

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-79592; File No. SR-NSCC-2016-803)

December 19, 2016

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice Filing to Accelerate its Trade Guaranty, Add New Clearing Fund Components, Enhance its Intraday Risk Management, Provide for Loss Allocation of “Off-the-Market Transactions,” and Make Other Changes

National Securities Clearing Corporation (“NSCC”) filed on October 25, 2016 with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2016-803 (“Advance Notice”) pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 (“Payment, Clearing and Settlement Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> under the Securities Exchange Act of 1934 (“Exchange Act”). The Advance Notice was published for comment in the Federal Register on November 30, 2016.<sup>3</sup> The Commission did not receive any comments on the

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<sup>1</sup> 12 U.S.C. 5465(e)(1). The Financial Stability Oversight Council designated NSCC a systemically important financial market utility on July 18, 2012. See Financial Stability Oversight Council 2012 Annual Report, Appendix A, <http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf>. Therefore, NSCC is required to comply with the Payment, Clearing and Settlement Supervision Act and file advance notices with the Commission. See 12 U.S.C. 5465(e).

<sup>2</sup> 17 CFR 240.19b-4(n)(1)(i).

<sup>3</sup> Securities Exchange Act Release No. 79391 (November 23, 2016), 81 FR 86348 (November 30, 2016) (SR-NSCC-2016-803) (“Notice”). NSCC also filed a related proposed rule change with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, seeking approval of changes to its rules necessary to implement the Advance Notice. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. The proposed rule change was published in the Federal Register on November 10, 2016. Securities Exchange Act Release No. 79245 (November 4, 2016), 81 FR 79071 (November 10, 2016) (SR-NSCC-2016-005). The Commission did not receive any comments on that proposal.

Advance Notice. This publication serves as notice of no objection to the Advance Notice.

I. Description of the Advance Notice

The Advance Notice, as described by NSCC, is a proposal to modify NSCC's Rules & Procedures ("Rules")<sup>4</sup> to: (i) accelerate NSCC's trade guaranty from midnight of one day after trade date ("T+1") to the point of trade comparison and validation for bilateral submissions or to the point of trade validation for locked-in submissions; (ii) add three new components to NSCC's Clearing Fund formula, in the form of a Margin Requirement Differential ("MRD"), a Coverage Component, and an Intraday Backtesting Charge); (iii) enhance NSCC's current intraday mark-to-market margin process; (iv) introduce a new loss allocation provision for any trades that fall within the proposed definition of "Off-the-Market Transactions;" and (v) make other related and technical changes, such as eliminating the current Specified Activity charge<sup>5</sup> from the Clearing Fund formula, no longer permitting NSCC to delay processing and reporting for certain index receipt transactions, clarifying the calculation of the Excess Capital Premium charge,<sup>6</sup> and removing certain references to ID Net Subscribers.<sup>7</sup> These proposed

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<sup>4</sup> Available at [http://dtcc.com/~media/Files/Downloads/legal/rules/nsccl\\_rules.pdf](http://dtcc.com/~media/Files/Downloads/legal/rules/nsccl_rules.pdf).

<sup>5</sup> The Specified Activity charge is a current component of the Clearing Fund formula that mitigates the risk of NSCC's trade guaranty attaching prior to NSCC collecting margin on the transactions, where there is a shortened settlement cycle for the transaction. Notice, supra note 3.

<sup>6</sup> The Excess Capital Premium is a charge imposed on a Member when the Member's Required Deposit exceeds its excess net capital, as described in Procedure XV of the Rules. Notice, supra note 3.

<sup>7</sup> The ID Net service allows subscribers to the service to net all eligible affirmed institutional transactions at the Depository Trust Company against their CNS transactions at NSCC. See Securities Exchange Act Release No. 57901 (June 2,

modifications are described in detail below.

(A) Accelerated Trade Guaranty

Pursuant to Addendum K of the Rules, NSCC currently guarantees the completion of trades that are cleared and settled through NSCC's Continuous Net Settlement, or "CNS" system<sup>8</sup> ("CNS trades"), and through its Balance Order Accounting Operation<sup>9</sup> ("Balance Order trades") that have reached the later of midnight of T+1 or midnight of the day they are reported to NSCC members ("Members").<sup>10</sup> NSCC proposes to shorten the time at which its trade guaranty applies to trades by amending its Rules to guarantee the completion of CNS trades and Balance Order trades upon comparison and validation for bilateral submissions to NSCC or upon validation for locked-in submissions to NSCC.<sup>11</sup>

NSCC has previously shortened the time at which its trade guaranty applied to

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2008), 73 FR 32373 (June 6, 2008) (SR-NSCC-2007-14). NSCC's ID Net service is defined further in Rule 65. Rules, supra note 4.

