

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-74132; File No. SR-FICC-2014-11)

January 26, 2015

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Amend the Government Securities Division Rulebook and the Mortgage Backed Securities Clearing Rules In Order to Move the Time of Novation with Respect to Certain Trades, Include Rules to Reflect Existing Processes, and Clarify Certain Rules to Reflect Current Practices

I. Introduction

On December 2, 2014, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-FICC-2014-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed change was published for comment in the Federal Register on December 16, 2014.³ The Commission received no comment letters in response to the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

The rule change, as proposed, moves the time of novation applicable to certain transactions submitted to FICC’s Government Securities Division (“GSD”) and FICC’s Mortgage Backed Securities Division (“MBSD”) to earlier in the clearing process in order to

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-73805 (December 10, 2014), 79 FR 74790 (December 16, 2014) (SR-FICC-2014-11).

provide members with additional legal certainty, for purposes of members' regulatory capital requirements, that FICC will be the legal counterparty with respect to their guaranteed trades.

Currently, FICC guarantees the settlement of a trade upon comparison, which generally occurs when FICC issues initial "output" to GSD netting members or MBSD clearing members, as applicable, indicating that their trades have compared,⁴ provided that the trade meets the requirements of the GSD Rulebook ("GSD Rules") or the MBSD Rulebook ("MBSD Rules"), as applicable.⁵

Novation, which refers to the termination of delivery, receive and related payment obligations between the original parties to the contract and the replacement of such obligations with identical obligations between each party and FICC, currently does not occur until later in the clearing and settlement process than comparison. Under the GSD Rules, novation currently occurs when subsequent "netting output" is issued to netting members (usually the day before settlement). Under the MBSD Rules, novation currently occurs when subsequent "pool netting output" is issued to clearing members (usually the day before settlement).

FICC stated in its proposed rule change that it was proposing the rule change because it understood that, as its members (or their advisors) analyze their netting rights with respect to transactions cleared through FICC for purposes of regulatory capital requirements, it is beneficial for members that FICC become the legal counterparty at the point its guarantee attaches.

Time of Novation – Rule Changes

⁴ In the case of GSD locked-in trades, comparison occurs upon receipt of the trade data submitted to FICC from the locked-in trade source. GSD Rule 6C.

⁵ See GSD Rule 11B and MBSD Rule 5.

Under the revised GSD Rules and MBSD Rules, as approved, novation will occur at comparison for netting eligible transactions (for GSD) and SBO-Destined Trades⁶ (for MBSD). This means that, at the point of trade comparison, FICC will both guarantee the settlement of the transactions (as it does today) and novate such transactions, becoming the legal counterparty to each submitting member with respect to such transactions.

Under the revised GSD Rules, as approved pursuant to this rule change, all netting eligible transactions that compare in accordance with the GSD Rules will novate at the point of comparison.

As amended by this proposal, pursuant to the MBSD Rules, only SBO-Destined Trades, all of which are included in the TBA Netting process and must be submitted to the Pool Netting process,⁷ will novate at the point of comparison. Other types of transactions, including Trade-

⁶ The MBSD Rules define a “SBO-Destined Trade” as a to-be-announced (“TBA”) transaction in the clearing system intended for TBA Netting in accordance with the provisions of the Rules. MBSD Rule 1. In a TBA transaction, members agree on a sale price, quantity, and the characteristics of the securities being sold, but they do not specify which particular securities will be delivered on the settlement date.

⁷ MBSD conducts two separate netting processes to consolidate settlement obligations and reduce the number of securities and the amount of cash that must be exchanged to settle transactions. TBA Netting is the process used to net SBO-Destined Trades that have compared in accordance with the MBSD Rules. TBA Netting is conducted before particular securities (“pools”) are identified to the SBO-Destined Trades. Pool Netting, which occurs after MBSD clearing members allocate pools to transactions, is the process used to aggregate and match offsetting pool delivery obligations submitted by MBSD clearing members to satisfy their settlement obligations. MBSD Rules 6 and 7. An MBSD clearing member may submit a transaction to Pool Netting even if such transaction was not submitted for TBA Netting. The rule change includes the addition of a new Section 7 to MBSD Rule 8 stating that each clearing member must submit to FICC for inclusion in Pool Netting each SBOO and SBON Trade to which such clearing member is a party. The terms “SBOO Trade” and “SBON Trade” are defined in MBSD Rule 1, as amended by this rule change. Section 7 of MBSD Rule 8 has been added to reflect MBSD’s existing requirements and practices.

for-Trade Transactions⁸ and Specified Pool Trades,⁹ will continue to be guaranteed at comparison, as they are today, but FICC will not novate such transactions at comparison. Instead, such transactions will be treated as they are today: (1) to the extent Trade-for-Trade Transactions are included in the Pool Netting process,¹⁰ FICC will novate such Transactions once the Pool Netting¹¹ process is completed and (2) Specified Pool Trades, which are not included in the TBA Netting process nor the Pool Netting process, are not novated today (they settle outside of FICC between the submitting counterparties) and will continue to not be novated under the proposal.¹²

In order to effectuate this change in the time of novation as described above, the rule change adds language to the GSD Rules (new Section 8 of Rule 5) and the MBSD Rules (new Section 13 of Rule 5) that states that FICC will guarantee and novate applicable transactions upon comparison, subject to the parameters set forth in the rule change, as proposed.

