

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-92303; File No. SR-FICC-2020-017)

June 30, 2021

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change to Modify the Calculation of the MBSD VaR Floor to Incorporate a Minimum Margin Amount

On November 20, 2020, Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-FICC-2020-017 (“Proposed Rule Change”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The Proposed Rule Change was published for comment in the Federal Register on December 10, 2020.³ On

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 90568 (December 4, 2020), 85 Fed. Reg. 79541 (December 10, 2020) (SR-FICC-2020-017) (“Notice”). FICC also filed the proposal contained in the Proposed Rule Change as advance notice SR-FICC-2020-804 (“Advance Notice”) with the Commission pursuant to Section 806(e)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”). 12 U.S.C. 5465(e)(1); 17 CFR 240.19b-4(n)(1)(i). Notice of filing of the Advance Notice was published for comment in the Federal Register on January 6, 2021. Securities Exchange Act Release No. 90834 (December 31, 2020), 86 Fed. Reg. 584 (January 6, 2021) (File No. SR-FICC-2020-804) (“Notice of Filing”). Upon publication of the Notice of Filing, the Commission extended the review period of the Advance Notice for an additional 60 days because the Commission determined that the Advance Notice raised novel and complex issues. On March 12, 2021, the Commission issued a request for information regarding the Advance Notice. See Commission’s Request for Additional Information, available at <https://www.sec.gov/comments/sr-ficc-2020-804/srficc2020804-8490035-229981.pdf>. On April 16, 2021, FICC submitted its response thereto. See Response to Commission’s Request for Additional Information, available at <https://www.sec.gov/comments/sr-ficc-2020-804/srficc2020804-8685526-235624.pdf>; Letter from James Nygard, Director and Assistant General Counsel, FICC (April 16, 2021), available at

December 30, 2020, pursuant to Section 19(b)(2) of the Act,⁴ the Commission designated a longer period within which to approve, disapprove, or institute proceedings to determine whether to approve or disapprove the Proposed Rule Change.⁵ On February 16, 2021, the Commission instituted proceedings to determine whether to approve or disapprove the Proposed Rule Change.⁶ On June 11, 2021, pursuant to Section 19(b)(2) of the Act,⁷ the Commission extended the period for the conclusion of proceedings to determine whether to approve or disapprove the Proposed Rule Change.⁸

The Commission received comment letters on the Proposed Rule Change.⁹ In addition, the Commission received a letter from FICC responding to the public

<https://www.sec.gov/comments/sr-ficc-2020-804/srficc2020804-8679555-235605.pdf>. The proposal contained in the Proposed Rule Change and the Advance Notice shall not take effect until all regulatory actions required with respect to the proposal are completed.

⁴ 15 U.S.C. 78s(b)(2).

⁵ Securities Exchange Act Release No. 90794 (December 23, 2020), 85 Fed. Reg. 86591 (December 30, 2020) (SR-FICC-2020-017).

⁶ Securities Exchange Act Release No. 91092 (February 9, 2021), 86 Fed. Reg. 9560 (February 16, 2021) (SR-FICC-2020-017).

⁷ 15 U.S.C. 78s(b)(2)(B)(ii)(II).

⁸ Securities Exchange Act Release No. 92117 (June 7, 2021), 86 Fed. Reg. 31354 (June 11, 2021) (SR-FICC-2020-017).

⁹ Comments on the Proposed Rule Change are available at <https://www.sec.gov/comments/sr-ficc-2020-017/srficc2020017.htm>. Comments on the Advance Notice are available at <https://www.sec.gov/comments/sr-ficc-2020-804/srficc2020804.htm>. Because the proposals contained in the Advance Notice and the Proposed Rule Change are the same, all comments received on the proposal were considered regardless of whether the comments were submitted with respect to the Advance Notice or the Proposed Rule Change.

comments.¹⁰ For the reasons discussed below, the Commission is approving the Proposed Rule Change.

I. DESCRIPTION OF THE PROPOSED RULE CHANGE

A. Background

FICC, through MBSD, serves as a central counterparty (“CCP”) and provider of clearance and settlement services for the mortgage-backed securities (“MBS”) markets. A key tool that FICC uses to manage its respective credit exposures to its members is the daily collection of margin from each member. The aggregated amount of all members’ margin constitutes the Clearing Fund, which FICC would access should a defaulted member’s own margin be insufficient to satisfy losses to FICC caused by the liquidation of that member’s portfolio.

Each member’s margin consists of a number of applicable components, including a value-at-risk (“VaR”) charge (“VaR Charge”) designed to capture the potential market price risk associated with the securities in a member’s portfolio. The VaR Charge is typically the largest component of a member’s margin requirement. The VaR Charge is designed to provide an estimate of FICC’s projected liquidation losses with respect to a defaulted member’s portfolio at a 99 percent confidence level.

To determine each member’s daily VaR Charge, FICC generally uses a model-based calculation designed to quantify the risks related to the volatility of market prices

¹⁰ See Letter from Timothy J. Cuddihy, Managing Director of Depository Trust & Clearing Corporation Financial Risk Management, (March 5, 2021) (“FICC Letter”).

associated with the securities in a member's portfolio.¹¹ As an alternative to this calculation, FICC also uses a haircut-based calculation to determine the "VaR Floor," which replaces the model-based calculation to become a member's VaR Charge in the event that the VaR Floor is greater than the amount determined by the model-based calculation.¹² Thus, the VaR Floor currently operates as a minimum VaR Charge.

During the period of extreme market volatility in March and April 2020, FICC's current model-based calculation and the VaR Floor haircut-based calculation generated VaR Charge amounts that were not sufficient to mitigate FICC's credit exposure to its members' portfolios at a 99 percent confidence level. Specifically, during the period of extreme market volatility, FICC observed that its margin collections yielded backtesting deficiencies beyond FICC's risk tolerance.¹³ FICC states that these deficiencies arose

¹¹ The model-based calculation, often referred to as the sensitivity VaR model, relies on historical risk factor time series data and security-level risk sensitivity data. Specifically, for TBAs, the model-based calculation incorporates the following risk factors: (1) key rate, which measures the sensitivity of a price change to changes in interest rates; (2) convexity, which measures the degree of curvature in the price/yield relationship of key interest rates; (3) spread, which is the yield spread added to a benchmark yield curve to discount a TBA's cash flows to match its market price; (4) volatility, which reflects the implied volatility observed from the swaption market to estimate fluctuations in interest rates; (5) mortgage basis, which captures the basis risk between the prevailing mortgage rate and a blended Treasury rate; and (6) time risk factor, which accounts for the time value change (or carry adjustment) over an assumed liquidation period. See Securities Exchange Act Release No. 79491 (December 7, 2016), 81 Fed. Reg. 90001, 90003-04 (December 13, 2016) (File No. SR-FICC-2016-007).

¹² FICC uses the VaR Floor to mitigate the risk that the model-based calculation does not result in margin amounts that accurately reflect FICC's applicable credit exposure, which may occur in certain member portfolios containing long and short positions in different asset classes that share a high degree of historical price correlation.

¹³ Backtesting is an ex-post comparison of actual outcomes (i.e., the actual margin collected) with expected outcomes derived from the use of margin models. See

from a particular aspect of its margin methodology with respect to MBS (particularly, higher coupon TBAs¹⁴), i.e., that current prices may reflect higher mortgage prepayment risk than FICC’s margin methodology currently takes into account during periods of extreme market volatility. In the Proposed Rule Change, FICC proposes to revise the margin methodology in its Rules¹⁵ and its quantitative risk model¹⁶ to better address the risks posed by member portfolios holding TBAs during such volatile market conditions.

