SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-98086; File No. SR-NSCC-2022-015)

August 8, 2023

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving a Proposed Rule Change to Make Certain Enhancements to the Gap Risk Measure and the VaR Charge

I. INTRODUCTION

On December 2, 2022, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-NSCC-2022-015 (the "Proposed Rule Change") pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The Proposed Rule Change was published for comment in the Federal Register on December 21, 2022,[3] and the Commission has received one comment regarding the changes proposed in the Proposed Rule Change.[4]

On January 24, 2023, pursuant to Section 19(b)(2) of the Act,[5] 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.[6] On March 20, 2023, the Commission instituted proceedings, pursuant to Section 19(b)(2)(B) of the

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 96511 (Dec. 15, 2022), 87 FR 78157 (Dec. 21, 2022) (File No. SR-NSCC-2022-015) ("Notice of Filing").

4 Comments are available at https://www.sec.gov/comments/sr-nscc-2022-015/srnscc2022015.htm.

5 15 U.S.C. 78s(b)(2).

6 Securities Exchange Act Release No. 96740 (Jan. 24, 2023), 88 FR 5953 (Jan. 30, 2023) (File No. SR-NSCC-2022-015).

Act,[7] to determine whether to approve or disapprove the Proposed Rule Change.[8] On June 8, 2023, the Commission designated a longer time period, pursuant to Section 19(b)(2)(B)(ii)(II) of the Act,[9] to determine whether to approve or disapprove the Proposed Rule Change.[10]

For the reasons discussed below, the Commission is approving the Proposed Rule Change.

II. DESCRIPTION OF THE PROPOSED RULE CHANGE[11]

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 unit investment trust transactions in the U.S. markets. A key tool that NSCC uses to manage its credit exposure to its members is collecting an appropriate amount of margin (i.e., collateral) from each member.[12]

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

8 Securities Exchange Act Release No. 97171 (Mar. 20, 2023), 88 FR 17898 (Mar. 24, 2023) (File No. SR-NSCC-2022-015).

9 15 U.S.C 78s(b)(2)(B)(ii)(II).

10 Securities Exchange Act Release No. 97671 (June 8, 2023), 88 FR 38926 (June 14, 2023 (File No. SR-NSCC-2022-015).

11 Capitalized terms not defined herein are defined in NSCC's Rules & Procedures ("Rules"), available at https://www.dtcc.com/~/media/Files/Downloads/legal/rules/nscc_rules.pdf.

12 Pursuant to its Rules, NSCC uses the term "Required Fund Deposit" to denote margin or collateral collected from its members. See Rule 4 (Clearing Fund) and Procedure XV (Clearing Fund Formula and Other Matters) of the Rules, supra note 11.

A. Overview of NSCC's Margin Methodology

A member's margin is designed to mitigate potential losses to NSCC associated with the liquidation of the member's portfolio in the event that member defaults.[13] The aggregate of all members' margin deposits (together with certain other deposits required under the Rules) constitutes NSCC's clearing fund. NSCC would access its clearing fund should a defaulting member's own margin and resources at NSCC be insufficient to satisfy losses to NSCC caused by the liquidation of that member's portfolio.[14]

NSCC employs daily backtesting to determine the sufficiency of each member's margin, by simulating the liquidation gains or losses using the actual unsettled positions in the member's portfolio, and the actual historical returns for each security held in the portfolio. A backtesting deficiency would result if the liquidation losses were greater than the member's margin. NSCC investigates the causes of any backtesting deficiencies, paying particular attention to members with backtesting deficiencies that bring the results for that member below the 99 percent confidence target (i.e., greater than two backtesting deficiency days in a rolling twelve-month period) to determine if there is an identifiable cause of repeat backtesting deficiencies.[15] NSCC also evaluates whether multiple members may experience backtesting deficiencies for the same underlying reason.[16]

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13 Under NSCC's Rules, a default would generally be referred to as a "cease to act" and could encompass a number of circumstances, such as a member's failure to make a margin payment on time. See Rule 46 (Restrictions on Access to Services) of the Rules, supra note 11.

14 See Rule 4, supra note 11.

15 See National Securities Clearing Corporation, Disclosure Framework for Covered Clearing Agencies and Financial Market Infrastructures, at 61 (Dec. 2022), available at https://www.dtcc.com/legal/policy-and-compliance.

