

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-79764; File No. SR-DTC-2016-008)

January 9, 2017

Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of Proposed Rule Change Relating to Processing of Transactions in Money Market Instruments

The Depository Trust Company (“DTC”) filed on September 23, 2016 with the Securities and Exchange Commission (“Commission”) proposed rule change SR-DTC-2016-008 (“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 October 11, 2016.³ On, November 18, 2016, the Commission extended to January 9, 2017 the date by which it shall either approve, disapprove, or institute proceedings to determine whether to approve or disapprove the Proposed Rule Change.⁴ The Commission did not receive any comments on the Proposed Rule Change. For the reasons discussed below, the Commission is granting approval of the Proposed Rule Change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 34-79046 (October 5, 2016), 81 FR 70200 (October 11, 2016) (SR-DTC-2016-008) (“Notice”). DTC also filed the Proposed Rule Change as an advance notice with the Commission, 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. 12 U.S.C. 5465(e) and 17 CFR 240.19b-4(n)(1), respectively. The advance notice was published in the Federal Register on November 9, 2016. Securities Exchange Act Release No. 79224 (November 3, 2016), 81 FR 78884 (November 9, 2016) (SR-DTC-2016-802). The Commission did not receive any comments on the advance notice.

⁴ Securities Exchange Act Release No. 34-79351 (November 18, 2016), 81 FR 85295 (November 25, 2016) (SR-DTC-2016-008)

I. Description of the Proposed Rule Change

The Proposed Rule Change is a proposal by DTC to modify (i) the DTC Rules, By-laws and Organization Certificate (“Rules”),⁵ (ii) the DTC Settlement Service Guide (“Settlement Guide”),⁶ and (iii) the DTC Distributions Service Guide (“Distributions Guide”),⁷ in order to change the way in which DTC processes transactions in money market instruments (“MMI”). The proposal would affect DTC’s processing of issuances of MMI securities as well as maturity presentments, income presentments, principal presentments, and reorganization presentments (collectively, “presentments” and with issuances of MMI securities, “MMI Obligations”).

Specifically, DTC proposes to: (i) with respect to delivery of MMI securities, require purchasers of the securities (or their custodian, if applicable) to acknowledge that they agree to receive the securities via DTC’s Receiver Authorized Delivery (“RAD”) system before DTC processes the transaction; (ii) with respect to cash, require an issuing and paying agent (“IPA”) of an MMI issuer to acknowledge its funding obligations for MMI presentments before DTC processes the transaction, except in limited circumstances where there are no funding obligations;⁸ (iii) implement an enhanced

⁵ Available at <http://www.dtcc.com/legal/rules-and-procedures.aspx>.

⁶ Available at <http://www.dtcc.com/~media/Files/Downloads/legal/service-guides/Settlement.pdf>.

⁷ Available at <http://www.dtcc.com/~media/Files/Downloads/legal/service-guides/Distributions%20Service%20Guide%20FINAL%20November%202014.pdf>.

⁸ An affirmative MMI funding acknowledgement by the IPA would not be required where the aggregate amount of an issuer’s delivery of MMI securities that have been approved in RAD exceeds the aggregate amount of presentments because payment for those securities would fully fund the presentments. In such a case,

process to check certain MMI transactions against DTC's risk management controls (referred to as "MMI Optimization"); (iv) eliminate the largest provisional net credit risk management control; and (v) eliminate DTC's receive versus payment net additions control, as described below. In addition, the proposal would amend DTC's Distributions Guide to conform to the proposed changes.

A. Background

Today, according to DTC, when an issuer issues MMI securities at DTC, the IPA for that issuer sends issuance instructions to DTC electronically, which results in crediting the applicable MMI securities to the DTC account of the IPA. The MMI securities are then delivered by DTC to the accounts of the applicable DTC participants ("Participants") that are purchasing the issuance, typically as custodians for individual investors, in accordance with their purchase amounts. The IPA's delivery instructions may be free of payment or, most often, for payment (i.e., delivery versus payment or "DVP"). Unlike deliveries free of payment, DVP transactions are subject to DTC's risk management controls for both the IPA and the receiving Participants, which means they are monitored for Net Debit Cap and Collateral Monitor sufficiency.⁹

the IPA would be deemed to have provided a funding acknowledgement and DTC would process the transactions, subject to risk management controls.