B. Minimum Margin Amount

FICC proposes to introduce a new minimum margin amount into its margin methodology. Under the proposal, FICC would revise the existing definition of the VaR Floor, which acts as the minimum margin requirement, to mean the greater of (1) the current haircut-based calculation, as described above, and (2) the proposed minimum margin amount, which would use a dynamic haircut method based on observed TBA

17 CFR 240.17Ad-22(a)(1). FICC conducts daily backtesting to determine the adequacy of its margin assessments. MBSD’s monthly backtesting coverage ratio with respect to margin amounts was 86.6 percent in March 2020 and 94.2 percent in April 2020. See Notice, supra note 3 at 79543.

¹⁴ The vast majority of agency MBS trading occurs in a forward market, on a “to-be-announced” or “TBA” basis. In a TBA trade, the seller agrees on a sale price, but does not specify which particular securities will be delivered to the buyer on settlement day. Instead, only a few basic characteristics of the securities are agreed upon, such as the MBS program, maturity, coupon rate, and the face value of the bonds to be delivered.

¹⁵ The MBSD Clearing Rules are available at <https://www.dtcc.com/legal/rules-and-procedures.aspx>.

¹⁶ As part of the Proposed Rule Change, FICC filed Exhibit 5B – Proposed Changes to the Methodology and Model Operations Document MBSD Quantitative Risk Model (“QRM Methodology”). Pursuant to 17 CFR 240.24b-2, FICC requested confidential treatment of Exhibit 5B.

price moves. Application of the minimum margin amount would increase FICC's margin collection during periods of extreme market volatility, particularly when TBA price changes would otherwise significantly exceed those projected by either the model-based calculation or the current VaR Floor calculation.

Specifically, the minimum margin amount would serve as a minimum VaR Charge for net unsettled positions, calculated using the historical market price changes of certain benchmark TBA securities.¹⁷ FICC proposes to calculate the minimum margin amount per member portfolio.¹⁸ The proposal would allow offsetting between short and

¹⁷ FICC would consider the MBSD portfolio as consisting of four programs: Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac") conventional 30-year mortgage-backed securities ("CONV30"), Government National Mortgage Association ("Ginnie Mae") 30-year mortgage-backed securities ("GNMA30"), Fannie Mae and Freddie Mac conventional 15-year mortgage-backed securities ("CONV15"), and Ginnie Mae 15-year mortgage-backed securities ("GNMA15"). Each program would, in turn, have a default benchmark TBA security.

FICC would map 10-year and 20-year TBAs to the corresponding 15-year TBA security benchmark. As of August 31, 2020, 20-year TBAs account for less than 0.5%, and 10-year TBAs account for less than 0.1%, of the positions in MBSD clearing portfolios. FICC states that these TBAs were not selected as separate TBA security benchmarks due to the limited trading volumes in the market. See Notice, supra note 3 at 79543.

¹⁸ The specific calculation would involve the following: FICC would first calculate risk factors using historical market prices of the benchmark TBA securities. FICC would then calculate each member's portfolio exposure on a net position across all products and for each securitization program (i.e., CONV30, GNMA30, CONV15 and GNMA15). Finally, FICC would multiply a "base risk factor" by the absolute value of the member's net position across all products, plus the sum of each risk factor spread to the base risk factor multiplied by the absolute value of its corresponding position, to determine the minimum margin amount.

To determine the base risk factor, FICC would calculate an "outright risk factor" for GNMA30 and CONV30, which constitute the majority of the TBA market and of positions in MBSD portfolios. For each member's portfolio, FICC would assign the base risk factor based on whether GNMA30 or CONV30 constitutes

long positions within TBA securities programs since the TBAs aggregated in each program exhibit similar risk profiles and can be netted together to calculate the minimum margin amount to cover the observed market price changes for each portfolio.

The proposal would allow a lookback period for those historical market price moves and parameters of between one and three years, and FICC would set the initial lookback period for the minimum margin amount at two years.¹⁹ FICC states that the minimum margin amount would improve the responsiveness of its margin methodology during periods of market volatility because it would have a shorter lookback period than the model-based calculation, which reflects a ten-year lookback period.²⁰

II. DISCUSSION AND COMMISSION FINDINGS

the larger absolute net market value in the portfolio. If GNMA30 constitutes the larger absolute net market value in the portfolio, the base risk factor would be equal to the outright risk factor for GNMA30. If CONV30 constitutes the larger absolute net market value in the portfolio, the base risk factor would be equal to the outright risk factor for CONV30.

For a detailed example of the minimum margin amount calculation, see Notice, supra note 3 at 79544.

¹⁹ FICC would be permitted to adjust the lookback period within the range in accordance with FICC's model risk management practices and governance procedures set forth in the Clearing Agency Model Risk Management Framework. See Securities Exchange Act Release No. 81485 (August 25, 2017), 82 Fed. Reg. 41433 (August 31, 2017) (SR-DTC-2017-008; SR-FICC-2017-014; SR-NSCC-2017-008); Securities Exchange Act Release No. 84458 (October 19, 2018), 83 Fed. Reg. 53925 (October 25, 2018) (SR-DTC-2018-009; SR-FICC-2018-010; SR-NSCC-2018-009); Securities Exchange Act Release No. 88911 (May 20, 2020), 85 Fed. Reg. 31828 (May 27, 2020) (SR-DTC-2020-008; SR-FICC-2020-004; SR-NSCC-2020-008).

²⁰ Notice, supra note 3 at 79543-44.

Section 19(b)(2)(C) of the Act²¹ directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. After carefully considering the Proposed Rule Change, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to FICC. In particular, the Commission finds that the Proposed Rule Change is consistent with Sections 17A(b)(3)(F)²² and (b)(3)(I)²³ of the Act and Rules 17Ad-22(e)(4)(i), (e)(6)(i), and (e)(23)(ii) thereunder.²⁴

A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act²⁵ requires that the rules of a clearing agency, such as FICC, be designed to, among other things, (i) promote the prompt and accurate clearance and settlement of securities transactions, (ii) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, and (iii) protect investors and the public interest.

As described above in Section I.B., FICC proposes to introduce the minimum margin amount into its margin methodology to help ensure that FICC collects sufficient

²¹ 15 U.S.C. 78s(b)(2)(C).

²² 15 U.S.C. 78q-1(b)(3)(F).

²³ 15 U.S.C. 78q-1(b)(3)(I).

²⁴ 17 CFR 240.17Ad-22(e)(4)(i), (e)(6)(i), and (e)(23)(ii).

²⁵ 15 U.S.C. 78q-1(b)(3)(F).

margin to manage its potential loss exposure during periods of extreme market volatility, particularly when TBA price changes would otherwise significantly exceed those projected by the current model-based calculation and the current VaR Floor calculation (i.e., during periods of extreme market volatility, similar to that which occurred in March and April 2020). The minimum margin amount calculation would use a dynamic haircut method based on observed TBA price moves.²⁶ FICC states that the minimum margin amount would improve the responsiveness of its margin methodology during periods of market volatility because it would have a shorter lookback period (two years, initially) than the model-based calculation (ten years).²⁷

As described above in Section I.A., FICC provided backtesting data to demonstrate that during the period of extreme market volatility in March and April 2020, FICC's current model-based calculation and VaR Floor haircut generated VaR Charge amounts that were not sufficient to mitigate FICC's credit exposure to its members' portfolios at a 99 percent confidence level.

²⁶ See supra note 17.