16 See id.

Each member's margin consists of a number of applicable components, each of which is calculated to address specific risks faced by NSCC.[17] Each member's start of day required fund deposit is calculated overnight, based on the member's prior end-of-day net unsettled positions.[18] NSCC notifies members early the following morning, and members are required to make deposits by approximately 10:00 a.m. EST.[19]

Generally, the largest portion of a member's margin is the volatility component. The volatility component is designed to reflect the amount of money that could be lost on a portfolio over a given period within a 99th percentile level of confidence. This component represents the amount assumed necessary to absorb losses while liquidating the member's portfolio.

NSCC's methodology for calculating the volatility component of a member's required fund deposit depends on the type of security and whether the security has sufficient pricing or trading history for NSCC to robustly estimate the volatility component using statistical techniques. Generally, for most securities (e.g., equity securities), NSCC calculates the volatility component using, among other things, a parametric Value at Risk ("VaR") model, which results in a "VaR Charge."[20] The VaR Charge usually comprises the largest portion of a member's required fund deposit.

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17 See Procedure XV of the Rules, supra note 11.

18 See Procedure XV, Sections II(B) of the Rules, supra note 11.

19 See id. The Rules provide that required deposits to the clearing fund are due within one hour of demand, unless otherwise determined by NSCC. Id.

20 See Sections I(A)(1)(a)(i) and I(A)(2)(a)(i) of Procedure XV of the Rules, supra note 11.

B. Current Treatment of Gap Risk in NSCC's Margin Methodology

Under NSCC's current Rules, one of the potential methods of calculating the VaR Charge relies on a measure of gap risk. It does not accrue for all portfolios, but instead only serves as the VaR Charge if it is the largest of three potential calculations.[21]

Gap risk events have been generally understood as idiosyncratic issuer events (for example, earning reports, management changes, merger announcements, insolvency, or other unexpected, issuer-specific events) that cause a rapid shift in price volatility levels. The gap risk charge was designed to address the risk presented by a portfolio that is more susceptible to the effects of gap risk events, i.e., those portfolios holding positions that represent more than a certain percent of the entire portfolio's value, such that the event could impact the entire portfolio's value.[22]

The current gap risk charge applies only if a member's overall net unsettled non-index position with the largest absolute market value in the portfolio represents more than a certain percent of the entire portfolio's value, that is, if the net unsettled position exceeds a specified "concentration threshold." The concentration threshold can be set no higher than 30 percent and is evaluated periodically based on members' backtesting results over a twelve month look-back period, and it is currently set at 5%.[23] NSCC's

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21 Specifically, the VaR Charge is the greatest of (1) the larger of two separate calculations based on different underlying estimates that utilize a parametric VaR model, which addresses the market risk of a member's portfolio (referred to as the core parametric estimation), (2) the gap risk calculation, and (3) a portfolio margin floor calculation based on the market values of the long and short positions in the portfolio, which addresses risks that might not be adequately addressed with the other volatility component calculations.

22 See Section I(A)(1)(a)(i)II and I(A)(2)(a)(i)II of Procedure XV of the Rules, supra note 11. See also Exchange Act Release Nos. 82780 (Feb. 26, 2018), 83 FR 9035 (Mar. 2, 2018) (SR-NSCC-2017-808); 82781 (Feb. 26, 2018), 83 FR 9042 (Mar. 2, 2018) (SR-NSCC-2017-020) ("Initial Filing").

23 See Section I(A)(1)(a)(i)II and I(A)(2)(a)(i)II of Procedure XV of the Rules, supra note 11; see Important Notice a9055 (Sept. 27, 2021), at https://www.dtcc.com/-

Rules currently calculate a gap risk charge only for "non-index" positions, meaning positions in the portfolio other than positions in ETFs that track diversified indices. This is because index-based ETFs that track closely to diversified indices are generally considered less prone to the effects of gap risk events.

The risk of large, unexpected price movements, particularly those caused by a gap risk event, are more likely to have a greater impact on portfolios with large net unsettled positions in securities that are susceptible to those events. Generally, index-based ETFs that track closely to diversified indices are less prone to the effects of gap risk events. Therefore, if the concentration threshold is met, NSCC currently calculates the gap risk charge for positions in the portfolio other than positions in ETFs that track diversified indices, referred to as "non-index positions."

