SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-90182; File No. SR-FICC-2020-009)

October 14, 2020

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Amendment No. 2 and Order Granting Accelerated Approval of a Proposed Rule Change, 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"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] proposed rule change SR-FICC-2020-009 to add two new charges to FICC's margin methodologies.[3] On August 13, 2020, FICC filed Amendment No. 1 to the proposed rule change, to make clarifications and corrections to the proposed rule change.[4] The proposed rule change, as

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 FICC also filed the proposals contained in the proposed rule change as advance notice SR-FICC-2020-802 with the Commission pursuant to Section 806(e)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act"), 12 U.S.C. 5465(e)(1), and Rule 19b-4(n)(1)(i) of the Act, 17 CFR 240.19b-4(n)(1)(i).

4 Amendment No. 1 made clarifications and corrections to the description of the proposed rule change and Exhibits 3 and 5 of the filing. On August 13, 2020, FICC filed Amendment No. 1 to the advance notice to make similar clarifications and corrections to the advance notice.

modified by Amendment No. 1, was published for public comment in the Federal Register on August 20, 2020,[5] and the Commission received no comments.

On August 27, 2020, FICC filed Amendment No. 2 to the proposed rule change to provide additional data for the Commission to consider in analyzing the proposed rule change.[6] The proposed rule change, as modified by Amendment Nos. 1 and 2, is hereinafter referred to as the "Proposed Rule Change." On October 2, 2020, pursuant to Section 19(b)(2) of the Act,[7] the Commission designated a longer period within which to approve, disapprove, or institute proceedings to determine whether to approve or disapprove the Proposed Rule Change.[8] The Commission is publishing this notice to

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5 Securities Exchange Act Release No. 89560 (August 14, 2020), 85 Fed. Reg. 51503 (August 20, 2020) ("Notice"). The advance notice, as modified by Amendment No. 1, was published for public comment in the Federal Register on September 4, 2020. Securities Exchange Act Release No. 89718 (September 1, 2020), 85 Fed. Reg. 55341 (September 4, 2020) (File No. SR-FICC-2020-802). The comment period for the advance notice, as modified by Amendment No. 1 closed on September 21, 2020, and the Commission received no comments.

6 In Amendment No. 2, FICC updated Exhibit 3 to the proposed rule change to include impact analysis data with respect to the proposed rule change. FICC filed Exhibit 3 as a confidential exhibit to the proposed rule change pursuant to 17 CFR 240.24b-2. On August 27, 2020, FICC filed Amendment No. 2 to the advance notice to provide similar additional data for the Commission's consideration. The advance notice, as amended by Amendment Nos. 1 and 2, is hereinafter referred to as the "Advance Notice." On October 2, 2020, the Commission published notice of filing of Amendment No. 2 and notice of no objection to the Advance Notice. Securities Exchange Act Release No. 90033 (September 28, 2020), 85 Fed. Reg. 62348 (October 2, 2020) (File No. SR-FICC-2020-802).

7 15 U.S.C. 78s(b)(2).

8 Securities Exchange Act Release No. 90083 (October 2, 2020), 85 Fed. Reg. 63610 (October 8, 2020).

solicit comments on Amendment No. 2 from interested persons and, for the reasons discussed below, to approve the Proposed Rule Change on an accelerated basis.

I. DESCRIPTION OF THE PROPOSED RULE CHANGE

First, the Proposed Rule Change 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 GSD Rules, the "Rules")[9] to introduce the Margin Liquidity Adjustment Charge ("MLA Charge") as an additional margin component. Second, the Proposed Rule Change 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")[10] 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.[11] FICC is comprised of

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

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

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

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 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.[12] 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.[13]

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.[14] 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

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12 See GSD Rule 4 (Clearing Fund and Loss Allocation) and MBSD Rule 4 (Clearing Fund and Loss Allocation), supra note 9.

13 See id.

14 See id.

market prices associated with the securities in a member's portfolio.[15] The VaR Charge 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.[16]

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.[17] 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.[18]

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[19] (e.g., mortgage pool transactions). In

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15 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 9.

16 See Notice, supra note 5 at 51504. 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 9.

17 See Notice, supra note 5 at 51504.

18 See id.

19 See id.

a member default, liquidating such large positions within a potentially compressed timeframe[20] (e.g., in a fire sale) could have an impact on the underlying market, resulting in price moves that increases FICC's risk of incurring additional liquidation costs. Therefore, FICC designed the MLA Charge to address this specific risk.[21]

The MLA Charge would be based on comparing the market value of member portfolio positions in specified asset groups[22] 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,[23] 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,

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20 FICC's risk models assume the liquidation occurs over a period of three business days. See Notice, supra note 5 at 51504-05.

21 See Notice, supra note 5 at 51504-07.

22 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, supra note 5 at 51505.

23 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.

