SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90033; File No. SR-FICC-2020-802)

September 28, 2020

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Amendment No. 2 and Notice of No Objection to Advance Notice, as Modified by Amendment Nos. 1 and 2, to Introduce the Margin Liquidity Adjustment Charge and Include a Bid-Ask Charge in the VaR Charges

On July 30, 2020, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") advance notice SR-FICC-2020-802 pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 ("Clearing Supervision Act"),[1] and Rule 19b-4(n)(1)(i)[2] under the Securities Exchange Act of 1934 ("Exchange Act")[3] to add two new charges to FICC's margin methodologies. On August 13, 2020, FICC filed Amendment No. 1 to the advance notice, to make clarifications and corrections to the advance notice.[4] The advance notice, as modified by Amendment No. 1, was published for public comment in the Federal Register on September 4, 2020,[5] and the Commission has received no comments

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1 12 U.S.C. 5465(e)(1).

2 17 CFR 240.19b-4(n)(1)(i).

3 15 U.S.C. 78a et seq.

4 Amendment No. 1 made clarifications and corrections to the description of the advance notice and Exhibits 3 and 5 of the filing.

5 Securities Exchange Act Release No. 89718 (September 1, 2020), 85 Fed. Reg. 55341 (September 4, 2020) (File No. SR-FICC-2020-802) ("Notice of Filing"). On July 30, 2020, FICC also filed a related proposed rule change (SR-FICC-2020-009) with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder. On August 13, 2020, FICC filed Amendment No. 1 to the proposed rule change to make similar clarifications and corrections to the

regarding the changes proposed in the advance notice as modified by Amendment No. 1.[6] On August 27, 2020, FICC filed Amendment No. 2 to the advance notice to provide additional data for the Commission to consider in analyzing the advance notice.[7] The advance notice, as modified by Amendment Nos. 1 and 2, is hereinafter referred to as the "Advance Notice." The Commission is publishing this notice to solicit comments on Amendment No. 2 from interested persons and, for the reasons discussed below, is hereby providing notice of no objection to the Advance Notice.

I. THE ADVANCE NOTICE

First, the proposals in the Advance Notice would revise the FICC Government Securities Division ("GSD") Rulebook ("GSD Rules") and FICC Mortgage-Backed Securities Division ("MBSD") Clearing Rules ("MBSD Rules," and together with the

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proposed rule change. See 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4 respectively. The proposed rule change, as amended by Amendment No. 1, was published in the Federal Register on August 20, 2020. Securities Exchange Act Release No. 89560 (August 14, 2020), 85 Fed. Reg. 51503 (August 20, 2020). On August 27, 2020, FICC filed Amendment No. 2 to the proposed rule change to provide similar additional data for the Commission's consideration. The proposed rule change, as amended by Amendment Nos. 1 and 2, is hereinafter referred to as the "Proposed Rule Change." In the Proposed Rule Change, FICC seeks approval of proposed changes to its rules necessary to implement the Advance Notice. The comment period for the related Proposed Rule Change filing closed on September 10, 2020, and the Commission received no comments.

6 As the proposals contained in the Advance Notice were also filed as a proposed rule change, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice.

7 In Amendment No. 2, FICC updated Exhibit 3 to the advance notice to include impact analysis data with respect to the proposals in the advance notice. FICC filed Exhibit 3 as a confidential exhibit to the advance notice pursuant to 17 CFR 240.24b-2.

GSD Rules, the “Rules”)[8] to introduce the Margin Liquidity Adjustment Charge (“MLA Charge”) as an additional margin component. Second, the proposals in the Advance Notice would revise the Rules, GSD Methodology Document – GSD Initial Market Risk Margin Model (“GSD QRM Methodology Document”), and MBSD Methodology and Model Operations Document – MBSD Quantitative Risk Model (“MBSD QRM Methodology Document,” and together with the GSD QRM Methodology Document, the “QRM Methodology Documents”)[9] to add a bid-ask spread risk charge (“Bid-Ask Spread Charge”) to the margin calculations of GSD and MBSD.

