

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-80734; File Nos. SR-DTC-2017-002; SR-FICC-2017-006; SR-NSCC-2017-002)

May 19, 2017

Self-Regulatory Organizations; The Depository Trust Company; Fixed Income Clearing Corporation; National Securities Clearing Corporation; Order Approving Proposed Rule Changes to Enhance the Credit Risk Rating Matrix and Make Other Changes

On March 22, 2017, The Depository Trust Company (“DTC”), Fixed Income Clearing Corporation (“FICC”), and National Securities Clearing Corporation (“NSCC,” each a “Clearing Agency,” and collectively, “Clearing Agencies”) filed with the Securities and Exchange Commission (“Commission”) proposed rule changes SR-DTC-2017-002, SR-FICC-2017-006, and SR-NSCC-2017-002 (collectively, the “Proposed Rule Changes”) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> The Proposed Rule Changes were published for comment in the Federal Register on April 11, 2017.<sup>3</sup> The Commission received no comments to the Proposed Rule Changes. This order approves the Proposed Rule Changes.

---

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

<sup>2</sup> 17 CFR 240.19b-4. The Clearing Agencies also filed the Proposed Rule Changes as advance notices pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 and Rule 19b-4(n)(1) under the Act. 15 U.S.C. 5465(e)(1) and 17 CFR 240.19b-4(n)(1). The advance notices were published for comment in the Federal Register on April 7, 2017. See Securities Exchange Act Release Nos. 80395 (April 7, 2017), 82 FR 17921 (April 13, 2017) (SR-NSCC-2017-801); 80396 (April 7, 2017), 82 FR 17906 (April 13, 2017) (SR-FICC-2017-804); and 80394 (April 7, 2017), 82 FR 17901 (April 13, 2017) (SR-DTC-2017-801). The Commission did not receive any comments on the advance notices.

<sup>3</sup> Securities Exchange Act Release Nos. 30383 (April 5, 2017), 82 FR 17468 (April 11, 2017) (SR-FICC-2017-006); 80382 (April 5, 2017), 82 FR 17483 (April 11, 2017) (SR-DTC-2017-002); and 80381 (April 5, 2017), 82 FR 17475 (April 11, 2017) (SR-NSCC-2017-002) (“Notices”).

## I. Description of the Proposed Rule Changes

The Proposed Rule Changes consist of proposed modifications to the Rules, By-Laws and Organizational Certificate of DTC (“DTC Rules”), the Rulebook of GSD (“GSD Rules”), the Clearing Rules of MBSB (“MBSB Rules”), and the Rules & Procedures of NSCC (“NSCC Rules”) (collectively, the “Rules”).<sup>4</sup> The Proposed Rule Changes are proposals by the Clearing Agencies to amend the Rules to: (i) enhance their shared credit risk rating matrix (“Credit Risk Rating Matrix” or “CRRM”), which was developed by the Clearing Agencies to evaluate the credit risks posed by certain Clearing Agency members to the Clearing Agencies (and by implication to all of the Clearing Agency members), as a result of providing services to such members; and (ii) make other amendments to the Rules, both related and unrelated to the CRRM, to provide more transparency and description regarding the Clearing Agencies’ current ongoing membership monitoring process, as described below.

Currently, the CRRM rates the credit risk presented by members of the Clearing Agencies that are U.S. broker-dealers and U.S. banks. The CRRM assigns a credit rating based on certain quantitative factors (“Credit Rating”), which vary based upon whether

---

<sup>4</sup> Available at <http://www.dtcc.com/en/legal/rules-and-procedures>. FICC is comprised of two divisions: the Government Securities Division (“GSD”) and the Mortgage-Backed Securities Division (“MBSB”). Each division serves as a central counterparty, becoming the buyer and seller to each of their respective members’ securities transactions and guarantying settlement of those transactions, even if a member defaults. GSD provides, among other things, clearance and settlement for trades in U.S. Government debt issues. MBSB provides, among other things, clearance and settlement for trades in mortgage-backed securities. GSD and MBSB maintain separate sets of rules, margin models, and clearing funds.

