

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-68621; File No. SR-NSCC-2012-810)

January 10, 2013

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Advance Notice to Eliminate the Offset of Its Obligations with Institutional Delivery Transactions that Settle at The Depository Trust Company for the Purpose of Calculating Its Clearing Fund Under Procedure XV of Its Rules & Procedures

Pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> thereunder, notice is hereby given that on December 18, 2012, the National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) the advance notice described in Items I, II and III below, which Items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments on the advance notice from interested persons.

I. Clearing Agency’s Statement of the Terms of Substance of the Advance Notice

NSCC proposes to modify its Rules & Procedures (“Rules”) to eliminate the offset of NSCC obligations with institutional delivery (“ID”) transactions that settle at the Depository Trust Company (“DTC”) for the purpose of calculating the NSCC clearing fund (“Clearing Fund”) under Procedure XV of the Rules.

II. Clearing Agency’s Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the advance notice and discussed any comments it received on the advance notice. The text of these statements may be examined at the places specified in Item IV below. NSCC

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<sup>1</sup> 12 U.S.C. 5465(e)(1).

<sup>2</sup> 17 CFR 240.19b-4(n)(i).

has prepared summaries, set forth in sections (A) and (B) below, of the most significant aspects of these statements.<sup>3</sup>

(A) Advance Notices Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Description of Change

*Background*

A primary objective of NSCC's Clearing Fund is to have on deposit from each applicable clearing member ("Member") assets sufficient to satisfy losses that may otherwise be incurred by NSCC as the result of the default of the Member and the resultant close out of that Member's unsettled positions under NSCC's trade guaranty. Each Member's Clearing Fund required deposit is calculated daily pursuant to a formula set forth in Procedure XV of the Rules 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 Procedure XV.<sup>4</sup>

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<sup>3</sup> The Commission has modified the text of the summaries prepared by NSCC.

<sup>4</sup> In addition to those described in this filing, Clearing Fund components also include (i) a mark-to-market component which, with certain exclusions, takes into account any difference between the contract price and market price for net positions of each security in a Member's portfolio through settlement; (ii) a "special charge" in view of price fluctuations in or volatility or lack of liquidity of any security; (iii) an additional charge relating to a Member's outstanding fail positions; (iv) a "specified activity charge" for transactions scheduled to settle on a shortened settlement cycle (i.e., less than T+3 or T+3 for "as-of" transactions); (v) an additional charge that NSCC may require of Members on surveillance status; and (vi) an "Excess Capital Premium" that takes into account the degree to which a Member's collateral requirement compares to the Member's excess net capital by applying a charge if a Member's Required Deposit, minus any amount applied from the charges described in (ii) and (iii) above, is above its required capital.

The Value-at-Risk component, or “VaR,” is a core component of this formula and 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.<sup>5</sup> The Market Maker Domination component, or “MMDOM,” is charged to Market Makers,<sup>6</sup> or firms that clear for them. In calculating the MMDOM, if the sum of the absolute values of net unsettled positions in a security for which the firm in question makes a market is greater than that firm’s excess net capital, NSCC may then charge the firm an amount equal to such excess or the sum of each of the absolute values of the affected net unsettled positions, or a combination of both. MMDOM operates to identify concentration within a given CUSIP.

Pursuant to Procedure XV of the Rules, NSCC may calculate the VaR and MMDOM components of a Member’s Clearing Fund requirement after taking into account any offsetting pending (i.e., non-fail) ID transactions that have been confirmed and/or affirmed through an institutional delivery system acceptable to NSCC (typically Omgeo LLC (“Omgeo”), a joint venture of the Depository Trust and Clearing Corporation and Thomson Reuters) (“ID Offset”).<sup>7</sup>

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<sup>5</sup> NSCC’s equity VaR model assumes a 99% confidence interval, uses a 150-day historical look-back period, and assumes a three-day liquidation period. In effect, NSCC assumes the market conditions observed over the past 150 days are predictive of the market conditions expected over the course of the next three business days. Pursuant to Procedure XV, NSCC may exclude from the VaR charge “Net Unsettled Positions in classes of securities whose volatility is (x) less amenable to statistical analysis, such as OTC Bulletin Board or Pink Sheet issues or issues trading below a designated dollar threshold, or (y) amenable to generally accepted statistical analysis in a complex manner, such as municipal or corporate bonds.” The charge for such positions is determined by multiplying the absolute value of the positions by a pre-determined percentage.