<sup>8</sup> CNS and its operation are described in Rule 11 and Procedure VII. Rules, supra note 4.

<sup>9</sup> The Balance Order Accounting Operation is described in Rule 5 and Procedure V. Rules, supra note 4. NSCC does not become a counterparty to Balance Order trades, but it does provide a trade guaranty to the receive and deliver parties that remains effective through close of business on the originally scheduled settlement date.

<sup>10</sup> Today, shortened process trades, such as same-day and next-day settling trades, are already guaranteed upon comparison or trade recording processing.

<sup>11</sup> Validation refers to the process whereby NSCC validates a locked-in trade, or compares and validates a bilateral trade, to confirm such trade has sufficient and correct information for clearance and settlement processing. For purposes of this description in the proposed rule change, the process of comparing and validating bilateral submissions and the process for validating locked-in submissions are collectively referred to as "trade validation." Notice, supra note 3.

trades in response to processing developments, risk management considerations, and to follow industry settlement cycles.<sup>12</sup> According to NSCC, the accelerated trade guaranty and related changes it now proposes would benefit the industry by mitigating counterparty risk and enhancing counterparties' ability to assess that risk by having NSCC become the central counterparty ("CCP") to CNS trades and by applying the trade guaranty to Balance Order trades at an earlier point in the settlement cycle. The transfer of counterparty credit risk from Members to NSCC at an earlier point in the settlement cycle would facilitate a shortened holding period of bilateral credit risk for Members by transferring the obligation onto NSCC.

To implement this proposed change, NSCC would amend Addendum K of the Rules<sup>13</sup> to provide that CNS trades and Balance Order trades would be guaranteed by NSCC at the time of trade validation.<sup>14</sup> NSCC also proposes to clarify in Addendum K<sup>15</sup> that the guaranty of obligations arising out of the exercise or assignment of options that are settled at NSCC is not governed by Addendum K<sup>16</sup> but by a separate arrangement between NSCC and The Options Clearing Corporation, as referred to in Procedure III of

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<sup>12</sup> See Securities Exchange Act Release Nos. 44648 (August 2, 2001), 66 FR 42245 (August 10, 2001) (SR-NSCC-2001-11); 35442 (March 3, 1995), 60 FR 13197 (March 10, 1995) (SR-NSCC-95-02); 35807 (June 5, 1995), 60 FR 31177 (June 13, 1995) (SR-NSCC-95-03); and 27192 (August 29, 1989), 54 FR 37010 (approving SR-NSCC-87-04, SR-MCC-87-03, and SR-SCCP-87-03 until December 31, 1990).

<sup>13</sup> Supra note 4.

<sup>14</sup> The proposed accelerated trade guaranty would not apply to items not currently guaranteed today.

<sup>15</sup> Supra note 4.

<sup>16</sup> Id.

the Rules.<sup>17</sup>

(B) Proposed Enhancements to NSCC's Clearing Fund Formula

In conjunction with the proposed accelerated trade guaranty, NSCC would enhance its Clearing Fund formula to address the risks posed by the expanded trade guaranty. Specifically, NSCC proposes to amend Procedure XV (Clearing Fund Formula and Other Matters) of the Rules<sup>18</sup> to include three new components: the MRD, the Coverage Component, and the Intraday Backtesting Charge.

*1. Margin Requirement Differential*

The MRD component is designed by NSCC to help mitigate the risks posed to NSCC by day-over-day fluctuations in a Member's portfolio. It would do this by forecasting future changes in a Member's portfolio based on a historical look-back at each Member's portfolio over a given time period. A Member's portfolio may fluctuate significantly from one trading day to the next as the Member executes trades throughout the day. Currently, daily fluctuations in a Member's portfolio resulting from such trades do not pose any additional or different risk to NSCC because those trades are not guaranteed by NSCC until a margin in the form of a Required Deposit<sup>19</sup> reflecting such

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<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> NSCC collects Required Deposits from all Members as margin to protect NSCC against losses in the event of a Member's default. The objective of the Required Deposit is to mitigate potential losses to NSCC associated with liquidation of the Member's portfolio if NSCC ceases to act for a Member (i.e., a "default"). NSCC determines Members' Required Deposit amounts using a risk-based margin methodology that is intended to capture market price risk. The methodology uses historical market moves to project or forecast the potential gains or losses on the liquidation of a defaulting Member's portfolio, assuming that a portfolio would take three days to liquidate or hedge in normal market conditions. The projected liquidation gains or losses are used to determine the Member's Required Deposit,

trades is collected by NSCC. However, under the accelerated trade guaranty proposal, NSCC's trade guaranty would attach to current-day trades immediately upon trade validation, before Required Deposits reflecting these trades have been collected (which NSCC refers to herein as the "coverage gap").<sup>20</sup> The MRD would increase Members' Required Deposits by an amount calculated to cover forecasted fluctuations in Members' portfolios, based upon historical activity.