To calculate the gap risk charge, NSCC multiplies the gross market value of the largest non-index net unsettled position in the portfolio by a gap risk haircut, which can be no less than 10 percent ("gap risk haircut").[24] Currently, NSCC determines the gap risk haircut empirically as no less than the larger of the 1st and 99th percentiles of three-day returns of a set of CUSIPs that are subject to the VaR Charge pursuant to the Rules, giving equal rank to each to determine which has the highest movement over that three-day period. NSCC uses a look-back period of not less than ten years plus a one-year stress period, and if the one-year stress period overlaps with the look-back period, only the non-overlapping period would be combined with the look-back period. The resulting

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/media/Files/pdf/2021/9/27/a9055.pdf (notifying members that the concentration threshold had been changed from 10% to 5%).

[24] See Section I(A)(1)(a)(i)II and I(A)(2)(a)(i)II of Procedure XV of the Rules, supra note 11.

haircut is then rounded up to the nearest whole percentage and applied to the largest non-index net unsettled position to determine the gap risk charge.

C. Proposed Changes to NSCC's Gap Risk Charge

NSCC is proposing to make the following changes to the gap risk charge: (1) make the gap risk charge an additive component of the member's total VaR Charge when it is applicable, rather than being applied as the applicable VaR Charge only when it is the largest of three separate calculations, (2) adjusting the gap risk charge to be based on the two largest positions in a portfolio, rather than based on the single largest position, (3) changing the floor of the gap risk haircut from 10 percent to 5 percent for the largest position, adding a floor of the gap risk haircut of 2.5 percent for the second largest position, and providing that gap risk haircuts would be determined based on backtesting and impact analysis, (4) amending which ETF positions are excluded from the gap risk charge to more precisely include ETFs that are more prone to gap risk, i.e., are non-diversified, and (5) making certain technical and clarifying changes regarding the gap risk charge.

First, NSCC is proposing to make the result of the gap risk charge calculation an additive component of a member's total VaR Charge, rather than applicable as the VaR Charge only when it is the highest result of three calculations. Under the proposal, the VaR Charge would be equal to the sum of (1) the greater of either the core parametric estimation or the portfolio margin floor calculation, neither of which is changing in this proposal,[25] and (2) the gap risk charge calculation. Rather than being applied only when the gap risk charge exceeds the other two calculations, the gap risk charge calculation

[25] See note 23 supra.

would apply every time the top two positions exceed the concentration threshold and would always be a portion of the overall VaR Charge in such circumstances. NSCC states that making this charge additive could improve its ability to mitigate idiosyncratic risks that it could face through the collection of the VaR Charge.[26] Based on impact studies, NSCC believes this broader application together with the other proposed changes outlined below would better protect against more idiosyncratic risk scenarios than the current methodology.[27]

Second, NSCC is proposing to make the gap risk charge rely upon the absolute values of the two largest non-diversified net unsettled positions, as opposed to using the absolute value of only the single largest non-diversified net unsettled position. Therefore, the gap risk charge would be calculated by first multiplying each of the two largest non-diversified net unsettled positions with a gap risk haircut, and then adding the sum of the resulting products. The gap risk charge would be applicable if that sum of the resulting products exceeded the concentration threshold.[28] NSCC states that applying the gap risk charge to the two largest non-diversified positions in the portfolio would cover

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26 See Notice of Filing, supra note 3, 87 FR at 78159.

27 Id.

28 As noted in Section II.B above, the concentration threshold is currently set at 5%, and the Rules define the concentration threshold as no more than 30 percent of the value of the entire portfolio. See Section I(A)(1)(a)(i)II and I(A)(2)(a)(i)II of Procedure XV of the Rules, supra note 11. The proposed changes would clarify that the concentration threshold is not fixed at 30 percent by defining concentration threshold as a percentage designated by NSCC of the value of the entire portfolio and determined by NSCC from time to time, and that shall be no more than 30 percent. NSCC believes this proposed change will help clarify that the concentration threshold could change from time to time but could not be set to be more than 30 percent. See Notice of Filing, supra note 3, 87 FR at 78161.

concurrent gap moves involving more than one concentrated position, adding more flexibility and coverage.[29]