the member is a broker-dealer or bank.<sup>5</sup> The current CRRM also uses a relative scoring approach (i.e., rating participants on a curve) and relies on peer grouping of members to calculate the Credit Rating of a member. Ultimately, the ratings generated are based on a 7-point rating system, with “1” being the strongest Credit Rating and “7” being the weakest Credit Rating. Although the current CRRM does not directly consider qualitative factors, the Clearing Agencies’ credit risk staff may manually downgrade a particular member’s Credit Rating based on various qualitative factors.<sup>6</sup> Members that receive a Credit Rating of 5, 6, or 7 are placed on the Clearing Agencies’ “Watch List,” as these members present a greater risk of default.<sup>7</sup>

To improve the coverage and the effectiveness of the current CRRM, the Clearing Agencies are proposing three enhancements, as discussed below. In addition to the enhancements, the Clearing Agencies also propose to make other changes to their Rules to more fully describe the Clearing Agencies’ current ongoing membership monitoring process, both related and unrelated to the CRRM, also discussed below.<sup>8</sup>

A. Proposed CRRM Enhancements

---

<sup>5</sup> For U.S. broker-dealers, the Clearing Agencies consider size (i.e., total excess net capital), capital, leverage, liquidity, and profitability. For U.S. banks, the Clearing Agencies consider size, capital, asset quality, earnings, and liquidity.

<sup>6</sup> Quantitative factors currently considered by the Clearing Agencies include: (a) available news reports and/or regulatory observations relating to the member; (b) member’s liquidity arrangements; and (c) material changes to the member’s organizational structure.

<sup>7</sup> Members on the Watch List are subject to enhanced surveillance by the Clearing Agencies and additional margin charges.

<sup>8</sup> Although each of the Clearing Agencies uses the CRRM uniformly, the description of the respective Clearing Agencies’ Rules regarding the CRRM are different. To address this issue, the Clearing Agencies propose to adopt similar Rules at each Clearing Agency.

Currently, the CRRM is comprised of two Credit Rating models – one for U.S. broker-dealers and one for U.S. banks. The first proposed enhancement would expand the CRRM by adding a third model that would enable the CRRM to generate Credit Ratings for members that are foreign banks or foreign trust companies that have audited financial data that is publicly available. The Credit Rating for these particular members would be based on both quantitative and qualitative factors, as indicated in the second enhancement, below. According to the Clearing Agencies, the expected benefit of this expansion and enhancement of the CRRM would be that the Clearing Agencies could better evaluate the default risk of their foreign bank or foreign trust company members.

The second proposed enhancement would supplement the Clearing Agencies' ability to manually downgrade members by incorporating new qualitative factors into the two existing CRRM models, as well as in the new foreign bank and trust company model.<sup>9</sup> Instead of relying primarily on quantitative data, as do the current CRRM models, the proposed enhancement would modify the CRRM models to blend qualitative factors with quantitative factors to produce a Credit Rating for each applicable member in relation to the member's credit risk. For U.S. banks, foreign banks, and foreign trust companies, the enhanced CRRM would use 70/30 weights between quantitative and

---

<sup>9</sup> Quantitative and qualitative factors used for each of the three models differ. The quantitative factors for foreign banks and foreign trust companies would include size, capital, leverage, liquidity, profitability, and growth. Qualitative factors would include market position and sustainability, information reporting and compliance, management quality, capital management, and business/product diversity. The added qualitative factors for U.S. broker-dealers would include market position and sustainability, management quality, capital management, liquidity management, geographic diversification, business/product diversity, and access to alternative sources of funding. The added qualitative factors for U.S. banks would include the current business environment, regulatory compliance and litigation risk, management quality, liquidity management, and parental demands/needs.

qualitative factors to generate Credit Ratings. For U.S. broker-dealers, the weights between quantitative and qualitative factors would be 60/40. According to the Clearing Agencies, these weights were chosen by the Clearing Agencies based on the industry best practice, as well as research and sensitivity analysis conducted by the Clearing Agencies.<sup>10</sup> The Clearing Agencies would review and adjust both the weights and the quantitative and qualitative factors as needed, based on recalibration of the CRRM. According to the Clearing Agencies, this proposed enhancement is expected to reduce the need and the frequency for them to manually override a member's Credit Rating.

