

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-75768; File No. SR-NSCC-2015-003)

August 27, 2015

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Proposed Rule Change to Enhance NSCC's Margining Methodology as Applied to Family-Issued Securities of Certain NSCC Members

Pursuant to Section 19(b)(1)<sup>1</sup> of the Securities Exchange Act of 1934 ("Act") and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on August 14, 2015, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by NSCC.<sup>3</sup> NSCC filed the proposed rule change pursuant to Section 19(b)(2)<sup>4</sup> of the Act. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change consists of amendments to NSCC's Rules & Procedures ("Rules") in order to enhance NSCC's margining methodology as applied to

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> On August 14, 2015, NSCC filed this proposed rule change as an advance notice (SR-NSCC-2015-803) 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), and Rule 19b-4(n)(1)(i) of the Act, 17 CFR 240.19b-4(n)(1)(i). A copy of the advance notice is available at <http://www.dtcc.com/legal/sec-rule-filings.aspx>.

<sup>4</sup> 15 U.S.C. 78s(b)(2).

family-issued securities of NSCC Members<sup>5</sup> that are placed on NSCC’s “Watch List”, i.e., those Members who present a heightened credit risk to NSCC or have demonstrated higher risk related to their ability to meet settlement, as more fully described below.

II. Clearing Agency’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NSCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

(A) Clearing Agency’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

As a central counterparty, NSCC occupies an important role in the securities settlement system by interposing itself between counterparties to financial transactions and thereby reducing the risk faced by participants and contributing to global financial stability. The effectiveness of a central counterparty’s risk controls and the adequacy of its financial resources are critical to achieving these risk-reducing goals. In that context, NSCC continuously reviews its margining methodology in order to ensure the reliability of its margining in achieving the desired coverage. In order to be most effective, NSCC must take into consideration the risk characteristics specific to certain securities when margining those securities.

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<sup>5</sup> Terms not defined herein are defined in the Rules, available at [http://dtcc.com/~media/Files/Downloads/legal/rules/nsc\\_rules.pdf](http://dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf).

Among the various risks that NSCC considers when evaluating the effectiveness of its margining methodology are its counterparty risks and identification and mitigation of “wrong-way” risk, particularly specific wrong-way risk, defined as the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of that counterparty deteriorates.<sup>6</sup> NSCC has identified an exposure to wrong-way risk when it acts as central counterparty to a Member with respect to positions in securities that are issued by that Member or that Member’s affiliate. These positions are referred to as “family-issued securities.” In the event that a Member with unsettled long positions in family-issued securities defaults, NSCC would close out those positions following a likely drop in the credit-worthiness of the issuer, possibly resulting in a loss to NSCC.

NSCC is proposing to address its exposure to this type of wrong-way risk in two steps. First, NSCC proposes in this filing to enhance its margin methodology as applied to the family-issued securities of its Members that are on its Watch List<sup>7</sup> by excluding these securities from the volatility component, or “VaR” charge, and then charging an amount calculated by multiplying the absolute value of the long net unsettled positions in that Member’s family-issued securities by a percentage that is no less than 40%. The haircut rate to be charged would be determined based on the Member’s rating on the

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<sup>6</sup> See Principles for financial market infrastructures, issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions 47 n.65 (April 2012), available at <http://www.bis.org/publ/cpss101a.pdf>.

<sup>7</sup> As part of its ongoing monitoring of its membership, NSCC utilizes an internal credit risk rating matrix to rate its risk exposures to its Members based on a scale from 1 (the strongest) to 7 (the weakest). Members that fall within the higher risk rating categories (i.e. 5, 6, and 7) are considered on NSCC’s “Watch List”, and may be subject to enhanced surveillance or additional margin charges, as permitted under NSCC’s Rules. See Section 4 of Rule 2B and Section I(B)(1) of Procedure XV of NSCC’s Rules, supra Note 5.

credit risk rating matrix and the type of family-issued security submitted to NSCC. Fixed income securities that are family-issued securities would be charged a haircut rate of no less than 80% for firms that are rated 6 or 7 on the credit risk rating matrix, and no less than 40% for firms that are rated 5 on the credit risk rating matrix; and equity securities that are family-issued securities would be charged a haircut rate of 100% for firms that are rated 6 or 7 on the credit risk rating matrix, and no less than 50% for firms that are rated 5 on the credit risk rating matrix. NSCC would have the authority to adjust these haircut rates from time to time within these parameters as described in Procedure XV of NSCC's Rules without filing a proposed rule change with the Commission pursuant to Section 19(b)(1) of the Act,<sup>8</sup> and the rules thereunder, or an advance notice with the Commission pursuant to Section 806(e)(1) of the Clearing Supervision Act,<sup>9</sup> and the rules thereunder.

Because NSCC Members that are on its Watch List present a heightened credit risk to the clearing agency or have demonstrated higher risk related to their ability to meet settlement, NSCC believes that this charge would more effectively capture the risk characteristics of these positions and can help mitigate NSCC's exposure to wrong-way risk. NSCC proposes to amend Section I(B)(1) of Procedure XV of its Rules, as marked on Exhibit 5 hereto,<sup>10</sup> to enhance its margining methodology as described herein.

Second, NSCC will continue to evaluate its exposures to wrong-way risk, specifically wrong-way risk presented by family-issued securities, including by reviewing

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<sup>8</sup> 15 U.S.C. 78s(b)(1).