A. Background

FICC serves as a central counterparty (“CCP”) and provider of significant clearance and settlement services for cash-settled U.S. Treasury and agency securities and the non-private label mortgage-backed securities markets.[10] FICC is comprised of two divisions, GSD and MBSD. GSD provides real-time trade matching, clearing, risk management, and netting for trades in U.S. government debt issues, including repurchase agreements. MBSD provides real-time automated trade matching, trade confirmation, risk management, netting, and electronic pool notification to the mortgage-backed

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8 Capitalized terms not defined herein are defined in the Rules, available at https://www.dtcc.com/legal/rules-and-procedures.aspx.

9 FICC filed the proposed changes to the QRM Methodology Documents as confidential exhibits to the Advance Notice pursuant to 17 CFR 240.24b-2.

10 See Securities Exchange Act Release No. 69838 (June 24, 2013), 78 Fed. Reg. 39027 (June 28, 2013).

securities market. GSD and MBSD maintain separate Rulebooks, margin methodologies, and members.

In its role as a CCP, a key tool that FICC uses to manage its credit exposure to its respective GSD and MBSD members is by determining and collecting an appropriate Required Fund Deposit (i.e., margin) for each member.[11] The aggregate of all members' Required Fund Deposits constitutes the respective GSD and MBSD Clearing Funds. FICC would access the GSD or MBSD Clearing Fund should a defaulted member's own Required Fund Deposit be insufficient to satisfy losses to FICC caused by the liquidation of that member's portfolio.[12]

Each member's Required Fund Deposit consists of a number of applicable components, which are calculated to address specific risks that the member's portfolio presents to FICC.[13] Generally, the largest component of a member's Required Fund Deposit is the value-at-risk ("VaR") Charge, which is calculated using a risk-based margin methodology that is intended to capture the risks related to the movement of market prices associated with the securities in a member's portfolio.[14] The VaR Charge

[11] See GSD Rule 4 (Clearing Fund and Loss Allocation) and MBSD Rule 4 (Clearing Fund and Loss Allocation), supra note 8.

[12] See id.

[13] See id.

[14] See GSD Rule 1 (Definitions), MBSD Rule 1 (Definitions), GSD Rule 4 (Clearing Fund and Loss Allocation), and MBSD Rule 4 (Clearing Fund and Loss Allocation), supra note 8.

is designed to calculate the potential losses on a portfolio over a three-day period of risk assumed necessary to liquidate the portfolio, within a 99 percent confidence level.[15]

FICC states that it regularly assesses market and liquidity risks as such risks relate to its margin methodologies to evaluate whether margin levels are commensurate with the particular risk attributes of each relevant product, portfolio, and market.[16] FICC states that the proposed MLA Charge and Bid-Ask Spread Charge are necessary for FICC's margin methodologies to effectively account for risks associated with certain types and attributes of member portfolios.[17]

B. Margin Liquidity Adjustment Charge

FICC's current margin methodologies do not account for the risk of a potential increase in market impact costs that FICC could incur when liquidating a defaulted member's portfolio that contains a concentration of large positions, as compared to the overall market, in either (i) a particular security or group of securities sharing a similar risk profile, or (ii) in a particular transaction type (e.g., mortgage pool transactions).[18] In a member default, liquidating such large positions within a potentially compressed timeframe[19] (i.e., in a fire sale) could have an impact on the underlying market, resulting

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15 See Notice of Filing, supra note 5 at 55342. Unregistered Investment Pool Clearing Members are subject to a VaR Charge with a minimum target confidence level assumption of 99.5 percent. See MBSD Rule 4, Section 2(c), supra note 8.