⁹ DVP transfers at DTC are structured so that the completion of delivery of securities to a Participant in end-of-day settlement is contingent on the receiving Participant satisfying its end-of-day net settlement obligation, if any. The risk of Participant failure to settle is managed through risk management controls that would enable DTC to complete settlement despite the failure to settle of the Participant, or affiliated family of Participants, with the largest net settlement obligation. The two principal controls are the Net Debit Cap and Collateral Monitor. The largest net settlement obligation of a Participant or affiliated family of Participants cannot exceed DTC liquidity resources, based on the Net Debit Cap, and must be fully collateralized, based on the Collateral Monitor.

When MMI securities of a particular acronym¹⁰ mature, the current presentment process involves DTC automatically sweeping the matured positions from the applicable Participant accounts and debiting the settlement account of the applicable IPA for the amount of the matured position, with corresponding credits made to the settlement accounts of the deliverers. Because presentments are currently processed automatically at DTC, IPAs have the option to refuse to pay (“RTP”) for maturing MMI Obligations to protect against the possibility that an IPA may not be able to fund settlement because it has not received funds from the relevant issuer. An IPA that refuses payment for a presentment (i.e., refuses to make payment for the delivery of matured MMI securities for which it is the designated IPA and/or pay interest or dividend income on MMI securities for which it is the designated IPA) must notify DTC of its RTP. An IPA may notify DTC of an RTP until 3:00 p.m. ET on the date of the affected presentment.

Under the current Rules, the effect of an RTP is for DTC to reverse all processed MMI security deliveries of that MMI acronym, including issuances, related funds credits and debits, and presentments, which means that the securities would fail to settle. This reversal of processed (but not yet settled) transactions could override DTC’s risk management controls (i.e., Collateral Monitor and Net Debit Cap) and could result in a Participant’s account having, unexpectedly, a net debit balance that exceeds its Net Debit Cap and/or having insufficient collateral to secure its settlement obligations throughout the day. Thus, RTPs can create uncertainty and pose systemic risk with respect to a Participant’s and, ultimately, DTC’s ability to complete end-of-day net funds settlement.

¹⁰ MMI of an issuer are designated by DTC using unique four-character identifiers referred to as acronyms. An MMI issuer can have multiple acronyms representing its securities. MMI transactions and other functions relating to MMI are done on an “acronym-by-acronym” basis.

Currently, to mitigate the risks associated with an RTP, the Rules and the Settlement Guide provide for the Largest Provisional Net Credit control (“LPNC Control”). Under the LPNC Control, DTC withholds from each Participant’s Net Debit Cap the two largest intraday net MMI credits owed to that Participant. The MMI credits withheld are not included in the calculation of the Participant’s Collateral Monitor or its net debit balance. This provides protection in the event that processed (but not yet settled) MMI transactions are reversed by DTC as a result of an RTP.¹¹

According to DTC, its Rules and procedures relating to settlement processing for the MMI program¹² were designed to limit credit, liquidity, and operational risk for DTC and Participants. In connection with ongoing efforts by DTC to evaluate the risk associated with the processing of MMI Obligations, DTC has determined that the risks presented by intra-day reversals of processed MMI Obligations should be eliminated to prevent the possibility that a reversal could override DTC’s risk controls and heighten liquidity and settlement risk. DTC also states that eliminating intra-day reversals of processed MMI Obligations would enhance intra-day finality and allow for the elimination of the LPNC Control, which creates intra-day blockage and affects liquidity through the withholding of settlement credits.

