

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-88494; File No. SR-NSCC-2020-002)

March 27, 2020

Self-Regulatory Organizations; National Securities Clearing Corporation; Order
Approving a Proposed Rule Change to Enhance the Calculation of the Family-Issued
Securities Charge

On January 28, 2020, National Securities Clearing Corporation (“NSCC”) 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-NSCC-2020-002 to enhance the calculation of the Family-Issued Securities Charge.³ The proposed rule change was published for comment in the Federal Register on February 18, 2020,⁴ and the Commission received no comment letters regarding the changes proposed in the proposed rule change.⁵ For the reasons discussed below, the Commission is approving the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ NSCC also filed the proposals contained in the proposed rule change as advance notice SR-NSCC-2020-801 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, 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). Notice of Filing of the Advance Notice was published for comment in the Federal Register on February 27, 2020. Securities Exchange Act Release No. 88267 (February 24, 2020), 85 Fed. Reg. 11437 (February 27, 2020) (File No. SR-NSCC-2020-801).

⁴ Securities Exchange Act Release No. 88163 (February 11, 2020), 85 Fed. Reg. 8964 (February 18, 2020) (“Notice of Filing”).

⁵ As the proposals contained in the proposed rule change were also filed as an advance notice, all public comments received on the proposals are considered

I. DESCRIPTION OF THE PROPOSED RULE CHANGE

The proposed rule change would revise NSCC's Rules and Procedures ("Rules")⁶ to amend the calculation of NSCC's existing margin charge applied to long positions in Family-Issued Securities to address certain risk presented by these positions.

A. Background

NSCC provides clearing, settlement, risk management, central counterparty services, and a guarantee of completion for virtually all broker-to-broker trades involving equity securities, corporate and municipal debt securities, and certain other securities. NSCC manages its credit exposure to its Members by determining an appropriate Required Fund Deposit for each Member, which serves as each Member's margin.⁷ The aggregate of all NSCC Members' Required Fund Deposits (together with certain other deposits required under the Rules) constitutes NSCC's Clearing Fund, which NSCC would access should a Member default and that Member's Required Fund Deposit, upon liquidation, is insufficient to satisfy NSCC's losses.

Each Member's Required Fund Deposit consists of a number of applicable components, each of which is calculated to address specific risks faced by NSCC.⁸

regardless of whether the comments are submitted on the proposed rule change or the advance notice.

⁶ Capitalized terms not defined herein are defined in NSCC's Rules and Procedures ("Rules"), available at http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf.

⁷ See Rule 4 (Clearing Fund) and Procedure XV (Clearing Fund Formula and Other Matters) of the Rules, supra note 6.

⁸ Id.

NSCC states that it regularly assesses the market, liquidity, and other risks that its margining methodologies are designed to mitigate to evaluate whether margin levels are commensurate with the particular risk attributes of each relevant product, portfolio, and market.⁹ Such risks include risks introduced by its counterparties or Members. In particular, NSCC seeks to identify and mitigate its exposures to specific wrong-way risk (“SWWR”), which is the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of that counterparty deteriorates. Such risk would arise when NSCC acts as central counterparty to a Member with unsettled long positions in securities that were issued by that Member or an affiliate of that Member (“Family-Issued Securities”). If that Member defaults, NSCC would seek to cover its losses by closing out the unsettled Family-Issued Securities long positions. However, because the Member default would also likely lead to a drop in the creditworthiness of the Member and, therefore, the value of the Family-Issued Securities, NSCC would likely not be able to completely cover its losses in closing out those positions.

In order to address this particular form of SWWR, NSCC imposes a charge on all Members with unsettled long positions in their own Family-Issued Securities, called the FIS Charge, which is calculated by multiplying the value of the net unsettled long positions in Family-Issued Securities by a certain percentage (“Haircut Rate”). Currently, the Haircut Rate applied in the FIS Charge calculation is based on a Member’s rating category on NSCC’s Credit Risk Rating Matrix (“CRRM”), which ranges from 1 to 7. NSCC utilizes the CRRM to evaluate its credit risk exposure to each Member; a

⁹ See Notice of Filing supra note 4, at 85 Fed. Reg. 8965.

higher CRRM rating represents a higher credit risk (i.e., a greater risk of defaulting on settlement obligations) and may cause a Member to be subject to enhanced surveillance or additional margin requirements.¹⁰

Currently, the applicable Haircut Rate for the FIS Charge depends on a Member's rating on the CRRM. Specifically, for Members that are rated 6 or 7 on the CRRM, the applicable Haircut Rate for net unsettled long positions in Family-Issued Securities shall be (1) at least 80 percent for fixed income securities, and (2) 100 percent for equity securities. For Members that are rated 1 through 5 on the CRRM, the applicable Haircut Rate shall be (1) at least 40 percent for fixed income securities, and (2) at least 50 percent for equity securities.¹¹

B. Proposed Changes to FIS Charge

In the proposed rule change, NSCC is proposing to revise the calculation of the FIS Charge to use the same Haircut Rate for all Members regardless of their CRRM rating category. Under the proposal, net unsettled long positions in (1) fixed income securities that are Family-Issued Securities are charged a Haircut Rate of no less than 80 percent, and (2) equity securities that are Family-Issued Securities are charged a Haircut Rate of 100 percent.