16 See Notice of Filing, supra note 5 at 55342.

17 See id.

18 See id.

19 FICC's risk models assume the liquidation occurs over a period of three business days. See Notice of Filing, supra note 5 at 55342-43.

in price moves that increases FICC's risk of incurring additional liquidation costs. Therefore, FICC designed the MLA Charge to address this specific risk.[20]

The MLA Charge would be based on comparing the market value of member portfolio positions in specified asset groups[21] to the available trading volume of those asset groups in the market. If the market value of a member's positions in a certain asset group is large in comparison to the available trading volume of that asset group,[22] then it is more likely that FICC would have to manage reduced marketability and increased liquidation costs for those positions during a member default scenario. Specifically, FICC's margin methodology assumes for each asset group that a certain share of the

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[20] See id.

[21] For GSD, the asset groups would include the following, each of which share similar risk profiles: (a) U.S. Treasury securities, which would be further categorized by maturity – those maturing in (i) less than one year, (ii) equal to or more than one year and less than two years, (iii) equal to or more than two years and less than five years, (iv) equal to or more than five years and less than ten years, and (v) equal to or more than ten years; (b) Treasury-Inflation Protected Securities ("TIPS"), which would be further categorized by maturity – those maturing in (i) less than two years, (ii) equal to or more than two years and less than six years, (iii) equal to or more than six years and less than eleven years, and (iv) equal to or more than eleven years; (c) U.S. agency bonds; and (d) mortgage pools transactions.

For MBSD, to-be-announced ("TBA") transactions, Specified Pool Trades and Stipulated Trades would be included in one mortgage-backed securities asset group. Notice of Filing, supra note 5 at 55343.

[22] FICC determines average daily trading volume by reviewing publicly available data from the Securities Industry and Financial Markets Association ("SIFMA"), at https://www.sifma.org/resources/archive/research/statistics.

market can be liquidated without price impact.[23] Aggregate positions in an asset group which exceed this share are generally considered as large and would therefore incur application of the MLA Charge to anticipate and address those increased costs.

To determine the market impact cost for each portfolio position in certain asset groups (i.e., Treasuries maturing in less than one year and TIPS for GSD, and in the mortgage-backed securities asset group for MBSD), FICC would use the directional market impact cost, which is a function of the position's net directional market value.[24] To determine the market impact cost for all other positions in a portfolio, FICC would add together two components: (1) the directional market impact cost, as described above, and (2) the basis cost, which is based on the position's gross market value.[25] FICC states that the calculation of market impact cost for positions in Treasuries maturing in less than one year, TIPS for GSD, and in the mortgage-backed securities asset group for MBSD would not include basis cost because basis risk is negligible for these types of positions.[26] For all asset groups, when determining the market impact costs, the net directional

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23 FICC would establish the particular share for each asset group or subgroup based on empirical research which includes the simulation of asset liquidation over different time horizons. See Notice of Filing, supra note 5 at 55343.

24 The net directional market value of an asset group within a portfolio is calculated as the absolute difference between the market value of the long positions in that asset group, and the market value of the short positions in that asset group. For example, if the market value of the long positions is $100,000, and the market value of the short positions is $150,000, the net directional market value of the asset group is $50,000. See id.

25 To determine the gross market value of the positions in each asset group, FICC would sum the absolute value of each CUSIP in the asset group. See id.

26 See id.

market value and the gross market value of the positions would be divided by the average daily volumes of the securities in each asset group over a lookback period.[27]

FICC would then compare the calculated market impact cost to a portion of the VaR Charge that is allocated to positions in each asset group.[28] If the ratio of the calculated market impact cost to the one-day VaR Charge is greater than a determined threshold, an MLA Charge, as described below, would be applied to that asset group. Correspondingly, if the ratio of these two amounts is equal to or less than this threshold, an MLA Charge would not be applied to that asset group. The threshold would be based on an estimate of the market impact cost that is incorporated into the calculation of the one-day VaR charge.[29]

When applicable, an MLA Charge would be calculated as a proportion of the product of (1) the amount by which the ratio of the calculated market impact cost to a portion of the VaR Charge allocated to that position exceeds the threshold, and (2) a

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27 Supra note 22; see Notice of Filing, supra note 5 at 55343.

