

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-68982; File No. SR-DTC-2012-810)

February 25, 2013

Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing Amendment No. 1 and No Objection to Advance Notice Filing, as Modified by Amendment No. 1, to Reduce Liquidity Risk Relating to Its Processing of Maturity and Income Presentments and Issuances of Money Market Instruments

I. Introduction

On December 28, 2012, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-DTC-2012-810 (“Advance Notice”) pursuant to Section 806(e) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”),¹ entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act” or “Title VIII”) and Rule 19b-4(n) of the Securities Exchange Act of 1934 (“Exchange Act”). The Advance Notice was published in the Federal Register on January 18, 2013.² DTC filed Amendment No. 1 to the Advance Notice on January 30, 2013.³ The Commission received one comment on the Advance

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

² Release No. 34-68690 (Jan. 18, 2013), 78 FR 5516 (Jan. 25, 2013). DTC also filed a proposed rule change under Section 19(b)(1) of the Exchange Act relating to these changes. Release No. 34-68548 (Dec. 28, 2012), 78 FR 795 (Jan. 4, 2013). The Commission extended the period of review of the proposed rule change on February 5, 2013. Release No. 34-68834 (Feb. 5, 2013), 78 FR 9762 (Feb. 11, 2013).

³ The Amendment revised the text of DTC’s Settlement Service Guide related to the Advance Notice by adding a sentence to clarify the change as stated in the Advance Notice and correcting a grammatical error.

Notice.⁴ This publication serves as notice of filing Amendment No. 1 and of no objection to the Advance Notice, as modified by Amendment No. 1.

II. Analysis

A. Description of MMI Processing and Proposed Rule Change

DTC filed the Advance Notice to permit it to make rule changes designed to reduce liquidity risk relating to DTC's processing of maturity and income presentments ("Maturity Obligations") and issuances of money market instruments ("MMIs"), as discussed below.

MMIs are settled at DTC on a trade-for-trade basis. Issuers of MMIs that are not direct members of DTC enlist banks ("Issuing/Paying Agent" or "IPA") to issue MMIs to broker-dealers, who in turn sell the MMIs to MMI investors. Debt issuance instructions are transmitted to DTC by the IPA, which triggers DTC crediting the IPA's DTC account and creating a deliver order to the broker-dealers' accounts on behalf of the investors.

Maturity Obligations are initiated automatically by DTC early each morning for MMIs maturing that day. DTC debits the amount of the Maturity Obligations to the appropriate IPA's account and credits the same amount to the appropriate broker-dealer and custodian accounts. The debits and credits are conditional until final settlement at the end of the day. According to DTC, IPAs do not have a legal obligation to honor maturing MMIs if they have not received funding from the issuer.

According to DTC, the common source of funding for Maturity Obligations is new issuances of MMIs in the same acronym by the same issuer on the day the Maturity Obligations

⁴ See Comment from Karen Jackson dated December 30, 2012, <http://sec.gov/comments/sr-dtc-2012-10/dtc201210-1.htm>. The comment discusses the ability of individuals to withdraw money from money market accounts, which is not implicated by the proposed rule change.

are due. In a situation where new MMI issuances exceed the Maturity Obligations, the issuer would have no net funds payment due to the IPA on that day. However, because Maturity Obligations are processed and debited from IPA accounts automatically, IPAs currently incur credit risk if the issuers do not issue MMIs that exceed the Maturity Obligations.⁵ Because IPAs do not have a legal obligation to honor maturing MMIs in the absence of funding from the issuer, IPAs may communicate to DTC an Issuer Failure/Refusal to Pay (“RTP”) for any issuer acronym up to 3:00 p.m. ET on the day of the affected Maturity Obligation. Such an instruction causes DTC, pursuant to its Rules, to reverse all transactions related to that issuer’s acronym, including Maturity Obligations and any new MMI issuances, posing a potential for systemic risk since the reversals may override DTC’s risk management controls such as the Collateral Monitor (“CM”)⁶ and net debit cap (“Net Debit Cap,” collectively with CM, “Settlement Risk Controls”).⁷

⁵ DTC guidelines suggest that issuers fund their net debit obligations to the IPA by 1:00 p.m. ET to alleviate this credit risk.

⁶ A DTC “Participant” is a regulated institution that is eligible to use and uses DTC’s services. See DTC Participant Handbook (Sept. 2011). DTC tracks collateral in a Participant’s DTC account through the CM. At all times, the CM reflects the amount by which the collateral value in the account exceeds the net debit balance in the account. When processing a transaction, DTC verifies that the CM of each of the deliverer and receiver will not become negative when the transaction is processed. If the transaction would cause either party to have a negative CM, the transaction will recycle until the deficient account has sufficient collateral to proceed or until the applicable cutoff occurs. See id.

⁷ The Net Debit Cap control is designed so that DTC may complete settlement even if a Participant fails to settle. Before completing a transaction in which a Participant is the receiver, DTC calculates the effect the transaction would have on such Participant’s account, and determines whether any resulting net debit balance would exceed the Participant’s net debit cap. Any transaction that would cause the net debit balance to exceed the net debit cap is placed on a pending (recycling) queue until the net debit cap will not be exceeded by processing the transaction. See DTC Participant Handbook (Sept. 2011).

DTC currently withholds intraday from each MMI member the largest provisional net credit (“LPNC”) of a single issuer’s acronym for purposes of calculating the member’s position in relation to the Settlement Risk Controls. DTC believes that the LPNC control helps protect DTC against either (i) the single largest issuer failure on a business day, or (ii) multiple failures on a business day that, taken together, do not exceed the largest provisional net credit.