The third enhancement would replace the current CRRM's relative scoring approach (which considers other members' Credit Ratings) with a statistical approach that would estimate the absolute probability of default of each member by ranking members based on their individual probability of default. According to the Clearing Agencies, under the current relative scoring approach, a member's Credit Rating can be affected by changes in its peer group, even if the member's financial condition is unchanged. They believe this issue would be addressed by the proposed statistical approach because it would eliminate any potential distortion of the rating from the member's peer group that can occur under the relative scoring approach, and therefore a member's Credit Rating would better reflect the absolute measure of the member's default risk.

#### B. Proposed Other Changes Related to the CRRM

The Proposed Rule Changes also contain a number of other changes to the Clearing Agencies' Rules with respect to the CRRM. Generally, these CRRM-related

---

<sup>10</sup> Notices at 82 FR 17485, 17477, 17470.

changes are intended to make the Rules more clear, consistent, and current for members that rely on them. The proposed CRRM-related changes would include:

- adding both the CRRM and the Watch List to the definitions sections of the Clearing Agencies' Rules;
- providing more description regarding the Clearing Agencies' continuing ability to downgrade a member's Credit Rating if the Clearing Agencies believe the factors used as part of the CRRM may not identify all risks that a member may present to the Clearing Agencies, and providing more description that any such downgrade could result in the member being placed on the Watch List and/or being subject to enhanced surveillance;
- providing more description regarding the Clearing Agencies' ability to place non-CRRM members on the Watch List and/or subject them to enhanced surveillance, if necessary under certain specified conditions, such as news reports and/or regulatory observations that raise reasonable concerns relating to the member and material changes to the member's organizational structure;
- providing more description regarding, with respect to members on the Watch List, that the Clearing Agencies will (i) collect additional deposits to the clearing fund; and (ii) retain deposits in excess of the required deposits;
- providing more description regarding the Clearing Agencies' ability to continue to monitor and review all members on an ongoing and periodic basis, and that such monitoring may include conducting reviews of news and market developments relating to these members, as well as financial reports and other public information of these members;

- providing more description regarding both members placed on the Watch List and members subject to enhanced surveillance for other reasons being subject to more thorough monitoring of their financial condition and/or operational capability, and being required to provide more frequent financial disclosures;
- providing more description regarding thresholds for any margin “add-on charges”<sup>11</sup> not applying to Watch List members, but applying to non-Watch List members; and
- conforming changes to other sections of the Clearing Agencies’ Rules to use consistent terminology and to provide updated cross references.

C. Proposed Other Changes Unrelated to the CRRM

The Clearing Agencies also propose changes that would provide more description regarding the Clearing Agencies’ explicit authority to review additional reporting from members regarding their financial or operational condition. Such reporting could include information regarding the businesses and operations of the member and its risk management practices with respect to the Clearing Agencies’ services utilized by the member for another person (“Indirect Member”). According to the Clearing Agencies, such a review could result in the member being placed on the Watch List, and/or becoming subject to enhanced surveillance. The Clearing Agencies believe such authority would enable them to better determine whether the member and Indirect

---

<sup>11</sup> Add-on charges are margin requirements that are in addition to the Clearing Agencies’ primary value-at-risk margin requirement, such as an intraday charge to account for market volatility and a charge for having a concentrated position in a security. See, e.g., NSCC Procedure XV, Section 1.(B), supra note 4.

Member has sufficient financial resources and monitor compliance with the Clearing Agencies' financial requirements on an ongoing basis.

