

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-88469; File No. SR-NSCC-2020-801)

March 25, 2020

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice to Enhance the Calculation of the Family-Issued Securities Charge

On January 28, 2020, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2020-801 (“Advance Notice”) pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, entitled Payment, Clearing and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)<sup>1</sup> and Rule 19b-4(n)(1)(i)<sup>2</sup> under the Securities Exchange Act of 1934 (“Exchange Act”)<sup>3</sup> to amend the calculation of NSCC’s existing margin charge applied to long positions in Family-Issued Securities<sup>4</sup> to address certain risk presented by these positions. The Advance Notice was published for public comment in the Federal Register on February 27, 2020,<sup>5</sup>

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

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

<sup>3</sup> 15 U.S.C. 78a et seq.

<sup>4</sup> Terms not defined herein are defined in NSCC’s Rules and Procedures (“Rules”), available at [http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc\\_rules.pdf](http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf).

<sup>5</sup> Securities Exchange Act Release No. 88267 (Feb. 24, 2020), 85 Fed. Reg. 11437 (Feb. 27, 2020) (SR-NSCC-2020-801) (“Notice of Filing”). On January 28, 2020, NSCC also filed a related proposed rule change (SR-NSCC-2020-002) with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder (“Proposed Rule Change”). 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. In the Proposed Rule Change, which was published in the Federal Register on February 18, 2020, NSCC seeks approval of proposed changes to its rules necessary to implement the Advance Notice. Securities Exchange Act

and the Commission has received no comments regarding the changes proposed in the Advance Notice.<sup>6</sup> This publication serves as notice of no objection to the Advance Notice.

## **I. THE ADVANCE NOTICE**

### **A. Background**

NSCC provides clearing, settlement, risk management, central counterparty services, and a guarantee of completion for virtually all broker-to-broker trades involving equity securities, corporate and municipal debt securities, and certain other securities. NSCC manages its credit exposure to its Members by determining an appropriate Required Fund Deposit for each Member, which serves as each Member's margin.<sup>7</sup> The aggregate of all NSCC Members' Required Fund Deposits (together with certain other deposits required under the Rules) constitutes NSCC's Clearing Fund, which NSCC would access should a Member default and that Member's Required Fund Deposit, upon liquidation, is insufficient to satisfy NSCC's losses.

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Release No. 88163 (Feb. 11, 2020), 85 Fed. Reg. 8964 (Feb. 18, 2020). The comment period for the related Proposed Rule Change filing closed on March 10, 2020.

<sup>6</sup> Since the proposal contained in the Advance Notice was also filed as a proposed rule change, all public comments received on the proposal are considered regardless of whether the comments are submitted on the Proposed Rule Change or the Advance Notice.

<sup>7</sup> Terms not defined herein are defined in NSCC's Rules and Procedures ("Rules"), available at [http://www.dtcc.com/~media/Files/Downloads/legal/rules/nscc\\_rules.pdf](http://www.dtcc.com/~media/Files/Downloads/legal/rules/nscc_rules.pdf). See Rule 4 (Clearing Fund) and Procedure XV (Clearing Fund Formula and Other Matters) of the Rules.

Each Member's Required Fund Deposit consists of a number of applicable components, each of which is calculated to address specific risks faced by NSCC.<sup>8</sup> NSCC states that it regularly assesses the market, liquidity, and other risks that its margining methodologies are designed to mitigate to evaluate whether margin levels are commensurate with the particular risk attributes of each relevant product, portfolio, and market.<sup>9</sup> Such risks include risks introduced by its counterparties or Members. In particular, NSCC seeks to identify and mitigate its exposures to specific wrong-way risk ("SWWR"), which is the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of that counterparty deteriorates. Such risk would arise when NSCC acts as central counterparty to a Member with unsettled long positions in securities that were issued by a Member or an affiliate of that Member ("Family-Issued Securities"). If that Member defaults, NSCC would seek to cover its losses by closing out the unsettled Family-Issued Securities long positions. However, because the Member default would also likely lead to a drop in the creditworthiness of the Member and, therefore, the value of the Family-Issued Securities, NSCC would likely not be able to completely cover its losses in closing out those positions.

