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Kevin M. O'Neill, Deputy Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Standards for Covered Clearing Agencies (File Number S7-03-14)

Dear Mr. O'Neill:

The Depository Trust & Clearing Corporation ("DTCC") appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "Commission" or the "SEC") on its proposed rules regarding "Covered Clearing Agencies" (the "Proposed Rules") set forth in Release No. 34-71699 dated March 12, 2014 (the "Release").[1]

Introduction

The Proposed Rules, which would amend SEC Rule 17Ad-22[2] (the "Clearing Agency Standards"), would impose new (or heightened) standards on any "covered clearing agency." Covered clearing agencies are those clearing agencies that have been designated as systemically important and for which the SEC acts as the supervisory agency (including DTCC's clearing agency subsidiaries The Depository Trust Company ("DTC"), National Securities Clearing Corporation ("NSCC") and Fixed Income Clearing Corporation ("FICC")), as well as certain other clearing agencies that provide security-based swap central counterparty services or engage in other activities that the SEC deems to have a complex risk profile. The Proposed Rules are largely consistent with the *Principles for Financial Market Infrastructures* ("PFMI"), which were developed by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions ("CPSS/IOSCO") and published in April 2012 (the "PFMI Report").[3]

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[1] Standards for Covered Clearing Agencies, 79 Fed. Reg. 16,866 (proposed Mar. 26, 2014) (to be codified at 17 C.F.R. pt. 240).
[2] 17 C.F.R. § 240.17Ad-22 (2013).
[3] COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS & TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, PRINCIPLES FOR FINANCIAL MARKET INFRASTRUCTURES (Apr. 2012), *available at* http://www.bis.org/publ/cpss101a.pdf.

The method by which the SEC translates the PFMI into binding rules is to require covered clearing agencies to 'establish, implement, maintain and enforce written policies and procedures reasonably designed' to effectuate the particular principle or requirement.[4] In some instances the Proposed Rules provide greater specificity than either the PFMI principle, or the analogous rule adopted by the Commodity Futures Trading Commission ("CFTC")[5] or proposed by the Board of Governors of the Federal Reserve System (the "Board"),[6] and in other cases the Commission is proposing rules with fewer additional specific requirements than those proposed by the Board or adopted by the CFTC.[7]

Noting the role of SEC staff in the development and drafting of the PFMI Report,[8] the Release indicates that the Commission believes that the standards set forth in the PFMI are generally consistent with the requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act") applicable to clearing agencies, and that the Proposed Rules are intended to be in line with the standards set forth in the PFMI Report.[9] This is critical to achieve consistency with the regulatory framework applicable to systemically important market infrastructures, both in the United States and in other jurisdictions, and also for the determination that covered clearing agencies that are central counterparties ("CCPs") can achieve "qualifying CCP" ("QCCP") status under the Basel III framework, which should have the effect of reducing capital charges that foreign bank members of U.S. clearing agencies may have than if such entities were not deemed QCCPs.

The SEC's press release announcing the Proposed Rules[10] also notes that the proposal, as currently structured, would create two tiers of regulations under SEC Rule 17Ad-22: enhanced rules for covered clearing agencies under Rule 17Ad-22(e), and the existing rules that would apply for all other registered clearing agencies under Rule 17Ad-22(d).[11] In addition, under the proposal, existing Rule 17Ad-22(b), which applies only to those clearing agencies that provide central counterparty services, would continue to apply to covered clearing agencies that are CCPs. So as regards covered clearing agencies, in some cases the new rules would supersede the existing rules, but in other cases (with respect to CCPs), the new rules are intended to apply concurrently with existing rules.

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[4] *See, e.g.*, Release at 16,875.
[5] Derivatives Clearing Organizations and International Standards, 78 Fed. Reg. 72,476 (Dec. 2, 2013) (to be codified at 17 C.F.R. pt. 39).
[6] Financial Market Utilities, 79 Fed. Reg. 3666 (proposed Jan. 22, 2014) (to be codified at 12 C.F.R. pt. 234).
[7] *See* Release at 16,945-47.
[8] *See also* Policy on Payment System Risk, 79 Fed. Reg. 2838, 2840 (proposed Jan. 16, 2014) (noting the significant role played by the SEC, CFTC and Federal Reserve in the development of the PFMI).
[9] Release at 16,871, 16,949.
[10] Press Release, SEC, SEC Proposes Rules for Systemically Important and Security-Based Swap Clearing Agencies (Mar. 12, 2014) ("Press Release"), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541113410 (last visited May 20, 2014).
[11] *Id.* (expressing rationale that "[t]he two tiers would provide flexibility for new entrants that might seek to operate as registered clearing agencies while applying enhanced requirements to those clearing agencies that raise systemic risk concerns due to, among other things, their size, systemic importance, global reach, or the risks inherent in the products they clear.").

General Comments

DTCC is broadly supportive of the Proposed Rules, and we recognize the considerable efforts of the Commission and staff in promulgating the Proposed Rules. We read Proposed Rule 17Ad-22(e), as a collective set of regulations, as generally following a principles-based approach that acknowledges the inherent differences among clearing agencies in the services they provide, markets they serve, and differences in their business structures. As such, the Proposed Rules should provide covered clearing agencies with the flexibility they need to design and structure their policies and procedures to effectuate a given requirement in a manner that they determine appropriately takes these factors into account. DTCC supports this approach.