²⁷ Notice, supra note 3 at 79543-44. VaR calculations typically rely on historical data over a specified lookback period to estimate the probability distribution of potential market prices. The length of the lookback period is designed to reflect the market movements over the lookback period, and calculate margin levels accordingly. A VaR calculation that utilizes a relatively short lookback period would therefore respond with a sharper increase to a period of market volatility than a VaR calculation that utilizes a longer lookback period. Similarly, a VaR calculation that utilizes a short lookback period would respond with a sharper decrease once the period of market volatility recedes beyond lookback period. As a result, while a longer lookback period typically produces more stable VaR estimates over time, a shorter lookback period is typically more responsive to recent market events. See, e.g., Securities Exchange Act Release No. 80341 (March 30, 2017), 82 Fed. Reg. 16644 (April 5, 2017) (SR-FICC-2017-801).

FICC designed the minimum margin amount calculation to better address the risks posed by member portfolios holding TBAs during such periods of extreme market volatility. As described in the Notice, FICC has provided data demonstrating that if the minimum margin amount had been in place, overall margin backtesting coverage (based on 12-month trailing backtesting) would have increased from approximately 99.3% to 99.6% through January 31, 2020 and approximately 97.3% to 98.5% through June 30, 2020.²⁸ The Commission has reviewed FICC's data and analysis (including detailed information regarding the impact of the proposed change on the portfolio of each FICC member over various time periods), and agrees that its results indicate that the proposed minimum margin amount would generate margin levels that should better enable FICC to cover the credit exposure arising from its members' portfolios. Moreover, the Commission believes that adding the minimum margin amount to FICC's margin methodology should allow FICC to collect margin that better reflects the risks and particular attributes of its members' portfolios during periods of extreme market volatility. For these reasons, the Commission believes that implementing the minimum margin amount should help ensure that, in the event of a member default, FICC's operation of its critical clearance and settlement services would not be disrupted because of insufficient financial resources. Accordingly, the Commission finds that the minimum margin amount should help FICC to continue providing prompt and accurate clearance and settlement of securities transactions in the event of a member default, consistent with Section 17A(b)(3)(F) of the Act.

Moreover, as described above in Section I.A., FICC would access the mutualized

²⁸ See Notice, supra note 3 at 79545.

Clearing Fund should a defaulted member's own margin be insufficient to satisfy losses to FICC caused by the liquidation of that member's portfolio. The minimum margin amount should help ensure that FICC has collected sufficient margin from members, thereby limiting non-defaulting members' exposure to mutualized losses. The Commission believes that by helping to limit the exposure of FICC's non-defaulting members to mutualized losses, the minimum margin amount should help FICC assure the safeguarding of securities and funds which are in its custody or control, consistent with Section 17A(b)(3)(F) of the Act.

The Commission believes that the Proposed Rule Change should also help protect investors and the public interest by mitigating some of the risks presented by FICC as a CCP. Because a defaulting member could place stresses on FICC with respect to FICC's ability to meet its clearance and settlement obligations upon which the broader financial system relies, it is important for FICC to maintain a robust margin methodology to limit FICC's credit risk exposure in the event of a member default. As described above in Section I.B., the proposed minimum margin amount likely would function as the VaR Charge during periods of extreme market volatility, particularly when TBA price changes could otherwise significantly exceed those projected by the model-based calculation and the current VaR Floor calculation. When applicable, the minimum margin amount would increase FICC's margin collection during periods of extreme market volatility. The minimum margin amount should help improve FICC's ability to collect sufficient margin amounts commensurate with the risks associated with its members' portfolios during periods of extreme market volatility. By enabling FICC to collect margin that more accurately reflects the risk characteristics of mortgage-backed securities and market

conditions, FICC would be in a better position to absorb and contain the spread of any losses that might arise from a member default. Therefore, the minimum margin amount should reduce the possibility that FICC would need to utilize resources from non-defaulting members due to a member default, which could cause liquidity stress to non-defaulting members and inhibit their ability to facilitate securities transactions. Accordingly, because the minimum margin amount should help mitigate some of the risks presented by FICC as a CCP, the Commission believes that the proposal is designed to protect investors and the public interest, consistent with Section 17A(b)(3)(F) of the Act.

Several commenters suggest that FICC's implementation of the minimum margin amount would not be in the public interest because it would burden markets in times of stress and force members to maintain additional reserve funding capacity.²⁹ More specifically, commenters suggest that due to potentially increased margin requirements, small- and mid-sized broker-dealers will be forced to scale back their offerings of risk management tools and services to smaller originators, who will then turn to larger institutions for these tools and services. They suggest that this would result in a more

²⁹ See Letter from James Tabacchi, Chairman, Independent Dealer and Trade Association, Mike Fratantoni, Chief Economist/Senior Vice President, Mortgage Bankers Association (January 26, 2021) (“IDTA/MBA Letter I”) at 2-3, 5; Letter from Christopher Killian, Managing Director, Securities Industry and Financial Markets Association (January 29, 2021) (“SIFMA Letter I”) at 2, 4; Letter from Christopher Killian, Managing Director, Securities Industry and Financial Markets Association (February 23, 2021) (“SIFMA Letter II”) at 2; Letter from Christopher A. Iacovella, Chief Executive Officer, American Securities Association (January 28, 2021) (“ASA Letter”) at 1-2. The Commission further addresses these comments below in Sections II.C. and II.D. to the extent the comments raise issues related to Rules (e)(4)(i) and (e)(6)(i) under the Exchange Act. 17 CFR 240.17Ad-22(e)(4)(i) and (e)(6)(i).

concentrated market, or that smaller originators would not be able to obtain these tools and services, putting the smaller originators in a position in which they could not implement their desired risk management approaches or fully serve their customer bases.³⁰

In response, FICC states that the Proposed Rule Change is not intended to advantage or disadvantage capital formation in any particular market segment.³¹ Instead, FICC states that the Proposed Rule Change focuses entirely on managing the clearance and settlement risk associated with TBAs.³²

The Commission acknowledges that the minimum margin amount could increase the margin required from some members, which may, in turn, cause such members to incur additional costs to access the liquidity needed to meet elevated margin requirements. Despite these potential impacts, the Commission believes that FICC has provided sufficient justification for the proposal. Specifically, FICC's backtesting data demonstrates that its current methodology did not generate enough margin during March and April 2020, and the proposed minimum margin amount would generate margin levels that should better enable FICC to cover the credit exposure arising from its members' portfolios.

The Commission also acknowledges the possibility that, as a result of the Proposed Rule Change, some members might pass along some of the costs related to margin requirements such that these costs ultimately are borne, to some degree, by their

³⁰ See id.

³¹ See FICC Letter at 4.

³² See id.

clients. However, a non-defaulting member's exposure to mutualized losses resulting from a member default, and any consequent disruptions to clearance and settlement absent the Proposed Rule Change, might also increase costs to a member's clients and potentially adversely impact market participation, liquidity, and access to capital. The Proposed Rule Change, by helping to reduce counterparty default risk, would allow the corresponding portion of transaction costs to be allocated to more productive uses by members and their clients who otherwise would bear those costs.³³ Moreover, as discussed above, by helping to limit the exposure of non-defaulting members to mutualized losses, the Proposed Rule Change should help FICC assure the safeguarding of securities and funds of its members that are in FICC's custody or control, consistent with Section 17A(b)(3)(F).

While the Commission acknowledges that the proposal could result in certain FICC members raising the price of liquidity provision (or reducing the amount of liquidity provision) to their mortgage originator clients to account for increased margin requirements, a number of factors could mitigate such effects on market liquidity. First, to the extent that the minimum margin amount might raise margin requirements differently across MBS (e.g., higher coupon TBAs might generate higher margin requirements than other MBS), market participants, including mortgage originators, could respond by trading more of the securities for which the minimum margin amount would not increase margin or would increase margin less than higher coupon TBAs.