In order to address this particular form of SWWR, NSCC imposes a charge on all Members with unsettled long positions in their own Family-Issued Securities, called the FIS Charge, which is calculated by multiplying the value of the net unsettled long positions in Family-Issued Securities by a certain percentage ("Haircut Rate").

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<sup>8</sup> Id.

<sup>9</sup> See Notice of Filing supra note 5, at 85 Fed. Reg. 11437.

Currently, the Haircut Rate applied in the FIS Charge calculation is based on a Member's rating category on NSCC's Credit Risk Rating Matrix ("CRRM"), which ranges from 1 to 7. NSCC utilizes the CRRM to evaluate its credit risk exposure to each Member; a higher CRRM rating represents a higher credit risk (i.e., a greater risk of defaulting on settlement obligations) and may cause a Member to be subject to enhanced surveillance or additional margin requirements.<sup>10</sup>

Currently, the applicable Haircut Rate for the FIS Charge depends on a Member's rating on the CRRM. Specifically, for Members that are rated 6 or 7 on the CRRM, the applicable Haircut Rate for net unsettled long positions in Family-Issued Securities shall be (1) at least 80 percent for fixed income securities, and (2) 100 percent for equity securities. For Members that are rated 1 through 5 on the CRRM, the applicable Haircut Rate shall be (1) at least 40 percent for fixed income securities, and (2) at least 50 percent for equity securities.<sup>11</sup>

**B. Proposed Changes to FIS Charge**

In the Advance Notice, NSCC is proposing to revise the calculation of the FIS Charge to use the same Haircut Rate for all Members regardless of their CRRM rating category. Under the proposal, net unsettled long positions in (1) fixed income securities that are Family-Issued Securities are charged a Haircut Rate of no less than 80 percent,

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<sup>10</sup> See Rule 1 and Section 4 of Rule 2B of the Rules, supra note 8. See also Securities Exchange Act Release Nos. 80734 (May 19, 2017), 82 FR 24177 (May 25, 2017) (SR-DTC-2017-002, SR-FICC-2017-006, SR-NSCC-2017-002); and 80731 (May 19, 2017), 82 FR 24174 (May 25, 2017) (SR-DTC-2017-801, SR-FICC-2017-804, SR-NSCC-2017-801).

<sup>11</sup> See Procedure XV (Clearing Fund Formula and Other Matters) of the Rules, supra note 7.

and (2) equity securities that are Family-Issued Securities are charged a Haircut Rate of 100 percent.

NSCC states that it may still be exposed to SWWR despite applying different Haircut Rates based on a Member's rating on the CRRM, and it can better mitigate its exposure to this risk by calculating the FIS Charge without considering Members' CRRM rating categories.<sup>12</sup> According to NSCC, while the current methodology appropriately assumes that Members with a higher rating category on the CRRM present a heightened credit risk to NSCC or have demonstrated higher risk related to their ability to meet settlement, this methodology does not account for the risk that a Member may default due to unanticipated causes (referred to as a "jump-to-default" scenario) not captured by the CRRM.<sup>13</sup> This is because the CRRM relies on historical data as a predictor of future risks,<sup>14</sup> whereas jump-to-default scenarios are triggered by unanticipated causes that could not be predicted based on historical trends or data (e.g., instances of fraud or other bad actions by a Member's management). Therefore, NSCC represents that the proposed change is designed to cover SWWR arising from potential jump-to-default scenarios by applying the higher applicable Haircut Rate in calculating the FIS Charge for all Members.<sup>15</sup>

The practical outcome of this proposed change is that for all Family Issued Securities, NSCC would apply a haircut equivalent to the current Haircut Rate for

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<sup>12</sup> See Notice of Filing supra note 5, at 85 Fed. Reg. 11438.

<sup>13</sup> See id.

<sup>14</sup> See id.

<sup>15</sup> See id.