Where elements of the Proposed Rules differ in detail or approach from the PFMI, in many cases such distinctions reflect the nature of the securities markets within which the covered clearing agencies operate, and the particular requirements of the Exchange Act.[12] This is particularly true with regards to the Commission's approach to segregation and portability, and to liquidity risk.[13] In some cases the Commission has outlined more detailed and prescriptive requirements – particularly in the areas of credit risk, margin, liquidity risk and business risk/capital requirements – which the Release indicates are designed to assure a minimum standard of robust risk management practices. The focus of these provisions is that, given their systemic importance, covered clearing agencies need to maintain sufficient financial resources to minimize the impact that either participant default or business loss could have on their operations and the continued provision of their critical services to their relevant markets. A common theme to these provisions is that covered clearing agencies need to review the assumptions and parameters underlying the models and approaches they utilize to maintain their financial resources on an ongoing basis, so as to be able to identify and address in a timely manner developing trends or factors in their markets that could adversely affect the continued maintenance of such coverage. DTCC supports this approach, together with the implicit corollary that covered clearing agencies also need to have the appropriate flexibility to implement timely modifications to relevant parameters, assumptions and approaches, if their review indicates such modifications are warranted.

As a general matter, and with respect to each particular provision, the Commission seeks specific comments on whether it has struck the appropriate balance between taking a principles-based approach (which provides covered clearing agencies with the greatest degree of flexibility in implementing the proposed requirement) and a more prescriptive detailed approach (which may limit the amount of discretion available to the clearing agency in effectuating the particular requirement). DTCC believes that the Commission has generally struck the appropriate balance between the principle and level of detailed requirements, but we note below a few instances where we believe further refinement might strengthen the Proposed Rules and clarify their interpretation.

[12] *See, e.g.*, Release at 16,904-05 (regarding Proposed Rule 17Ad-22(e)(14): Segregation and Portability, and the operation of the U.S. securities cash markets).
[13] Proposed Rule 17Ad-22(e)(7). These differences are discussed in the Release at 16,946.

DTCC also believes that certain of the Proposed Rules would benefit from clarification, and some revision to avoid duplicative - and potentially conflicting - application. We discuss these provisions, and our suggested clarifications, below.

1. Tiered Standards

The Commission's expressed rationale for having two tiers of applicable rules—one applicable to covered clearing agencies and one for all other clearing agencies--is that the two tiers would provide flexibility for new entrants that might seek to operate as registered clearing agencies, while applying enhanced requirements to those clearing agencies that raise systemic risk concerns due to, among other things, their size, systemic importance, global reach, or the risks inherent in the products they clear.[14] While DTCC understands this rationale, it is not clear that *all* of the proposed provisions of 17Ad-22 (e) represent new or "heightened" standards, or standards related to the particular risks arising from a clearing agency's systemic importance. In some cases the proposed new provision appears to represent a clarification of the existing provision, or a slightly different formulation designed to conform to the PFMI. Examples of such provisions include the rules relating to legal risk (17Ad-22(e)(1) versus existing rule 17Ad-22(d)(1)), settlement finality (17Ad-22(e)(8) versus existing rule 17Ad-22(d)(12)), the elimination of principal risk (17Ad-22(e)(12) versus 17Ad-22(d)(13)), and physical deliveries (17Ad-22(e)(10) versus existing rule 17Ad-22(d)15)).

DTCC acknowledges the value of clarifying rule text and updating rules to conform with the text of the PFMI to promote regulatory consistency, but we recommend that the Commission give a level of priority to reviewing and revising the existing Clearing Agency Standards contained in Rules 17Ad-22(b) and (d) to align them accordingly, particularly if the purpose of the textual change proposed in the analogue provision of 17Ad-22(e) is intended to clarify or represent a logical outgrowth of the original provision. Such harmonization would avoid potential confusion and the inconsistent application of rules.

More importantly, however, to the extent any provision of the Proposed Rules reflects a best practice, or is deemed necessary to ensure the safety and soundness of the national clearance and settlement system, then the provision should apply to all registered clearing agencies, regardless of their status as systemically important or not. Clarifying requirements for settlement finality and requiring some objective measure of liquidity resources are examples of requirements that DTCC believes represent both best practices, and key components to a clearing agency's operating in a manner necessary for the safety and soundness of the U.S. securities markets.[15]

2. Overlapping Rules

The current Clearing Agency Standards include a set of provisions—Rule 17Ad-22(b)—that are applicable only to central counterparties. The rule contains seven separate provisions: four relate to credit and market risk exposure (sections (b)(1) through(4)) and include minimum

[14] *See supra* note 11.
[15] *See* Release at 16,889; *see also id.* at 16,941 (noting, regarding liquidity risk management, that "[n]o rule under the Exchange Act currently requires a registered clearing agency through its written policies and procedures to address liquidity risk.").

requirements for measuring credit risk, margin, financial resources to cover participant defaults, and annual model validation, and three provisions (sections (b)(5) through (7)) which specifically address CCP access criteria. As noted above, under the proposal as currently structured, these provisions would continue to apply to CCP covered clearing agencies, alongside provisions of the proposed rules in 17Ad-22(e) that would cover many of the same matters. In particular, DTCC believes that Proposed Rules 17Ad-22(e)(4)(Credit Risk), (6)(Margin) and (7)(Liquidity Risk) fully address all of the matters covered by 17Ad-22(b)(1) through (4), and in substantially greater detail.