<sup>9</sup> 12 U.S.C. 5465(e)(1).

<sup>10</sup> The Commission notes that Exhibit 5 is attached to the filing, not to this Notice.

the impact of expanding the application of the proposed margining methodology to the family-issued securities of those Members that are not on the Watch List. NSCC is proposing to apply the enhanced margining methodology to the family-issued securities of Members that are on the Watch List at this time because, as stated above, these Members present a heightened credit risk to the clearing agency or have demonstrated higher risk related to their ability to meet settlement. As such, there is a clear and more urgent need to address NSCC's exposure to wrong-way risk presented by these firms' family-issued securities.

However, any future change to the margining methodology as applied to the family-issued securities of Members that are not on the Watch List would be subject to a separate proposed rule change pursuant to Section 19(b)(1) of the Act,<sup>11</sup> and the rules thereunder, and an advance notice pursuant to Section 806(e)(1) of the Clearing Supervision Act,<sup>12</sup> and the rules thereunder.

*Implementation Timeframe.* Subject to Commission approval of this proposed rule change, Members would be advised of the implementation date through issuance of an NSCC Important Notice. NSCC expects to run these changes in a test environment for a three month parallel period prior to implementation. Details and dates regarding this test would be communicated to Members through an NSCC Important Notice. As stated above, NSCC will conduct additional analysis of its exposure to wrong-way risk, and, following implementation of this proposed rule change, will engage in outreach to its

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<sup>11</sup> 15 U.S.C. 78s(b)(1).

<sup>12</sup> 12 U.S.C. 5465(e)(1).

membership when evaluating whether to expand the application of the proposed enhanced margining methodology to Members not on its Watch List.

2. Statutory Basis

Pursuant to Section 17A(b)(3)(F) of the Act, NSCC's Rules must be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>13</sup> Rule 17Ad-22(b)(1), promulgated under the Act, requires NSCC to measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.<sup>14</sup> Rule 17Ad-22(b)(2), promulgated under the Act, requires NSCC to use risk-based models for setting margin requirements.<sup>15</sup>

By enhancing the margin methodology as applied to the family-issued securities of its Members that are on its Watch List, the proposed rule change would assist NSCC in collecting margin that more accurately reflects the risk characteristics of these securities, thereby limiting NSCC's exposures to potential losses from defaults by these Members under normal market conditions. By more closely capturing the risk characteristics of these positions, the proposed enhancement to the margining methodology would also assist NSCC in its continuous efforts to ensure the reliability and effectiveness of its risk-based margining methodology. In this way, the proposed rule change would help NSCC,

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<sup>13</sup> 5 U.S.C. 78q-1(b)(3)(F).

<sup>14</sup> 17 CFR 240.17Ad-22(b)(1).

<sup>15</sup> 17 CFR 240.17Ad-22(b)(2).

as a central counterparty, maintain effective risk controls, contributing to the goal of maintaining financial stability in the event of a Member default.

Therefore, NSCC believes the proposed rule change is consistent with the requirements of the Act and the rules and regulations promulgated thereunder applicable to NSCC, in particular Section 17A(b)(3)(F) of the Act and Rule 17Ad-22(b)(1) and (2), promulgated under the Act, cited above.

(B) Clearing Agency's Statement on Burden on Competition

The proposed rule change may impose a burden on competition by applying the enhanced margining methodology only to NSCC Members on NSCC's Watch List. However, NSCC believes any related burden on competition would be necessary and appropriate, as permitted by Section 17A(b)(3)(I) of the Act for a number of reasons.<sup>16</sup>

First, while NSCC will continue to review its exposures to wrong-way risk and will consider expanding the application of the proposed margining methodology to additional Members, NSCC has determined to initially limit the applicability of the proposed rule change to Members on its Watch List because those Members present a heightened credit risk to the clearing agency or have demonstrated a higher risk in their ability to meet settlement. Second, by limiting NSCC's exposures to losses that it may face in clearing family-issued securities of such Members, the proposed rule change would contribute to the goal of maintaining financial stability in the event of the default of a Member on the Watch List, which would help facilitate the prompt and accurate clearance and settlement of securities transactions and protect investors and the public

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<sup>16</sup> 5 U.S.C. 78q-1(b)(3)(I).

interest, in furtherance of the requirements of the Act applicable to NSCC, as discussed above.

As such, NSCC believes any burden on competition resulting from the proposed rule change would be both necessary and appropriate in furtherance of the purposes of the Act, in particular Section 17A(b)(3)(F) of the Act and Rule 17Ad-22(b)(1) and (2), promulgated under the Act, cited above.

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In November 2013, NSCC engaged in outreach to its Members by providing those Members with a description of the proposed rule change and the results of an impact study showing the potential impact of this proposal on Members' Clearing Fund required deposits. NSCC did not receive any written comments relating to this proposed rule change in response to this outreach. NSCC will notify the Commission of any written comments received by NSCC.

III. Date of Effectiveness of the Proposed Rule Change, and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such a proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.



The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2015-003 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NSCC-2015-003. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for

website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of NSCC and on DTCC's website (<http://dtcc.com/legal/sec-rule-filings.aspx>). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NSCC-2015-003 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>17</sup>

Robert W. Errett  
Deputy Secretary

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<sup>17</sup> 17 CFR 200.30-3(a)(12).