The MRD would be calculated and charged on a daily basis, as a part of each Member's Required Deposit, and consists of two components: "MRD VaR" and "MRD MTM." MRD VaR would look at historical day-over-day positive changes in the start of day ("SOD") volatility component of a Member's Required Deposit<sup>21</sup> (the volatility component is referred to as the "Volatility Charge") over a 100-day look-back period and would be calculated to equal the exponentially weighted moving average ("EWMA") of such changes to the Member's Volatility Charge during the look-back period. MRD MTM would look at historical day-over-day increases to the SOD mark-to-market component of a Member's Required Deposit<sup>22</sup> over a 100-day look-back period and

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which is calculated to cover projected liquidation losses to be at or above a 99 percent confidence level ("Coverage Target"). Notice, supra note 3.

<sup>20</sup> The coverage gap is the period between the time that NSCC would guarantee a trade and the time that NSCC would collect additional margin to cover such trade.

<sup>21</sup> The Volatility Charge component of the Clearing Fund formula for CNS trades and Balance Order trades is described in Procedure XV, Sections I.(A)(1)(a) and I.(A)(2)(a), respectively.

<sup>22</sup> The SOD mark-to-market component of the Clearing Fund formula for CNS trades consists of Regular Mark-to-Market and ID Net Mark-to-Market, which are described in Procedure XV, Sections I.(A)(1)(b) and I.(A)(1)(c), respectively. The SOD mark-to-market component of the Clearing Fund formula for Balance Order trades is described in Procedure XV, Section I.(A)(2)(b).

would be calculated to equal the EWMA of such changes to the Member's SOD mark-to-market component during the look-back period. The MRD would be calculated to equal the sum of MRD VaR and MRD MTM times a multiplier calibrated based on backtesting results. NSCC has determined that a 100-day look-back period would provide a sufficient time series to reflect current market conditions.

By addressing the day-over-day changes to each Member's SOD Volatility Charge and SOD mark-to-market component, NSCC states that the MRD would help mitigate the risks posed to NSCC by un-margined day-over-day fluctuations to a Member's portfolio resulting from intraday trading activity that would be guaranteed during the coverage gap.

## 2. *Coverage Component*

The Coverage Component is designed by NSCC to mitigate the risks associated with a Member's Required Deposit being insufficient to cover projected liquidation losses to the Coverage Target by adjusting a Member's Required Deposit towards the Coverage Target. NSCC would face increased exposure to a Member's un-margined portfolio as a result of the proposed accelerated trade guaranty and would have an increased need to have each Member's Required Deposit meet the Coverage Target. The Coverage Component would supplement the MRD by preemptively increasing a Member's Required Deposit by an amount calculated to forecast potential deficiencies in the margin coverage of a Member's guaranteed portfolio. The preemptive nature of the Coverage Component differentiates it from NSCC's current Backtesting Charge<sup>23</sup> (to be renamed as the "Regular Backtesting Charge" pursuant to this proposal, as described

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<sup>23</sup> Rules, Procedure XV, Section I(B)(3), supra note 4.

below) and the Intraday Backtesting Charge, both of which are backwards looking increases to the Member's Required Deposit to above the Coverage Target.

The Coverage Component would be calculated and charged on a daily basis as a part of each Member's Required Deposit. To calculate the Coverage Component, NSCC would compare the simulated liquidation profit and loss of a Member's portfolio, using the actual positions in the Member's portfolio and the actual historical returns on the security positions in the portfolio, against the sum of each of the following components of the Clearing Fund formula: Volatility Charge, the MRD, Illiquid Charge, and Market Maker Domination Charge (collectively, "Market Risk Components"). The results of that calculation would determine if there were any deficiencies between the amounts collected by these components and the simulated profit and loss of the Member's portfolio that would have been realized had it been liquidated during a 100-day look-back period. NSCC would then determine a daily "peak deficiency" amount for each Member equal to the maximum deficiency over a rolling 10 business day period for the preceding 100 days. The Coverage Component would be calculated to equal the EWMA of the peak deficiencies over the 100-day look-back period.

### *3. Intraday Backtesting Charge*

NSCC currently employs daily backtesting to determine the adequacy of each Member's Required Deposit. NSCC compares the Required Deposit<sup>24</sup> for each Member with the simulated liquidation profit and loss using the actual positions in the Member's portfolio and the actual historical returns on the security positions in the portfolio. NSCC investigates the cause of any backtesting deficiencies. As a part of this investigation,

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<sup>24</sup> For backtesting comparisons, NSCC uses the Required Deposit amount without regard to the actual collateral posted by the Member.

