

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69742; File No. SR-NSCC-2013-04)

June 12, 2013

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change in Connection with the Implementation of The Foreign Account Tax Compliance Act (FATCA)

On April 22, 2013, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-NSCC-2013-04 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> The proposed rule change was published for comment in the Federal Register on May 8, 2013.<sup>3</sup> The Commission did not receive comments on the proposed rule change. This order approves the proposed rule change.

I. Description

NSCC is amending various NSCC rules “in connection with the implementation of sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended, which sections were enacted as part of the Foreign Account Tax Compliance Act, and the Treasury Regulations or other official interpretations thereunder (collectively “FATCA”).”<sup>4</sup> In its filing with the Commission, NSCC provided information concerning FATCA background, implementation, and NSCC’s proposed rule changes.

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Securities Exchange Act Release No. 69497 (May 2, 2013), 78 FR 26838 (May 8, 2013) (SR-NSCC-2013-04).

<sup>4</sup> Id. at 26838.

## **NSCC's Background Statement**

FATCA was enacted on March 18, 2010, as part of the Hiring Incentives to Restore Employment Act, and became effective, subject to transition rules, on January 1, 2013. The U.S. Treasury Department finalized and issued various implementing regulations (“FATCA Regulations”) on January 17, 2013. FATCA generally requires foreign financial institutions (“FFIs”)<sup>5</sup> to become “participating FFIs” by entering into agreements with the Internal Revenue Service (“IRS”). Under these agreements, FFIs are required to report to the IRS information on U.S. persons and entities that have (directly or indirectly) accounts with these FFIs. If an FFI does not enter into such an agreement with the IRS, FATCA will impose a 30% withholding tax on U.S.-source interest, dividends and other periodic amounts paid to such “nonparticipating FFI” (“Income Withholding”), as well as on the payment of gross proceeds arising from the sale, maturity, or redemption of securities or any instrument yielding U.S.-source interest and dividends (“Gross Proceeds Withholding,” and, together with Income Withholding, “FATCA Withholding”). The 30% FATCA Withholding taxes will apply to payments made to a nonparticipating FFI acting in any capacity, including payments made to a nonparticipating FFI that is not the beneficial owner of the amount paid and acting only as a custodian or other intermediary with respect to such payment. To the extent that U.S.-source interest, dividend, and other periodic amount or gross proceeds payments are due to a nonparticipating FFI in any capacity, a U.S. payor, such as NSCC, transmitting such payments to the nonparticipating FFI will be liable

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<sup>5</sup> According to NSCC, non-U.S. financial institutions are referred to as “foreign financial institutions” or “FFIs” in the FATCA Regulations.

to the IRS for any amounts of FATCA Withholding that the U.S. payor should, but does not, withhold and remit to the IRS. According to NSCC, under FATCA, a U.S. payor, such as NSCC, could be required to deduct Income Withholding with regard to a participating FFI if either: (x) the participating FFI makes a statutory election to shift its withholding responsibility under FATCA to the U.S. payor; or (y) the U.S. payor is required to ignore the actual recipient and treat the payment as if made instead to certain owners, principals, customers, account holders or financial counterparties of the participating FFI. NSCC believes it is not in a position to accept this burden shift and is implementing preventive measures to protect itself against such a burden through the rule changes contained herein.

According to NSCC, as an alternative to FFIs entering into individual agreements with the IRS, the U.S. Treasury Department provided another means of complying with FATCA for FFIs which are resident in non-U.S. jurisdictions that enter into intergovernmental agreements (“IGA”) with the United States.<sup>6</sup> Generally, such a jurisdiction (“FATCA Partner”) would pass laws to eliminate the conflicts of law issues that would otherwise make it difficult for FFIs in its jurisdiction to collect the information required under FATCA and transfer this information, directly or indirectly, to the United States. An FFI resident in a FATCA Partner jurisdiction would either transmit FATCA reporting to its local competent tax authority, which in turn would transmit the information to the IRS, or the FFI would be

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<sup>6</sup> NSCC states that as of the date of this proposed rule change filing, the United Kingdom, Mexico, Ireland, Switzerland, Spain, Norway, Denmark, Italy, and Germany have signed or initialed an IGA with the United States. The U.S. Treasury Department has announced that it is engaged in negotiations with more than 50 countries and jurisdictions regarding entering into an IGA.

authorized/required by FATCA Partner law to enter into an FFI agreement and transmit FATCA reporting directly to the IRS. Under both IGA models, payments to such FFIs would not be subject to FATCA Withholding so long as the FFI complies with the FATCA Partner's laws mandated in the IGA.