<sup>6</sup> As used in Procedure XV, the term Market Maker means a firm that is registered by FINRA as a Market Maker.

<sup>7</sup> The changes proposed by this advance notice will not impact NSCC’s ID Net Service.

NSCC is proposing to eliminate the ID Offset from its Clearing Fund calculations in order to eliminate the market risk that, in the event NSCC ceases to act for a Member with pending ID transactions, it may be unable to complete those pending ID transactions in the time frame contemplated by its current Clearing Fund calculations and, as a result, may have insufficient margin in its Clearing Fund.

*ID Transactions*

The parties involved in an institutional trade include the institutional investor (such as mutual funds, insurance companies, hedge funds, bank trust departments, and pension funds), the investment manager (who enters trade orders on behalf of institutional investors), the buying broker and the selling broker, and custodian banks.<sup>8</sup> Trades between the buying broker and the selling broker are typically settled through NSCC's Continuous Net Settlement system ("CNS").<sup>9</sup>

Before ID trades are sent to DTC, where they settle delivery versus payment, the trade allocation details are matched between the executing broker and the institutional investor. After an executing broker has provided a final notice of execution associated with the client's order, most institutional clients will provide trade allocation details to the executing broker using a

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<sup>8</sup> Prime broker ID transactions settling at NSCC are not included in the ID Offset, as they are included in the Member's NSCC activity once such transactions are affirmed, and, therefore, are not addressed in this filing. The ID transactions included in the ID Offset and described in this advance notice are activity that is held in custody at a bank.

<sup>9</sup> CNS is NSCC's core netting and allotting system, where all eligible compared and recorded transactions for a particular settlement date are netted by issue into one net long (buy) or net short (sell) position, and NSCC becomes the contra-party for settlement purposes, assuming the obligation of its Members that are receiving securities to receive and pay for those securities, and the obligation of Members that are delivering securities to make the delivery.

service provided by Omgeo. When the executing broker accepts and processes the trade allocations, an electronic confirmation is provided through Omgeo's TradeSuite service to the institutional investor or its agent (typically the institutional client's custodian bank) for affirmation. Omgeo links with the various parties to institutional trades to provide real-time central matching capabilities, electronically comparing trade details and notifying parties of any exceptions. After the trade allocation details are affirmed, the trade is considered matched and institutional delivery details are sent to DTC for settlement.

Completion of the money and securities settlement of institutional trades occurs at DTC. Because investment managers are not participants of and do not have direct accounts at DTC, their securities are held in custodial accounts with banks who are participants at DTC. Therefore, when the institutional delivery details for confirmed and affirmed ID trades are sent to DTC from Omgeo, the delivering investment manager's custodian bank or broker, as the case may be, must authorize the delivery, generating a deliver order that will settle in accordance with DTC's rules.

NSCC Risk Management receives a daily feed from Omgeo, including both ID trades that have only been confirmed as well as those that have also been affirmed. For purposes of the ID Offset, NSCC includes ID trades that are confirmed and/or affirmed on trade date (T) and those ID trades which have been affirmed on T+1 and remain affirmed through settlement date (SD).

#### *ID Offset*

Procedure XV currently allows for a Member's net unsettled NSCC position in a particular CUSIP to be compared to any pending ID transactions settling at DTC for potential offset for purposes of calculating the VaR and the MMDOM components of a Member's Clearing Fund requirement, defined as the ID Offset. The ID Offset is based on the assumption

that, in the event of a Member insolvency, NSCC will be able to close out any trades for which there is a corresponding ID transaction settling at DTC by completing that ID transaction. Therefore, the VaR and the MMDOM components are calculated after taking into account any offsetting pending (i.e., non-fail) ID transactions that have been confirmed and/or affirmed, reducing the Clearing Fund requirement for those Members with ID transactions. ID transactions are included in the ID Offset only if they are on the opposite side of the market from the Member's net NSCC position (i.e., only if they reduce that net position).