DTCC believes that subjecting CCP covered clearing agencies to both sets of requirements may create unnecessary ambiguities and inconsistencies. Given the Commission's rationale behind the adoption of more prescriptive requirements for covered clearing agencies, DTCC recommends that the proposal be revised so that the provisions of 17Ad-22(b)(1) through (4) are not applicable to CCP covered clearing agencies. At a minimum, the requirement for CCPs to calculate and maintain a record of their financial resources available to cover participant defaults (in 17Ad-22(c)(1)) should be clarified to make clear that that calculation, for covered clearing agency CCPs, would be determined and calculated in accordance with the provisions of 17Ad-22(e)(4) (and not (b)(3)).

3. <u>Applicability of Certain Provisions to Clearing Agencies that are CSDs</u>

In the current Clearing Agency Standards, the risk mitigant provisions relating to central securities depositories are contained in rule 17Ad-22(d). Under the structure of the Proposed Rules, these provisions would not be applied to covered clearing agencies, including those that provide central securities depository ("CSD") custody and settlement services. Proposed Rule 17Ad-22(e)(4) (Credit Risk) is intended to capture, and enhance, the requirements to address credit risk for both CCP and CSD covered clearing agencies. However, as currently written, most of the provisions in that rule are designed to deal with the types of risks—and the tools commonly used to address them — applicable to CCPs, rather then the different risks faced by CSDs. Examples include the apparent requirement that CSDs hold the financial resources they maintain to cover the risk of participant default in a guaranty or clearing fund.[16] The distinction between relevant risk management tools used by CSDs (versus CCPs) is recognized in the way that the comparable PFMI Principle, and the Board's proposed Regulation HH provision,[17] are drafted.

Accordingly, DTCC recommends that this provision be revised, to clarify those portions of the Credit Risk Rule that are intended to apply to CCP covered clearing agencies, and those that should apply to CSD covered clearing agencies. We attach, as Annex 1 to this letter proposed revisions to address these concerns.

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[16] While we note that DTC maintains a Participants Fund as a liquidity and loss allocation resource, the fund is sized and allocations calculated in a manner that differs substantially from how clearing/guaranty funds are sized and maintained by CCPs.

[17] *See* PFMI Principle 4 (Credit Risk); Financial Market Utilities, 79 Fed. Reg. at 3690 (to be codified at 12 C.F.R. § 234.3(a)(4)).

4. **Recovery and Wind-Down Planning**

The Proposed Rules would require a covered clearing agency to establish a plan for its recovery and orderly wind-down.[18] While DTCC supports the Commission's goal of aligning its regulatory requirements with comparable U.S. and international standards, including the PFMI, we note that CPSS/IOSCO has acknowledged that a resolution or wind-down is not necessarily a workable option for critical market infrastructure providers that are the sole providers of their services in a given market. [19]

In its August 2013 consultative report on FMI recoveries, CPSS/IOSCO observed that, where an orderly wind-down may not be feasible, then the "choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions".[20] Indeed, DTCC believes that while covered clearing agencies should analyze the feasibility of an orderly wind-down in their plans and include it when appropriate, recovery strategies (that is, strategies to allocate losses outside of, and without requiring, an orderly wind-down and before the need to initiate resolution proceedings) are the most effective way to promote financial stability, ensure the continuation of critical services, and distribute losses in a fair and economically efficient manner.

5. **Liquidity**

The Commission's approach to how a covered clearing agency should address its liquidity needs is very detailed. Recognizing the considerable liquidity demands attendant in the U.S. cash markets,[21] the proposed provision provides clearing agencies with some flexibility in determining what their "qualifying" available liquidity resources are. In addition to cash and committed arrangements, a covered clearing agency may also include: (i) "other prearranged funding arrangements determined to be highly reliable even in extreme but plausible market conditions" by the clearing agency's board following a review conducted for this purpose not less than annually, and (ii) available assets that are eligible for pledging to the central bank, if the clearing agency has access to routine credit at the bank that permits such pledging or other transactions by the clearing agency.[22] DTCC believes this approach reflects an appropriate balance between the need for covered clearing agencies to have sufficient reliable liquidity resources to meet their ongoing settlement obligations in the event of participant default, and the realities of the availability and costs of committed liquidity funding.

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[18] Proposed Rule 17Ad-22(e)(3)(ii).

[19] COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS & TECHNICAL COMMITTEE OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, CONSULTATIVE REPORT, RECOVERY OF FINANCIAL MARKET INFRASTRUCTURES (Aug. 2013), Key Attribute 2.2.2, *available at* http://www.bis.org/publ/cpss109.pdf. The report noted: "an orderly wind-down may also be deemed by authorities to be inappropriate, perhaps because the FMI is the sole provider of critical services and a viable alternative to using that particular FMI does not exist. Therefore, even if a jurisdiction and its FMIs are in full observance of the PFMI, then as set out in the [FSB's report on the key attributes of effective resolution regimes for financial institutions ("Key attributes")], FMIs "should be subject to [a] resolution regime ...that appl[ies] the objectives and provisions of the Key attributes in a manner appropriate to FMIs and their critical role in financial markets."