28 As noted earlier, FICC's margin methodology uses a three-day assumed period of risk. For purposes of this calculation, FICC would use a portion of the VaR Charge that is based on a one-day assumed period of risk (the "one-day VaR Charge"). Any changes to what FICC determines would be the appropriate portion of the VaR Charge would be subject to FICC's model risk management governance procedures set forth in the Clearing Agency Model Risk Management Framework ("Model Risk Management Framework"). See Securities Exchange Act Release Nos. 81485 (August 25, 2017), 82 Fed. Reg. 41433 (August 31, 2017) (File No. SR-FICC-2017-014); 84458 (October 19, 2018), 83 Fed. Reg. 53925 (October 25, 2018) (File No. SR-FICC-2018-010); 88911 (May 20, 2020), 85 Fed. Reg. 31828 (May 27, 2020) (File No. SR-FICC-2020-004).

29 FICC states that it would review the method for calculating the thresholds from time to time, and any changes would be subject to FICC's model risk management governance procedures set forth in the Model Risk Management Framework. See id.

portion of the VaR Charge allocated to that asset group. For each portfolio, FICC would total the MLA Charges for the positions in each asset group to determine a total MLA Charge for the member. On a daily basis, FICC would calculate the final MLA Charge for each member (if applicable), to be included as a component of each member's Required Fund Deposit.

In certain circumstances, FICC may be able to partially mitigate the risks that the MLA Charge is designed to address by extending the time period for liquidating a defaulted member's portfolio beyond the three day period. Accordingly, the Advance Notice also describes a method that FICC would use to reduce a member's total MLA Charge when the volatility charge component of the member's margin increases beyond a specified point. Specifically, FICC would reduce the member's MLA Charge where the market impact cost of a particular portfolio, calculated as part of determining the MLA Charge, would be large relative to the one-day volatility charge for that portfolio (i.e., a portion of the three-day assumed margin period of risk). When the ratio of calculated market impact cost to the one-day volatility charge is lower, FICC would not adjust the MLA Charge. However, as the ratio gets higher, FICC would reduce the MLA Charge.

FICC designed this reduction mechanism to avoid assessing unnecessarily large MLA Charges.[30]

MLA Excess Amount for GSD Sponsored Members[31]

For GSD, the calculation of the MLA Charge for a Sponsored Member that clears through a single account sponsored by a Sponsoring Member would be the same as described above. For a GSD Sponsored Member that clears through multiple accounts sponsored by multiple Sponsoring Members, in addition to calculating an MLA Charge for each account (as described above), FICC would also calculate an MLA Charge for the Sponsored Member's consolidated portfolio.

If the MLA Charge of the consolidated portfolio is not higher than the sum of all MLA Charges for each account of the Sponsored Member, then the Sponsored Member would only be charged an MLA Charge for each sponsored account, as applicable. However, if the MLA Charge of the consolidated portfolio is higher than the sum of all MLA Charges for each account of the Sponsored Member, the Sponsored Member would

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30 See Notice of Filing, supra note 5 at 55343-44.

31 See GSD Rule 3A, supra note 8. Sponsored Membership at GSD is a program that allows well-capitalized members to sponsor their eligible clients into GSD membership. Sponsored membership at GSD offers eligible clients the ability to lend cash or eligible collateral via FICC-cleared delivery-versus-payment sale and repurchase transactions. Sponsoring Members facilitate their clients' GSD trading activity and act as processing agents on their behalf for all operational functions including trade submission and settlement with FICC. A Sponsored Member may be sponsored by one or more Sponsoring Members.

be charged the amount of such difference (referred to as the "MLA Excess Amount"), in addition to the applicable MLA Charge.