³³ See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786, 70866-67 (October 13, 2016) (S7-03-14) ("CCA Standards Adopting Release").

Alternatively, mortgage originators could hedge the interest rate risk of their mortgage pipelines by trading in other hedging instruments such as Treasury futures and mortgage option contracts.³⁴

Moreover, the Commission does not believe that the impact of the Proposed Rule Change would be that mortgage originators would raise mortgage rates in response to increased costs for liquidity. The ability of mortgage originators to raise mortgage rates depends in part on competition at the local loan market level, which could incentivize mortgage originators to avoid raising mortgage rates in spite of absorbing the costs associated with the minimum margin amount. Because competition between mortgage originators varies across local loan markets,³⁵ their ability to raise mortgage rates likely also varies across markets. Mortgage originators in more competitive markets likely would have less ability to raise mortgage rates to pass on costs that may be associated with the Proposed Rule Change than mortgage originators in less competitive markets.³⁶ Thus, it is unclear whether this proposal will have any effect on mortgage rates.

Further, the introduction of cost-saving technologies may lower mortgage origination costs and facilitate the entry of new mortgage originators operating on lower-

³⁴ See Vickery, James I., and Joshua Wright. “TBA trading and liquidity in the agency MBS market.” Economic Policy Review 19, no. 1 (2013).

³⁵ See Scharfstein, David, and Adi Sunderam. “Market power in mortgage lending and the transmission of monetary policy.” Unpublished working paper, Harvard University 2 (2016) (showing that county-level competition among mortgage originators, as measured by the market share of the top four mortgage originators concentration, varies across different counties in the U.S.).

³⁶ See id. at 3.

cost business models.³⁷ The entry of these new mortgage originators could limit the pricing power of incumbent mortgage originators in a given loan market. Finally, the Federal Reserve’s continued commitment to purchasing agency MBS³⁸ could continue to exert downward pressure on mortgage rates and mitigate an increase in mortgage rates, if any, by mortgage originators in response to Proposed Rule Change. FICC also provided confidential analysis as part of the Proposed Rule Change indicating that there does not appear to be a clear linkage between FICC margin amounts and community lenders’ mortgage activity.

Finally, the Commission believes that the impact of the minimum margin amount would be entirely determined by a member’s portfolio composition and trading activity rather than the member’s size or type. The Proposed Rule Change would calculate the VaR Charge based on the risks presented by positions in the member’s portfolio. To the extent a member’s VaR Charge would increase under the Proposed Rule Change, that increase would be based on the securities held by the member and FICC’s requirement to collect margin to appropriately address the associated risk.

³⁷ See Buchak, Greg, Gregor Matvos, Tomasz Piskorski, and Amit Seru. “Fintech, regulatory arbitrage, and the rise of shadow banks.” Journal of Financial Economics 130, no. 3 (2018): 453-483.

³⁸ In response to the COVID-19 outbreak, the Federal Open Market Committee (“FOMC”) announced that the Federal Reserve would purchase at least \$200 billion of agency mortgage-backed securities over the coming months. While the Federal Reserve tapered purchases between April and May 2020, it restarted purchases in June 2020. (See <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm>.) On December 12, 2020, the FOMC directed the Federal Reserve Bank of New York to continue to purchase \$40 billion of agency mortgage-backed securities per month. (See https://www.newyorkfed.org/markets/opolicy/operating_policy_201216.)

Accordingly, notwithstanding the potential impact that the Proposed Rule Change might indirectly have on small mortgage originators, the Commission believes that such potential impacts are justified by the potential benefits to members and the resulting overall improved risk management at FICC described above (i.e., the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds based on the collection of margin commensurate with the risks presented by TBAs), to render the Proposed Rule Change consistent with the investor protection and public interest provisions of Section 17A(b)(3)(F) of the Act.

For the reasons discussed above, the Commission believes that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(F) of the Act.³⁹

B. Consistency with Section 17A(b)(3)(I) of the Act

Section 17A(b)(3)(I) of the Act requires that the rules of a clearing agency do not impose any burden on competition not necessary or appropriate in furtherance of the Act.⁴⁰ This provision does not require the Commission to find that a proposed rule change represents the least anticompetitive means of achieving the goal. Rather, it requires the Commission to balance the competitive considerations against other relevant policy goals of the Act.⁴¹

The Commission received comments regarding the impacts the Proposed Rule Change might have on competition. One commenter argues that FICC has not explained

³⁹ 15 U.S.C. 78q-1(b)(3)(F).

⁴⁰ 15 U.S.C. 78q-1(b)(3)(I).

⁴¹ See Bradford National Clearing Corp., 590 F.2d 1085, 1105 (D.C. Cir. 1978).

how the additional margin collected pursuant to the minimum margin amount would be equitably distributed amongst members to avoid an unnecessary burden on competition.⁴² Several commenters argued that the proposal would disproportionately affect small- and mid-sized broker-dealer members rather than larger bank-affiliated broker-dealer members.⁴³ One commenter states that FICC’s impact study demonstrates that smaller members would bear a greater burden than larger members if the minimum margin amount were to be adopted.⁴⁴ One commenter argues that larger members should bear more of the minimum margin amount burden because their business models likely include subsidiaries that confer an unfair advantage by enabling them to net their

⁴² See Letter from James Tabacchi, Chairman, Independent Dealer and Trade Association, Mike Fratantoni, Chief Economist/Senior Vice President, Mortgage Bankers Association (February 23, 2021) (“IDTA/MBA Letter II”) at 3.

⁴³ See IDTA/MBA Letter I at 2-4, 6; IDTA/MBA Letter II at 2-3; ASA Letter at 1-2; SIFMA Letter I at 4.

⁴⁴ See IDTA/MBA Letter II at 2-3. Specifically, the commenter cites FICC’s statement that during the impact study period, the largest dollar increase for any member would have been \$333 million, or 37% increase in the VaR Charge. The commenter assumes that the member with the largest dollar increase is one of FICC’s largest clearing members. The commenter also cites FICC’s statement that the largest percentage increase in VaR Charge for any member would have been 146%, or \$22 million. The commenter assumes that the member with the largest percentage increase is a smaller member. Thus, the commenter concludes that the minimum margin amount would affect smaller members more dramatically than larger members. Additionally, the commenter cites FICC’s statement that the top 10 members based on size of the VaR Charges would have contributed 69.3% of the aggregate VaR Charges had the minimum margin amount been in place; whereas those 10 members only would be responsible for 54% of the additional margin collected pursuant to the minimum margin amount. Therefore, the commenter concludes that FICC’s largest members would contribute disproportionately less than FICC’s smaller members pursuant to the minimum margin amount.

exposures.⁴⁵

In response, FICC states that the Notice addressed concerns that the Proposed Rule Change would impose a burden on competition.⁴⁶ Specifically, the Notice acknowledged that based on FICC's impact studies, the minimum margin amount would have increased members' VaR Charges by an average of approximately 42% during the impact study period, and that the Proposed Rule Change could impose a burden on competition.⁴⁷ Additionally, the Notice stated that members may be affected disproportionately by the minimum margin amount because members with higher percentages of higher coupon TBAs in their portfolios were more likely to be impacted.⁴⁸

Regarding comments that the minimum margin amount would disproportionately affect smaller members, FICC acknowledges that the minimum margin amount could increase margin requirements as a result of extreme market volatility, and that it may also result in higher margin costs overall for members whose business is concentrated in higher coupon TBAs, relative to other members with more diversified portfolios.⁴⁹ However, FICC states that the methodology for computing the minimum margin amount

⁴⁵ See Letter from James Tabacchi, Chairman, Independent Dealer and Trade Association (February 23, 2021) ("IDTA Letter") at 2. The commenter also speculates that the business models of larger members that enable them to net their exposures likely increases concentration risk at those members, which the minimum margin amount does not address.