[20] *Id.*

[21] *See* Release at 16,946.

[22] *See* Release at 16,890, 16,921, 16,971.

The provision would require that a covered clearing agency conduct due diligence to evaluate and confirm that it has a reasonable basis to believe that each liquidity provider understands and can manage the provider's liquidity risks and that they have the capacity to perform their obligation as required. While the term "due diligence" is not defined in the rule, the Release notes that it is intended to have the same meaning as commonly understood by market participants.[23] The commentary further notes that the clearing agency would be expected to conduct its own internal investigation of each liquidity provider. By way of example, it notes a reasonable basis could include review of both public and non-public documents that would allow the clearing agency "to gather information about relevant factors, including but not limited to the strength of the liquidity provider's financial condition, its risk management capabilities, and its internal controls."[24] DTCC believes the due diligence requirement must take into account the context of the inquiry and the appropriate level of information that would be available to a clearing agency borrower. As a general matter, commercial lenders are not likely to provide their borrowers with non-public information on their internal policies or controls; nor, more importantly, should clearing agencies be expected to evaluate a commercial lender's internal risk controls. Covered clearing agencies should be cognizant of the regulatory regime that applies to their liquidity providers, and be able to take such factors into account when evaluating the ability of lenders to manage and perform their funding obligations.

6. **Requirements for Central Securities Depositories**

Proposed Rule 17Ad-22(e)(11), the analogue of PFMI Principle 11, provides that a covered clearing agency providing central securities depository services must adopt policies and procedures reasonably designed, among other things, to "ensure the integrity of securities issues..."[25] DTCC is concerned that the language of the proposed rule differs materially from the comparable statement in PFMI Principle 11 and the proposed Regulation HH rule. Principle 11, and its analogue rule in Regulation HH, require the CSD to have rules and procedures designed "*to help* ensure" the integrity of securities issues[26], whereas the SEC proposal requires the CSD rules and procedures to "ensure" the integrity of securities issues.[27] Our concern is that no CSD, but most especially no U.S. CSD, is in a position to guarantee the integrity of the securities it holds as a central securities depository.

DTCC recognizes that DTC has a role to play in this process, but it is not the principal party responsible for the creation and/or issuance of securities (unlike the role played by CSDs in some jurisdictions where they may act as registrar and have a principal role in the creation of certain dematerialized securities). In the U.S., DTC does not maintain the register of ownership of securities; rather that is maintained by the issuer or its transfer agent. For securities held at DTC, the nominee of DTC (Cede & Co.) is reflected on that register as having legal title to those securities. For securities to be held at DTC, they must satisfy both eligibility requirements and corporate law requirements. That is, they must be duly authorized, issued and fully paid, and be "freely tradable" under the Securities Act of 1933, as amended. Thus the integrity of issues of

[23] *See id.* at 16,891.
[24] *Id.*
[25] *Id.* at 16,973.
[26] PFMI Principle 11; Financial Market Utilities, 79 Fed. Reg. at 3692 (to be codified at 12 C.F.R. § 234.3(a)(11)).
[27] Release at 16,973.

securities made eligible and held at DTC depends on their proper issuance by issuers and the actions of transfer agents to maintain that integrity, as well as the integrity of the membership of the CSD in the deposit and transfer of interests.

For this reason, we strongly urge the Commission to restore the words "to help" preceding the word "ensure," so as to avoid a different meaning from the other standards that could lead, under strict construction, to an interpretation that U.S. CSDs are held to a materially higher standard, which we do not believe is the Commission's intention. A potential effect of this drafting may be to shift risk onto the CSD and away from parties that should be primarily responsible for ensuring against such risks, e.g., the issuer and its transfer agent, rather than to allow for the variety of ways in which CSDs operate in different jurisdictions and the roles they may play in the creation and issuance of securities, as contemplated by PFMI Principle 11, for instance.

DTCC understands that there may be a concern that the phrase "to help" might be considered too vague and detract from a clear standard; however, we would suggest that "to help" is precisely what the CSD does with respect to the issuance and transfer of securities held by it. A CSD may (and DTC does) cooperate with other principals responsible for the integrity of securities issuances so that, collectively, the integrity of such issues may be better protected. To this end, if the Commission is reluctant to revert "to help ensure", an alternative formulation could be the substitution of another phrase, such as "to promote" (which characterizes the cooperative approach and also reflects a proactive stance) or "to protect" (which perhaps also would cover custodial aspects of the CSD service).