According to NSCC, under the FATCA Regulations, (A) beginning January 1, 2014, NSCC will be required to do Income Withholding on any payments made to any nonparticipating FFI approved for membership by NSCC as of such date or thereafter, (B) beginning July 1, 2014, NSCC will be required to do Income Withholding on any payments made to any nonparticipating FFI approved for membership by NSCC prior to January 1, 2014 and (C) beginning January 1, 2017, NSCC will be required to do Gross Proceeds Withholding on all nonparticipating FFIs, regardless when any such FFI's membership was approved.

#### **NSCC's Statement on FATCA Implementation**

According to NSCC, in preparation for FATCA's implementation, FFIs are being asked to identify their expected FATCA status as a condition of continuing to do business. Customary legal agreements in the financial services industry already contain provisions allocating the risk of any FATCA Withholding tax that will need to be collected, and requiring that, upon FATCA's effectiveness, foreign counterparties must certify (and periodically recertify) their FATCA status using the relevant tax forms that the IRS has announced it will provide.<sup>7</sup> Advance disclosure

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<sup>7</sup> For example, credit agreements now routinely require foreign lenders to agree to provide certifications of their FATCA status under approved IRS forms to U.S. borrowers, and subscription agreements for alternative investment funds that are anticipated to earn U.S.-source income are routinely requiring similar covenants.

by an FFI client or counterparty would permit a withholding agent to readily determine whether it must, under FATCA, withhold on payments it makes to the FFI. If an FFI fails to provide appropriate compliance documentation to a withholding agent, such FFI would be presumed to be a nonparticipating FFI and the withholding agent will be obligated to withhold on certain payments.

NSCC states that FATCA will require NSCC to deduct FATCA Withholding on payments to certain members and limited members arising from certain transactions processed by NSCC on behalf of such members.<sup>8</sup> Because FATCA treats any entity holding financial assets for the account of others as a “financial institution,” NSCC believes that almost all of its members and limited members which are treated as non-U.S. entities for federal income tax purposes, including those members and limited members that are U.S. branches of non-U.S. entities, will likely be FFIs under FATCA (collectively, “FFI Members”).<sup>9</sup> NSCC says that as a result, it will be liable to the IRS for any failures to withhold correctly under FATCA on payments made to its FFI Members.

In light of this, NSCC has evaluated its existing systems and services to determine whether and how it may comply with its FATCA obligations. As a result of this evaluation, NSCC has determined that its existing systems cannot process the new FATCA Withholding obligations with regard to the securities transactions processed by it, as no similar withholding obligation of this magnitude has ever been

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<sup>8</sup> According to NSCC, FFI members and limited members resident in IGA countries that are compliant with the terms of applicable IGAs should not be subject to FATCA Withholding.

<sup>9</sup> Currently, only a small percentage of NSCC’s members and limited members are treated as non-U.S. entities for federal income tax purposes.

imposed upon it to date, and NSCC has therefore not built its systems to support such an obligation.

In addition, NSCC states that the vast majority of the transactions that are processed at NSCC are processed through its Continuous Net Settlement (“CNS”) System. CNS is NSCC’s core netting, allotting, and fail-control engine. Within CNS, each security and related money settlement obligation is netted to one net security and/or payment position per member, including FFI Members, with NSCC as its central counterparty. CNS maintains an orderly flow of security and money balances, providing clearance and settlement for equities, corporate bonds, unit investment trusts and municipal bonds that are eligible for book entry delivery at The Depository Trust Company (“DTC”), an affiliate of NSCC.

Further, NSCC’s related Money Settlement Service provides for net money settlement with regard to payments attributable to CNS, as well as with regard to payments attributable to other NSCC-processed transactions, including mutual fund and insurance transactions. Money settlement at NSCC occurs at the end of the day and, from an operational perspective, is centralized with DTC’s end-of-day money settlement in order to provide common NSCC members/DTC participants with consolidated reporting and a single point of access for all settlement information. Throughout the day, debit and credit data generated by member activity are recorded in the settlement system. At the end of the processing day, the data is summarized by product category (e.g., CNS, mutual funds, etc.) and netted to produce an aggregate debit or credit for each member. Similarly, DTC activity is also recorded and netted. Following the determination of final net numbers for each NSCC member and/or

DTC participant, these amounts are further netted to produce a consolidated net settlement obligation. So, for example, a member with a settlement debit at NSCC, which member is also a DTC participant, will have that debit netted against its settlement credit at DTC. Settling banks, who may settle on behalf of multiple NSCC members and/or DTC participants, must separately acknowledge the respective settlement balances of their customer members/participants at each clearing agency. The consolidated net balances of their respective member/participant customers are then further netted to produce a single net-net settling bank consolidated debit or credit. Settlement of these net-net balances occurs through use of the Federal Reserve's National Settlement Service, whereby DTC, on its own behalf and as NSCC's settlement agent, submits instructions to have the Federal Reserve accounts of the settling banks charged for their net-net debit balances and credited with their net-net credit balances. NSCC believes that this net-net settlement functionality could make FATCA Withholding virtually impossible, or, at the very least, would create onerous efficiency and liquidity issues for both NSCC and its membership.