*Potential Inability to Complete ID Transactions*

Generally, when NSCC ceases to act for a Member, it is obligated, for those transactions to which the trade guaranty has attached, to pay for deliveries made by non-defaulting Members that are due, through CNS, to the failed Member on the day of insolvency and the days following. As described above, the current calculation of the VaR and MMDOM components of NSCC's Clearing Fund are based on the assumption that, in the event of a Member default, NSCC will be able to complete the pending ID transactions that were used to offset that Member's unsettled NSCC position. If NSCC is unable to complete the ID transactions as contemplated by this calculation, then NSCC may need to liquidate a portfolio that could be substantially different than the portfolio that NSCC collected Clearing Fund for, leaving NSCC potentially under collateralized and exposed to market risk, because when it calculated the Clearing Fund requirement, NSCC assumed, under its current rules, a portfolio that included Member positions to be offset by ID transactions.

There are a number of reasons why NSCC may not be able to complete an insolvent Member's open ID transactions. First, NSCC does not guarantee ID transactions and completion of these transactions by the counterparty of the ID transaction, which is not a Member of NSCC,

is voluntary. Further, the institutional customer is not a Member of NSCC, is not bound by NSCC's Rules, and is not party to any legally binding contract with NSCC that requires the institutional customer or its custodian to complete the transaction. Finally, based on news that a Member may be in distress or insolvent, the institutional customer or its investment advisor may feel compelled to take immediate market action with respect to the institutional buy or sell transaction, in order to reduce its market risk; this effectively eliminates the option for NSCC to complete these transactions, either entirely or on the timetable assumed by the Clearing Fund calculation.

While NSCC's Risk Management systems net ID transactions by CUSIP across all settlement days for the purposes of the ID Offset, ID transactions settle trade by trade between the executing broker and the custodian. As a result, the netted ID position used to offset the NSCC position could potentially be comprised of thousands of individual trades with hundreds of different counterparties. It would be time consuming for NSCC to contact each counterparty individually to get their agreement to complete ID transactions, which would delay the determination of the portfolio requiring liquidation in the event of a cease to act, and thus hold up the prompt close out of the defaulter's open positions, exposing NSCC to additional market risk not covered by the margin collected.

#### *Implementation Time Frame*

Following Commission approval, in order to mitigate the impact of this advance notice, NSCC proposes to implement the changes set forth in this filing on over an 18-month period. On a date no earlier than 10 days following notice to Members by Important Notice ("Initial Implementation Date"), NSCC proposes to eliminate the ID Offset from ID transactions that have only been confirmed, but have not yet been affirmed. At this time, NSCC will continue to

apply the ID Offset to ID transactions that have been affirmed. During the 12-month period following the Initial Implementation Date, NSCC will discuss with Members, whose business will be affected by the elimination of the ID Offset, mechanisms to mitigate this impact.

Beginning on a date approximately 12 months from the Initial Implementation Date, and no earlier than 10 days following notice to Members by Important Notice, NSCC will eliminate from the ID Offset all affirmed ID transactions that have reached settlement date at the time the Clearing Fund calculations are run. Three months later, or approximately 15 months following the Initial Implementation Date, and on a date no earlier than 10 days following notice to Members by Important Notice, NSCC will eliminate from the ID Offset all affirmed ID transactions that have reached either settlement date or the day prior to settlement date. Finally, on a date approximately 18 months following the Initial Implementation Date, and no earlier than 10 days following notice to Members by Important Notice, NSCC will eliminate the ID Offset entirely for all ID transactions. Members will be advised of each proposed implementation date through issuance of NSCC Important Notices, which are publically available at [www.dtcc.com](http://www.dtcc.com).

The table below illustrates this proposed implementation schedule:

**Proposed Implementation Schedule for Elimination of ID Offsets**

<u>Action</u>	<u>Scheduled Implementation</u>
Eliminate from ID Offset those ID transactions that have <b>only</b> been confirmed, but have not yet been affirmed	Following approval of rule filing, and on a date no earlier than 10 days following notice to Members by Important Notice (“Initial Implementation Date”)
Eliminate from ID Offset all affirmed ID transactions that have reached Settlement Date (“SD”)	12 months following the Initial Implementation Date, and on a date no earlier than 10 days following notice to Members by Important Notice
Eliminate from ID Offset all affirmed ID	15 months following the Initial

transactions that have reached SD and the day prior to SD (SD-1)	Implementation Date, and on a date no earlier than 10 days following notice to Members by Important Notice
Eliminate from ID Offset all ID transactions	18 months following the Initial Implementation Date , and on a date no earlier than 10 days following notice to Members by Important Notice

*Proposed Rule Changes*

NSCC proposes to amend Procedure XV to eliminate the ID Offset from calculation of the VaR and MMDOM components of a Member’s Clearing Fund requirement as currently provided for in, with respect to CNS transactions, Section I(A)(1)(a)(i) and Section I(A)(1)(d), and, with respect to Balance Order transactions, Section I(A)(2)(a)(i) and Section I(A)(2)(c).