⁴⁶ See FICC Letter at 3; Notice, supra note 3 at 79547-48.

⁴⁷ See id.

⁴⁸ See id.

⁴⁹ See FICC Letter at 3; Notice, supra note 3 at 79545, 47.

does not take into consideration the member’s size or overall mix of business.⁵⁰ Any effect the proposal would have on a particular member’s margin requirement is solely a function of the default risk posed to FICC by the member’s activity at FICC – firm size or business model is not pertinent to the assessment of that risk.⁵¹ Accordingly, FICC believes that the Proposed Rule Change does not discriminate against members or affect them differently on either of those bases.⁵²

The Commission acknowledges that the Proposed Rule Change could entail increased margin charges. In considering the costs and benefits of the requirements of Rule 17Ad-22(e)(6), the Commission expressly acknowledged that “since risk-based initial margin requirements may cause market participants to internalize some of the costs borne by the CCP as a result of large or risky positions, confirming that margin models are well-specified and correctly calibrated with respect to economic conditions will help ensure that the margin requirements continue to align the incentives of a CCP’s members with the goal of financial stability.”⁵³ Nevertheless, in response to the comments that the

⁵⁰ See FICC Letter at 4.

⁵¹ See id.

⁵² See id.

⁵³ See CCA Standards Adopting Release, supra note 33, 81 Fed. Reg. at 70870. In addition, when considering the benefits, costs, and effects on competition, efficiency, and capital formation, the Commission recognized that a covered clearing agency, such as FICC, might pass incremental costs associated with compliance on to its members, and that such members may seek to terminate their membership with that CCA. See id., 81 Fed. Reg. at 70865. Moreover, when considering similar comments related to a proposed rule change designed to address a covered clearing agency’s liquidity risk, the Commission concluded that the imposition of additional costs did not render the proposal inconsistent with the Act. See Securities Exchange Act Release No. 82090 (November 15, 2017), 82 Fed. Reg. 55427, 55438 n. 209 (November 21, 2017) (SR-FICC-2017-002).

Proposed Rule Change would disproportionately affect small- and mid-sized broker-dealer members or those broker-dealer members that are not affiliated with large banks, the Commission believes that the impact of the minimum margin amount would be entirely determined by a member's portfolio composition and trading activity rather than the member's size or type. The Proposed Rule Change would calculate the VaR Charge based on the risks presented by positions in the member's portfolio. To the extent a member's VaR Charge would increase under the Proposed Rule Change, that increase would be based on the securities held by the member and FICC's requirement to collect margin to appropriately address the associated risk.

In addition, as noted above, the Commission acknowledges that the impact of a higher margin requirement may present higher costs on some members relative to others due to a number of factors, such as access to liquidity resources, cost of capital, business model, and applicable regulatory requirements. These higher relative burdens may weaken certain members' competitive positions relative to other members.⁵⁴ However, the Commission believes that such burden on competition stemming from a higher impact on some members than on others is necessary and appropriate in furtherance of the Act. FICC is required to establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, considers and produces margin levels commensurate with the risks and particular attributes of each relevant

⁵⁴ These potential burdens are not fixed, and affected members may choose to restructure their liquidity sources, costs of capital, or business model, thereby moderating the potential impact of the Proposed Rule Change.

product, portfolio, and market.⁵⁵ FICC's members include a large and diverse population of entities with a range of ownership structures.⁵⁶ By participating in FICC, each member is subject to the same margin requirements, which are designed to satisfy FICC's regulatory obligation to manage the risks presented by its members. As discussed in more detail in Section II.D. below, the Proposed Rule Change is designed to ensure that FICC collects margin that is commensurate with the risks presented by each member's portfolio resulting from periods of extreme market volatility.

Furthermore, FICC has provided data demonstrating that if the minimum margin amount had been in place, overall margin backtesting coverage (based on 12-month trailing backtesting) would have increased from approximately 99.3% to 99.6% through January 31, 2020 and approximately 97.3% to 98.5% through June 30, 2020.⁵⁷ As noted above, the Commission has reviewed FICC's backtesting data and agrees that it indicates that had the minimum margin amount been in place during the study period, it would have generated margin levels that better reflect the risks and particular attributes of the member portfolios and help FICC achieve backtesting coverage closer to FICC's targeted confidence level. In turn, the Commission believes that the Proposed Rule Change would improve FICC's ability to maintain sufficient financial resources to cover its credit exposures to each member in full with a high degree of confidence. By helping FICC to better manage its credit exposure, the Proposed Rule Change would improve FICC's

⁵⁵ See 17 CFR 240.17Ad-22(e)(6)(i).

⁵⁶ See FICC MBSD Membership Directory, available at <https://www.dtcc.com/client-center/ficc-mbs-directories>.

⁵⁷ See Notice, supra note 3 at 79545.

ability to mitigate the potential losses to FICC and its members associated with liquidating a member's portfolio in the event of a member default, in furtherance of FICC's obligations under Section 17A(b)(3)(F) of the Act.

Therefore, for the reasons stated above, the Commission believes that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(I) of the Act⁵⁸ because any competitive burden imposed by the Proposed Rule Change is necessary and appropriate in furtherance of the Act.

C. Consistency with Rule 17Ad-22(e)(4)(i)

Rule 17Ad-22(e)(4)(i) under the Act requires that FICC establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.⁵⁹

Several commenters question whether FICC has adequately demonstrated that the proposed minimum margin amount is consistent with Rule 17Ad-22(e)(4)(i) under the Exchange Act, arguing that there are more effective methods that FICC could use to mitigate the relevant risks. Three commenters argue that the model-based calculation is well-suited to address FICC's credit risk in volatile market conditions, and instead of adding the minimum margin amount to its margin methodology, FICC should enhance

⁵⁸ 15 U.S.C. 78q-1(b)(3)(I).

⁵⁹ 17 CFR 240.17Ad-22(e)(4)(i).

this calculation to address periods of extreme market volatility such as occurred in March and April 2020.⁶⁰

In response to these comments, FICC explains that enhancing the model-based calculation would not be an effective approach towards mitigating the risk resulting from periods of extreme market volatility. Although the model-based calculation takes into account risk factors typical to TBAs, the extreme market volatility of March and April 2020 was caused by other factors (e.g., changes in the Federal Reserve purchase program) affecting TBA factors, yet such factors are not accounted for in the model-based calculation.⁶¹ To further demonstrate why the minimum margin amount is necessary, FICC relies upon the results of recent backtesting analyses demonstrating that its existing VaR Charge calculations did not respond effectively to the March and April 2020 levels of market volatility and economic uncertainty such that FICC's margin collections during that period did not meet its 99 percent confidence level.⁶²

The Commission believes that the proposed minimum margin amount is consistent with Rule 17Ad-22(e)(4)(i) under the Exchange Act.⁶³ As described above, FICC's current VaR Charge calculations resulted in margin amounts that were not sufficient to mitigate FICC's credit exposure to its members' portfolios at FICC's targeted confidence level during periods of extreme market volatility, particularly when

⁶⁰ See IDTA/MBA Letter I at 4-5; ASA Letter at 1; SIFMA Letter I at 2-3; Letter from Christopher Killian, Managing Director, Securities Industry and Financial Markets Association (February 23, 2021) ("SIFMA Letter II") at 1-2.

⁶¹ See FICC Letter at 2-3.

⁶² See FICC Letter at 3.

⁶³ 17 CFR 240.17Ad-22(e)(4)(i).