⁸ The MBSD Rules define “Trade-for-Trade Transaction” as a TBA transaction submitted to FICC not intended for TBA Netting in accordance with the provisions of the Rules. MBSD Rule 1.

⁹ The MBSD Rules define “Specified Pool Trades” as a trade in which all required pool data, including the pool number to be delivered on the contractual settlement date, are agreed upon by the clearing member at the time of execution. MBSD Rule 1.

¹⁰ Trade-for-Trade Transactions that are not submitted to the Pool Netting process must be settled outside of FICC between the submitting counterparties.

¹¹ As noted in SR-FICC-2008-01, a clearing member that has a trade that was matched with a stipulation (“Stip Trade”) would not submit such trade for Pool Netting. Pool Netting creates delivery obligations based off the net position of clearing members without regard to the original counterparty relationship. With a Stip Trade, the buyer and seller will want to ensure the receipt or delivery, as applicable, is maintained between themselves to ensure that the other party adheres to the stipulated terms. Securities Exchange Act Release No. 34-66550 (March 9, 2012), 77 FR 15155 (March 14, 2014) (SR-FICC-2008-01). Therefore, as with the current process, FICC does not expect to novate Stip Trades.

¹² MBSD Rule 10.

Conforming changes also will be made to GSD Rule 3A, GSD Rule 6B, GSD Rule 6C, GSD Rule 11, GSD Rule 14, GSD Rule 20, GSD Rule 21A, Rule 22B, MBSD Rule 6, MBSD Rule 8, MBSD Rule 10, MBSD Rule 11 and MBSD Rule 17A. In addition, the definition of “novation” in both GSD Rule 1 and MBSD Rule 1 is clarified to reflect that delivery, receive and related payment obligations between members will be terminated and replaced with identical obligations to and from FICC at the point in time that the trade is compared in accordance with the applicable Rules.

The rule change, as approved, makes clear that under the MBSD Rules certain settlement obligations continue to be settled between the settlement counterparties and not vis-à-vis FICC; these are the obligations that are not included in the Pool Netting process pursuant to MBSD Rule 8 (Pool Netting). The rule change does not change this existing process. However, because the rule change moves the time of novation up to the time of comparison for certain MBSD transactions, the rule change (in MBSD Rule 5, Section 2) makes clear that the settlement counterparties continue to settle with each other but do so on behalf of FICC for those transactions that are novated to FICC.

According to FICC, the proposal to move the time of novation as noted above does not change FICC’s risk exposures. Because FICC currently guarantees eligible trades upon comparison, FICC already assumes responsibility for settling such trades at the point of comparison. According to FICC, adding legal novation at the point of comparison does not increase FICC’s obligations and therefore, does not require any changes to FICC’s risk management processes. In addition, FICC notes that the rule change does not change FICC’s operational processes.

Formalization of Existing Processes

In addition, the rule changes formalize the following existing processes:

- Section 7 of MBSD Rule 8 is added to state that all SBOO Trades and SBON Trades¹³ must be submitted to Pool Netting.
- MBSD Rules 15 and 16 are revised to clarify that, upon the insolvency of a member's original counterparty to a compared trade, such member cannot unilaterally modify its obligations with respect to transactions originally entered with such counterparty. In the MBSD Rules, because certain trades are not novated and will continue to not be novated under this proposal, the rule change makes clear that upon a cease to act with respect to a member by FICC, the solvent member to a compared trade with the defaulting member may not unilaterally act with respect to such trade.

These changes are not intended to change FICC's current operations or processes.

Clarification to Reflect Current Processes

In addition, the rule change clarifies certain GSD and MBSD Rules to reflect actual practices and requirements as follows:

- MBSD Rule 17 is revised to clarify that when FICC ceases to act for a member, FICC may dispose of such member's Trade-for-Trade Transactions based upon their generic terms. These changes are not intended to change FICC's current operations or processes.

Specific Changes

With respect to the GSD Rules, the proposed changes are as follows:

- The term "Interactive Submission Method" is revised to correct a typographical error.

¹³ The terms "SBOO Trade" and "SBON Trade" are defined in MBSD Rule 1, as amended by this proposal.