7. **Participant Default Rules and Procedures**

Proposed Rule 17Ad-22(e)(13), similar the current rule 17Ad-22(d)(11), would require covered clearing agencies to have policies, rules and procedures designed to provide that, in the event of participant default, they have the authority and operational capacity to take timely action to contain losses and liquidity demands and continue to meet their obligations. The proposed provision, however, is more detailed, requiring covered clearing agencies, at a minimum, to: (i) include provisions addressing the allocation of uncovered credit losses if its collateral and other resources are insufficient to fully cover such exposures, (ii) describe their process to replenish any financial resources it may use following a default or other event, and (iii) require their participants and, "when practicable" other stakeholders, to participate in testing and review of its default procedures (including close-out procedures), at least annually.[28]

The commentary to this section notes that "[t]he Commission preliminarily believes requiring member and, where practicable, stakeholder participation in periodic testing is appropriate because successful default management will require coordination among these parties, particularly during periods of market stress."[29] DTCC believes this view derives principally from the default management practices of derivatives CCPs, where participant participation in a close-out auction process is key to successful default management. This is in marked contrast to the U.S. cash markets, where a close out by both a CSD (DTC) and CCPs is achieved by market purchases and sales. Here a high degree of confidentiality is thus necessary to minimize potential

[28] *Id.* at 16,974.
[29] *Id.* at 16,903.

market disruption as a result of such purchases and sales, and concomitantly to minimize the risk of closeout loss. Moreover, read literally, the provision would require a covered clearing agency to mandate the participation of *all* its participants in such tests. DTCC believes this is not realistically achievable[30], nor likely to be of sufficient benefit to participants or the clearing agency to outweigh the significant time and costs involved by all parties in organizing and coordinating such a large event. Equally important, given the highly sensitive nature of information involved in such tests, such broad based participation would not, in our view, be appropriate.

DTCC acknowledges the importance of educating participants as to how the clearing agency approaches default management, and participants' role in such process; nevertheless, DTCC believes that this can be achieved by methods other than mandating they participate in annual closeout tests. We believe this is one area where covered clearing agencies should be afforded the discretion and flexibility to develop mechanisms to foster such education on the one hand, while separately being able to develop testing scenarios—with inclusion of those "stakeholders" (including those of its participants) it deems appropriate and practicable – in its annual testing process.

8. Business Risk/Capital Requirements

Proposed Rule 17Ad-22(e)(15) would require covered clearing agencies to hold "sufficient liquid net assets funded by equity" to cover potential general business losses so that it can continue to provide operations and services as a going concern.[31] The requirement includes: (i) determining the amount of such assets based upon its general business risk profile and the length of time required to achieve a recovery or orderly wind-down (as appropriate) of its critical operations; and (ii) holding liquid net assets funded by equity equal to the greater of: (1) six months current operating expenses, or (2) the amount determined by its board to be sufficient to ensure a recovery or orderly wind-down of critical operations as contemplated by its recovery and resolution plan.[32] The provision further requires that such assets need be of high quality and sufficient liquidity to allow the clearing agency to meet its current and projected operating expenses under a range of scenarios, including adverse market conditions.[33]

In addition, the rule requires that covered clearing agencies maintain a "viable" plan approved by the board and updated at least annually, for raising additional equity should the entity's equity fall close to or below the minimum required amount.[34]

DTCC supports the proposed requirement that covered clearing agencies hold a level of capital necessary to enable them to continue their business operations should they incur business or operational losses, and we believe that six months of operating expenses, generally, is an appropriate base level of funding.

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[30] For example, as of May 19, 2014, DTC and NSCC had, respectively, 267 and 170 full service participants.
[31] *Id.* at 16,974.
[32] *Id.*
[33] *Id.*
[34] *Id.*

With regard to the requirement to hold "liquid net assets *funded by equity*" ("LNA"), we believe the SEC should not take a narrow view as to how such amounts are determined. DTCC would expect that the determination of what constitutes such assets be calculated by comparing the covered clearing agency's shareholders' equity to proprietary cash and liquid marketable securities, and then deducting from this amount any amount of unaffiliated third-party debt. Unaffiliated third party indebtedness should be taken into account in determining LNA since repayment of those amounts will reduce LNA. In contrast, where a covered clearing agency has significant shareholders equity, we believe it appropriate that it be able to further liquefy that equity by means of intercompany funding, so long as the requisite amount of cash and/or liquid securities is held and maintained at the covered clearing agency level. Such arrangements would not reduce the clearing agency's equity, and would serve to liquefy investments that are otherwise held, for example, in premises and equipment. This is important where the ownership of a covered clearing agency is through part of a larger corporate structure (whether through a holding company structure or otherwise), as this approach recognizes the role that holding company (or similar) structures play in funding their affiliates: holding companies typically act as a central funding vehicle for their subsidiaries, and may have broader access to financial markets which can be used to source funding to further liquefy the equity base of their subsidiaries. As such, DTCC views intercompany financing as providing a clearing agency with a high level of flexibility, given that the terms of such affiliate funding can be structured to best meet the clearing agency's needs.

As regards to the determination of equity capital, DTCC recommends that what constitutes equity capital should be clarified and broadly construed to include noncumulative perpetual preferred stock, which would be "permanently available."[35] These securities provide for loss absorption for the purposes of the Proposed Rule, without posing added risks. Such a broad definition of equity capital is necessary and important to provide a range of capital support and replenishment options to covered clearing agencies, particularly non-public industry-owned utilities. Preferred stock can be structured in a manner that does not dilute the voting or representation rights of other owners (including participants) and so comports with the Exchange Act's "fair representation" requirement.[36]

Under the U.S. banking regulators' final regulations implementing the Basel III regulatory capital requirements, most bank-issued noncumulative perpetual preferred stock would constitute "additional tier 1 capital."[37] Accordingly, DTCC believes that the elements of capital that

[35] *See* PFMI Principle 15, explanatory note 3.15.5.