NSCC pays particular attention to Members with backtesting deficiencies that bring the results for that Member below the Coverage Target to determine if there is an identifiable cause of repeat backtesting deficiencies. NSCC also evaluates whether multiple Members experience backtesting deficiencies for the same underlying reason. Upon implementation of the accelerated trade guaranty, NSCC would employ a similar backtesting process on an intraday basis to determine the adequacy of each Member's Required Deposit. However, instead of backtesting a Member's Required Deposit against the Member's SOD portfolio, NSCC would use portfolios from two intraday time slices.<sup>25</sup>

NSCC's objective with the Intraday Backtesting Charge is to increase Required Deposits for Members that are likely to experience intraday backtesting deficiencies on the basis described above by an amount sufficient to maintain such Member's intraday backtesting coverage above the Coverage Target. Members that maintain consistent end of day positions but have a high level of intraday trading activity pose risk to NSCC if they were to default intraday.

Because the intraday trading activity and size of the intraday backtesting deficiencies vary among impacted Members, NSCC would assess an Intraday Backtesting Charge that is specific to each impacted Member. To do so, NSCC would examine each impacted Member's historical intraday backtesting deficiencies observed over the prior 12-month period to identify the five largest intraday backtesting deficiencies that have occurred during that time. The presumptive Intraday Backtesting

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<sup>25</sup> Intraday time slices are subject to change based upon market conditions and would include the positions from SOD plus any additional positions up to that time.

Charge amount would equal that Member's fifth largest historical intraday backtesting deficiency, subject to adjustment as further described below. NSCC believes that applying an additional margin charge equal to the fifth largest historical intraday backtesting deficiency to a Member's Required Deposit would have brought the Member's historically observed intraday backtesting coverage above the Coverage Target.<sup>26</sup>

Although the fifth largest historical backtesting deficiency for a Member would be used as the Intraday Backtesting Charge in most cases, NSCC would retain discretion to adjust the charge amount based on other circumstances that might be relevant for assessing whether an impacted Member is likely to experience future backtesting deficiencies and the estimated size of such deficiencies. According to NSCC, examples of relevant circumstances that could be considered by NSCC in calculating the final, applicable Intraday Backtesting Charge amount include material differences among the Member's five largest intraday backtesting deficiencies observed over the prior 12-month period, variability in the net settlement activity after the collection of the Member's Required Deposit, and observed market price volatility in excess of the Member's historical Volatility Charge. Based on NSCC's assessment of the impact of these circumstances on the likelihood, and estimated size, of future intraday backtesting deficiencies for a Member, NSCC could, in its discretion, adjust the Intraday Backtesting

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<sup>26</sup> Intraday backtesting would include 500 observations per year (twice per day over 250 observation days). Each occurrence of a backtesting deficiency would reduce a Member's overall backtesting coverage by 0.2 percent (1 exception / 500 observations). Accordingly, an Intraday Backtesting Charge equal to the fifth largest backtesting deficiency would have brought backtesting coverage up to 99.2 percent.

Charge for such Member in an amount that NSCC determines to be more appropriate for maintaining such Member's intraday backtesting results above the Coverage Target.

In order to differentiate the Backtesting Charge assessed on the start of the day portfolio from the Backtesting Charge assessed on an intraday basis, NSCC would amend the Rules by adding a defined term "Regular Backtesting Charge" to Procedure XV, Section I.(B)(3).<sup>27</sup>

If NSCC determines that an Intraday Backtesting Charge should apply to a Member who was not assessed an Intraday Backtesting Charge during the immediately preceding month or that the Intraday Backtesting Charge applied to a Member during the previous month should be increased, NSCC would notify the Member on or around the 25th calendar day of the month prior to the assessment of the Intraday Backtesting Charge or prior to the increase to the Intraday Backtesting Charge, as applicable, if not earlier.

NSCC would impose the Intraday Backtesting Charge as an additional charge applied to each impacted Member's Required Deposit on a daily basis for a one-month period and would review each applied Intraday Backtesting Charge each month. However, the Intraday Backtesting Charge would only be applicable to those Members whose overall 12-month trailing intraday backtesting coverage falls below the Coverage Target. If an impacted Member's trailing 12-month intraday backtesting coverage exceeds the Coverage Target (without taking into account historically imposed Intraday Backtesting Charges), the Intraday Backtesting Charge would be removed.

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<sup>27</sup> Supra note 4.

(C) Enhanced Intraday Mark-to-Market Margining

NSCC proposes to enhance its current intraday margining to further mitigate the intraday coverage gap risk that may be introduced to NSCC as a result of the proposed accelerated trade guaranty. As part of its Clearing Fund formula, NSCC currently collects a SOD mark-to-market margin, which is designed to mitigate the risk arising out of the value change between the contract/settlement value of a Member's open positions and the current market value. A Member's SOD mark-to-market margin is calculated and collected daily as part of a Member's daily Required Deposit based on the Member's prior end-of-day positions. The SOD mark-to-market component of the daily Required Deposit is calculated to cover a Member's exposure due to market moves and/or trading and settlement activity by bringing the portfolio of open positions up to the current market value.