- For clean-up and clarification purposes, the term “Novation” is revised to reflect that delivery, receive and related payment obligations between GSD netting members will be terminated and replaced with identical obligations to and from FICC at the point in time that the trade is compared in accordance to the GSD Rules.
- Rule 3A, Sections 2(i), 7(a), 7(d), 14(c), and 16(a) are revised to reflect that trades submitted by Sponsored Members¹⁴ will novate to FICC at the time that such trades receive FICC’s guaranty of settlement.
- Rule 5 is revised to include a new Section 8 entitled “Novation and Guaranty of Compared Trades,” which provides for the following: (1) compared trades that meet the requirements of the GSD Rules and were entered into in good faith will novate to FICC and FICC will guarantee the settlement for each such compared trade; (2) if a compared trade becomes uncomparing or cancelled, FICC’s guaranty and novation of such trade will be reversed and cancelled; (3) if a compared trade is modified after novation and such modification does not cause the trade to become uncomparing, then the modification will cause a corresponding modification to the deliver, receive and related payment obligations between the GSD netting members and FICC; (4) at the time that a compared trade becomes novated, such trade ceases to be bound by any bilateral agreement between the parties with respect to the deliver, receive and related payment obligations, however, if the trade becomes uncomparing or is cancelled, such trade shall be governed by the bilateral agreement that governed the trade prior to the novation; and (5) if a right of substitution was established by the parties to a repurchase transaction, such right will continue and be recognized by FICC after novation.

¹⁴ The term “Sponsored Member” means any Person that has been approved by FICC to be sponsored into membership by a Sponsoring Member pursuant to Rule 3A. GSD Rule 1.

- Rule 6B, Section 4 deletes the provision which states that an uncomparing trade will cease to be guaranteed by FICC because this concept is now covered in Rule 5, Section 8.
- Rule 6C, Section 10 deletes the provision which states that a locked-in trade that becomes uncomparing will cease to be guaranteed by FICC because this concept is now covered in Rule 5, Section 8.
- Rule 6C, Section 11 deletes the provision which states that a netting eligible auction purchase that becomes uncomparing will cease to be guaranteed by FICC because this concept is now covered in Rule 5, Section 8.
- Rule 6C, Section 12 deletes the provision which states that a GCF Repo Transaction¹⁵ that becomes uncomparing will cease to be guaranteed by FICC because this concept is now covered in Rule 5, Section 8.
- Rule 11, Section 6 is revised to reflect that (1) novation occurs at comparison; and (2) at netting, the previously novated deliver, receive and related payment obligations between the netting members and FICC will be terminated and replaced by net deliver, receive and related payment obligations as listed in the report made available by FICC to the netting members.
- Rule 11B is revised to correct typographical errors.
- Rule 14, Section 3 is revised to reflect that (1) novation occurs at comparison; and (2) at netting, the previously novated deliver, receive and related payment obligations between the netting members and FICC created by Forward Trades will be terminated and replaced by net

¹⁵ Pursuant to the GSD Rules, the term “GCF Repo Transaction” means a Repo Transaction involving generic CUSIP numbers the data on which are submitted to FICC on a locked-in-trade basis pursuant to the provisions of Rule 6C, for netting and settlement by FICC pursuant to the provisions of Rule 20. GSD Rule 1.

deliver, receive and related payment obligations as listed in the report made available by FICC to the netting members.

- Rule 20, Section 5 is revised to reflect that with respect to GCF Repo Transactions, novation will occur at comparison in accordance with Rule 5, Section 8.
- Rule 21A is revised to incorporate the concept of novation.
- Rule 22B included a sentence providing that upon FICC's default, trades that had compared would be deemed novated. Because the GSD Rules are being revised to reflect that novation occurs at comparison, this sentence is no longer necessary. As a result, it is being deleted in connection with this rule change.

With respect to the MBSD Rules, the changes are as follows:

- For clean-up and clarification purposes, the term "Novation" is revised to reflect that delivery, receive and related payment obligations between MBSD clearing members will be terminated and replaced with identical obligations to and from FICC in accordance with the MBSD Rules.
- The term "SBO Contra-Side Member" is revised to correct a typographical error.
- The term "SBO Net-Out Position" is revised to clarify that the term is used in connection with offsetting purchase and sale SBO-Destined Trades that were originally between different clearing members (but, once novated at comparison, are between such members and FICC).
- The term "SBO Net-Out Unit" is being deleted because this term is not used in the MBSD Rules.
- The term "SBO Netted Position" is revised to clarify that the term is used in connection with offsetting purchase and sale SBO-Destined Trades that were originally between the same clearing members (but, once novated at comparison, are between such members and FICC).