Third, NSCC proposes to revise the calculation of the gap risk haircut in response to making the proposal an additive component of a member's VaR Charge. Currently, the gap risk haircut is determined by selecting the largest of the 1st and 99th percentiles of three-day returns of a composite set of equities, using a look-back period of not less than 10 years plus a one year stress period.[30] NSCC believes that this methodology results in implicit overlapping of the risk covered by the core parametric VaR and the gap risk charge.[31] Because the proposal would make the gap risk charge an additive component to the VaR Charge rather than a substitutive component, NSCC does not believe that the current methodology for the gap risk haircut would result in an appropriate level of margin.[32] Under the proposal, NSCC would determine and calibrate the concentration threshold and the gap risk haircut periodically based on backtesting and impact analysis. NSCC states that the concentration threshold and the gap risk haircuts would be selected from various combinations of concentration thresholds and gap risk haircuts based on backtesting and impact analysis across all member portfolios, initially using a five year look-back period.[33] NSCC believes that this would provide more flexibility to set the parameters from time to time to provide improved backtesting

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[29] See Notice of Filing, supra note 3, 87 FR at 78160.

[30] Id. at 78161.

[31] See id.

[32] Id.

[33] Id.

performance, broader coverage for idiosyncratic risk scenarios and flexibility for model tuning to balance performance and cost considerations.[34]

In addition, NSCC proposes to revise the determination of the gap risk haircut in response to the proposal's inclusion of the two largest non-diversified net unsettled positions, as opposed to only the one, and to its additive nature. Currently, the percent that is applied to the largest non-index net unsettled position in the portfolio is no less than 10 percent.[35] Because of the proposal's shift to including the two largest positions, NSCC believes it is appropriate to set a lower floor for the gap risk haircut that applies to the largest of those two positions.[36] Moreover, because the gap risk charge would now be additive and would apply more frequently, NSCC believes that the flexibility to set a lower floor for the largest position would be appropriate.[37]

Specifically, NSCC is proposing to lower the gap risk haircut that would be applied to the largest non-diversified net unsettled position to be a percent that is no less than 5 percent. The gap risk haircut that would be applied to the second largest non-diversified net unsettled position in the portfolio would be no larger than the gap risk haircut that would be applied to the largest non-diversified net unsettled position and would be subject to a floor of 2.5 percent. NSCC states that, upon implementation of the proposed rule change, NSCC would set the concentration threshold at 10%, apply a gap risk haircut on the largest non-diversified net unsettled position of 10% and a gap risk

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[34] Id.

[35] Id.

[36] Id.

[37] Id.

haircut on the second largest non-diversified net unsettled position of 5%.[38] NSCC would set the concentration threshold and the gap risk haircuts based on backtesting and impact analysis in accordance with NSCC's model risk management practices and governance set forth in the Model Risk Management Framework.[39] NSCC would provide notice to members by important notice of the concentration threshold and gap risk haircuts that it would be applying.

Fourth, NSCC is proposing to amend what positions are excluded from the gap risk charge calculation. Currently, only "non-index" positions and index-based exchange-traded products that track a narrow market index are included in the gap risk charge.[40] Under the proposal, this would be revised to refer to "non-diversified" positions instead of non-index positions. The rule text would specify that NSCC would exclude ETF positions from the calculation (that is, it would consider them diversified) if the positions have characteristics that indicate that they are less prone to the effects of gap risk events, including whether the ETF positions track to an index that is linked to a broad based market index, contain a diversified underlying basket, are unleveraged or track to an asset class that is less prone to gap risk. NSCC states that the proposed change would result in certain non-index based ETFs being excluded from the gap risk

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38 Id.

39 See Exchange Act Release Nos. 81485 (Aug. 25, 2017), 82 FR 41433 (Aug. 31, 2017) (File No. SR-NSCC-2017-008); 84458 (Oct. 19, 2018), 83 FR 53925 (Oct. 25, 2018) (File No. SR-NSCC-2018-009); 88911 (May 20, 2020), 85 FR 31828 (May 27, 2020) (File No. SR-NSCC-2020-008); 92381 (July 13, 2021), 86 FR 38163 (July 19, 2021) (File No. SR-NSCC-2021-008); and 94272 (Feb. 17, 2022), 87 FR 10419 (Feb. 24, 2022) (File No. SR-NSCC-2022-001). NSCC's model risk management governance procedures include daily backtesting of model performance, periodic sensitivity analyses of models and annual validation of models. They would also provide for review of the concentration threshold and the gap risk haircuts at least annually.