NSCC believes that undertaking FATCA Withholding, given NSCC's net-net settlement functionality, could require NSCC in certain circumstances to resort to a draw on NSCC's clearing fund ("Clearing Fund") in order to fund FATCA Withholding taxes with regard to nonparticipating FFI Members in non-FATCA Partner jurisdictions whenever the net credit owed to such FFI Member is less than the 30% FATCA tax. For example, if a nonparticipating FFI (in a non-FATCA Partner jurisdiction) is owed a \$100M payment from the sale of U.S. securities, but

such nonparticipating FFI is in a net debit position at the end of that day because of NSCC's net settlement functionality and end-of-day crediting and debiting, there would be no payment to this FFI Member from which NSCC can withhold. In this example, NSCC would likely need to fund the \$30M FATCA Withholding tax until such time as the FFI Member can reimburse NSCC and, as NSCC has no funds for this purpose, it likely would require a draw on the Clearing Fund.<sup>10</sup> NSCC would need to consider an increase in the amount of cash required to be deposited into the Clearing Fund, either by FFI Members or perhaps all of its members, which would reduce such member's liquidity and could have significant systemic effects. The amount of the FATCA Withholding taxes would be removed from market liquidity, which could lead to increased risk of member failure and increased financial instability.

For the reasons explained above and the following additional reasons, NSCC is amending its rules to implement preventive measures that would generally require all of NSCC's (i) existing members and limited members that are treated as non-U.S.

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<sup>10</sup> NSCC notes that the FATCA Regulations provide that "clearing organizations," which settle money on a net basis, may withhold on a similar net basis for FATCA purposes. However, the end-of-day net settlement amounts, which are attributable to the sales and dispositions of many different securities as well as debits and credits for other items, would likely not qualify for the special FATCA netting rule. Additionally, as discussed above, each of NSCC's member's end-of-day money settlement obligation is cross-netted with such member's respective money settlement obligation at DTC, and therefore, qualifying as a "clearing organization" under FATCA would still not prevent the possibility that NSCC would need to fund FATCA Withholding taxes from the Clearing Fund. Even if the end-of-day net-net settlement amount would qualify as the correct amount from which to do FATCA Withholding, the liquidity risks described herein are still present. This is because the sheer dollar value attributable to NSCC's net daily payments among NSCC and members means that withholding FATCA tax from such net settlement payments, in any material proportion, would likely reduce liquidity and thus increase financial instability.



entities for federal tax income purposes and (ii) any applicants applying to become members or limited members, that are treated as non-U.S. entities for federal income tax purposes to be participating FFIs because NSCC believes that:

- Undertaking FATCA Withholding by NSCC (even if possible) would make it economically unfeasible for affected FFI Members to engage in transactions involving U.S. securities. It would likely also quickly cause a significant negative impact on such FFI Members' liquidity because such withholding taxes would be imposed on the very large sums that NSCC pays to such FFI Members.

Furthermore, FFI Members would be burdened with extra costs and the negative impact on liquidity caused by the likely need to substantially increase the amount of cash required to be deposited into the Clearing Fund.

- The cost of implementing a FATCA Withholding system for a small number of nonparticipating FFI Members would be substantial and disproportionate to the related benefit. Under the Model I IGA form and its executed versions with various FATCA Partners, NSCC would not be required to withhold with regard to FFI residents in such FATCA Partner jurisdictions. Accordingly, NSCC's withholding obligations under FATCA would effectively be limited to nonparticipating FFI Members in non-FATCA Partner jurisdictions. Since the cost of developing and maintaining a complex FATCA Withholding system would be passed on to NSCC's members at large, it may burden members that otherwise comply with, or are not subject to, FATCA Withholding.

- As briefly noted above, absent this current action and in order to avoid counterparty credit risk, NSCC would likely require each of the nonparticipating FFI

Members in non-FATCA Partner jurisdictions to make initial or additional cash deposits to the Clearing Fund as collateral for the approximate potential FATCA tax liability of such nonparticipating FFI Member or otherwise adjust required deposits to the Clearing Fund. The amount of such deposits, which could amount to billions of dollars, would be removed from market liquidity.

- From the nonparticipating FFI Member's perspective, having 30% of its payments withheld and sent to the IRS would have a severe negative impact on such nonparticipating FFI Member's financial status. In many cases, the gross receipts would be for client accounts, and the nonparticipating FFI Member would need to make such accounts whole. Without receipt of full payment for its dispositions, the nonparticipating FFI Member would not have sufficient assets to fund its client accounts.