Because the SOD mark-to-market component is calculated only once daily using the prior end-of-day positions and prices, it does not cover a Member's exposure arising out of any intraday changes to position and market value in a Member's portfolio. For such exposure, the Volatility Charge already collected from each Member as part of the Member's daily Required Deposit is calculated to cover projected changes in the contract/settlement value of a Member's portfolio, which should be sufficient to cover intraday changes to a Member's portfolio, and thus NSCC's risk of loss as a result of that Member's intraday activities. However, in certain instances, a Member could have intraday mark-to-market changes that are significant enough that NSCC is exposed to an increased risk of loss that would not be covered by the Member's Volatility Charge. To monitor and account for these instances, NSCC measures each Member's intraday mark-

to-market exposure against the Volatility Charge twice daily and collects an intraday mark-to-market amount from any Member whose intraday mark-to-market exposure meets or exceeds 100 percent of the Member's Volatility Charge, although NSCC may lower that threshold and measure exposure more often during volatile market conditions. NSCC believes that such Members pose an increased risk of loss to NSCC because the coverage provided by the Volatility Charge, which is designed to cover estimated losses to a portfolio over a specified time period, would be exhausted by an intraday mark-to-market exposure so large that the Member's Required Deposit would potentially be unable to absorb further intraday losses to the Member's portfolio.

To further mitigate the risk posed to NSCC by the proposed accelerated trade guaranty, NSCC is proposing to enhance its collection of intraday mark-to-market margin by imposing the intraday mark-to-market margin amount at a lower threshold. With this proposal, instead of collecting intraday mark-to-market margin if a Member's intraday mark-to-market exposure meets or exceeds 100 percent of the Member's Volatility Charge, NSCC would make an intraday margin call if a Member's intraday mark-to-market exposure meets or exceeds 80 percent of the Member's Volatility Charge (while still retaining the ability to reduce the threshold during volatile market conditions). This proposed change would serve to collect more intraday margin earlier and more proactively preserve the coverage provided by a Member's Volatility Charge and Required Deposit.

Finally, to ensure that Members are aware that NSCC regularly monitors and considers intraday mark-to-market as part of its regular Clearing Fund formula and understand the circumstances and criteria for the assessment of an intraday mark-to-

market call, NSCC proposes to amend Procedure XV to include a comprehensive description of the enhanced intraday mark-to-market margin charge and the proposed new criteria NSCC would use to assess it.

(D) Loss Allocation Provision for Off-the-Market Transactions

NSCC proposes to introduce a new loss allocation provision for any trades that fall within the proposed definition of “Off-the-Market Transactions.” This loss allocation provision would be designed to limit NSCC’s exposure to certain trades that have a price that differs significantly from the prevailing market price for the underlying security at the time the trade is executed. It would apply in the event that NSCC ceases to act for a Member that engaged in Off-the-Market Transactions and only to the extent that NSCC incurs a net loss in the liquidation of such Transactions.<sup>28</sup>

NSCC would define “Off-the-Market Transaction” as a single transaction (or a series of transactions settled within the same trade cycle) that is (i) greater than \$1 million in gross proceeds, and (ii) at trade price that differs significantly (i.e., either higher or lower) from the most recently observed market price, at the time the trade was submitted to NSCC, by a percentage amount determined by NSCC based upon market conditions and factors that impact trading behavior of the underlying security, including volatility, liquidity and other characteristics of such security.

In addition to defining Off-the-Market Transactions, the proposed change would establish the loss allocation for when they occur. Specifically, any net losses to NSCC resulting from the liquidation of a guaranteed, Off-the-Market Transaction of a defaulted

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<sup>28</sup> A net loss on liquidation of the Off-the-Market Transaction means that the loss on liquidation of the Member’s portfolio exceeds the collected Required Deposit of the Member and such loss is attributed to the Off-the-Market Transaction.