TBA price changes significantly exceeded those implied by the VaR model risk factors. The Commission believes that adding the minimum margin amount calculation to its margin methodology should better enable FICC to collect margin amounts that are sufficient to mitigate FICC's credit exposure to its members' portfolios.

In reaching this conclusion, the Commission thoroughly reviewed and analyzed the (1) Proposed Rule Change, including the supporting exhibits that provided confidential information on the calculation of the proposed minimum margin amount, impact analyses (including detailed information regarding the impact of the proposed change on the portfolio of each FICC member over various time periods), and backtesting coverage results, (2) comments received, and (3) Commission's own understanding of the performance of the current margin methodology, with which the Commission has experience from its general supervision of FICC, compared to the proposed margin methodology.⁶⁴ Specifically, as discussed above, the Commission has considered the results of FICC's backtesting coverage analyses, which indicate that the current margin methodology results in backtesting coverage that does not meet FICC's targeted confidence level. FICC's backtesting data shows that if the minimum margin amount had been in place, overall margin backtesting coverage (based on 12-month trailing backtesting) would have increased from approximately 99.3% to 99.6% through January 31, 2020 and approximately 97.3% to 98.5% through June 30, 2020.⁶⁵ The analyses also

⁶⁴ In addition, because the proposals contained in the Advance Notice and the Proposed Rule Change are the same, all information submitted by FICC was considered regardless of whether the information was submitted with respect to the Advance Notice or the Proposed Rule Change. See supra note 9.

⁶⁵ See Notice, supra note 3 at 79545.

indicate that the minimum margin amount would result in improved backtesting coverage towards meeting FICC's targeted coverage level. Therefore, the Commission believes that the proposal would provide FICC with a more precise margin calculation, thereby enabling FICC to manage its credit exposures to members by maintaining sufficient financial resources to cover such exposures fully with a high degree of confidence..

In response to the comments regarding enhancing the model-based calculation instead of adding the minimum margin amount, the Commission believes that FICC's model-based calculation takes into account risk factors that are typical TBA attributes, whereas the extreme market volatility of March and April 2020 was caused by other external factors that are less subject to modeling. Thus, the commenters' preferred approach is not a viable alternative that would allow for consideration of such factors.

Accordingly, for the reasons discussed above, the Commission believes that the changes proposed in the Proposed Rule Change are reasonably designed to enable FICC to effectively identify, measure, monitor, and manage its credit exposure to members, consistent with Rule 17Ad-22(e)(4)(i).⁶⁶

D. Consistency with Rules 17Ad-22(e)(6)(i) and (iii)

Rules 17Ad-22(e)(6)(i) and (iii) under the Act require that FICC establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market, and calculates

⁶⁶ 17 CFR 240.17Ad-22(e)(4)(i).

margin sufficient to cover its potential future exposure to participants.⁶⁷

One commenter suggests that the minimum margin amount would be inefficient and ineffective at collecting margin amounts commensurate with the risks presented by the securities in member portfolios.⁶⁸ Several commenters argue that the proposed minimum margin amount calculation would produce sudden and persistent spikes in margin requirements.⁶⁹ One commenter argues that the minimum margin amount would effectively replace FICC's existing model-based calculation with one likely to produce procyclical results by increasing margin requirements at times of increased market volatility.⁷⁰ One commenter suggests the March-April 2020 market volatility was so unique that FICC need not adjust its margin methodology to account for a future similar event.⁷¹

In addition, one commenter argues that the proposed minimum margin amount is inconsistent with Rule 17Ad-22(e)(6)(i) because the minimum margin amount calculation is not reasonably designed to mitigate future risk due to its reliance on historical price movements that will not generate margin requirements that equate to future protections against market volatility.⁷² Two commenters argue that the proposed minimum margin

⁶⁷ 17 CFR 240.17Ad-22(e)(6)(i) and (iii).

⁶⁸ See id.

⁶⁹ See IDTA/MBA Letter I at 5; ASA Letter at 2; SIFMA Letter I at 3-4.

⁷⁰ See IDTA/MBA Letter I at 5.

⁷¹ See SIFMA Letter I at 3.

⁷² See IDTA/MBA Letter I at 4.

amount calculation is not reasonably designed to mitigate future risks because the calculation relies on historical price movements, which will not necessarily generate margin amounts that will protect against future periods of market volatility.⁷³ One commenter argues that the minimum margin amount is not necessary despite the March and April 2020 backtesting deficiencies because there were no failures or other events that caused systemic issues.⁷⁴

Several commenters speculate that since the minimum margin amount is typically larger than the model-based calculation, the minimum margin amount will likely become the predominant calculation for determining a member's VaR Charge.⁷⁵ One commenter argues that instead of the minimum margin amount, FICC should consider adding concentration charges to its margin methodology to address the relevant risks.⁷⁶

In response, FICC states that any increased margin requirements resulting from the proposed minimum margin amount during periods of extreme market volatility would appropriately reflect the relevant risks presented to FICC by member portfolios holding large TBA positions.⁷⁷ FICC also states that the minimum margin amount's reliance on observed price volatility with a shorter lookback period will provide margin that responds

⁷³ See IDTA/MBA Letter I at 5; SIFMA Letter I at 2.

⁷⁴ See SIFMA Letter I at 2.

⁷⁵ See IDTA/MBA Letter I at 4-5; ASA Letter at 1; SIFMA Letter I at 2-3.

⁷⁶ See IDTA/MBA Letter I at 5.

⁷⁷ See FICC Letter at 5-6.

quicker during market volatility to limit FICC's exposures.⁷⁸ FICC also notes that the margin increases that the minimum margin amount would have imposed following the March-April 2020 market volatility would not have persisted at such high levels indefinitely.⁷⁹

In addition, regarding whether the minimum margin amount will likely become the predominant calculation for determining a member's VaR Charge, FICC states that as the period of extreme market volatility stabilized and the model-based calculation recalibrated to current market conditions, the average daily VaR Charge increase decreased from \$2.2 billion (i.e., 42%) to \$838 million (i.e., 7%) during the fourth quarter of 2020.⁸⁰ Regarding concentration charges, FICC states that concentration charges and the minimum margin amount address separate and distinct types of risk.⁸¹ Whereas the minimum margin amount is designed to cover the risk of market price volatility, concentration charges (e.g., FICC's recently approved Margin Liquidity Adjustment Charge⁸²) are designed to mitigate the risk to FICC of incurring additional market impact cost from liquidating a directionally concentrated portfolio.⁸³

⁷⁸ See id.

⁷⁹ See id.

⁸⁰ See FICC Letter at 5.

⁸¹ See FICC Letter at 7-8.

⁸² See Securities Exchange Act Release No. 90182 (October 14, 2020), 85 Fed. Reg. 66630 (October 20, 2020) (SR-FICC-2020-009).

⁸³ See FICC Letter at 7-8.

The Commission believes that the proposal is consistent with Rule 17Ad-22(e)(6)(i). Implementing the proposed minimum margin amount would result in margin requirements that reflect the risks such holdings present to FICC better than FICC's current margin methodology. In reaching this conclusion and considering the comments above, the Commission thoroughly reviewed and analyzed the (1) Proposed Rule Change, including the supporting exhibits that provided confidential information on the calculation of the proposed minimum margin amount, impact analyses, and backtesting coverage results, (2) comments received, and (3) Commission's own understanding of the performance of the current margin methodology, with which the Commission has experience from its general supervision of FICC, compared to the proposed margin methodology. Based on its review and analysis of these materials, including the effect that the minimum margin amount would have on FICC's backtesting coverage, the Commission believes that the proposed minimum margin amount is designed to consider, and collect margin commensurate with, the market risk presented by member portfolios holding TBA positions, specifically during periods of market volatility such as what occurred in March and April 2020. For the same reasons, the Commission disagrees with the comments suggesting that the minimum margin amount calculation is not designed to effectively and efficiently collect margin sufficient to mitigate the risks presented by the securities.