¹¹ See Securities Exchange Act Release No. 71888 (April 7, 2014), 79 FR 20285 (April 11, 2014) (SR-DTC-2014-02) (clarifying the LPNC procedures in the Settlement Guide) and Securities Exchange Act Release No. 68983 (February 25, 2013), 78 FR 13924 (March 1, 2013) (SR-DTC-2012-10) (updating the Rules related to LPNC).

¹² The procedures applicable to MMI settlement processing are set forth in the Settlement Guide. Supra note 6.

B. Proposed Changes

The proposal would eliminate provisions for intra-day reversals of processed MMI Obligations based on an IPA's RTP or issuer insolvency of which DTC becomes aware, as described below.

Pursuant to the proposal, DTC would no longer automatically process MMI Obligations. DTC's processing of MMI Obligations involves the delivery of cash and/or securities. With respect to securities, DTC would require purchasers of MMI issuances (or their custodian, if applicable) to acknowledge in RAD that they agree to receive the MMI securities before DTC processes the transaction. With respect to cash, an IPA would make an MMI funding acknowledgment using a new DTC platform designed to accept such acknowledgments. When an MMI funding acknowledgement is received, DTC would attempt to process transactions in the acronym(s) for which the MMI funding acknowledgment pertains.

If the IPA has provided an MMI funding acknowledgment for the full amount of presentments, then all transactions in that acronym would be sent to the normal DTC processing system and tested against DTC's risk management controls. If the IPA provides an MMI funding acknowledgement for only partial funding of the presentments, then DTC would undertake the proposed "MMI Optimization" process to determine whether risk management controls would be satisfied by all deliverers and purchasers of the acronym and determine whether all parties would maintain adequate positions to complete the applicable transactions. However, as long as the issuances that could satisfy deliverer and purchaser risk controls for that MMI acronym are equal to or greater than

the maturing presentments of that acronym, the applicable transactions (i.e., those that pass risk controls) could be processed without an IPA's funding acknowledgement.

If DTC does not receive the necessary acknowledgments from both the IPA and purchasers for an acronym for which maturing MMI Obligations are due on that day and/or DTC is aware, through ordinary business channels, that the issuer of an acronym is insolvent ("Acronym Payment Failure"), then DTC would not process transactions in the acronym.¹³

In the event of an Acronym Payment Failure, DTC would: (i) prevent further issuance and maturity activity for the acronym in DTC's system; (ii) prevent deliveries of MMI securities of the acronym and halt all activity in that acronym; (iii) set the collateral value of the MMI securities in the acronym to zero for purposes of calculating the Collateral Monitor of any affected Participant; and (iv) notify Participants of the Acronym Payment Failure via DTC's current notification process. Notwithstanding the occurrence of an Acronym Payment Failure, the IPA would remain liable for funding pursuant to any MMI funding acknowledgment previously provided for that business day.

A "Temporary Acronym Payment Failure" would occur when an IPA notifies DTC that it temporarily refuses to pay income presentments, and only income presentments, for an acronym, which typically would be due to an issuer's inability to fund income presentments on that day. A Temporary Acronym Payment Failure would only be initiated if there are no maturity presentments, principal presentments, and/or

¹³ DTC would automatically consider an Acronym Payment Failure that occurred due to an IPA's failure to provide timely MMI funding acknowledgement (i.e., provide the acknowledgment by 3:00 p.m. ET) as an RTP.

reorganization presentments on that business day. DTC would require the issuer and/or IPA to resolve such a situation by the next business day.

In the event of a Temporary Acronym Payment Failure, DTC would: (i) temporarily devalue to zero all of the issuer's MMI securities for purposes of calculating the Collateral Monitor, unless and until the IPA acknowledges funding with respect to the income payments on the following business day; (ii) notify Participants of the delayed payment; and (iii) block from DTC's systems all further issuances and maturities by that issuer for the remainder of the business day on which notification of the Temporary Payment Failure was received by DTC. An IPA would not be able to avail itself of a Temporary Acronym Payment Failure for the same acronym on consecutive business days.