Member would be allocated directly and entirely to the surviving counterparty to that transaction, or on whose behalf the Off-the-Market Transaction was submitted to NSCC. Losses would be allocated to counterparties in proportion to their specific Off-the-Market Transaction gain and would be allocated only to the extent of NSCC's loss; however, no allocation would be made if the defaulted Member has satisfied all requisite intraday mark-to-market margin assessed by NSCC with respect to the Off-the-Market Transaction.<sup>29</sup>

According to NSCC, this proposed change would allow NSCC to mitigate the risk of loss associated with guaranteeing these Off-the-Market Transactions. NSCC has recognized that applying the accelerated trade guaranty to transactions whose price significantly differs from the most recently observed market price could inappropriately increase the loss that NSCC may incur if a Member that has engaged in Off-the-Market Transactions defaults and its open, guaranteed positions are liquidated. Members not involved in Off-the-Market Transactions, or not involved in Off-the-Market Transactions that result in losses to NSCC, would not be included in this process. This exclusion would apply only to losses that are attributable to Off-the-Market Transactions and would not exclude Members from other obligations that may result from any loss or liabilities incurred by NSCC from a Member default.

To implement this proposed change, NSCC would amend Rule 4<sup>30</sup> (Clearing Fund) to provide that, if a loss or liability of NSCC is determined by NSCC to arise in

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<sup>29</sup> A Member's Off-the-Market Transaction that has been marked to market is, by definition, no longer an Off-the-Market Transaction when the mark-to-market component of the Member's Required Deposit is satisfied.

<sup>30</sup> Supra note 4.

connection with the liquidation of any Off-the-Market Transactions, such loss or liability would be allocated directly to the surviving counterparty to the Off-the-Market Transaction that submitted the transaction to NSCC for clearing. NSCC also would amend Rule 1<sup>31</sup> (Definitions and Descriptions) to include a definition of Off-the-Market Transactions.

(E) Other Related and Technical Changes

*1. Removing the Specified Activity Charge*

Currently, NSCC collects a Specified Activity charge, which is designed to cover the risk posed to NSCC by transactions that settle on a T+2, T+1, or T timeframe.<sup>32</sup> Because such transactions may be guaranteed by NSCC prior to the collection of margin, they pose an increased risk to NSCC (a similar risk that posed to NSCC by the proposed accelerated trade guaranty). The Specified Activity charge currently mitigates this risk by increasing the Required Deposit for a Member in relation to the number of Specified Activity trades submitted to NSCC by the Member over a 100-day look-back period. However, according to NSCC, the addition of the proposed MRD and Coverage Components to the Clearing Fund formula would mitigate the risks posed by trades guaranteed by NSCC prior to the collection of margin on those trades, thereby obviating the need to collect a separate Specified Activity charge. Accordingly, because it would be duplicative of the MRD and Coverage Components that are being added to the Clearing Fund Formula, NSCC proposes to eliminate the Specified Activity charge.

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<sup>31</sup> Id.

<sup>32</sup> Examples of these trades can include next day settling trades, same day settling trades, cash trades, and sellers' options.

2. *Eliminating Delay in Processing and Reporting of Next Day Settling Index Receipts*

Next day settling index receipts may be guaranteed prior to the collection of margin reflecting such trades and thus carry a risk similar to the risk posed by Specified Activity trades described above. More specifically, because these trades are settled on the day after they are received and validated by NSCC, NSCC currently attaches its guaranty to them at the time of validation, prior to the collection of a Required Deposit that reflects such trades. Unlike the risk from Specified Activity trades, which is mitigated by the Specified Activity charge, the risk for next day settling index receipts is currently mitigated by permitting NSCC to delay the processing and reporting of these trades if a Member's Required Deposit is not paid on time. However, as with the risk associated with Specified Activity, under the proposed change, this risk would generally be mitigated by the addition of the MRD and Coverage Component. Therefore, NSCC proposes to amend Procedure II of the Rules<sup>33</sup> (Trade Comparison and Recording Service) to remove the language that permits NSCC to delay the processing and reporting of next day settling index receipts until the applicable margin on these transactions is paid.

3. *Clarifying that the MRD and Coverage Component Should Not Be Included in The Calculation of a Member's Excess Capital Premium Charge*

The Excess Capital Premium charge<sup>34</sup> is designed to address significant, temporary increases in a Member's Required Deposit based upon any one day of activity.

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<sup>33</sup> Supra note 4.

<sup>34</sup> As stated above, the Excess Capital Premium is a charge imposed on a Member when the Member's Required Deposit exceeds its excess net capital, as described in Procedure XV of the Rules. Rules, supra note 4.

It is not designed to provide additional Required Deposits over an extended period of time. Currently, the Excess Capital Premium charge for a Member is calculated based upon the Member's Required Deposit and the Member's excess net capital. The Premium is the amount by which a Member's Required Deposit exceeds its excess regulatory capital multiplied by the Member's ratio of Required Deposit to excess regulatory capital, expressed as a percent. Because they would be new components of a Member's Required Deposit under the current proposal, the MRD and Coverage Component would necessarily be included in the calculation of a Member's Excess Capital Premium. However, the MRD and Coverage Component each utilize a historical look-back period, which accounts for the risk of such activity well after the relevant trades have settled. Risks related to such trades would be reflected in increased amounts assessed for these components over the subsequent time periods. If these components are included in the calculation of the Excess Capital Premium, especially during periods following an increase in activity, the increased MRD and Coverage Component could lead to more frequent Excess Capital Premium charges over an extended period of time. According to NSCC, this is not the intended purpose of the Excess Capital Premium and could place an unnecessary burden on Members. Accordingly, NSCC proposes to exclude these charges from the calculation of the Excess Capital Premium.