- These rule changes should not create business issues or be onerous to NSCC's membership because requiring FFIs to certify (and to periodically recertify) their FATCA status, and imposing the costs of non-compliance on them, are becoming standard market practice in the United States, separate and apart from membership in NSCC.

### **Rule Changes**

NSCC states that managing the risks inherent in executing securities transactions is a key component of NSCC's business. NSCC's risk tolerances (i.e., the levels of risk NSCC is prepared to confront, under a range of possible scenarios, in carrying out its business functions) are determined by the Board of Directors, in consultation with the Group Chief Risk Officer. NSCC uses a combination of risk

management tools, including strict criteria for membership, to mitigate the risks inherent in its business.

In line with its risk management focus, NSCC has determined that compliance with FATCA, so that NSCC shall not be responsible for FATCA Withholding, should be a general membership requirement (A) for all applicants that are treated as non-U.S. entities for federal income tax purposes, and (B) for all existing FFI Members.<sup>11</sup> NSCC is amending its rules as follows:

- Rule 1: adding “FFI Member,” “FATCA,” “FATCA Certification,” “FATCA Compliance Date”<sup>12</sup> and “FATCA Compliant” as defined terms;
- Rule 2, Section 4: requiring that all FFI Members (both new and existing), in general: (i) agree not to conduct any transaction or activity through NSCC if such FFI Member is not FATCA Compliant, (ii) certify and, as required under the timelines set forth under FATCA, periodically recertify, to NSCC that they are FATCA Compliant, and (iii) indemnify NSCC for any losses sustained by NSCC resulting from such FFI Member’s failure to be FATCA Compliant;
- Rule 2A, Section 1.B.: adding FATCA Compliance as a qualification requirement for any applicant that will be an FFI Member;

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<sup>11</sup> NSCC may grant a waiver under certain circumstances, provided, however, that NSCC will not grant a waiver if it causes NSCC to be obligated to withhold under FATCA on gross proceeds from the sale or other disposition of any property.

<sup>12</sup> Although Income Withholding with regard to FFI Members approved for membership by NSCC prior to January 1, 2014 is first required under FATCA beginning July, 1 2014, the proposed amendments to NSCC rules would require such existing FFI Members to be FATCA compliant approximately 60 days prior to July 1, 2014 in order for NSCC to comply with its disciplinary and notice processes as set forth in NSCC rules.

- Rule 2A, Section 1.B., Foot Note 1: making a technical clarification to expressly include the policy statement set forth in Addendum O as other qualification standards that NSCC has promulgated with regard to certain applicants;
- Rule 2A, Section 1.C.: adding that each applicant must complete and deliver a FATCA Certification to NSCC as part of its membership application unless NSCC has waived this requirement with regard to membership type;
- Rule 2B, Section 1: making a technical clarification by adding a footnote to expressly include the policy statement set forth in Addendum O as qualifications and standards which are continuing membership requirements;
- Rule 2B, Section 2.B: specifying that failure to be FATCA Compliant creates a duty upon an FFI Member (both new and existing) to inform NSCC;
- Addendum O: requiring applicants that are subject to this Policy Statement (i) to be FATCA Compliant, (ii) to deliver to NSCC a FATCA Certification, and to periodically recertify such FATCA Certification, (iii) to agree not to submit any order for processing through NSCC if the applicant fails to be FATCA Compliant at any time, and (iv) to agree to indemnify NSCC for any losses sustained by NSCC resulting from the applicant's failure to be FATCA Compliant, as conditions to admission and continued membership.

## II. Discussion

Section 19(b)(2)(C) of the Act<sup>13</sup> 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

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<sup>13</sup> 15 U.S.C. 78s(b)(2)(C).

applicable to such organization. Section 17A(b)(3)(F) of the Act<sup>14</sup> requires the rules of a clearing agency to be designed to, among other things, promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, and protect investors and the public interest. The Commission finds that NSCC's proposed rule change is consistent with these requirements because it is designed to comply with FATCA while eliminating uncertainty in funds settlement. Specifically, based on NSCC's representations, the Commission understands that the proposed rule change is designed codify NSCC's rules in a way that will allow NSCC to comply with FACTA without developing and maintaining a complex FATCA Withholding system and, as a result, it will eliminate uncertainty in funds settlement that NSCC believes will arise if NSCC is subject to FATCA Withholding.

In approving this proposed rule change, the Commission is mindful of the IRS's jurisdiction respecting FATCA. This Order does not interpret FATCA. The Commission's approval of the proposed rule change in no way constitutes a determination or finding by the Commission that the proposed rule change complies with FATCA, which is under the purview of the IRS.

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<sup>14</sup> 12 U.S.C. 78q-1(b)(3)(F).

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act<sup>15</sup> and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-NSCC-2013-04) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>16</sup>

Kevin M. O'Neill  
Deputy Secretary

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

<sup>16</sup> 17 CFR 200.30-3(a)(12).