[36] The "fair representation requirement" refers to the requirement of Section 17A(a)(3)(C) of the Exchange Act that the rules of a registered clearing agency must "assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs." Section 17A(a)(3)(C) further provides that the Commission "may determine that the representation of participants is fair if they are afforded a reasonable opportunity to acquire voting stock of the clearing agency, directly or indirectly, in reasonable proportion to their use of such clearing agency . . ." A series of Exchange Act releases issued by the Commission describe a variety of other ways that the fair representation requirement could be satisfied using processes other than the ownership of voting stock. *See* Exchange Act Releases Nos. 13584 (June 1, 1977), 14531 (March 6, 1978), 16900 (June 17, 1980) and 20221 (September 23, 1983). The issuance of preferred stock to with no voting (or limited voting) rights at the clearing agency level would certainly not impact satisfaction of the fair representation requirement.

[37] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital, 78 Fed. Reg.

constitute (or would constitute, if the covered clearing agency were subject to Basel III capital requirements) "common equity tier 1 capital" or "additional tier 1 capital" under Basel III should be permitted to count as equity for purposes of 17Ad-22(e)(15), and this should be reflected in the final text of the Proposed Rule.

As regards the requirements for a "viable" plan for raising additional equity, where the Proposed Rule would require the capital plan to be reviewed and updated annually by the covered clearing agency's board, we do not believe that an annual review is necessary. In the absence of material changes to the covered clearing agency's business or capital position, or circumstances that result in significant changes in the capital markets, we believe that a biannual review should be sufficient, provided that the plan is reviewed sooner should such changes occur.

9. **Tiered Relationships**

Proposed Rule 17Ad-22(e)(19) would require covered clearing agencies to identify, monitor, and manage the material risks to the clearing agency from arrangements where 'indirect participants' rely on the services of direct participants to access the clearing agency's clearance and settlement facilities. While this requirement generally follows the PFMI approach, it is a new requirement, and was recognized as such in the PFMI Report; it is also one of the principles that has been most heavily commented on by FMIs and the broader dealer community.

The PFMI Report recognizes that there are broad differences in types of FMIs and the market structure for the products they serve, with attendant differences in their risk profiles. DTCC reads the Proposed Rule, which takes a principles-based approach, as intended to permit a flexible approach to the manner in which a given clearing agency would address the rule's requirements. DTCC believes clearing agencies should use a risk-based approach when crafting policies and procedures to implement the requirement, and such policies will, realistically, need to take account of the level of information available to the clearing agency, which will vary depending on the market structure within which they operate. DTCC believes that a covered clearing agency should provide its direct participants with information relevant to their activities (both direct and indirect) that is available to the clearing agency, which those participants can then use to assess and manage their relationships with their correspondent customers; on the other hand, the clearing agency should evaluate the risks presented to it by such indirect relationships in the context of the direct participant's overall risk management policies and procedures. In all events, there needs to be a clear distinction—and recognition of the differences --- between the supervisory oversight of the direct participant by its primary supervisor, which should include evaluating the firm's correspondent clearing relationships—and the type of oversight that a clearing agency can be reasonably be expected to provide.

10. **Communication Standards**

Proposed Rule 17Ad-22(e)(22) would require a covered clearing agency to establish policies and procedures reasonably designed to ensure that it uses, or at a minimum accommodates, relevant

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62,018, 62,172-73 (Oct. 11, 2013) (to be codified at 12 C.F.R. §§ 3.20(c), 217.20(c)); *see also id.* at 62,048 ("The agencies expect that most outstanding noncumulative perpetual preferred stock that qualifies as tier 1 capital under the agencies' general risk-based capital rules will qualify as additional tier 1 capital under the final rule.").

internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing and settlement. In discussing this provision, the Release indicates that the "Commission understands that covered clearing agencies currently use the relevant internationally accepted communication procedures and standards, so the Commission expects only limited changes may be necessary to satisfy the requirements of the proposed rule."[38]

DTCC recognizes that many users of FMIs operate across borders and in economic zones with markets evolving toward interoperability. For these users it is important the clearing agency/ FMIs in which they participate should use and accommodate international communications standards, so that they can connect with such FMIs in a consistent and standard way. For these users, standardization has the potential to generate operational and cost efficiencies.

Users which process only transactions in a particular market, however, typically rely on long-standing, highly automated communications methods and messaging formats that are viewed as industry-standard, even though they may not align with international standards (this is the case for domestic transactions, as an example). These users should not be required to retool their communications with the clearing agency for that market to comply with international communication standards. Any such requirement may impose substantial costs on those users that would be devoid of any material benefits. We note, in this regard, that the requirement correctly permits a covered clearing agency to "accommodate" international standards as an equally appropriate means of satisfying the requirement as is the exclusive use of a standard, so that, for example, a clearing agency providing such an accommodation can permit users who wish to use international standards exclusively to do so, without forcing those users who do not wish (and have no need to) use the standards to convert to them.