#### 4. *Removing Reference to ID Net Subscribers*

NSCC also proposes to change Procedure XV<sup>35</sup> to clarify how the "Regular Mark-to-Market" component of the Required Deposit for CNS transactions is calculated. The Mark-to-Market component of a Member's Required Deposit is designed to protect

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<sup>35</sup> Id.

NSCC from risk of loss based on changes to the value of a Member's portfolio and therefore may result in a debit to a Member (i.e., NSCC would collect more Required Deposit), but cannot result in a credit from NSCC to a Member. Accordingly, if a Member's mark-to-market calculation for a CNS or Balance Order trade results in a credit to the Member, NSCC's policy is to adjust the calculation to zero, thereby avoiding a credit from NSCC to the Member. When NSCC implemented the ID Net service,<sup>36</sup> it added a provision to Procedure XV<sup>37</sup> that explicitly stated this policy with respect to CNS transactions of subscribers to the ID Net service. According to NSCC, this change inadvertently created an implication that the calculation of Regular Mark-to-Market credit for Members who were not ID Net Subscribers would not be set to zero. NSCC proposes to revise the applicable provision of Procedure XV to remove the reference to ID Net Subscribers.

## II. Discussion and Commission Findings

Although the Act does not specify a standard of review for an advance notice, its stated purpose is instructive: 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 utilities and strengthening the liquidity of systemically important financial market utilities.<sup>38</sup> Section 805(a)(2) of the Act authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions

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<sup>36</sup> Supra note 6.

<sup>37</sup> Supra note 4.

<sup>38</sup> See 12 U.S.C. 5461(b).

engaged in designated activities for which it is the Supervisory Agency or the appropriate financial regulator.<sup>39</sup> Section 805(b) of the Act 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.<sup>40</sup>

The Commission has adopted risk management standards under Section 805(a)(2) of the Act<sup>41</sup> and Section 17A of the Exchange Act<sup>42</sup> (“Clearing Agency Standards”).<sup>43</sup> The Clearing Agency Standards require registered clearing agencies to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.<sup>44</sup> It is therefore appropriate for the Commission to review proposed changes in advance notices against these Clearing

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<sup>39</sup> 12 U.S.C. 5464(a)(2).

<sup>40</sup> 12 U.S.C. 5464(b).

<sup>41</sup> 12 U.S.C. 5464(a)(2).

<sup>42</sup> 15 U.S.C. 78q-1.

<sup>43</sup> See 17 CFR 240.17Ad-22. Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11).

<sup>44</sup> Id.

Agency Standards and the objectives and principles of these risk management standards as described in Section 805(b) of the Act.<sup>45</sup>

The Commission believes the proposal in the Advance Notice is consistent with the objectives and principles described in Section 805(b) of the Act,<sup>46</sup> and the Clearing Agency Standards, in particular, Rule 17Ad-22(b)(1)<sup>47</sup> and Rule 17Ad-22(b)(2)<sup>48</sup> under the Exchange Act, as described in detail below.

*A. Consistency with Section 805(b) of the Act*

First, the Commission believes that the changes proposed in the Advance Notice, as described above, are consistent with promoting robust risk management. NSCC's proposal to add the three new components to its margin methodology (i.e, the MRD, Coverage Component, and Intraday Backtesting Charge) would enable NSCC to collect more margin, thereby promoting robust risk management practices at NSCC with respect to the potential default of a Member. By collecting more margin, NSCC would be in a better position to manage the counterparty credit risk presented by Members, particularly the additional counterparty credit risk from the proposed accelerated trade guaranty. Similarly, the proposal to lower the threshold for collection of intraday mark-to-margin by collecting intraday mark-to-market margin when NSCC's exposure to a Member meets or exceeds 80 percent of that Member's Volatility Charge, rather than 100 percent, would enhance NSCC's intraday mark-to-market margin practice by allowing NSCC to

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<sup>45</sup> 12 U.S.C. 5464(b).

<sup>46</sup> Id.

<sup>47</sup> 17 CFR 240.17Ad-22(b)(1).

<sup>48</sup> 17 CFR 240.17Ad-22(b)(2).

collect more intraday margin stemming from intraday price fluctuations more often. As such, the proposed threshold reduction would also promote robust risk management practices at NSCC. With respect to the proposed change to introduce a new loss allocation provision for certain off-the-market transactions, it too would promote robust risk management at NSCC, as it would help protect NSCC from transactions of a defaulted Member that were made at prices that differed significantly from the prevailing market price at the time the trade is executed and resulted in a loss to NSCC in connection with NSCC's liquidation of the transaction.