*Anticipated Effect on and Management of Risk*

As a central counterparty, NSCC occupies an important role in the securities settlement system by interposing itself between counterparties to financial transactions and thereby reducing the risk faced by participants and contributing to global financial stability. In this role, however, NSCC is necessarily subject to certain risks in the event of the default or failure of a Member.

NSCC reviews its risk management processes against federal securities laws and rulemaking promulgated by the Commission, and applicable regulatory and industry guidelines, including but not limited to the Principles for Financial Market Infrastructures (“PFMI”) of the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (“CPSS-IOSCO”).<sup>10</sup> In accordance with

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<sup>10</sup> CPSS-IOSCO PFMI (April 2012), available at <http://www.bis.org/publ/cpss101a.pdf>.

Commission rules,<sup>11</sup> specifically Rule 17Ad-22(b)(1) addressing measurement and management of credit exposures, Rule 17Ad-22(b)(2) addressing margin requirements, and Rule 17Ad-22(d)(11) addressing default procedures, and also in accordance with the PFMI, this advance notice should enhance NSCC's ability to more effectively manage its credit exposures to participants, help ensure that it is able to cover its credit exposures to its participants for all products through an effective, risk-based margin system, limit NSCC's exposures and losses, and enhance protections against market risk that may arise when NSCC ceases to act for a Member with open ID transaction activity.

(B) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

While written comments relating to the advance notice have not yet been solicited, NSCC has received a letter on behalf of certain Members seeking further review of the impact of the proposed changes contained in the advance notice and consideration of alternatives. NSCC notified the Commission of the contents of the letter and promptly delivered a response to those Members addressing their concerns. A Member working group has been established to discuss mechanisms for impacted Members to mitigate the potential impact of the rule changes described in this filing.

III. Date of Effectiveness of the Advance Notice and Timing for Commission Action

The clearing agency may implement the proposed change pursuant to Section 806(e)(1)(G) of the Clearing Supervision Act<sup>12</sup> if it has not received an objection to the

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<sup>11</sup> Securities and Exchange Commission Release No. 34-68080 (October 22, 2012), 77 FR 66219 (November 2, 2012); File No. S7-08-11 (available at <http://www.sec.gov/rules/final/2012/34-68080.pdf>), effective on January 2, 2013.

<sup>12</sup> 12 U.S.C. 5465(e)(1)(G).

proposed change within 60 days of the later of (i) the date that the Commission received the advance notice or (ii) the date the Commission receives any further information it requested for consideration of the notice. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date of receipt of the advance notice, or the date the Commission receives any further information it requested, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission. The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.<sup>13</sup>

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<sup>13</sup> NSCC also filed the proposals contained in this advance notice as a proposed rule change under Section 19(b)(1) of the Act and Rule 19b-4 thereunder. 15 U.S.C. 78s(b)(1); 17 CFR 240.19b-4. Pursuant to Section 19(b)(2) of the Act, within 45 days of the date of publication of the proposed rule change in the Federal Register or within such longer period up to 90 days if the Commission designates or the self-regulatory organization consents the Commission will either: (i) by order approve or disapprove the proposed rule change or (ii) institute proceedings to determine whether the proposed rule change should be disapproved. 17 U.S.C. 78s(b)(2)(A). See Release No. 34-68549 (December 28, 2012), 78 FR 792 (January 4, 2013).

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the advance notice is consistent with the Clearing Supervision Act. Comments may be submitted by any of the following methods:

##### 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](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2012-810 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, D.C. 20549-1090.

All submissions should refer to File Number SR-NSCC-2012-810. This file number should be 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 advance notice that are filed with the Commission, and all written communications relating to the advance notice 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 Room, 100 F Street, NE, Washington, D.C. 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of NSCC and on NSCC's website at

[http://dtcc.com/downloads/legal/rule\\_filings/2012/nscs/SR-NSCC-2012-10.pdf](http://dtcc.com/downloads/legal/rule_filings/2012/nscs/SR-NSCC-2012-10.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-NSCC-2012-810 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Kevin M. O'Neill  
Deputy Secretary