The MLA Excess Amount is designed to capture the additional market impact cost that could be incurred when a Sponsored Member defaults, and each of the Sponsoring Members liquidates positions associated with that defaulted Sponsored Member. If large positions in the same asset group are being liquidated by multiple Sponsoring Members, the market impact cost to liquidate those positions could increase. The MLA Excess Amount would address this additional market impact cost by capturing any difference between the calculations of the MLA Charge for each sponsored account and for the consolidated portfolio.

C. Bid-Ask Spread Charge

The bid-ask spread refers to the difference between the observed market price that a buyer is willing to pay for a security and the observed market price at which a seller is willing to sell that security. FICC faces the risk of potential bid-ask spread transaction costs when liquidating the securities in a defaulted member's portfolio. However, FICC's current margin methodologies do not account for this risk of potential bid-ask spread transaction costs to FICC in connection with liquidating a defaulted member's portfolio. Therefore, FICC designed the Bid-Ask Spread Charge to address this deficiency in its current margin methodologies.

The Bid-Ask Spread Charge would be haircut-based and tailored to different groups of assets that share similar bid-ask spread characteristics.[32] FICC would assign

[32] For GSD, the asset groups would include the following, each of which share similar bid-ask spread risk profiles: (a) mortgage pools ("MBS"); (b) TIPS; (c) U.S. agency bonds; and (d) U.S. Treasury securities, which would be further

each asset group a specified bid-ask spread haircut rate (measured in basis points ("bps")) that would be applied to the gross market value of the portfolio's positions in that particular asset group. FICC would calculate the product of the gross market value of the portfolio's positions in a particular asset group and the applicable basis point charge to obtain the bid-ask spread risk charge for these positions. FICC would total the applicable bid-ask spread risk charges for each asset class in a member's portfolio to calculate the member's total Bid-Ask Spread Charge.

FICC determined the proposed initial haircut rates on an analysis of bid-ask spread transaction costs using (1) the results of FICC's annual member default simulation

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segmented into separate classes based on maturities as follows: (i) less than five years, (ii) equal to or more than five years and less than ten years, and (iii) equal to or more than ten years. Only the MBS asset group is applicable to MBSD member portfolios.

FICC would exclude Option Contracts in to-be-announced ("TBA") transactions from the Bid-Ask Spread Charge because, FICC states that in the event of a member default, FICC would liquidate any Option Contracts in TBAs in a member's portfolio at the intrinsic value of the Option Contract and, therefore, does not face a transaction cost related to the bid-ask spread. Notice of Filing, supra note 5 at 55344.

and (2) market data sourced from a third-party data vendor. FICC's proposed initial haircut rates are listed in the table below:

Asset Group	**Haircut (bps)**
MBS	0.8
TIPS	2.1
U.S. Agency bonds	3.8
U.S. Treasuries (maturing < 5 years)	0.6
U.S. Treasuries (maturing 5-10 years)	0.7
U.S. Treasuries (maturing 10+ years)	0.7

FICC proposes to review the haircut rates annually. Based on analyses of recent years' simulation exercises, FICC does not anticipate that these haircut rates would change significantly year over year. FICC may also adjust the haircut rates following its annual model validation review, to the extent the results of that review indicate the current haircut rates are not adequate to address the risk presented by transaction costs from a bid-ask spread.[33]

Finally, FICC would make technical changes to the QRM Methodology Documents to re-number the sections and tables, and update certain section titles, as necessary to incorporate the MLA Charge and Bid-Ask Spread Charge into those documents.

II. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the advance notice is consistent with the Clearing Supervision 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. Please include File Number SR-FICC-2020-802 on the subject line.

Paper Comments:

Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, N.E., Washington, D.C. 20549.

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33 All proposed changes to the haircuts would be subject to FICC's model risk management governance procedures set forth in the Model Risk Management Framework. See supra note 28.

All submissions should refer to File Number SR-FICC-2020-802. 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 advance notice that are filed with the Commission, and all written communications relating to the advance notice 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, N.E., Washington, D.C. 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings will also be available for inspection and copying at the principal office of FICC and FICC's website at https://www.dtcc.com/legal.