40 See Section I(A)(1)(a)(i)II and I(A)(2)(a)(i)II of Procedure XV of the Rules, supra note 11. See also Initial Filing, supra note 22.

charge whereas they are currently included, such as unleveraged U.S. dollar based ETFs.[41] NSCC also states that this proposed change would provide greater transparency to members regarding which positions are excluded from this calculation.[42]

NSCC states that certain ETFs, both index based and non-index based, are less prone to the effects of gap risk events as a result of having certain characteristics and, therefore, are less likely to pose idiosyncratic risks that the gap risk charge is designed to mitigate.[43] By contrast, based on the proposed methodology, NSCC would include certain commodity ETFs in the gap risk charge that track to an index that is not a broad-based diversified commodity index; such ETFs are not currently subject to the gap risk charge, but would be subject going forward.

Fifth, NSCC would make certain technical and clarifying changes regarding the gap risk charge, as detailed in the Notice of Filing.[44]

III. DISCUSSION AND COMMISSION FINDINGS

Section 19(b)(2)(C) of the Act[45] 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

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41 See Notice of Filing, supra note 3, 87 FR at 78160.

42 Id. NSCC states that it uses a third-party provider to identify ETFs that meet its criteria of being diversified. See id.

43 Id.

44 See id. at 78161-62 (describing technical changes (i) regarding the gap risk charge for securities financing transactions cleared by NSCC, the methodology of which already includes the gap risk charge as an additive component to margin and which would not change as a result of this proposal, (ii) to make clear that the gap risk charge applies to Net Unsettled Positions, (iii) to remove an unnecessary reference, (iv) to reflect that NSCC considers impact analysis when determining and calibrating the concentration threshold and gap risk haircuts, and (v) to make other technical changes for clarity).

45 15 U.S.C. 78s(b)(2)(C).

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)[46] of the Act and Rules 17Ad-22(e)(4)(i) and (e)(6)(i) thereunder.[47]

A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency 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 promote the public interest.[48]

The Commission believes that the proposed changes to the calculation of the gap risk charge described in section II.C above should allow NSCC to ensure that it continues to collect margin sufficient to address the risks posed by its members' portfolios. Based on its review of the confidential information provided by NSCC and reviewed by the Commission, including the impact study demonstrating the collective impact of the proposed changes on the margin collected both at the overall clearing agency level and on a member-by-member basis and on NSCC's backtesting performance,[49] the proposed

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[46] 15 U.S.C. 78q-1(b)(3)(F).

[47] 17 CFR 240.17Ad-22(e)(4)(i) and (e)(6)(i).

[48] 15 U.S.C. 78q-1(b)(3)(F).

[49] NSCC submitted more detailed results of the impact study as confidential Exhibit 3 to the Proposed Rule Change. NSCC requested confidential treatment of Exhibit 3 pursuant to 5 U.S.C. 552(b)(4) and 552(b)(8) and 17 CFR. 200.80(b)(4) and 200.80(b)(8). A commenter raised a concern regarding redacted portions of the filing, which consisted of certain supporting exhibits filed confidentially as Exhibit 3 to the filing. See https://www.sec.gov/comments/sr-nscc-2022-015/srnscc2022015-320658.htm. NSCC asserted that this exhibit to the filing was entitled to

changes with respect to the calculation of the gap risk charge provide better margin coverage than the current methodology.

The Commission believes that making the gap risk charge an additive component, as opposed to a potential substitutive option applicable only if it exceeds other methodologies for determining the VaR Charge, should help NSCC better protect against more idiosyncratic risk scenarios in concentrated portfolios than the current methodology. In addition, adjusting the gap risk calculation to take into account the two largest positions, as well as to apply two separate haircuts based on backtesting and impact analysis with floors set forth in the Rules, should allow NSCC to cover concurrent gap moves involving more than one concentrated position. Moreover, modifying the criteria for ETF positions subject to the gap risk charge based on whether they are non-diversified rather than whether they are non-index would allow NSCC to more accurately determine which ETFs should be included and excluded from the gap risk charge based

