

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-67059; File No. SR-FICC-2012-04)

May 24, 2012

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Clarify the Ability of the Government Securities Division to Use Implied Volatility Indicators as part of the Volatility Model in its Clearing Fund Formula

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder² notice is hereby given that on May 15, 2012, Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared primarily by FICC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Government Securities Division (“GSD”) of FICC proposes to amend the definition of VaR Charge in Rule 1 to clarify the ability of FICC GSD to use implied volatility indicators as part of the volatility model in its clearing fund formula.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FICC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FICC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

significant aspects of these statements.³

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

A primary objective of GSD's Clearing Fund⁴ is to have on deposit from each applicable Member⁵ assets sufficient to satisfy losses that may otherwise be incurred by GSD as the result of the default of the Member and the resultant close out of that Member's unsettled positions under GSD's trade guaranty. The required Clearing Fund deposit of each Member is calculated twice daily⁶ pursuant to a formula set forth in Section 1b of GSD Rule 4 designed to provide sufficient funds to cover this risk of loss. The Clearing Fund formula accounts for a variety of risk factors through the application of a number of components, each described in Section 1b of GSD Rule 4.

The volatility component of the Clearing Fund formula is designed to calculate the amount of money that may be lost on a portfolio over a given period of time assumed necessary to liquidate the portfolio within a given level of confidence. Pursuant to Section 1b of Rule 4, GSD may calculate the volatility component on a value at risk charge ("VaR Charge") "utilizing

³ The Commission has modified the text of the summaries prepared by FICC.

⁴ FICC GSD Rule 1 – Definitions provides that "[t]he term 'Clearing Fund' means the Clearing Fund established by the Corporation pursuant to these Rules, which shall be comprised of the aggregate of all Required Fund Deposits and all other deposits, including Cross-Guaranty Repayment Deposits, to the Clearing Fund."

⁵ FICC GSD Rule 1 – Definitions provides that "[t]he term 'Member' means a Comparison-Only Member or a Netting Member. The term 'Member' shall include a Sponsoring Member in its capacity as a Sponsoring Member and a Sponsored Member, each to the extent specific in Rule 3A."

⁶ A Member's Clearing Fund deposit may also be recalculated on an intraday basis as needed.

such assumptions (including confidence levels) and based on such historical data as [GSD] deems reasonable, and shall cover such range of historical volatility as [GSD] from time to time deems appropriate.”⁷ FICC believes that Section 1b of Rule 4 therefore provides GSD with the flexibility to adjust the calculation of the volatility component of its Clearing Fund formula as needed to react to changes in market conditions, including through the use of such assumptions and data as it deems appropriate within its VaR Charge.

The historical simulation model currently used to calculate the VaR Charge in GSD’s Clearing Fund formula is driven by historical data observed in the fixed-income market. While the model weighs the data it uses in favor of more recent observations, it is still limited in its ability to quickly reflect sudden changes in market volatility, which may lead to the collection of insufficient margin during periods of sudden market volatility.

GSD’s Clearing Fund formula, in particular the VaR Charge, provides GSD with the discretion to adjust the model assumptions and data as necessary to react to these market conditions. To enhance the model’s performance, additional information and other observable market data, including data derived from financial products with future maturity dates, thus may be incorporated into or utilized by the volatility model, including data observed in implied volatility indicators that are derived from historical prices of financial products that have maturity dates in the future (such as the 1-year option on the 10-year swap rate). For the avoidance of doubt, this proposed rule change would amend the definition of VaR Charge to make clear that the assumptions and data utilized in calculating the VaR Charge may be based on observable market data, which may include implied market volatility indicators that are derived from historical prices of financial products that have maturity dates in the future, so as to enhance

⁷ FICC GSD Rule 1 – Definitions defining the term VaR Charge in relevant part.

the performance of the model and enable GSD to more effectively achieve and maintain the confidence level required by regulatory and industry standards.⁸ Incorporation of such information into volatility calculations is a generally accepted practice for portfolio volatility models, currently used by other clearing agencies, and accordingly consistent with current rules of FICC.

GSD reviews its risk management processes against applicable regulatory and industry standards, including, but not limited to: (i) the Recommendations for Central Counterparties (“RCCP”) of the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (“CPSS-IOSCO”) and (ii) the securities laws of the United States and rules promulgated by the Commission.

CPSS-IOSCO RCCP Recommendation 4: Margin requirements recommends that a central counterparty (“CCP”) should maintain sufficient financial resources to cover potential exposures in normal market conditions.⁹ It also recommends that margin models and parameters should be regularly reviewed and back-tested to ensure a 99% coverage level is maintained.

CPSS-IOSCO Recommendation 3: Measurement and management of credit exposures recognizes the need for flexibility in the models underlying the calculation of margin requirements. To this point, the explanatory note to RCCP Recommendation 3 recognizes that, “[t]he appropriate amount of data to use [in a CCP’s margin formula] will vary from market to

⁸ The text of the proposed change to the definition of VaR Charge can be found in Exhibit 5 to proposed rule change SR-FICC-2012-04 at http://www.dtcc.com/downloads/legal/rule_filings/2012/ficc/SR-FICC-2012-04.pdf.