All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FICC-2020-802 and should be submitted on or before [insert date 15 days from publication in the Federal Register].

III. DISCUSSION AND COMMISSION FINDINGS

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, the stated purpose of the Clearing Supervision Act is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for SIFMUs and strengthening the liquidity of SIFMUs.[34]

Section 805(a)(2) of the Clearing Supervision Act authorizes the Commission to prescribe regulations containing risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency.[35] Section 805(b) of the Clearing Supervision Act provides the following objectives and principles for the Commission's risk management standards prescribed under Section 805(a):[36]

- to promote robust risk management;
- to promote safety and soundness;
- to reduce systemic risks; and
- to support the stability of the broader financial system.

Section 805(c) provides, in addition, that the Commission's risk management standards may address such areas as risk management and default policies and procedures, among others areas.[37]

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act (the "Clearing

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34 See 12 U.S.C. 5461(b).

35 12 U.S.C. 5464(a)(2).

36 12 U.S.C. 5464(b).

37 12 U.S.C. 5464(c).

Agency Rules").[38] The Clearing Agency Rules require, among other things, each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk management practices on an ongoing basis.[39] As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act. As discussed below, the Commission believes the proposal in the Advance Notice is consistent with the objectives and principles described in Section 805(b) of the Clearing Supervision Act,[40] and in the Clearing Agency Rules, in particular Rules 17Ad-22(e)(4) and (e)(6).[41]

A. Consistency with Section 805(b) of the Clearing Supervision Act

The Commission believes that the Advance Notice is consistent with the stated objectives and principles of Section 805(b) of the Clearing Supervision Act.

The Commission believes that adopting FICC's proposed MLA Charge and Bid-Ask Spread Charge would be consistent with the promotion of robust risk management at FICC. As described above in Section I.B., FICC's current margin methodologies do not account for the potential increase in market impact costs that FICC could incur when

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38 17 CFR 240.17Ad-22. See Securities Exchange Act Release No. 68080 (October 22, 2012), 77 Fed. Reg. 66220 (November 2, 2012) (S7-08-11). See also Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786 (October 13, 2016) (S7-03-14) ("Covered Clearing Agency Standards"). FICC is a "covered clearing agency" as defined in Rule 17Ad-22(a)(5).

39 17 CFR 240.17Ad-22.

40 12 U.S.C. 5464(b).

41 17 CFR 240.17Ad-22(e)(4) and (e)(6).

liquidating a defaulted member's portfolio where the portfolio contains a concentration of large positions in a particular security or group of securities sharing a similar risk profile or in a particular transaction type. Additionally, as described above in Section I.C., FICC's current margin methodologies do not account for the risk of potential bid-ask spread transaction costs when liquidating the securities in a defaulted member's portfolio. FICC proposes to address these respective risks by adding the MLA Charge and Bid-Ask Spread Charge to its margin methodologies.[42]

Specifically, the MLA Charge should better enable FICC to manage the risk of incurring costs associated with the decreased marketability of a defaulted member's portfolio where the portfolio contains a large position in securities sharing similar risk profiles, resulting in potentially higher liquidation costs. To avoid excessive MLA Charges, FICC has identified circumstances that would warrant reducing a member's MLA Charge when FICC could otherwise partially mitigate the relevant risks by extending the time period for liquidating a defaulted member's portfolio beyond the three day period. The Commission views this targeted reduction in the MLA Charge as a feature of the proposal that demonstrates a robust approach towards managing the relevant risks through appropriate (i.e., not simply "larger") margin requirements. Additionally, since FICC's current margin methodologies do not account for bid-ask spread transaction costs when liquidating a defaulted member's portfolio, the Bid-Ask Spread Charge should enable FICC to manage such risks. Accordingly, the Commission

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[42] The Commission notes that the other clearing agencies it regulates have charges to account for these types of risks in their margin methodologies, and that addressing these types of risks has received a great deal of industry focus in recent years.

believes that adopting the proposed MLA Charge and Bid-Ask Spread Charge would allow for measurement and targeted mitigation of risks and costs not captured elsewhere in FICC's current margin methodologies, and would therefore provide for more comprehensive management of risks in a member default scenario, consistent with the promotion of robust risk management.