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confidential treatment because it contains: (i) trade secrets and commercial information that is privileged or confidential and which, if disclosed, would be accessible to the DTCC Companies' competitors and could result in substantial competitive injury to the DTCC Companies; and (ii) non-public, confidential information prepared for use by Commission staff. Under Section 23(a)(3) of the Exchange Act, the Commission is not required to make public statements filed with the Commission in connection with a proposed rule change of a self-regulatory organization if the Commission could withhold the statements from the public in accordance with the Freedom of Information Act ("FOIA"), 5 U.S.C. 552. 15 U.S.C. 78w(a)(3). The Commission has reviewed the documents for which NSCC requests confidential treatment and concludes that they could be withheld from the public under the FOIA. FOIA Exemption 4 protects confidential commercial or financial information. 5 U.S.C. 552(b)(4). Under Exemption 4, information is confidential if it "is both customarily and actually treated as private by its owner and provided to government under an assurance of privacy." Food Marketing Institute v. Argus Leader Media, 139 S. Ct. 2356, 2366 (2019). Based on its review of the materials submitted, the Commission believes that the information is the type that would not customarily be disclosed to the public. Specifically, this information consists of an impact study analyzing the effect that the changes to NSCC's margin methodology would have on each member's individual margin requirement to NSCC; information regarding NSCC's analysis and development of the particular changes to the margin methodology, including its consideration of potential alternative haircuts and thresholds; and excerpts from NSCC's non-public detailed margin methodology. In addition, by requesting confidential treatment, NSCC had an assurance of privacy because the Commission generally protects information that can be withheld under Exemption 4. Thus, the Commission has determined to accord confidential treatment to the confidential exhibits.

on characteristics that indicate that such ETFs are more or less prone to the effects of gap risk events, thereby providing more accurate coverage of the potential exposure arising from such positions.

For these reasons, the Commission believes that the Proposed Rule Change should enable NSCC to better manage its exposure to portfolios with identified concentration risk, thereby limiting its exposure to members in the event of a member default. The proposal should help ensure that, in the event of a member default, NSCC's operation of its critical clearance and settlement services would not be disrupted because of insufficient financial resources. Accordingly, the Commission finds that NSCC's proposal should help NSCC to continue providing prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.

Moreover, as described in Section II.A above, NSCC would access the mutualized clearing fund should a defaulted member's own margin be insufficient to satisfy losses to NSCC caused by the liquidation of that member's portfolio. Because NSCC's proposal to amend its calculation of the gap risk charge should help ensure that NSCC has collected sufficient margin from members, the proposed changes would also help minimize the likelihood that NSCC would have to access the clearing fund, thereby limiting non-defaulting members' exposure to mutualized losses. The Commission believes that by helping to limit the exposure of NSCC's non-defaulting members to mutualized losses, the proposed changes should help NSCC assure the safeguarding of securities and funds which are in its custody or control, consistent with Section 17A(b)(3)(F) of the Act.[50]

[50] 15 U.S.C. 78q-1(b)(3)(F).

Finally, as described in section II.C above, the proposed rule changes would amend the Rules to incorporate technical and clarifying changes regarding the gap risk charge. These changes should help ensure that NSCC's members understand how the gap risk charge would be determined, thereby improving transparency. The Commission believes that such changes would ensure that the Rules are accurate and clear to NSCC's members, thus promoting prompt and accurate clearance and settlement, which is consistent with Section 17A(b)(3)(F) of the Act.[51]

B. Consistency with Rule 17Ad-22(e)(4)(i) under the Exchange Act

Rule 17Ad-22(e)(4)(i) under the Exchange Act requires that a 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.[52]

Based on its review of the record, the Commission believes NSCC's proposal to broaden the scope of the gap risk charge and the related adjustments to its calculation could help improve NSCC's backtesting performance, provide broader coverage for idiosyncratic risk scenarios, and could help address the potential increased risks NSCC may face related to its ability to liquidate a portfolio that is susceptible to such risks in the event of a member default. Specifically, the Commission has reviewed and analyzed NSCC's analysis of the improvements in its backtesting coverage,[53] and agrees that the

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51 Id.

52 17 CFR 240.17Ad-22(e)(4)(i).

53 See supra note 49.

analysis demonstrates that the proposal would result in better backtesting coverage and, therefore, less credit exposure to its members.