Recent market events have increased DTC’s awareness of the possibility of multiple simultaneous MMI issuer failures. Multiple simultaneous MMI issuer failures may cause more IPAs on a given day to communicate an RTP to DTC, which could increase the amount of the reversal that could override the DTC Settlement Risk Controls. As a result, DTC is increasing the LPNC withholding to the two largest net credits (on an acronym basis). In order to alleviate any settlement blockage that may occur as a result of withholding the two largest LPNCs and to promote settlement finality, DTC will no longer process an RTP initiated by an IPA that serves as both an issuing agent and a paying agent in the same acronym on the same day when new MMI issuances in an acronym exceed, in dollar value, the Maturity Obligations in the same acronym on the same day and the receiving members’ Settlement Risk Controls permit completion of the transaction. As a result, DTC will remove the LPNC withholding with respect to such acronyms at the point in time when it eliminates the IPA’s option to initiate an RTP.

B. Discussion

Although Title VIII does not specify a standard of review for an Advance Notice, the stated purpose of Title VIII is instructive.⁸ The stated purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market

⁸ 12 U.S.C. 5461(b).

utilities (“FMUs”)⁹ and providing an enhanced role for the Federal Reserve Board in the supervision of risk management standards for systemically-important FMUs.¹⁰

Section 805(a)(2) of the Clearing Supervision Act¹¹ authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Clearing Supervision Act¹² states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

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

The Commission adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act on October 22, 2012 (“Clearing Agency Standards”).¹³ The Clearing Agency Standards became effective on January 2, 2013 and require clearing agencies that perform central counterparty services to establish, implement, maintain, and enforce written

⁹ DTC was designated a systemically-important FMU on July 18, 2012, by the Financial Stability Oversight Council. Financial Stability Oversight Council 2012 Annual Report, Appendix A, <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>.

¹⁰ 12 U.S.C. 5461(b).

¹¹ 12 U.S.C. 5464(a)(2).

¹² 12 U.S.C. 5464(b).

¹³ Release No. 34-68080 (Oct. 22, 2012), 77 FR 66219 (Nov. 2, 2012).

policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.¹⁴ As such, it is appropriate for the Commission to review Advance Notices against these risk management standards that the Commission promulgated under Section 805(a) and the objectives and principles of these risk management standards as described in Section 805(b).

The proposal to increase the LPNC withholding from one to two on an acronym basis is designed to further mitigate intraday credit risk borne by DTC and its members during the time between the initiation of Maturity Obligations and the MMI issuer funding for those Maturity Obligations, typically by issuing new MMIs. DTC states that the initiative for the proposal was a heightened awareness of the possibility of multiple simultaneous MMI issuer failures. The proposal to no longer process an RTP initiated by an IPA when new issuances in an acronym exceed, in dollar value, the Maturity Obligations in the same acronym on the same day is designed to promote settlement finality and to alleviate the possibility of settlement blockage that may result from DTC increasing the LPNC withholding from one to two. Consistent with Section 805(a), the Commission believes these changes promote the safety and soundness of the operations of DTC, reduce systemic risks typically associated with MMI transactions, and support the stability of the broader financial system by promoting settlement finality of MMI transactions.

Furthermore, Commission Rules 17Ad-22(d)(11) regarding Default Procedures and 17Ad-22(d)(12) regarding Timing of Settlement Finality, both adopted as part of the Clearing

¹⁴ The Clearing Agency Standards are substantially similar to the risk management standards established by the Board of Governors governing the operations of designated FMUs that are not clearing entities and financial institutions engaged in designated activities for which the Commission or the Commodity Futures Trading Commission is the Supervisory Agency. See Financial Market Utilities, 77 FR 45907 (Aug. 2, 2012).

Agency Standards,¹⁵ require that clearing agencies establish, implement, maintain and enforce, written policies and procedures reasonably designed to establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default, and require that intraday or real-time finality be provided where necessary to reduce risks, respectively.¹⁶ Here, as described in detail above, DTC's proposed rule change to increase the LPNC from one to two largest provisional credits should help it better contain losses and liquidity pressures, yet continue to meet its obligations; meanwhile, DTC's proposed rule change to no longer process RTPs for an acronym when the described circumstances are met and, then, remove the LPNC for the same acronym when an RTP is no longer viable should improve settlement finality, thus reducing DTC's risk. Since RTPs will no longer be processed when new issuances in an acronym exceed Maturity Obligations in the same acronym in the same day, removing the LPNC control in these cases should not increase DTC's exposure to MMI issuer credit risk.

¹⁵ Release No. 34-68080 (Oct. 22, 2012), 77 FR 66219 (Nov. 2, 2012).

¹⁶ Id. at 131-139.

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act,¹⁷ that the Commission DOES NOT OBJECT to the proposed rule change described in the Advance Notice, as modified by Amendment No. 1, and that DTC be and hereby is AUTHORIZED to implement the proposed rule change as of the date of this notice or the date of the “Notice of Filing Amendment No. 2 and Order Approving Proposed Rule Change, as Modified by Amendment No. 2, to Reduce Liquidity Risk Relating to [DTC’s] Processing of Maturity and Income Presentments and Issuances of Money Market Instruments,” SR-DTC-2012-10, whichever is later.

By the Commission.

Kevin M. O’Neill
Deputy Secretary

¹⁷ 12 U.S.C. 5465(e)(1)(I).