¹⁰ See Rule 1 and Section 4 of Rule 2B of the Rules, supra note 6. See also Securities Exchange Act Release Nos. 80734 (May 19, 2017), 82 Fed. Reg. 24177 (May 25, 2017) (SR-DTC-2017-002, SR-FICC-2017-006, SR-NSCC-2017-002); and 80731 (May 19, 2017), 82 Fed. Reg. 24174 (May 25, 2017) (SR-DTC-2017-801, SR-FICC-2017-804, SR-NSCC-2017-801).

¹¹ See Procedure XV (Clearing Fund Formula and Other Matters) of the Rules, supra note 6.

NSCC states that it may still be exposed to SWWR despite applying different Haircut Rates based on a Member's rating on the CRRM, and it can better mitigate its exposure to this risk by calculating the FIS Charge without considering Members' CRRM rating categories.¹² According to NSCC, while the current methodology appropriately assumes that Members with a higher rating category on the CRRM present a heightened credit risk to NSCC or have demonstrated higher risk related to their ability to meet settlement, this methodology does not account for the risk that a Member may default due to unanticipated causes (referred to as a "jump-to-default" scenario) not captured by the CRRM.¹³ This is because the CRRM relies on historical data as a predictor of future risks,¹⁴ whereas jump-to-default scenarios are triggered by unanticipated causes that could not be predicted based on historical trends or data (e.g., instances of fraud or other bad actions by a Member's management). Therefore, NSCC represents that the proposed change is designed to cover SWWR arising from potential jump-to-default scenarios by applying the higher applicable Haircut Rate in calculating the FIS Charge for all Members.¹⁵

The practical outcome of this proposed change is that for all Family-Issued Securities, NSCC would apply a haircut equivalent to the current Haircut Rate for Members that are rated 6 or 7 on the CRRM regardless of whether a Member is rated at a

¹² See Notice of Filing supra note 4, at 85 Fed. Reg. 8965.

¹³ See id.

¹⁴ See Notice of Filing supra note 4, at 85 Fed. Reg. 8965-66.

¹⁵ See Notice of Filing supra note 4, at 85 Fed. Reg. 8966.

6 or 7. To implement this proposal, NSCC would amend Sections I.(A)(1)(a)(iv) and I.(A)(2)(a)(iv) of Procedure XV of the Rules.

II. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Act¹⁶ directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. After carefully considering the proposed rule change, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to NSCC. In particular, the Commission finds that the proposed rule change is consistent with Section 17A(b)(3)(F)¹⁷ of the Act and Rules 17Ad-22(e)(4)(i) and (e)(6)(i) and (v) thereunder.¹⁸

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 NSCC, be designed to promote the prompt and accurate clearance and settlement of securities transactions, and to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.¹⁹

The Commission believes that the proposal is consistent with the promotion of prompt and accurate clearance and settlement of securities transactions. As described

¹⁶ 15 U.S.C. 78s(b)(2)(C).

¹⁷ 15 U.S.C. 78q-1(b)(3)(F).

¹⁸ 17 CFR 240.17Ad-22(e)(4)(i) and (e)(6)(i) and (v).

¹⁹ 15 U.S.C. 78q-1(b)(3)(F).

above, NSCC faces SWWR when it acts as central counterparty to a Member with long positions in Family-Issued Securities. Although NSCC's current margin methodology addresses SWWR through imposition of the FIS Charge, it does not address SWWR associated with a jump-to-default scenario. The proposal would address SWWR associated with a jump-to-default scenario by using the higher applicable Haircut Rate for all Members concerning their net unsettled long positions in Family-Issued Securities, regardless of the Members' CRRM rating category. As such, the proposal would address a risk not captured currently under NSCC's margin methodology and provide for more comprehensive risk management of NSCC's risks. Further, applying the higher applicable Haircut Rate in calculating the FIS Charge for all Members would result in the collection of additional margin, which should, in turn, better enable NSCC to manage the potential losses arising out of a Member default and continue operations of its critical clearance and settlement services in default scenarios. Accordingly, the Commission finds that NSCC's proposal should help NSCC to continue providing prompt and accurate clearance and settlement of securities transactions in the event of a Member default.