## II. Discussion of Commission Findings

Section 19(b)(2)(C) of the Act 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.<sup>12</sup> After carefully considering the Proposed Rule Changes, the Commission finds that the Proposed Rule Changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to the Clearing Agencies. In particular, the Commission believes the proposal is consistent with Section 17A(b)(3)(F) of the Act,<sup>13</sup> as well as Rules 17Ad-22(e)(1), (3), and (18) thereunder.<sup>14</sup>

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

Section 17A(b)(3)(F) of the Act requires, in part, that the rules of a clearing agency be designed to (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 and control of the Clearing Agencies or for which it is responsible, and (iii) protect investors and the public interest, generally.<sup>15</sup>

First, the Commission believes that (i) the above described CRRM-related changes that are intended to make the Rules more clear, consistent, and current for

---

<sup>12</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>13</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>14</sup> 17 CFR 240.17Ad-22(e)(1), (3), and (18)

<sup>15</sup> 15 U.S.C. 78q-1(b)(3)(F).

members that rely on them, as well as (ii) the above described non-CRRM related changes that are intended to provide more description regarding the Clearing Agencies' explicit authority to review additional reporting from members regarding their financial or operational condition, are each consistent with promoting prompt and accurate clearance and settlement. These changes are designed to provide specificity, clarity, and additional transparency to the Rules by improving the descriptions of the Clearing Agencies' existing practices. Such improved descriptions could help members better understand the Rules, which could help decrease the likelihood of errors in the performance of members' responsibilities to the Clearing Agencies, thereby helping to ensure that the Clearing Agencies' clearing and settlement systems work more efficiently. Therefore, the Commission believes that these Proposed Rule Changes could promote the prompt and accurate clearance and settlement of securities transactions by the Clearing Agencies, consistent with Section 17A(b)(3)(F) of the Act.<sup>16</sup>

Second, the Commission believes that the proposed enhancements to the CRRM are consistent with safeguarding funds within the Clearing Agencies' control. As described above, the Clearing Agencies propose to improve their methodology for calculating CRRM ratings by (i) more effectively evaluating the credit risk presented by a distinct class of members (i.e., foreign banks and foreign trust companies); (ii) more effectively incorporating qualitative data into the Credit Rating; and (iii) more accurately measuring the absolute probability of default by rated members. These enhancements, both individually and collectively, could improve the Clearing Agencies' ability to determine and evaluate the credit risk presented by many of the Clearing Agencies'

---

<sup>16</sup> Id.

members, which could enable the Clearing Agencies to deploy more effectively their risk management tools to manage the credit, market, and liquidity risks presented by such members. By enabling the Clearing Agencies to more effectively utilize their risk management tools, the proposed enhancements to the CRRM could help mitigate the risk that the Clearing Agencies would suffer a loss from a member default. Therefore, the Commission believes that these Proposed Rule Changes could help safeguard funds within the Clearing Agencies' control, consistent with Section 17A(b)(3)(F) of the Act.<sup>17</sup>

Third, the Commission believes that the proposed enhancements to the CRRM also could help protect investors and the public interest by mitigating some of the systemic risk presented by FICC and NSCC as central counterparties and by DTC as a securities depository. Because a defaulting member could place stresses on the Clearing Agencies, with respect to the Clearing Agencies' ability to meet their respective clearance and settlement obligations (upon which the broader financial system relies), it is imperative that the Clearing Agencies have a strong understanding of the credit risk presented by their members. As described above, the Proposed Rule Changes would add three enhancements to the CRRM to enable the Clearing Agencies to measure more effectively the credit risk presented by many members. As such, the Clearing Agencies could have a more refined view and understanding of credit risks presented by the CRRM rated members, which could help improve the Clearing Agencies' ability to calculate margin and deploy risk-management tools; thus, improving the likelihood that the Clearing Agencies would continue to meet their clearance and settlement obligations, despite a member default. Accordingly, the Commission believes that the proposed

---

<sup>17</sup> Id.

changes related to the CRRM enhancement could help protect investors and the public interest by promoting the stability of the broader financial system, consistent with Section 17A(b)(3)(F) of the Act.<sup>18</sup>