In response to comments regarding the sudden and persistent increases in margin that could arise from the minimum margin amount, the Commission acknowledges that, for some member portfolios in certain market conditions, application of the minimum margin amount calculation would result in an increase in the member's margin

requirement based on the potential exposures arising from the TBA positions. The Commission notes that, by design, the minimum margin amount should respond more quickly to heightened market volatility because of its use of historical price data over a relatively short lookback period, as opposed to the model-based calculation which relies on risk factors and uses a longer lookback period.

The Commission also observes, however, based on its review and analysis of FICC's confidential data and analyses, that the increase in margin requirements generated by the minimum margin amount – as compared to the other calculations – would generally only apply during periods of high market volatility and for a time period thereafter.⁸⁴ The frequency with which the minimum margin amount would constitute a majority of members' margin requirements decreases as markets become less volatile, and therefore, is not expected to persist indefinitely.⁸⁵ The Commission believes that including the minimum margin amount as a potential method of determining a member's margin requirement is appropriate, in light of the potential exposures that could arise in a time of heightened market volatility and the need for FICC to cover those exposures. Therefore, the Commission believes that the proposal would provide FICC with a margin calculation better designed to enable FICC to cover its credit exposures to its members by enhancing FICC's risk-based margin system to produce margin levels commensurate with, the risks and particular attributes of TBAs.

⁸⁴ FICC provided this data as part of its response to the Commission's Request for Additional Information in connection with the Advance Notice. Pursuant to 17 CFR 240.24b-2, FICC requested confidential treatment of its RFI response. See also FICC Letter at 5.

⁸⁵ See FICC Letter at 5.

In response to the comments regarding the potential procyclical nature of the minimum margin amount calculation and whether it is appropriate for the margin methodology to take into account such extreme market events, the Commission notes that as a general matter, margin floors generally operate to reduce procyclicality by preventing margin levels from falling too low. Moreover, despite the commenters' procyclicality concerns, the Commission understands that the purpose of the minimum margin amount calculation is to ensure that FICC collects sufficient margin in times of heightened market volatility, which means that FICC would, by design, collect additional margin at such times if the minimum margin amount applies. The Commission believes that, because heightened market volatility may lead to increased credit exposure for FICC, it is reasonable for FICC's margin methodology to collect additional margin at such times and to be responsive to market activity of this nature.

In response to the comment that the proposed minimum margin amount is not necessary because the March and April 2020 market volatility did not cause the failure of FICC members or otherwise cause broader systemic problems, the Commission disagrees. Similar to the Commission's analysis above, the relevant standard is not merely for FICC to maintain sufficient financial resources to avoid failures or systemic issues, but for FICC to cover its credit exposures to members with a risk-based margin system that produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.⁸⁶ During periods of extreme market volatility, FICC has demonstrated that adding the minimum margin amount to its margin methodology better enables FICC to manage its credit exposures to members by

⁸⁶ 17 CFR 240.17Ad-22(e)(6)(i).

producing margin charges commensurate with the applicable risks. The Commission has reviewed and analyzed FICC's backtesting data, and agrees that the data demonstrate that the minimum margin amount would result in better backtesting coverage and, therefore, less credit exposure of FICC to its members. Accordingly, the Commission believes that the proposed minimum margin amount would enable FICC to better manage its credit risks resulting from periods of extreme market volatility.

In response to the comments regarding the minimum margin amount calculation's reliance on historical price movements, the Commission does not agree that Rule 17Ad-22(e)(6)(i) precludes FICC from implementing a margin methodology that relies, at least in part, on historical price movements or that FICC's margin methodology must generate margin requirements that "equate to future protections against market volatility." FICC's credit exposures are reasonably measured both by events that have actually happened as well as events that could potentially occur in the future. For this reason, a risk-based margin system is necessary for FICC to cover its potential future exposure to members.⁸⁷ Potential future exposure is, in turn, defined as the maximum exposure estimated to occur at a future point in time with an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure.⁸⁸ Thus, to be consistent with its regulatory requirements, FICC must consider potential future

⁸⁷ See 17 CFR 240.17Ad-22(e)(6)(iii) (requiring a covered clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, calculates margin sufficient to cover its potential future exposure to participants in the interval between the last margin collection and the close out of positions following a participant default).

⁸⁸ 17 CFR 240.17Ad-22(a)(13).

exposure, which includes, among other things, losses associated with the liquidation of a defaulted member's portfolio.

In response to the comments regarding enhancing the model-based calculation instead of adding the minimum margin amount, the Commission believes that, as FICC stated in its response, the inputs to FICC's model-based calculation include risk factors that are typical TBA attributes, whereas the extreme market volatility of March and April 2020, which affected the TBA markets, was caused by other external factors that are less subject to modeling. Accordingly, the Commission believes that FICC would more effectively cover its exposure during such periods by including the minimum margin amount as an alternative margin component based on the price volatility in each member's portfolio using observable TBA benchmark prices, using a relatively short lookback period.⁸⁹

In response to the comments regarding whether the minimum margin amount will likely become the predominant calculation for determining a member's VaR Charge, the Commission disagrees. For example, the average daily VaR Charge increase from February 3, 2020 through June 30, 2020 would have been approximately \$2.2 billion or 42%, but as the model-based calculation took into account the current market conditions, the average daily increase during Q4 of 2020 would have been approximately \$838 million or 7%.⁹⁰

Finally, in response to the comments regarding concentration charges, the

⁸⁹ See FICC Letter at 3.

⁹⁰ See FICC Letter at 5. The Commission's conclusion is also based upon information that FICC submitted confidentially regarding member-level impact of the proposal from February through December 2020.

Commission notes that there is a distinction between concentration charges and the VaR Charge in that they are generally designed to mitigate different risks. Whereas the VaR Charge is designed to cover the risk of market price volatility, concentration charges are typically designed to mitigate the risk of incurring additional market impact cost from liquidating a directionally concentrated portfolio.⁹¹

Accordingly, the Commission believes that adding the minimum margin amount to FICC's margin methodology would be consistent with Rules 17Ad-22(e)(6)(i) and (iii) because this new margin calculation should better enable FICC to establish a risk-based margin system that considers and produces relevant margin levels commensurate with the risks associated with liquidating member portfolios in a default scenario, including volatility in the TBA market.⁹²

E. Consistency with Rule 17Ad-22(e)(23)(ii)

Rule 17Ad-22(e)(23)(ii) under the Exchange Act requires each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency.⁹³

Several commenters express concerns that the Proposed Rule Change does not provide sufficient information to enable FICC's members to identify and evaluate the

⁹¹ See Securities Exchange Act Release No. 34-90182 (October 14, 2020), 85 Fed. Reg. 66630 (October 20, 2020).

⁹² 17 CFR 240.17Ad-22(e)(6)(i) and (iii).

⁹³ 17 CFR 240.17Ad-22(e)(23)(ii).

minimum margin amount. Two commenters argue that FICC's margin calculations are opaque, which makes liquidity planning difficult for members.⁹⁴ In particular, these commenters express concern that the minimum margin amount could trigger sudden margin spikes that could result in forced selling or other market disruptions.⁹⁵ One commenter argues that since the Proposed Rule Change would set a member's VaR Charge as the greater of the model-based calculation, current VaR Floor haircut, and the minimum margin amount, members would always need to be prepared to fund the minimum margin amount, which makes it difficult for members to identify and evaluate the material costs associated with their trading activities.⁹⁶ Two commenters argue that the Proposed Rule Change did not discuss the anticipated impacts on members' cost to do business or disparate impacts between large and small members.⁹⁷ One commenter argues that enhancing the model-based calculation would better enable members to understand the causes of increased margin requirements than the minimum margin amount.⁹⁸ One commenter claims that at the time of its comment letter, FICC had not yet provided members with updated impact studies demonstrating that as 2020 market volatility stabilized, the minimum margin amount and model-based calculation became

⁹⁴ See SIFMA Letter I at 4; ASA Letter at 2.