The Commission also believes that the proposal is consistent with assuring the safeguarding of securities and funds which are in the custody or control of NSCC for which it is responsible. As described above, the proposal would allow NSCC to collect additional margin to collateralize exposures to SWWR associated with jump-to-default scenario that NSCC may face when liquidating Family-Issued Securities positions that are depreciating in value in response to a Member's default. By expanding the higher haircut rates to all Members, the proposal would assist NSCC in collecting margin and

maintaining the Clearing Fund that more precisely reflects NSCC's overall risk exposure to its Members. By better limiting NSCC's exposure to Members, the proposal is designed to help ensure that NSCC has collected sufficient margin from Members with long positions in Family-Issued Securities, so that non-defaulting Members would not be exposed to mutualized losses as a result of a default of a Member with long positions in Family-Issued Securities. By helping to limit non-defaulting Members' exposure to mutualized losses, the proposal is designed to help assure the safeguarding of securities and funds which are in NSCC's custody or control. For the reasons stated above, the Commission believes that the Proposed Rule Change is consistent with the requirements of Section 17A(b)(3)(F) of the Act.²⁰

B. Consistency with Rule 17Ad-22(e)(4)(i)

Rule 17Ad-22(e)(4)(i) under the Act requires that each covered clearing agency 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.²¹

As described above, NSCC is exposed to SWWR where it acts as central counterparty for its Members' transactions in Family-Issued Securities. Applying the same higher Haircut Rate to all Members with net long unsettled positions in Family-

²⁰ 15 U.S.C. 78q-1(b)(3)(F).

²¹ 17 CFR 240.17Ad-22(e)(4)(i).

Issued Securities, regardless of their rating on the CRRM, would help further mitigate NSCC's SWWR exposures, especially in a jump-to-default scenario. Thus, applying the same Haircut Rate in the FIS charge calculation is designed to help NSCC collect sufficient financial resources to help cover its credit exposures, with a high degree of confidence, to those Members seeking to clear and settle transactions in Family-Issued Securities. Therefore, the Commission believes the proposed change is consistent with Rule 17Ad-22(e)(4)(i).²²

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

Rule 17Ad-22(e)(6)(i) under the Act requires that each covered clearing agency that provides central counterparty services 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.²³ Rule 17Ad-22(e)(6)(v) under the Act requires that each covered clearing agency that provides central counterparty services 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.²⁴

²² Id.

²³ 17 CFR 240.17Ad-22(e)(6)(i).

²⁴ 17 CFR 240.17Ad-22(e)(6)(v).

As described above, NSCC faces SWWR in jump-to-default scenarios where it acts as central counterparty to Member transactions in Family-Issued Securities. This risk is present regardless of a Member's rating on the CRRM. However, the current methodology assumes that Members with a higher rating on the CRRM present a heightened credit risk to NSCC and applies a higher Haircut Rate to such Members. This distinction does not take into account the SWWR that would manifest in a jump-to-default scenario. As such, NSCC proposes to apply the same higher Haircut Rate to all Members. This proposal would improve NSCC's ability to mitigate its exposure to SWWR in a jump-to-default scenario, thereby helping NSCC to maintain a risk-based margin system that considers, and produces margin levels commensurate with, the risks and particular attributes of net unsettled long positions in Family-Issued Securities. Therefore, the Commission believes that the proposal would be consistent with Rule 17Ad-22(e)(6)(i).²⁵

Additionally, because the enhanced FIS Charge would be a component of the margin that NSCC collects from its Members to help cover NSCC credit exposure to the Members, and because the charge would be based on different product risk factors with respect to equity and fixed-income securities, it would be part of an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products, as described above. Therefore, the Commission believes the proposed change is consistent with Rule 17Ad-22(e)(6)(v).²⁶

²⁵ 17 CFR 240.17Ad-22(e)(6)(i).

²⁶ 17 CFR 240.17Ad-22(e)(6)(v).

III. CONCLUSION

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act²⁷ and the rules and regulations promulgated thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act²⁸ that proposed rule change SR-NSCC-2020-002, be, and hereby is, APPROVED.²⁹

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁰

J. Matthew DeLesDernier
Assistant Secretary

²⁷ 15 U.S.C. 78q-1.

²⁸ 15 U.S.C. 78s(b)(2).

²⁹ In approving the proposed rule change, the Commission considered the proposals' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁰ 17 CFR 200.30-3(a)(12).