Accordingly, the Commission believes that the proposal would enable NSCC to better manage its credit risks by allowing it to respond regularly and more effectively to any material deterioration of backtesting performances, market events, market structure changes, or model validation findings, thereby helping to ensure that NSCC can take steps to collect sufficient margin to maintain sufficient financial resources to cover its exposure to its members. Therefore, the Commission believes the Proposed Rule Change is consistent with Rule 17Ad-22(e)(4)(i) under the Exchange Act.

C. <u>Consistency with Rule 17Ad-22(e)(6)(i) under the Exchange Act</u>

Rule 17Ad-22(e)(6)(i) under the Exchange 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.[54]

The Commission understands that, as described above, the proposal as a whole is designed to enable NSCC to more effectively address the risks presented by members' concentrated positions in securities more prone to gap risk events and to produce margin levels that are more commensurate with the particular risk attributes of these concentrated holdings, including the market price risk of liquidating large positions in securities that are more prone to gap risk events. The Commission believes that the proposal would

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[54] 17 CFR 240.17Ad-22(e)(6)(i).

improve NSCC's ability to consider, and produce margin levels commensurate with, the risks and particular attributes presented by a portfolio that meets the concentration threshold and, therefore, is more susceptible to the impacts of idiosyncratic risks.

First, the Commission believes that broadening the gap risk charge to an additive feature of the VaR Charge and using the two largest non-diversified positions would help NSCC to more effectively manage the idiosyncratic risks of portfolios with concentrated holdings. Specifically, the proposed changes should result in an overall increase of margin for members that have positions subject to the gap risk charge.[55]

Second, given the proposed additive nature of the gap risk charge, the Commission believes the adjustments to the gap risk charge calculation (i.e., establishing floors for the gap risk haircuts applicable to the two largest positions) are reasonably designed to cover NSCC's exposure to members arising from gap risks. The Commission believes the adjustments to the gap risk charge calculation are reasonable because the record shows the proposal should improve NSCC's ability to mitigate against idiosyncratic risks that NSCC may face when liquidating a portfolio that contains a concentration of positions, while balancing NSCC's consideration of the potential costs to members that may be subject to the gap risk charge.[56] The Commission believes that the established floors for

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55 The impact study indicated that the proposed changes would have resulted in a 10.88% increase for the daily total VaR Charge on average and would have resulted in a 4.89% increase in the daily total clearing fund on average during that period. See Notice of Filing, supra note 3, 87 FR at 78158. In addition, the Commission reviewed confidential materials submitted to the Commission, which included more granular information, at a member level, of the impacts of this proposal as compared to the current methodology. See note 49 supra.

56 As part of the confidential materials submitted to the Commission, NSCC provided analysis of alternative potential haircuts and thresholds that it considered when developing the proposal. See note 49 supra. The Commission's review of those materials further supports its belief as to the reasonableness of this aspect of the proposal.

the two haircuts should also help ensure that the gap risk charge collects margin sufficient to cover the potential exposure in a gap risk event.

Third, by providing additional specific objective criteria to determine which positions would be subject to the gap risk charge, the Commission believes that NSCC should be able to better identify those securities that may be more prone to idiosyncratic risks. Specifically, the proposal should ensure that ETFs identified as non-diversified (whether index-based or not) and therefore more prone to idiosyncratic risks will be subject to the gap risk charge.

Taken together, the Commission believes that the proposal should permit NSCC to calculate a gap risk charge that is more appropriately designed to address the gap risks presented by concentrated positions in portfolios. Accordingly, the Commission believes the proposal is consistent with Rule 17Ad-22(e)(6)(i) under the Exchange Act because it is designed to assist NSCC in maintaining a risk-based margin system that considers, and produces margin levels commensurate with, the risks and particular attributes of portfolios with identified concentration risks.[57]

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57 17 CFR 240.17Ad-22(e)(6)(i).

IV. 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 Act[58] and the rules and regulations promulgated thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act[59] that proposed rule change SR-NSCC-2022-015, be, and hereby is, APPROVED.[60]

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[61]

Sherry R. Haywood,

Assistant Secretary.

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58 15 U.S.C. 78q-1.

59 15 U.S.C. 78s(b)(2).

60 In approving the Proposed Rule Change, the Commission considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

61 17 CFR 200.30-3(a)(12).