Further, the Commission believes that adopting FICC's proposed MLA Charge and Bid-Ask Spread Charge would be consistent with promoting safety and soundness at FICC. FICC designed the MLA Charge and Bid-Ask Spread Charge to ensure that FICC collects margin amounts sufficient to manage FICC's risk of incurring costs associated with liquidating defaulted member portfolios. The proposed MLA Charge and Bid-Ask Spread Charge would generally provide FICC with additional resources to manage potential losses arising out of a member default. Such an increase in available financial resources would decrease the likelihood that losses arising out of a member default would exceed FICC's resources and threaten the safety and soundness of FICC's ongoing operations. Accordingly, the Commission believes that adding the proposed MLA Charge and Bid-Ask Spread Charge to FICC's margin methodologies would be consistent with promoting safety and soundness at FICC.

Finally, the Commission believes that adopting FICC's proposed MLA Charge and Bid-Ask Spread Charge would be consistent with reducing systemic risks and supporting the stability of the broader financial system. As discussed above, in a member default scenario, FICC would access the GSD or MBSD Clearing Fund should the defaulted member's own Required Fund Deposit be insufficient to satisfy losses to FICC caused by the liquidation of that member's portfolio. FICC proposes to add the MLA

Charge and Bid-Ask Spread Charge to its margin methodologies to better manage the potential costs of liquidating a defaulted member's portfolio. FICC proposes to collect additional margin from members to cover such costs. This, in turn, could reduce the possibility that FICC would need to mutualize among the non-defaulting members a loss arising out of the close-out process. Reducing the potential for loss mutualization could, in turn, reduce the potential knock-on effects to non-defaulting members, their customers, and the broader market arising out of a member default. Further, the Commission notes that, to the extent that the MLA Charge results in any reduction in members' large positions in securities with similar risk profiles, it could reduce the potential risk of adverse market impacts that can arise from liquidating those large positions. However, the Commission also notes that the proposal to reduce the MLA Charge when FICC could otherwise partially mitigate the relevant risks would help ensure that FICC would not impose the MLA Charge without an appropriate risk management basis. Accordingly, the Commission believes that FICC's adoption of the proposed MLA Charge and Bid-Ask Spread Charge would be consistent with the reduction of systemic risk and supporting the stability of the broader financial system.

For the reasons stated above, the Commission believes the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.[43]

B. <u>Consistency with Rule 17Ad-22(e)(4)(i)</u>

Rule 17Ad-22(e)(4)(i) requires that FICC establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from

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43 12 U.S.C. 5464(b).

its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.[44]

As described above in Section I.B., FICC's current margin methodologies do not account for the risk of a potential increase in market impact costs that FICC could incur when liquidating a defaulted member's portfolio where the portfolio contains a large position in securities sharing similar risk profiles. Additionally, as described above, FICC's current margin methodologies do not account for the risk of potential bid-ask spread transaction costs when liquidating the securities in a defaulted member's portfolio. FICC proposes to address such risks by adding the MLA Charge and Bid-Ask Spread Charge to its margin methodologies. Adding these margin charges to FICC's margin methodologies should better enable FICC to collect margin amounts commensurate with the risk attributes of a broader range of its members' portfolios than FICC's current margin methodologies. Specifically, the MLA Charge should better enable FICC to manage the risk of increased costs to FICC associated with the decreased marketability of a defaulted member's portfolio where the portfolio contains a large position in securities sharing similar risk profiles. Additionally, since FICC's current margin methodologies do not account for bid-ask spread transaction costs associated with liquidating a defaulted

[44] 17 CFR 240.17Ad-22(e)(4)(i).

member's portfolio, the Bid-Ask Spread Charge should enable FICC to manage such risks and costs.