Equally important, we read the proposed provision as intending to provide the sufficient flexibility to enable a covered clearing agency, when evaluating systems upgrades or new services, to take into account (i) the nature of the service and its intended/likely users, (ii) the relevant communication protocols and alternatives then available which would be appropriate for that service and its users, as well as (iii) the potential costs to both the clearing agency and such users of such alternatives—in terms of initial build and ongoing license fees or charges. That is, where there may be more than one recognized standard or protocol available for a service, the covered clearing agency should be able to select the protocol that it deems most appropriate for the circumstances.

11. The Role of Written Policies and Procedures and Comprehensive Disclosure

Proposed Rule 17Ad-22(e) to requires covered clearing agencies to "establish, implement, maintain and enforce written policies and procedures reasonably designed" to achieve the goals of the proposed provisions.[39] DTCC believes that the precise form of these written policies and procedures should be a matter for the clearing agency to determine (as long as the written policies and procedures fulfill the requirements of the Proposed Rules), and may include clearing agency rules and procedures, service guides, operational arrangements, compliance procedures,

[38] Release at 16,932; *see also id.* at 16,913 n.357 (citing a study on messaging standards in the financial industry).
[39] Release at 16,971.

link agreements and/or protocols along with internal policies, procedures and materials relating to internal operations and controls.

DTCC notes that the Release states that the written policies and procedures of a covered clearing agency "would generally be deemed to be a proposed rule change" for purposes of Rule 19b-4 of the Exchange Act.[40] DTCC believes that there should be no change in the thresholds for filing proposed rule changes under Rule 19b-4[41] and notes that, consistent with past SEC practice, not all written policies and procedures adopted by a clearing agency in compliance with the lead-in to the Proposed Rule (and certainly no such written policies and procedures containing confidential or proprietary information about the clearing agency or relating to its internal operations and controls) are, or should have to be, the subject of rule filings under Rule 19b-4.[42]

The Proposed Rules would require covered clearing agencies to make comprehensive public disclosure about their structure and operations, through the operation of Proposed Rule 17Ad-22(e)(23). The required disclosure would take two forms: first, through the public disclosure of the covered clearing agency's relevant rules and material procedures (through operation of clause (i) of the rule), which DTCC understands generally to mean the public disclosure of clearing agency rulebooks and material participant operating procedures. The second form of disclosure (through operation of clause (iv) of the rule) would be through creation of a comprehensive narrative "disclosure framework", incorporating largely the structure outlined for this purpose by the PFMI Report and related Disclosure Framework, and as adapted to fit within the context of addressing the elements of the 17Ad-22(e) rules. DTCC reads the introductory language in clause (iv) of the rule, in this context,[43] to mean that the requirement to create a comprehensive document should address, in a narrative reasonably transparent format, how the clearing agency's governance arrangements, legal structure, approach to risk management and financial arrangements operate (as opposed to implying a separate obligation to publicly disclose all such policies and procedures, irrespective of whether they relate to internal operational policies or are otherwise comprehended within the requirements of clause (i) of the rule).

__Implementation Timeframe__

The Release does not specify an effective date for any or all of the Proposed Rules, although among the Commission's specific requests for comments, is the question of whether there should be a phase-in implementation period. DTCC believes that a phase-in of the Proposed Rules is necessary and appropriate.

In this connection, DTCC notes that the Board has proposed that Regulation HH and the PSR Policy become effective 30 days from the date the final rule is published in the Federal Register, but the Board recognizes that several of the expectations in the revised policy are new or

[40] *Id.* at 16,875 n.95.
[41] 17 C.F.R. at § 240.19b-4.
[42] Should the Commission wish to change its policies regarding the rule filing process under Exchange Act Rule 19b-4, it would have to do so pursuant to a separate rulemaking process, with the attendant opportunity for public comment.
[43] Clause (iv) requires that a covered clearing agency "[provide] a comprehensive public disclosure of its material rules, policies and procedures regarding governance arrangements and legal, financial, and operational risk management, accurate in all material respects at the time of publication" as they relate to certain specified matters.

heightened and, therefore, FMIs may need more time (up to 6 months) to implement such expectations. Among the questions for which the Board sought feedback is whether 6 months is enough time to enable the new expectations to be implemented.[44] Some commenters to the Board's proposals noted that more than six months should be provided for implementation of some of the heightened standards.[45] Commenter's have also indicated that the phase-in period should also include the enhanced requirements regarding link arrangements.[46]

The Proposed Rules, as they may be revised following the comment period, will require that covered clearing agencies (i) review their existing policies and procedures for compliance with the Proposed Rules, (ii) develop and draft new policies and procedures to implement the new or heightened requirements of the Proposed Rules, (iii) in some cases engage in rulemaking or in an advance notice process in order to implement the enhanced expectations, (iv) raise additional capital or qualifying liquidity resources, and (v) in all likelihood, hire and train additional personnel. DTCC notes that when evaluating the sufficiency of this timeframe, the Commission should be cognizant that, to the extent that a covered clearing agency may be required to engage in a rulemaking or advance notice process in order to implement or comply with the new expectations to which it will become subject, that process will provide an opportunity for public comment prior to regulatory approval, with the result that the covered clearing agency may not be able to effectively control the timing of such approvals, and they may well extend beyond a 6-month period. Moreover, DTCC notes that the Regulation Systems Compliance and Integrity proposal currently under review by the Commission will, upon its final adoption, likely impact compliance with the operational risk requirements contained in the Proposed Rules 17Ad-22(e)(17), and thus the implementation of these proposals will need to be harmonized. Accordingly DTCC respectfully suggests that the implementation phase-in extend to at least one year following publication of the final rule.