Second, the Commission believes that the changes proposed in the Advance Notice are consistent with promoting safety and soundness. As described above, NSCC proposes to accelerate its trade guaranty for CNS trades and Balance Order trades from midnight of T+1 to the point of trade validation. This earlier guaranty would promote safety and soundness for Members because the counterparty credit risk that Members currently hold until NSCC's guaranty applies at midnight of T+1 would shift to NSCC almost immediately upon NSCC's receipt of the trade on T. Because NSCC risk manages its guaranteed transactions, NSCC is able to better ensure that trades settle if a counterparty defaults.

The above-described proposed changes to NSCC's margin methodology (i.e., the addition of the MRD, Coverage Component, and Intraday Backtesting Charge), along with the proposed reduction of NSCC's intraday mark-to-margin threshold, also would promote safety and soundness at NSCC because they would improve NSCC's ability to collect margin. Likewise, the proposed loss allocation provision for off-the-market transactions would promote safety and soundness at NSCC by helping to protect NSCC

from losses due to transactions of a defaulted Member that were made at prices significantly different from the prevailing market price at the time of the trade.

Collectively, these proposed changes would enable NSCC to manage better the additional risk that would result from the proposed accelerated guaranty.

Third, the Commission believes that the Advance Notice is consistent with reducing systemic risks and promoting the stability of the broader financial system. As described above, by providing a trade guaranty at an earlier point in the settlement cycle, counterparty credit risk also would transfer from Members, which are not CCPs, to NSCC, which is a third-party CCP that risk-manages its guaranteed transactions, at an earlier point in the settlement cycle. Because NSCC risk manages its guaranteed transactions, NSCC is able to better ensure that trades settle if a counterparty defaults. Thus, the proposed accelerated process would help reduce systemic risks and promote the stability of the broader financial system by mitigating Members' exposure to a counterparty default earlier in the settlement cycle and by providing an earlier assurance that transactions will settle despite a Member default.

At the same time, the three proposed additions to NSCC's margin methodology, the proposed reduction of NSCC's intraday mark-to-margin threshold, and the proposed loss allocation provision for off-the-market transactions, as described above, would also help mitigate the systemic risks that NSCC presents as a CCP because they would improve NSCC's margining abilities and help protect NSCC against potential losses from a Member default. Accordingly, the changes would therefore promote the stability of the broader financial system.

*B. Consistency with Rule 17Ad-22(b)(1)*

Rule 17Ad-22(b)(1) under the Exchange Act requires a CCP, such as NSCC, to, among other things, “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . limit its exposures to potential losses from defaults by its participants under normal market conditions . . . .” As described above, because the proposed change would transfer counterparty credit risk to NSCC at an earlier point in the settlement cycle, NSCC proposes to enhance its margin methodology by adding three new margin components and by lowering the threshold for the intraday mark-to-market margin collection. It also proposes to establish a loss allocation provision for off-market transactions. These proposed changes are designed to limit NSCC’s exposure to potential losses from the default of a Member by enabling NSCC to collect more margin, better manage when it collects margin, and protect itself from certain losses of a defaulted Member. Therefore, the Commission believes that the proposal would be consistent with Rule 17Ad-22(b)(1).

*C. Consistency with Rule 17Ad-22(b)(2)*

Rule 17Ad-22(b)(2) under the Exchange Act requires a CCP, such as NSCC, to, among other things, “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [u]se margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements . . . .” Again, the proposal would add three new components to NSCC’s margin methodology (i.e, the MRD, Coverage Component, and Intraday Backtesting Charge), which use risk based models and parameters to calculate charges, and would lower the threshold at which NSCC would make an intraday mark-to-

market margin call. As such, the proposal would help NSCC better account for and cover its credit exposure to Members. In addition, by establishing the proposed margin components and the new intraday mark-to-market margin collection threshold, the proposal is consistent with using risk-based models and parameters to set margin requirements. Therefore, the Commission believes that the proposal would be consistent with Rule 17Ad-22(b)(2).

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,<sup>49</sup> that the Commission DOES NOT OBJECT to Advance Notice (SR-NSCC-2016-803) and that NSCC is AUTHORIZED to implement the proposed change as of the date of this notice or the date of an order by the Commission approving the proposed rule change (SR-NSCC-2016-005) that reflects rule changes that are consistent with this Advance Notice, whichever is later.

By the Commission.

Eduardo A. Aleman  
Assistant Secretary

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<sup>49</sup> 12 U.S.C. 5465(e)(1)(I).