The Commission believes that adding the MLA Charge and Bid-Ask Spread Charge to its margin methodologies should enable FICC to more effectively identify, measure, monitor, and manage its credit exposures in connection with liquidating a defaulted member's portfolio that may give rise to (1) decreased marketability due to large positions of securities sharing similar risk profiles, and (2) bid-ask spread transaction costs. Accordingly, the Commission believes that adding the MLA Charge and Bid-Ask Spread Charge to FICC's margin methodologies would be consistent with Rule 17Ad-22(e)(4)(i) because these new margin charges should better enable FICC to maintain sufficient financial resources to cover FICC's credit exposure to its members fully with a high degree of confidence.[45]

C. Consistency with Rules 17Ad-22(e)(6)(i) and (v)

Rule 17Ad-22(e)(6)(i) requires that FICC establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.[46] Rule 17Ad-22(e)(6)(v) requires that FICC establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, uses an appropriate method

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45 Id.

46 17 CFR 240.17Ad-22(e)(6)(i).

for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.[47]

As described above in Section I.B, FICC's current margin methodologies do not account for the potential increase in market impact costs when liquidating a defaulted member's portfolio where the portfolio contains a large position in securities sharing similar risk profiles. FICC proposes to address this risk by adding the MLA Charge to its margin methodologies. To avoid excessive MLA Charges and ensure margin requirements are commensurate with the relevant risks, FICC also contemplates reducing a member's MLA Charge when FICC could otherwise partially mitigate the relevant risks by extending the time period for liquidating a defaulted member's portfolio beyond the three day period.

Additionally, as described above in Section I.A and C, FICC's current margin methodologies do not account for the risk of incurring bid-ask spread transaction costs when liquidating the securities in a defaulted member's portfolio. FICC proposes to address this risk by adding the Bid-Ask Spread Charge to its margin methodologies. Adding the MLA Charge and Bid-Ask Spread Charge to FICC's margin methodologies should better enable FICC to collect margin amounts commensurate with the risk attributes of its members' portfolios than FICC's current margin methodologies. Specifically, the MLA Charge should better enable FICC to manage the risk of increased costs to FICC associated with the decreased marketability of a defaulted member's portfolio where the portfolio contains a large position in securities sharing similar risk profiles. Moreover, the proposal to reduce the MLA Charge when FICC could otherwise

[47] 17 CFR 240.17Ad-22(e)(6)(v).

partially mitigate the relevant risks demonstrates how the proposal provides an appropriate method for measuring credit exposure, in that it seeks to take into account the particular circumstances related to a particular portfolio when determining the MLA Charge. Additionally, since FICC's current margin methodologies do not account for bid-ask spread transaction costs associated with liquidating a defaulted member's portfolio, the Bid-Ask Spread Charge should enable FICC to manage such risks.

Accordingly, the Commission believes that adding the MLA Charge and Bid-Ask Spread Charge to FICC's margin methodologies would be consistent with Rules 17Ad-22(e)(6)(i) and (v) because these new margin charges should better enable FICC to establish a risk-based margin system that (1) considers and produces relevant margin levels commensurate with the risks associated with liquidating member portfolios in a default scenario, including decreased marketability of a portfolio's securities due to large positions in securities sharing similar risk profiles and bid-ask transaction costs, and (2) uses an appropriate method for measuring credit exposure that accounts for such risk factors and portfolio effects.[48]

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[48] 17 CFR 240.17Ad-22(e)(6)(i) and (v).

IV. CONCLUSION

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-FICC-2020-802) and that FICC is AUTHORIZED to implement the proposed change as of the date of this notice or the date of an order by the Commission approving Proposed Rule Change SR-FICC-2020-009, whichever is later.

By the Commission.

J. Matthew DeLesDernier
Assistant Secretary