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[44] Among the new expectations that the FRB recognized may take additional time to implement are the revised expectations on transparency and comprehensive disclosure requirements, the expectation to manage risks arising in tiered participation arrangements under Principle 19, certain aspects of Principle 3 (Framework for the Comprehensive Management of Risks) relating to the development of recovery or wind-down plans, Principle 4 (Credit Risk), Principle 7 (Liquidity Risk) and the capital requirements of Principle 15 (General Business Risk).

[45] Letter from Joseph R. Alexander, Senior Vice President, Deputy Gen. Counsel, and Sec'y, The Clearing House Payments Co. L.L.C., to Mr. Robert deV. Frierson, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 31, 2014), at 4, 21-22, *available at* http://www.federalreserve.gov/apps/foia/ViewAllComments.aspx?doc_id=R-1477&doc_ver=1 (last visited May 19, 2014) (requesting an 18 month implementation timeframe for tiered-participation arrangements).

[46] *See* letter from Craig S. Donohue, Executive Chairman, OCC, to Mr. Robert deV. Frierson, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 31, 2014), at 11 (noting that implementation of the link requirement "will require extensive cooperation and coordination between FMUs. A somewhat longer compliance period will allow FMUs to implement the rule in an orderly manner."). *Available at* http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1477&doc_ver=1 (last visited May 19, 2014). DTCC concurs with this view, particularly given that the Commission's proposed rule regarding link arrangements goes beyond the PFMI and Regulation HH to encompass trading venues—a new requirement.

We appreciate the opportunity to comment on the Proposed Rules and provide the information set forth above. Should you wish to discuss these comments further, please contact me at 212-855-3240 or lthompson@dtcc.com.

Sincerely yours,

Larry E. Thompson
Managing Director and General Counsel

Annex 1 to SEC Comment Letter

Proposed Rule 17Ad-22(e)(4)
Suggested Drafting Clarifications

(4) Effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by:

(i) Maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence;

(ii) To the extent not already maintained pursuant to paragraph (e)(4)(i) of this section, for a covered clearing agency providing central counterparty services that is either systemically important in multiple jurisdictions or a clearing agency involved in activities with a more complex risk profile, maintaining additional financial resources at the minimum to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the two participant families that would potentially cause the largest aggregate credit exposure for the covered clearing agency in extreme but plausible market conditions;

(iii) To the extent not already maintained pursuant to paragraph (e)(4)(i) of this section, for a covered clearing agency not subject to paragraph (e)(4)(ii) of this section, maintaining additional financial resources at the minimum to enable it to cover a wide range of foreseeable stress scenarios that include, but are not limited to, the default of the participant family that would potentially cause the largest aggregate credit exposure for the covered clearing agency in extreme but plausible market conditions;

(iv) Including [(x)] for a covered clearing agency providing central counterparty services, prefunded financial resources, excluding assessments for additional guaranty fund contributions or other resources that are not prefunded, when calculating the financial resources available to meet the standards under paragraphs (e)(4)(i) through (iii) of this section, as applicable [or (y) for a covered clearing agency providing central securities depository services, instituting risk controls, including collateral requirements and limits to cover the covered clearing agency's credit exposures;];

(v) For a covered clearing agency providing central counterparty services, Mmaintaining the financial resources required under paragraphs (e)(4)(i) through (iii) of this section, as applicable, in combined or separately maintained clearing or guaranty funds;

(vi) For a covered clearing agency providing central counterparty services, tTesting the sufficiency of its total financial resources available to meet the minimum financial resource requirements under paragraphs (e)(4)(i) through (iii) of this section, as applicable, by:

(A) Conducting a stress test of its total financial resources once each day using standard predetermined parameters and assumptions;

(B) Conducting a comprehensive analysis on at least a monthly basis of the existing stress testing scenarios, models, and underlying parameters and assumptions, and considering modifications to ensure they are appropriate for determining the covered clearing agency's required level of default protection in light of current and evolving market conditions;

(C) Conducting a comprehensive analysis of stress testing scenarios, models, and underlying parameters and assumptions more frequently than monthly when the products cleared or markets served display high volatility or become less liquid, and when the size or concentration of positions held by the covered clearing agency's participants increases significantly; and

(D) Reporting the results of its analyses under paragraphs (e)(4)(iv)(B) and (C) of this section to appropriate decision makers at the covered clearing agency, including but not limited to, its risk management committee or board of directors, and using these results to evaluate the adequacy of and adjust its margin methodology, model parameters, models used to generate clearing or guaranty fund requirements, and any other relevant aspects of its credit risk management framework, in supporting compliance with the minimum financial resources requirements set forth in paragraphs (e)(4)(i) through (iii) of this section; and

(vii) Performing a conforming model validation for its credit risk models to be performed not less than annually or more frequently as may be contemplated by the covered clearing agency's risk management framework established pursuant to paragraph (e)(3) of this section.