The Commission understands that the proposal would not: (i) decrease the total number and value of transactions that would pass DTC's risk controls throughout the processing day; or (ii) increase the volume of transactions that would fail to settle. The Commission also understands that the proposal would reduce blockage caused by DTC. Non-MMI transactions and fully funded MMI transactions would likely have a reduction in blockage because of the elimination of the LPNC Control. The elimination of the LPNC Control would no longer withhold billions of dollars of settlement credits as it does today, thus permitting MMI transactions subject to the LPNC Control to process earlier in the day. Moreover, it is expected that the value and volume of MMI transactions recycling due to failure to meet DTC's risk management controls during the late morning and afternoon periods would be reduced, because of such transactions being

held outside of DTC's processing system while they await the necessary acknowledgments.

Similar to the LPNC Control, the RVPNA Control is used to prevent a Participant from delivering free of value or undervalued any MMI securities that were received for payment on the same day.¹⁴ For example, under DTC's current rules, if Participant A delivers MMI securities to Participant B for payment, and then Participant B delivers the same MMI securities to Participant C free of payment (subject to risk management controls), the delivery to Participant C is final when the securities are credited to Participant C. DTC would, therefore, be unable to reverse the delivery to Participant C and, thus, DTC could not reverse the delivery from Participant B to Participant A. The RVPNA Control protects DTC against being unable to reverse such transactions of MMI Securities in the event of an RTP by the IPA. Because DTC would no longer permit the reversal of processed MMI transactions, DTC would no longer need the RVPNA Control.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act¹⁵ 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 Proposed Rule Change is

¹⁴ For purposes of RVPNA, MMI securities are considered undervalued if they are delivered for less than 10 percent below market value.

¹⁵ 15 U.S.C. 78s(b)(2)(C).

consistent with Section 17A(b)(3)(F) of the Act and Rule 17Ad-22(d)(12) under the Act,¹⁶ as described in detail below.

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 promote the prompt and accurate clearance and settlement of securities transactions and to protect investors and the public interest.¹⁷

The Commission believes that the Proposed Rule Change is consistent with promoting prompt and accurate clearance and settlement. First, as described above, DTC automatically processes MMI transactions today but permits RTPs in order to enable IPAs to protect against the possibility that the IPA does not receive the necessary funds from the relevant issuer. However, if DTC reverses processed (but not yet settled) MMI transactions because of an RTP, the transactions would fail to settle and the reversal could override DTC's risk management controls.

The Proposed Rule Change would eliminate such reversals, failures, and possible overrides because the proposal would require, before DTC would process an MMI transaction, that (i) purchasers of MMI issuances (or their custodian, if applicable) authorize delivery of the MMI securities, and (ii) IPAs provide an MMI funding acknowledgement that commits the IPA to the acknowledge funds. If DTC does not receive a RAD authorization or MMI funding acknowledgement, as applicable, it would not process the MMI transaction. However, if a RAD authorization or an MMI funding acknowledgment is receive, DTC would no longer permit an RTP for what was

¹⁶ 15 U.S.C. 78q-1(b)(3)(F); 17 C.F.R. 240.17Ad-22(d)(12).

¹⁷ 15 U.S.C. 78q-1(b)(3)(F).

authorized or acknowledge, thus eliminating the risk that the applicable MMI transaction would fail to settle or override DTC's risk management controls due to an RTP.

Although these proposed changes would establish new requirements before DTC would process such MMI transactions, the Commission believes that the benefits of eliminating the risk of a potential override of DTC's risk management controls from an RTP supports such requirements.

Second, the Proposed Rule Change would help ensure prompt and accurate clearance and settlement securities by employing the proposed MMI Optimization. MMI Optimization would, for MMI transactions that await funding, continually test the net effect of transactions, across multiple MMI issuers, on receiving and delivering Participants' risk controls, and then process the transactions once the controls are met. As such, MMI Optimization would help maximize processing and facilitate more timely settlement of MMI transactions, thus reducing risks that transactions may not settle.

