

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76077; File No. SR-NSCC-2015-003)

October 5, 2015

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

On August 14, 2015, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-NSCC-2015-003 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² to change its margin charge with respect to a member's positions in securities that are issued by such member or its affiliate (i.e., "family-issued securities") by excluding positions in these securities, when the member is on NSCC's Watch List,³ from its volatility margining model. The proposed rule change was published for comment in the Federal Register on September 2, 2015.⁴ The

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 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 weakest three rating categories (i.e., 5, 6, and 7) are placed on NSCC's "Watch List" and, as provided under NSCC's Rules and Procedures ("Rules"), may be subject to enhanced surveillance or additional margin charges. See Section 4 of Rule 2B and Section I(B)(1) of Procedure XV of NSCC's Rules, available at http://dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf.

⁴ See Securities Exchange Act Release No. 75768 (August 27, 2015), 80 FR 53219 (September 2, 2015) (SR-NSCC-2015-003). NSCC also filed an advance notice with the Commission seeking approval of changes to its Rules necessary to implement the proposed rule change. This advance notice was published in the Federal Register on September 17, 2015. Securities Exchange Act Release No. 75899 (September 11, 2015), 80 FR 55883 (September 17, 2015) (File No. SR-NSCC-2015-803).

Commission did not receive comment letters regarding the proposed change. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

I. Description of the Proposed Rule Change

The following is a description of the proposed rule change, as provided by NSCC:

The proposed rule change consists of amendments to NSCC's Rules in order to enhance NSCC's margining methodology as applied to family-issued securities of NSCC Members⁵ 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.

Background

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.

Among the various risks that NSCC considers when evaluating the effectiveness of its margining methodology are its counterparty risks and identification and mitigation

⁵ Terms not defined herein are defined in the Rules, available at http://dtcc.com/~media/Files/Downloads/legal/rules/nsccl_rules.pdf.

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.⁶ 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 has proposed to address its exposure to this type of wrong-way risk in two steps. First, NSCC has proposed in this filing to enhance its margin methodology as applied to the family-issued securities of its Members that are on its Watch List 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 will be determined based on the Member’s rating on the credit risk rating matrix and the type of family-issued security submitted to NSCC. Fixed income securities that are family-issued securities will 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 will 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

⁶ 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>.

that are rated 5 on the credit risk rating matrix. NSCC will 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,⁷ and the rules thereunder, or an advance notice with the Commission pursuant to Section 806(e)(1) of the Clearing Supervision Act,⁸ 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 will more effectively capture the risk characteristics of these positions and can help mitigate NSCC's exposure to wrong-way risk.

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

⁷ 15 U.S.C. 78s(b)(1).

⁸ 12 U.S.C. 5465(e)(1).

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,⁹ and the rules thereunder, and an advance notice pursuant to Section 806(e)(1) of the Clearing Supervision Act,¹⁰ and the rules thereunder.

Implementation

The effective date of the proposed rule change will be announced via a 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 will 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 membership when evaluating whether to expand the application of the proposed enhanced margining methodology to Members not on its Watch List.

III. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act¹¹ 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. The Commission believes the proposal is consistent with

⁹ 15 U.S.C. 78s(b)(1).

¹⁰ 12 U.S.C. 5465(e)(1).

¹¹ 15 U.S.C. 78s(b)(2)(C).

Section 17A(b)(3)(F) of the Act,¹² and Rule 17Ad-22(b)(1)¹³ and Rule 17Ad-22(b)(2)¹⁴ under the Act, as described in detail below.

Consistency with Section 17A(b)(3)(F) of the Act. Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions, as well as, in general, protect investors and the public interest.¹⁵ By enhancing the margin methodology applied to family-issued securities of members that are on NSCC’s Watch List, the proposal will assist NSCC in collecting margin that more accurately reflects NSCC’s exposure to a clearing member that clears family-issued securities and will assist NSCC in its continuous efforts to improve the reliability and effectiveness of its risk-based margining methodology by taking into account specific wrong-way risk. As such, the proposal will help NSCC, as a central counterparty, promote robust risk management, and thus promoting the prompt and accurate clearance and settlement of securities transactions, as well as, in general, protecting investors and the public interest.

Consistency with Rule 17Ad-22(b)(1). Rule 17Ad-22(b)(1)¹⁶ under the Act requires a CCP, such as NSCC, to “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . limit its exposures to potential losses from defaults by its participants under normal market conditions” NSCC faces

¹² 15 U.S.C. 78q-1(b)(3)(F).

¹³ 17 CFR 240.17Ad-22(b)(1).

¹⁴ 17 CFR 240.17Ad-22(b)(2).

¹⁵ 15 U.S.C. 78q-1(b)(3)(F).

¹⁶ 17 CFR 240.17Ad-22(b)(1).

specific wrong-way risk in all circumstances where a member submits family-issued securities to NSCC for clearance, including under normal market conditions. By enhancing the margin methodology applied to family-issued securities of NSCC's members that are on its Watch List, the proposal will limit NSCC's exposure to potential losses from the default of a member on NSCC's Watch List with family-issued securities under normal market conditions. As such, the Commission believes that the proposal is consistent with Rule 17Ad-22(b)(1).

Consistency with Rule 17Ad-22(b)(2). Rule 17Ad-22(b)(2)¹⁷ under the Act requires a CCP, such as NSCC, to “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [u]se margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements” By enhancing the margin methodology applied to family-issued securities of NSCC's members that are on its Watch List, the proposal will better account for and cover NSCC's credit exposure to less creditworthy members. In addition, by taking into account specific wrong-way risk arising from family-issued securities submitted to NSCC, the proposal is consistent with using risk based models and parameters to set margin requirements. As such, the Commission believes that the proposal is consistent with Rule 17Ad-22(b)(2).

¹⁷ 17 CFR 240.17Ad-22(b)(2).

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁸ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule change SR-NSCC-2015-003 be, and hereby is, APPROVED.¹⁹

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.²⁰

Robert W. Errett
Deputy Secretary

¹⁸ 15 U.S.C. 78q-1.

¹⁹ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁰ 17 CFR 200.30-3(a)(12).