B. Consistency with Rules 17Ad-22(e)(1), (e)(3), and (e)(18)

The Commission believes that the changes proposed in the Proposed Rule Changes are consistent with Rules 17Ad-22(e)(1), (e)(3)(i), and (e)(18) under the Act.<sup>19</sup>

The Commission believes that the changes proposed in the Proposed Rule Changes are consistent with Rule 17Ad-22(e)(1) under the Act, which requires, in part, that the Clearing Agencies “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [p]rovide for a well-founded, clear, transparent and enforceable legal basis for each aspect of its activities.”<sup>20</sup> As described above, the Clearing Agencies propose a number of other changes to their Rules that are designed to update them and to make them more consistent and provide greater description for members that rely on them. As such, the Commission believes that these proposed changes could make the Clearing Agencies’ Rules more clear and transparent for members that rely on them, consistent with Rule 17Ad-22(e)(1).

The Commission also believes that the changes proposed in the Proposed Rule Changes are consistent with Rule 17Ad-22(e)(3)(i) under the Act, which requires, in part, that the Clearing Agencies “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [m]aintain a sound risk management

---

<sup>18</sup> Id.

<sup>19</sup> 17 CFR 240.17Ad-22(e)(1); (e)(2); and (e)(3).

<sup>20</sup> 17 CFR 240.17Ad-22(e)(1).

framework for comprehensively managing . . . risks that arise in or are born by [the Clearing Agencies], which includes . . . systems designed to identify, measure, monitor and manage the range of risks that arise in or are borne by [the Clearing Agencies].”<sup>21</sup> As discussed above, the CRRM is a risk measurement tool used by the Clearing Agencies to help assess the credit risk presented by their various members. The proposed enhancements to the CRRM could help the Clearing Agencies better identify and measure such risks, which in turn could help facilitate the Clearing Agencies’ management of credit, market, and liquidity risk that arises from being a central counterparty (in the case of NSCC and FICC) and central securities depository (in the case of DTC). Accordingly, the Commission believes that the proposed enhancements are designed to help effectively manage the Clearing Agencies’ risk exposures, including their credit exposure to participants, arising from their payment, clearing, and settlement processes, consistent with Rule 17Ad-22(e)(3)(i).

Finally, the Commission believes that the proposal is consistent with Rule 17Ad-22(e)(18) under the Act, which requires, in part, that the Clearing Agencies “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [e]stablish objective, risk-based, and publicly disclosed criteria for participation, which . . . require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency, and monitor compliance with such participation requirements on an ongoing basis.”<sup>22</sup> As described above, the proposal would provide more description regarding the Clearing

---

<sup>21</sup> 17 CFR 240.17Ad-22(e)(3)(i).

<sup>22</sup> 17 CFR 240.17Ad-22(e)(18).

Agencies' authority to review additional reporting from members regarding their financial or operational condition and the financial information of any Indirect Member. Because such authority could enable the Clearing Agencies to better determine whether the member has sufficient financial resources and monitor compliance with the Clearing Agencies' financial requirements on an ongoing basis, the Commission believes this requirement is consistent with Rule 17Ad-22(e)(18).

III. Conclusion

On the basis of the foregoing, the Commission finds that the Proposed Rule Changes are consistent with the requirements of the Act, in particular the requirements of Section 17A of the Act<sup>23</sup> and the rules and regulations promulgated thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that

---

<sup>23</sup> 15 U.S.C. 78q-1.

proposed rule changes SR-DTC-2017-002, SR-FICC-2017-006, and SR-NSCC-2017-002 be and hereby are APPROVED as of the date of this order or the date of a notice by the Commission authorizing the Clearing Agencies to implement their advance notice proposals (SR-DTC-2017-801, SR-FICC-2017-804, and SR-NSCC-2017-801) that are consistent with the Proposed Rule Changes, whichever is later.<sup>24</sup>

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>25</sup>

Eduardo A. Aleman  
Assistant Secretary

---

<sup>24</sup> In approving the proposed rule change, the Commission considered the proposals' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>25</sup> 17 CFR 200.30-3(a)(12).