Third, the proposed removal of the LPNC and RVPNA Controls also would further promote prompt clearance and settlement. As described above, the LPNC Control currently withholds from each Participant the two largest intraday net MMI credits out of all of the MMI credits owed to that Participant in order to protect DTC from a Participant breaching its Net Debit Cap or having insufficient collateral in the event of a reversal caused by an RTP. However, withholding the credits makes them unavailable to the Participant, which can cause blockage (i.e., the failure of a transaction to process because of insufficient liquidity) for the Participant. Meanwhile, the RVPNA Control limits a Participant's ability to deliver MMI that the Participant is due to receive that day. By

preventing Participants from delivering certain MMI securities, the RVPNA Control also can create blockage.

Because DTC would no longer process MMI transactions without a purchaser's RAD authorization and an IPA's MMI funding acknowledgement, as applicable, RTPs and resulting intraday reversals no longer present the risk that the LPNC and RVPNA Controls are meant to address. As such, DTC would eliminate these controls. This change would make available to Participants the intraday credits that were previously withheld by those controls, which would decrease intraday liquidity blockage for the Participant and enable DTC to process MMI transactions earlier. Thus, Participants would have less exposure to intraday reversals that increase liquidity and settlement risk and a more complete view of their actual intraday net debit and credit balances.

The Commission also believes that the Proposed Rule Change is consistent with protecting investors and the public interest. As described above, DTC would no longer automatically process MMI presentments. Rather, DTC would require purchasers to authorize delivery via RAD and IPAs to provide a funding acknowledgment before processing MMI presentments, as applicable. Because these changes would eliminate the risk of reversals due to an RTP, the changes would mitigate the risk of a potential override of DTC's risk management controls. Thus, the Proposed Rule Change would help protect investors and the public interest by reducing DTC's exposure to potential failures, promoting DTC's safety and soundness, and providing greater assurance that transactions will settle despite a Participant default.

Therefore, for the above reasons, the Commission believes that the Proposed Rule Change will help promote the prompt and accurate clearance and settlement of securities

transactions and help protect investors and the public interest, consistent with Section 17A(b)(3)(F) of the Act, cited above.

B. Consistency with Rule 17Ad-22(d)(12)

Rule 17Ad-22(d)(12) under the Act requires DTC to establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure that final settlement occurs no later than the end of the settlement day; and require that intraday or real-time finality be provided where necessary to reduce risks.¹⁸ Through this proposal, DTC would no longer process MMI transactions automatically but, rather, would first require an IPA's funding acknowledgment and a purchaser's RAD authorization, as applicable. Where such acknowledgements and authorizations are provided, DTC would no longer permit an RTP, thus eliminating the risk of an intraday reversal of a processed MMI transaction. Additionally, the proposal would eliminate the LPNC and RVPNA Controls, which would help eliminate blockage caused by the LPNC Control's withholding of Participants' two largest net credits for MMI transactions and the RVPNA Control's restriction on delivering certain MMI securities. Each of these proposed changes, both individually and collectively, would help ensure that final settlement occurs at the end of the day. Therefore, the Commission believes that the changes proposed in the Advance Notice are consistent with Rule 17Ad-22(d)(12) under the Act.¹⁹

¹⁸ 17 C.F.R. 240.17Ad-22(d)(12).

¹⁹ Id.

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 Act²⁰ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule change SR-DTC-2016-008 be, and hereby is, APPROVED as of the date of this order or the date of a notice by the Commission authorizing DTC to implement DTC's advance notice proposal (SR-DTC-2016-802) that is consistent with this Proposed Rule Change, whichever is later.²¹

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

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Assistant Secretary

²⁰ 15 U.S.C. 78q-1.

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

²² 17 CFR 200.30-3(a)(12).