- The term “SBON Trade” is revised to correct a typographical error.
- The term “SBOO Trade” is revised to correct a typographical error.
- Rule 5, Section 1 is revised to correct a typographical error.
- Rule 5, Section 2 is revised to reflect that (1) transactions that are not novated pursuant to this proposal (pursuant to new Section 13 of Rule 5 discussed below) and not netted and novated through the Pool Netting system will be settled directly between the members; and (2) transactions novated pursuant to new Section 13 of Rule 5 and not thereafter netted through the Pool Netting system pursuant to Rule 8 will settle between members on behalf of FICC.
- Rule 5, Section 12 is revised to correct a typographical error.
- Rule 5 includes a new Section 13 entitled “Novation” which states the following: (1) FICC will guarantee and novate SBO-Destined Trades that meet the requirement of the MBSD Rules and have been entered into in good faith; (2) FICC will not novate SBO-Destined Trades that are partially compared; (3) to the extent a partially compared SBO-Destined Trade becomes fully compared, FICC will novate such trade; (4) if a trade becomes uncomparred or cancelled, the guaranty and novation of such transaction shall be reversed; (5) at the time that an SBO-Destined Trade is novated to FICC, such trade shall cease to be bound by any bilateral agreement between the parties to the trade with respect to the deliver, receive and related payment obligations, however, if the trade becomes uncomparred or is cancelled, such trade shall be governed by the bilateral agreement that governs such trade prior to the novation.
- Rule 6, Sections 1(a), (b) and (c) are revised to take into account the fact that SBO-Destined Trades are novated upon comparison and are, therefore, legally between MBSD clearing members and FICC after comparison.

- Rule 8, Section 6 is revised to take into account the fact that SBO-Destined Trades are novated upon comparison and are, therefore, legally between MBSD clearing members and FICC after comparison.
- Rule 8 includes a new Section 7 which is entitled “Obligation to Submit SBOO and SBON Trades to Pool Netting.” This Section reflects MBSD’s current requirement and current practice that clearing members are required to submit all SBOO Trades and SBON Trades for inclusion in the Pool Netting system.
- Rule 10, Section 2 is revised to clarify that clearing members are required to submit a notification of settlement for SBO Trades that are novated at comparison and processed through the TBA Netting system but that are not thereafter submitted to the Pool Netting system.
- Rule 11, Section 1 is revised to take into account the fact that SBO Trades are novated upon comparison and are, therefore, legally between MBSD clearing members and FICC after comparison.
- Rule 15 is revised to clarify the current process with respect to transactions submitted to and compared by FICC, whereby in the event a member’s original counterparty becomes insolvent, such member cannot unilaterally modify its obligations with respect to transactions originally entered with such counterparty.
- Rule 16 is revised to clarify the current process with respect to transactions submitted to and compared by FICC, whereby in the event a member’s original counterparty becomes insolvent, such member cannot unilaterally modify its obligations with respect to transactions originally entered with such counterparty.

- Rule 17, Section 2 is revised to clarify the current process whereby when FICC ceases to act for a clearing member, such member's Trade-for-Trade Transactions¹⁶ may be disposed of based upon their generic terms such as agency, product, coupon rate and maturity. The other changes are typographical corrections.
- Rule 17A is revised to clarify that in the event of FICC's default, novation is deemed to have occurred with respect to all transactions at the time such transactions are compared, whether or not such transactions are SBO-Destined Trades that would otherwise have been novated at comparison. The other changes to this provision are grammatical corrections.

III. Discussion

Section 19(b)(2)(C) of the Act¹⁷ 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 the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act¹⁸ requires, among other things, that the rules of a clearing agency be designed to achieve several goals, including promoting the prompt and accurate clearance and settlement of securities transactions and, to the extent applicable, derivative agreements, contracts, and transactions.

The Commission concludes that the proposed rule change is consistent with the requirements of Section 17A(b)(3)(F) of the Act, and the rules and regulations thereunder, because by moving novation for trades that enter GSD's Netting system and MBSD's TBA Netting system, the rule change, as approved, should clarify FICC's responsibilities to its

¹⁶ Including "stip" trades and any other TBA transactions not intended for TBA Netting.

¹⁷ 15 U.S.C. 78s(b)(2)(C).

¹⁸ 15 U.S.C. 78q-1(b)(3)(F).

members and remove potential uncertainty that previously existed due to a mismatch between the time of guaranty and the time of novation. As a result, such clarity should further facilitate the prompt and accurate clearance and settlement of securities transactions.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act, particularly those set forth in Section 17A,¹⁹ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁰ that the proposed rule change (SR-FICC-2014-11) be, and hereby is, APPROVED.²¹

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²²

Brent J. Fields
Secretary

¹⁹ 15 U.S.C. 78q-1.

²⁰ 15 U.S.C. 78s(b)(2).

²¹ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

²² 17 CFR 200.30-3(a)(12).