICC) and will collect the cash/ collateral amounts from the underlying custodial customers. The custodian will also be required by the CCA to have adequate capital to meet its clearing obligations to its customers.

Direct membership system changes required:

As a direct member, the custodial banks system must now direct all its US Treasury transactions for settlement (receive and deliver orders) to the CCA (FICC) instead of settling trade for trade with each counterparty's settlement

provider. This will require directing some cash trades (active traders) and all repo and reverse repo transactions to the CCA (FICC) for comparison and netting purposes. In turn, the CCA (FICC) will deliver comparison and netted transaction information back to the custodian bank system. Both the submission of transaction information and the receipt of comparison and netted information will be done preferably in real time due to the repo same day settlement cycle.

2. Sponsored CCA membership

The custodian is sponsored by an affiliate or an intermediary.

Affiliate Example- XYZ custody utilizes XYZ Security's direct membership to FICC. Delivery and receive messages are delivered to XYZ securities for submission to the FICC for comparison and netting.

Intermediate Example- XYZ custody utilizes a broker-dealer (not an affiliated member of the custodian) with direct membership to the FICC e.g., ABC Securities, DEF Brokerage, GHI Capital etc.

Under the sponsored membership, the custodian bank through an affiliate that is a direct member, can act as the intermediary between its underlying customers and the affiliate direct member with the CCA (FICC).

Additionally, if the underlying custodial customer(UCC) wants to submit its US Treasury transactions with the broker/dealers it's executing through, and the executing broker has a direct

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membership with the CCA (FICC), it can submit trades on behalf of the (UCC) This will require separate executing broker and repo trade agreements with each broker dealer, between the broker/dealer and the UCC. Under this scenario, the UCC will require credit and KYC approval with the broker/dealer prior to being accepted.

Sponsored membership system changes required:

Depending on whether the custodial bank is a sponsored member of an affiliate or whether your UCC’s are being sponsored by several other broker/dealers, it will predicate what system changes are necessary. If the custodian bank is sponsored by an affiliate, all these trade types will be sent to the affiliate for comparison and netting. The affiliate will in turn send all the comparison and netted information back to the custodian for the remaining balance order settlement. Again, this will be preferably done in real time.

In the case of a UCC transacting in repo with a direct member, the transactions will be directed to the individual broker dealers on a trade-for-trade basis, but a netted settlement balance order will be received from the individual broker dealer for the custodial bank to settle.

This will be different from the current process that will always expect the individual settlement information back from the UCC’s settlement counterparty.

3. Agency CCA membership

This membership is not applicable. This is when a direct member clears for an executing broker who is not an FICC member. Correspondent Clearing and Prime Broker related.

The agency membership applies to non-clearing executing brokers (Away trades) and Broker/Dealer correspondent and prime broker clearers. This membership should not apply to custodians.

Conclusion

Custodians and custodial customers will have choices to make. Custodians who do not have affiliates that are direct members of CCA’s (FICC) must decide if they want to engage in this type of business.

A substantial capital contribution is required and there is credit risk associated with being a direct netting member as the custodian will act as the middleman between the UCC and the CCA fronting the risk in the case of insolvency.

There is also an investment in software upgrades that will be required to facilitate real time comparison and netting. The custodian will also need to decide if it wants to be competitive with other custodians that either have affiliates that offer these services or offer it themselves.

Custodial customers will have to decide whether they want to choose a custodian that provides direct or sponsored membership services,

or if it’s worth it to independently have several agreements with each US Treasury securities executing and clearing brokers while maintaining a relationship with their current custodian.

As 2026 and 2027 deadlines are fast approaching, these are the decisions that will have to be made in the coming months by custodians and the custodial customers.



Gary DeDilectis
Director, Senior Product Manager,
Tata Consultancy Services