Members that are rated 6 or 7 on the CRRM regardless of whether a Member is rated at a 6 or 7. To implement this proposal, NSCC would amend Sections I.(A)(1)(a)(iv) and I.(A)(2)(a)(iv) of Procedure XV of the Rules.

## **II. DISCUSSION AND COMMISSION FINDINGS**

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, the stated purpose of the Clearing Supervision Act is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for SIFMUs and strengthening the liquidity of SIFMUs.<sup>16</sup>

Section 805(a)(2) of the Clearing Supervision Act authorizes the Commission to prescribe regulations containing risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency.<sup>17</sup> Section 805(b) of the Clearing Supervision Act provides the following objectives and principles for the Commission's risk management standards prescribed under Section 805(a):<sup>18</sup>

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

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<sup>16</sup> See 12 U.S.C. 5461(b).

<sup>17</sup> 12 U.S.C. 5464(a)(2).

<sup>18</sup> 12 U.S.C. 5464(b).

Section 805(c) provides, in addition, that the Commission’s risk management standards may address such areas as risk management and default policies and procedures, among others areas.<sup>19</sup>

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act (the “Clearing Agency Rules”).<sup>20</sup> The Clearing Agency Rules require, among other things, each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk management practices on an ongoing basis.<sup>21</sup> As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act. As discussed below, the Commission believes the proposal in the Advance Notice is consistent with the objectives and

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<sup>19</sup> 12 U.S.C. 5464(c).

<sup>20</sup> 17 CFR 240.17Ad-22. See Securities Exchange Act Release No. 68080 (October 22, 2012), 77 Fed. Reg. 66220 (November 2, 2012) (S7-08-11). See also Securities Exchange Act Release No. 78961 (September 28, 2016), 81 Fed. Reg. 70786 (October 13, 2016) (S7-03-14) (“Covered Clearing Agency Standards”). NSCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5).

<sup>21</sup> Id.

principles described in Section 805(b) of the Clearing Supervision Act,<sup>22</sup> and in Rules 17Ad-22(e)(4)(i)<sup>23</sup> and (e)(6)(i) and (v)<sup>24</sup> of the Clearing Agency Rules.

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

For the reasons discussed immediately below, the Commission believes that the Advance Notice is consistent with the stated objectives and principles of Section 805(b) of the Clearing Supervision Act.<sup>25</sup> Specifically, as discussed below, the Commission believes that the changes proposed in the Advance Notice are consistent with promoting robust risk management, promoting safety and soundness, reducing systemic risks, and supporting the broader financial system.<sup>26</sup>

First, the Commission believes that the proposal is consistent with promoting robust risk management. NSCC faces SWWR when it acts as central counterparty to a Member with long positions in FIS. Although NSCC's current margin methodology addresses SWWR through imposition of the FIS Charge, it does not address SWWR associated with a jump-to-default scenario. As described above, the proposal would address SWWR associated with a jump-to-default scenario by using the higher applicable Haircut Rate for all Members concerning their net unsettled long positions in Family-Issued Securities, regardless of the Members' CRRM rating category. As such, the proposal would address a risk not captured currently under NSCC's margin methodology

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<sup>22</sup> 12 U.S.C. 5464(b).

<sup>23</sup> 17 CFR 240.17Ad-22(e)(4)(i).

<sup>24</sup> 17 CFR 240.17Ad-22(e)(6)(i) and (v).

<sup>25</sup> 12 U.S.C. 5464(a)(2) and (b).

<sup>26</sup> 12 U.S.C. 5464(b).

and provide for more comprehensive risk management of NSCC's risks, consistent with the promotion of robust risk management.

Second, the Commission believes that the proposal is consistent with the promotion of safety and soundness at NSCC. The collection of additional margin, by applying the higher applicable Haircut Rate in calculating the FIS Charge for all Members, would better enable NSCC to manage the potential losses arising out of a Member default. Holding additional resources to address such losses would promote NSCC's safety and soundness.