⁹ Normal market conditions is defined in Explanatory Note to RCCP Recommendation 3 as “price movements that produce changes in exposures that are expected to breach margin requirements or other risk control mechanisms only 1% of the time.”

market and over time. If, for example, volatility rises, a CCP may want to use a short interval that better captures the new, higher volatility prevailing in its markets.”¹⁰ Similarly, the Commission proposed Rule 17Ad-22(b)(2) which addresses the margin requirements of a clearing agency that performs CCP services and would require those clearing agencies to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit credit exposures to participants in normal market conditions and use risk-based models and parameters to set margin requirements and review them at least monthly.¹¹ The Commission release that proposed Rule 17Ad-22(b)(2) states, “[m]arket conditions and risks are constantly changing and therefore the models and parameters used by a clearing agency providing CCP services to set margin may not accurately reflect the needs of a clearing agency if they are permitted to remain static.”¹²

FICC believes that this proposed rule change would clarify that GSD at its discretion may utilize implied volatility indicators that are derived from historical prices of financial products that have maturity dates in the future among the assumptions and other observable market data as part of its volatility model. The proposal would also clarify the ability of GSD to adjust its volatility calculations as needed to improve the performance of the model in periods of market volatility. It would therefore assist GSD to maintain the requisite confidence level notwithstanding those market conditions. As such, FICC believes that it conforms to CPSS-

¹⁰ Bank for International Settlements and International Organization of Securities Commissions, Recommendations for Central Counterparties (November 2004) available at www.bis.org/publ/cpss61.pdf.

¹¹ Exchange Act Release No. 34-64017 (March 3, 2011), 76 FR 11472 (March 16, 2011); File No. S7-08-11.

¹² Id.

IOSCO Recommendations 3 and 4, Commission proposed Rule 17Ad-22(b)(2), and Commission proposed Rule 17Ad-22(b)(1).¹³

As an example of one such adjustment to the volatility model, GSD plans to apply a multiplier (the augmented volatility adjustment multiplier) to the VaR Charge. The multiplier is based on the levels of change in current and implied volatility measures. An advantage of this approach is that as volatility subsides in the market so will the effect of the multiplier on Members' margin requirements. The volatility measures will be determined by reference to the implied volatility of the 1-year option on the 10-year USD LIBOR swap rate and the historical volatility of the 10-year USD LIBOR swap rate. It is expected that GSD will provide its Members with advance notice of the multiplier that may be applied to the Members' VaR Charge on a weekly basis.¹⁴ By using a single fixed multiplier based on observable market data, Members will be able to predict the impact on their margin requirement. Although the augmented volatility adjustment multiplier will be automatically applied to each Member's VaR Charge, GSD may in its sole discretion determine to waive the application of the multiplier to all of its Members in circumstances it deems warrant such a waiver.¹⁵

¹³ Commission proposed Rule 17Ad-22(b)(1) addresses the measurement and management of credit exposures by a clearing agency that performs CCP services and would require such a clearing agency to "establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control."

¹⁴ FICC GSD will reserve the right to recalculate the multiplier more frequently than weekly in volatile market conditions.

¹⁵ FICC GSD plans to apply a cap to the multiplier and initially the cap will be set at 2. FICC GSD will reserve the right to change the cap in its sole discretion.

FICC intends that this proposed rule change would be effective on a date no less than ten business days following an Important Notice to Members by FICC announcing any approval by the Commission.

As a clearing agency that performs CCP services, FICC GSD believes that it occupies an important role in the securities settlement system by interposing itself between counterparties to financial transactions and thereby reducing risks faced by participants and contributing to global financial stability. FICC believes that the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical to achieving these risk-reducing goals. FICC believes this proposed rule change would assist GSD in its efforts to ensure the efficacy of its volatility margin methodology in highly volatile markets and, thereby, should reduce GSD's and its Members' exposure to the losses of a defaulting Member.

FICC believes the proposed change is consistent with Section 17A of the Act¹⁶ and the rules and regulations thereunder because the proposed modifications would help assure the safeguarding of securities and funds which are in the custody or control of FICC or for which it is responsible by clarifying that FICC GSD's rules permit it to use implied volatility indicators that are derived from historical prices of financial products that have maturity dates in the future as part of the volatility model in its Clearing Fund formula.

(B) Self-Regulatory Organization's Statement on Burden on Competition

FICC does not believe that the proposed rule change would impose any burden on competition.

¹⁶ 15 U.S.C. 78q-1.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments on the proposed rule change have not yet been solicited or received.¹⁷

FICC will notify the Commission of any other written comments received by FICC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove the proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FICC-2012-04 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FICC-2012-04. This file number should be

¹⁷ FICC originally raised the prospect of the multiplier to the VaR charge to members in Important Notice GOV014.12 on January 27, 2012, to which FICC received comments. The comments FICC received were: (i) that the Important Notice lacked key information, including a sample calculation and details surrounding the application of the multiplier; and (ii) whether the proposal would be detrimental to smaller firms. FICC notified the Commission of the substance of these comments.

included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Section, 100 F Street, N.E., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of FICC and on FICC's website at

http://www.dtcc.com/downloads/legal/rule_filings/2012/ficc/SR-FICC-2012-04.pdf

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FICC-2012-04 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

Kevin M. O'Neill
Deputy Secretary

¹⁸ 17 CFR 200.30-3(a)(12).