⁹⁵ See id.

⁹⁶ See SIFMA Letter II at 2.

⁹⁷ See SIFMA Letter I at 4; ASA Letter at 2.

⁹⁸ See SIFMA Letter I at 4.

more aligned.⁹⁹ One commenter claims that FICC has not explained which entities contributed to the March and April 2020 backtesting deficiencies, or how any reduced Backtesting Charges during the impact study period were equitably distributed among members.¹⁰⁰ One commenter states that while the proposed lookback period for the minimum margin amount would be two years, the period FICC appears to have used to determine a deficit in the desired 99 percent coverage ratio is only one month.¹⁰¹ Finally, one commenter argues that the minimum margin amount is difficult to evaluate because FICC did not discuss whether the minimum margin amount would cause additional member obligations with respect to FICC’s Capped Contingency Liquidity Facility (“CCLF”).¹⁰²

In response to the comments, the Commission notes that FICC provided a detailed member-level impact analysis of the minimum margin amount as part of the Proposed Rule Change filing.¹⁰³ FICC discussed the impact analysis in the narrative of the Proposed Rule Change in general terms to avoid disclosing confidential member

⁹⁹ See IDTA/MBA Letter I at 3.

¹⁰⁰ See IDTA/MBA Letter I at 3; IDTA/MBA Letter II at 3.

¹⁰¹ See SIFMA Letter I at 3.

¹⁰² See SIFMA Letter I at 4. CCLF is a rules-based, committed liquidity resource designed to enable FICC to meet its cash settlement obligations in the event of a default of the member or family of affiliated members to which FICC has the largest exposure in extreme but plausible market conditions. See MBSD Rule 17, supra note 15.

¹⁰³ As part of the Proposed Rule Change, FICC filed Exhibit 3 – FICC Impact Studies. Pursuant to 17 CFR 240.24b-2, FICC requested confidential treatment of Exhibit 3.

information.¹⁰⁴

Additionally, FICC responds that it has provided its members with explanations regarding the effects of the minimum margin amount, including updated impact study data through the fourth quarter of 2020.¹⁰⁵ FICC further states that it provides ongoing tools and resources to assist its members to determine their margin requirements and the anticipated impact of the minimum margin amount.¹⁰⁶ Specifically, FICC maintains the Real Time Matching Report Center, Clearing Fund Management System, and FICC Customer Reporting service, which are member-accessible websites for accessing risk reports and other risk disclosures.¹⁰⁷ These websites enable a member to view and download margin requirement information and component details.¹⁰⁸ The reporting enables a member to view, for example, a portfolio breakdown by CUSIP, including the amounts attributable to the model-based calculation.¹⁰⁹ In addition, members are able to view and download spreadsheets that contain market amounts for current clearing positions, and the associated VaR Charge.¹¹⁰ FICC also maintains the FICC Risk Client Portal, which is a member-accessible website that enables members to view and analyze

¹⁰⁴ See Notice, supra note 3 at 79545.

¹⁰⁵ See FICC Letter at 6.

¹⁰⁶ See id.

¹⁰⁷ See id.

¹⁰⁸ See id.

¹⁰⁹ See id.

¹¹⁰ See id.

certain risks related to their portfolios, including daily customer reports and calculators to assess the risk and margin impact of certain activities.¹¹¹ FICC maintains the FICC Client Calculator that enables members to enter “what-if” position data and recalculate their VaR Charge to determine margin impact before trade execution.¹¹² Finally, the FICC Client Calculator allows members to see the impact to the VaR Charge if specific transactions are executed, or to anticipate the impact of an increase or decrease to a current clearing position.¹¹³

Regarding the comment that although the proposed lookback period for the minimum margin amount would be two years, the period FICC appears to have used to determine a deficit in the desired 99 percent coverage ratio is only one month, FICC states that the minimum margin amount lookback period is for the model calibration, whereas the backtesting coverage calculation is based on rolling 12 months.¹¹⁴

Finally, regarding CCLF, FICC states margin requirements and CCLF obligations are not directly related, and each is designed to account for different risks.¹¹⁵ Margin requirements are designed to address the market risk inherent in each member’s portfolio and mitigate potential losses to FICC associated with liquidating a member’s portfolio in a default scenario. CCLF is a rules-based liquidity tool designed to ensure that MBSD

¹¹¹ See FICC Letter at 6-7.

¹¹² See FICC Letter at 7.

¹¹³ See id.

¹¹⁴ See FICC Letter 5.

¹¹⁵ See FICC Letter at 7.

has sufficient liquidity resources to complete settlement in the event of the failure of FICC's largest member (including affiliates). FICC does not believe that CCLF procedures or member obligations would need to be modified as a result of implementing the minimum margin amount.¹¹⁶

For the foregoing reasons, the Commission disagrees with the comments stating that the Proposed Rule Change does not provide sufficient information to enable members to identify and evaluate the risks and other material costs they incur by participating in FICC or that the Proposed Rule Change does not allow members to predict the minimum margin amount's impact on their activities. The Commission acknowledges that, as some commenters have noted, the Proposed Rule Change does not provide or specify the actual models or calculations that FICC would use to determine the minimum margin amount. However, when adopting the CCA Standards,¹¹⁷ the Commission declined to adopt a commenter's view that a covered clearing agency should be required to provide, at least quarterly, its methodology for determining initial margin requirements at a level of detail adequate to enable participants to replicate the covered clearing agency's calculations, or, in the alternative, that the covered clearing agency should be required to provide a computational method with the ability to determine the initial margin associated with changes to each respective participant's portfolio or hypothetical portfolio, participant defaults and other relevant information. The Commission stated that "[m]andating disclosure of this frequency and granularity would

¹¹⁶ See id.

¹¹⁷ 17 CFR 240.17Ad-22(e).

be inconsistent with the principles-based approach the Commission is taking in Rule 17Ad-22(e).”¹¹⁸ Consistent with that approach, the Commission does not believe that Rule 17Ad-22(e)(23)(ii) would require FICC to disclose its actual margin methodology, so long as FICC has provided sufficient information for its members to understand the potential costs and risks associated with participating in FICC.

For the reasons discussed above, the Commission believes that the Proposed Rule Change would enable FICC to establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide sufficient information to enable members to identify and evaluate the risks, fees, and other material costs they incur as FICC’s members, consistent with Rule 17Ad-22(e)(23)(ii).¹¹⁹

III. CONCLUSION

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹²⁰ and the rules and regulations promulgated thereunder.

¹¹⁸ See CCA Standards Adopting Release, supra note 33, 81 Fed. Reg. at 70845.

¹¹⁹ 17 CFR 240.17Ad-22(e)(23)(ii).

¹²⁰ 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act¹²¹ that proposed rule change SR-FICC-2020-017, be, and hereby is, APPROVED.¹²²

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹²³

J. Matthew DeLesDernier
Assistant Secretary

¹²¹ 15 U.S.C. 78s(b)(2).

¹²² In approving the proposed rule change, the Commission considered the proposals' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f). See also Sections II.A. and II.B.

¹²³ 17 CFR 200.30-3(a)(12).