Finally, the Commission believes that the proposal is consistent with reducing systemic risk and supporting the broader financial system. As discussed above, NSCC proposes to collect additional margin to collateralize exposures to SWWR associated with a jump-to-default scenario, which could reduce the probability that NSCC would mutualize a loss stemming from the close-out of a defaulted Member with net unsettled long positions in Family-Issued Securities. While unavoidable under certain circumstances, reducing the probability of loss mutualization during periods of market stress could lessen the transmission of financial risks arising from a Member default to non-defaulting Members, their customers, and the broader market. Further, NSCC maintaining additional margin could further reduce the potential that NSCC would need to call for additional resources from Members in times of market stress. The Commission believes, therefore, that the proposal would be consistent with reducing systemic risk and supporting the stability of the broader financial system. Accordingly, and for the reasons stated above, the Commission believes the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.

**B. Consistency with Rule 17Ad-22(e)(4)(i)**

Rule 17Ad-22(e)(4)(i) under the Act requires that each covered clearing agency establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.<sup>27</sup>

As described above, NSCC is exposed to SWWR where it acts as central counterparty for its Members' transactions in Family-Issued Securities. Applying the same higher Haircut Rate to all Members with net long unsettled positions in Family-Issued Securities, regardless of their rating on the CRRM, would help further mitigate NSCC's SWWR exposures, especially in a jump-to-default scenario. Therefore, applying the same Haircut Rate in the FIS charge calculation is designed to help NSCC collect sufficient financial resources to help cover its credit exposures, with a high degree of confidence, to those Members seeking to clear and settle transactions in Family-Issued Securities. Therefore, the Commission believes the proposed change is consistent with Rule 17Ad-22(e)(4)(i).<sup>28</sup>

**C. Consistency with Rule 17Ad-22(e)(6)(i) and (v)**

Rule 17Ad-22(e)(6)(i) under the Act requires that each covered clearing agency that provides central counterparty services establish, implement, maintain and enforce

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<sup>27</sup> 17 CFR 240.17Ad-22(e)(4)(i).

<sup>28</sup> Id.

written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.<sup>29</sup> Rule 17Ad-22(e)(6)(v) under the Act requires that each covered clearing agency that provides central counterparty services establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.<sup>30</sup>

As described above, NSCC faces SWWR in jump-to-default scenarios where it acts as central counterparty to Member transactions in Family-Issued Securities. This risk is present regardless of a Member's rating on the CRRM. However, the current methodology assumes that Members with a higher rating on the CRRM present a heightened credit risk to NSCC and applies a higher Haircut Rate to such Members. This distinction does not take into account the SWWR that would manifest in a jump-to-default scenario. As such, NSCC proposes to apply the same higher Haircut Rate to all Members. This proposal would improve NSCC's ability to mitigate its exposure to SWWR in a jump-to-default scenario, thereby helping NSCC to maintain a risk-based margin system that considers, and produces margin levels commensurate with, the risks and particular attributes of net unsettled long positions in Family-Issued Securities.

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<sup>29</sup> 17 CFR 240.17Ad-22(e)(6)(i).

<sup>30</sup> 17 CFR 240.17Ad-22(e)(6)(v).

Therefore, the Commission believes that the proposal would be consistent with Rule 17Ad-22(e)(6)(i).<sup>31</sup>

Additionally, because the enhanced FIS Charge would be a component of the margin that NSCC collects from its Members to help cover NSCC credit exposure to the Members, and because the charge would be based on different product risk factors with respect to equity and fixed-income securities, it would be part of an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products, as described above. Therefore, the Commission believes the proposed change is consistent with Rule 17Ad-22(e)(6)(v).<sup>32</sup>

### **III. CONCLUSION**

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-NSCC-2020-801) and that NSCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-NSCC-2020-002, whichever is later.

By the Commission.

J. Matthew DeLesDernier  
Assistant Secretary

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<sup>31</sup> 17 CFR 240.17Ad-22(e)(6)(i).

<sup>32</sup> 17 CFR 240.17Ad-22(e)(6)(v).