FICC's margin methodologies assume for each asset group that a certain share of the market can be liquidated without price impact.[24] 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.[25] 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.[26] 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.[27]

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24 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, supra note 5 at 51504-05.

25 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 Notice, supra note 5 at 51505.

26 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.

27 See id.

For all asset groups, when determining the market impact costs, the net directional 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.[28]

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.[29] 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.[30]

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

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28 Supra note 23; see Notice, supra note 5 at 51505.

29 As noted earlier, FICC's margin methodologies use 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).

30 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 position exceeds the threshold, and (2) a 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 Proposed Rule Change 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.[31]

MLA Excess Amount for GSD Sponsored Members[32]

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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31 See Notice, supra note 5 at 51505.

32 See GSD Rule 3A, supra note 9. 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. <u>Bid-Ask Spread Charge</u>

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.[33] FICC would assign

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[33] 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, supra note 5 at 51506.

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.[34]

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.

34 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 29.

D. Description of Amendment No. 2

In Amendment No. 2, FICC updated Exhibit 3 to the Proposed Rule Change to include impact analysis data with respect to the Proposed Rule Change. Specifically, Amendment No. 2 includes impact studies for various time periods detailing the average and maximum MLA and Bid-Ask Charges for each member, by both percentage and amount. FICC filed Exhibit 3 as a confidential exhibit to the Proposed Rule Change pursuant to 17 CFR 240.24b-2.

II. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Act[35] 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 the rules and regulations thereunder applicable to such organization. After careful consideration, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to FICC. In particular, the Commission finds that the Proposed Rule Change is consistent with Sections 17A(b)(3)(F)[36] of the Act and Rules 17Ad-22(e)(4) and (e)(6) thereunder.[37]

A. Consistency with Section 17A(b)(3)(F)

Section 17A(b)(3)(F) of the Act requires, in part, that the rules of a clearing agency, such as FICC, be designed to promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds

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35 15 U.S.C. 78s(b)(2)(C).

36 15 U.S.C. 78q-1(b)(3)(F).

37 17 CFR 240.17Ad-22(e)(4) and (e)(6).

which are in the custody or control of the clearing agency or for which it is responsible, remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest.[38] The Commission believes that the Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Act.

First, as described above in Section I.A and B, FICC's current margin methodologies do not account for the potential increase in market impact costs that FICC could incur when 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. In addition, as described above in Section I.C, FICC's 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 risks by adding the MLA Charge and Bid-Ask Spread Charge, respectively, to its margin methodologies.[39]

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. Based on its review of the Proposed Rule Change, including confidential Exhibit 3 thereto,[40] the Commission understands that the

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38 15 U.S.C. 78q-1(b)(3)(F).

39 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.

40 Specifically, the confidential Exhibit 3 submitted by FICC includes, among other things, impact studies for various time periods detailing the average and

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. As discussed above, FICC designed the MLA Charge and Bid-Ask Spread Charge, respectively, to reflect two distinct and specific risks presented to FICC: (1) the risk associated with liquidating a defaulted member's portfolio that holds concentrated positions in securities sharing similar risk profiles; as well as (2) the risks associated with the bid-ask spread costs relevant to the securities in the defaulted member's portfolio. As a result, any margin increases that result from the MLA and the Bid-Ask Spread Charges are limited to address those respective risks. This targeted increase in available financial resources should decrease the likelihood that losses arising out of a member default stemming from the liquidation of concentrated positions or bid-ask spreads would cause FICC to exhaust its financial resources and threaten the operation of its critical clearance and settlement services. Accordingly, the Commission believes that the Proposed Rule Change should help FICC to continue providing prompt and accurate clearance and settlement of securities transactions in the event of a member default.

Second, as discussed above, in a member default scenario, FICC would access its 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 augment its ability to manage the potential costs of liquidating a

maximum MLA and Bid-Ask Spread Charges for each member, by both percentage and amount, a detailed methodology describing the calculation of the MLA and Bid-Ask Spread Charges, and information regarding how FICC determined the appropriate methodology.

defaulted member's portfolio by collecting additional margin 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 FICC arising out of a member default. Accordingly, the Commission believes the Proposed Rule Change would promote the safeguarding of securities and funds which are in the custody or control of FICC or for which FICC is responsible, consistent with Section 17A(b)(3)(F) of the Act.

The Commission believes that the Proposed Rule Change should help protect investors and the public interest by mitigating some of the risks presented by FICC as a CCP. Because a defaulting member could place stresses on FICC with respect to FICC's ability to meet its clearance and settlement obligations upon which the broader financial system relies, it is important that FICC has strong margin methodologies to limit FICC's credit risk exposure in the event of a member default. As described above, the Proposed Rule Change would add two charges specifically designed to address risks that are not currently addressed in FICC's margin methodologies related to: (1) the potential costs that FICC may incur when liquidating a portfolio that is concentrated in a particular security or group of securities with a similar risk profile, and (2) the potential costs that FICC may incur to cover the bid-ask spread when liquidating a portfolio. These changes should help ensure that FICC collects sufficient margin that is more commensurate with the risks associated with the potential concentration and bid-ask spread liquidation costs identified above, and thus more effectively cover its credit exposures to its members. By collecting margin that more accurately reflects the risk characteristics of such portfolios and the bid-ask spreads of securities they contain (i.e., the potential associated costs of liquidating such portfolios), FICC would be in a better position to absorb and contain the spread of any losses that might arise from a member default. Therefore, the Proposed Rule Change is designed to reduce the possibility that FICC would need to call for additional resources from non-defaulting members due to a member default, which could inhibit the ability of these non-defaulting members to facilitate securities transactions. Accordingly, the Commission believes that the proposal is designed to protect investors and the public interest by mitigating some of the risks presented by FICC as a CCP.[41]

In addition, similar to other clearing agencies, FICC provides a number of services that mitigate risk, reduce costs, and enhance processing efficiencies for the securities markets, market participants, issuers (including small issuers), and investors. By reducing FICC's risk exposure to its members and thus the likelihood of its failure, the Proposed Rule Change would help ensure that FICC would continue to provide such services, which would benefit securities markets, market participants, issuers (including small issuers), and investors. As a result, FICC should be more resilient so that it can satisfy its obligations as a CCP, which facilitates the protection of investors by helping to ensure that investors receive the proceeds from their securities transactions. Therefore, the Commission believes that, in light of the potential benefits to investors arising from the Proposed Rule Change and the overall improved risk management at FICC, the

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41 See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786, 70849 (October 13, 2016) ("While central clearing generally benefits the markets in which it is available, clearing agencies can pose substantial risk to the financial system as a whole, due in part to the fact that central clearing concentrates risk in the clearing agency.").

Proposed Rule Change is designed to protect investors and the public interest, consistent with Section 17A(b)(3)(F) of the Act.

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 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.[42]

As described above in Section I.A and 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

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42 17 CFR 240.17Ad-22(e)(4)(i).

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 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 FICC's 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.[43]

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

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.[44] Rule 17Ad-22(e)(6)(v)

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43 Id.

44 17 CFR 240.17Ad-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, uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.[45]

As described above in Section I.A and 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.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

[45] 17 CFR 240.17Ad-22(e)(6)(v).

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 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.[46]

III. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning whether Amendment No. 2 is consistent with the Act. Comments may be

[46] 17 CFR 240.17Ad-22(e)(6)(i) and (v).

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-2020-009 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.

All submissions should refer to File Number SR-FICC-2020-009. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the Proposed Rule Change that are filed with the Commission, and all written communications relating to the Proposed Rule Change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, 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-2020-009 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. ACCELERATED APPROVAL OF THE PROPOSED RULE CHANGE, AS MODIFIED BY AMENDMENT NO. 2

The Commission finds good cause, pursuant to Section 19(b)(2)(C)(iii) of the Act,[47] to approve the Proposed Rule Change, as modified by Amendment Nos. 1 and 2, prior to the thirtieth day after the date of publication of Amendment No. 2 in the Federal Register. As noted above, in Amendment No. 2, FICC updated the confidential Exhibit 3 to the Proposed Rule Change to include impact analysis data with respect to the Proposed Rule Change. Specifically, Amendment No. 2 includes impact studies for various time periods detailing the average and maximum MLA and Bid-Ask Charges for each member, by both percentage and amount. The Commission believes that the member-level data in Amendment No. 2 warrants confidential treatment. Amendment No. 2 neither modifies the Proposed Rule Change as originally published in any substantive manner, nor does Amendment No. 2 affect any rights or obligations of FICC or its members. Instead, Amendment No. 2 provides the Commission with information

47 15 U.S.C. 78s(b)(2)(C)(iii).

necessary to evaluate whether the Proposed Rule Change is consistent with the Act. Accordingly, the Commission finds good cause, pursuant to Section 19(b)(2)(C)(iii) of the Act,[48] to approve the Proposed Rule Change, as modified by Amendment Nos. 1 and 2, prior to the thirtieth day after the date of publication of notice of Amendment No. 2 in the Federal Register.

V. CONCLUSION

On the basis of the foregoing, the Commission finds that the Proposed Rule Change, as modified by Amendment Nos. 1 and 2, is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act[49] and the rules and regulations promulgated thereunder.

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[48] Id.

[49] 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act[50] that Proposed Rule Change SR-FICC-2020-009, as modified by Amendment Nos. 1 and 2, be, and hereby is, APPROVED on an accelerated basis.[51]

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[52]

J. Matthew DeLesDernier
Assistant Secretary

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50 15 U.S.C. 78s(b)(2).

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

52 17 CFR 200.30-3(a)(12).