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SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69301; File No. SR-NSCC-2012-810)

April 4, 2013

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice Filing 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

I. Introduction

On December 18, 2012, National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") advance notice SR-NSCC-2012-810 ("Advance Notice") pursuant to Section 806(e) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"),[1] entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Clearing Supervision Act" or "Title VIII") and Rule 19b-4(n) of the Securities Exchange Act of 1934 ("Exchange Act"). The Advance Notice was published in the Federal Register on January 17, 2013.[2] The Commission received two comment letters to the Advance Notice from one commenter.[3] NSCC responded to both comment letters.[4] This publication serves as notice of no objection to the Advance Notice.

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

2 Release No. 34-68621 (Jan. 10, 2013), 78 FR 3960 (Jan. 17, 2013). NSCC also filed a proposed rule change pursuant to Section 19(b)(1) of the Exchange Act on December 17, 2012 seeking Commission approval to permit NSCC to change its rules to reflect the proposed change described herein. The Commission published notice of the proposed rule change on December 28, 2012. Release No. 34-68549 (Dec. 28, 2012), 78 FR 792 (Jan. 4, 2013). The Commission extended the period of review of the proposed rule change on February 5, 2013. Release No. 34-68829 (Feb. 5, 2013), 78 FR 9751 (Feb. 11, 2013).

3 Comment Letter from Lek Securities Corporation dated January 25, 2013 (http://sec.gov/comments/sr-nscc-2012-810/nscc2012810-1.pdf), and Comment Letter

II. Analysis

NSCC filed the Advance Notice to permit it to make rule changes to its Rules & Procedures ("Rules") designed 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 its Rules, as discussed below.

A. ID Offset

NSCC maintains a Clearing Fund to have on deposit assets sufficient to satisfy losses that may otherwise be incurred by NSCC as the result of the default of an NSCC member ("Member") and the resulting closeout of that Member's unsettled positions under NSCC's trade guaranty. Each Member is required to contribute to the Clearing Fund pursuant to a formula calculated daily. The Clearing Fund formula accounts for a variety of risk factors through the application of a number of components, including Value-at-Risk ("VaR")[5] and Market Maker Domination ("MMDOM").[6]

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from Lek Securities Corporation dated March 18, 2013 (http://sec.gov/comments/sr-nscc-2012-810/nscc2012810-3.pdf) (collectively, the "Lek Letters").

[4] Response Letter from NSCC dated February 22, 2013 (http://sec.gov/comments/sr-nscc-2012-810/nscc2012810-2.pdf), and Response Letter from NSCC dated March 21, 2013 (http://sec.gov/comments/sr-nscc-2012-810/nscc2012810-4.pdf).

[5] The VaR component of the Clearing Fund calculation is a core component of the formula and is designed to calculate the amount of money that may be lost on a portfolio over a given period of time that is assumed necessary to liquidate the portfolio, within a given level of confidence. See Release No. 34-68621 (Jan. 10, 2013), 78 FR 3960 (Jan. 17, 2013).

[6] The MMDOM component of the Clearing Fund calculation is charged to market makers 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

NSCC currently calculates the VaR and MMDOM components of a Member's Clearing Fund required deposit after allowing for a Member's net unsettled NSCC positions in a particular CUSIP to be offset by any pending ID transactions settling at DTC in the same CUSIP, which have been confirmed and/or affirmed through an institutional delivery system acceptable to NSCC ("ID Offset").[7] ID Offset is based on the assumption that in the event of a Member's insolvency NSCC will be able to close out any trade for which there is a corresponding ID transaction settling at DTC by completing that ID transaction.[8]

B. Potential Inability to Complete ID Transactions

Generally, when NSCC ceases to act for a Member, it is obligated, for those transactions that it has guaranteed, to pay for deliveries made by non-defaulting Members that are due to the failed Member on the day they are due. If NSCC is unable to complete the ID transactions as contemplated by the current Clearing Fund calculation, then NSCC may need to liquidate a portfolio that could be substantially different than the portfolio for which NSCC collected its Clearing Fund, leaving NSCC potentially under-collateralized and exposed to market risk.

A defaulting Member's pending ID transactions may not be completed for a number of reasons. Completion of an ID transaction by its institutional counterparty is voluntary because that counterparty is not a Member, which means it is not bound by NSCC's Rules and is not

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unsettled positions, or a combination of both. MMDOM operates to identify concentration within a given CUSIP. See Release No. 34-68621 (Jan. 10, 2013), 78 FR 3960 (Jan. 17, 2013).

7 For purposes of the ID Offset, NSCC includes ID transactions that are confirmed and/or affirmed on trade date, as well as ID transactions affirmed one day after trade date and remain affirmed through settlement date. See Release No. 34-68621 (Jan. 10, 2013), 78 FR 3960 (Jan. 17, 2013).

8 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 the net position). See Release No. 34-68621 (Jan. 10, 2013), 78 FR 3960 (Jan. 17, 2013).

party to any legally binding contract with NSCC that requires it or its custodian to complete the transaction. Moreover, based on news that a Member may be in distress or insolvent, the institutional counterparty or its investment adviser may take immediate market action with respect to the ID transaction, in order to reduce its market risk, which effectively eliminates the option for NSCC to complete the transactions. Finally, ID transactions settle trade-by-trade between the executing broker and the custodian; the netted ID positions used to offset the NSCC position could be comprised of thousands of individual trades with hundreds of different counterparties. In the event of a Member default, it could be time consuming for NSCC to contact the counterparties individually to get their agreement to complete the ID transactions. Even if NSCC were to get all of the counterparties to agree to complete the ID transactions, this could delay the prompt closeout of the defaulter's open positions and possibly expose NSCC to additional market risk in excess of the Clearing Fund.

Due to the risk that, in the event it ceases to act for a Member with pending ID transactions, NSCC may be unable to complete the pending ID transactions in the timeframe contemplated by its current Clearing Fund calculations and, as a result, may have insufficient margin in its Clearing Fund, as described above, NSCC will eliminate the ID Offset calculation from the VaR and MMDOM components of a Member's Clearing Fund requirement deposit.

C. Implementation Schedule

In order to mitigate the impact of this rule change on its Members, NSCC will implement the changes set forth in the Advance Notice over an 18-month period. On a date no earlier than 10 days following notice to Members by Important Notice ("Initial Implementation Date"), NSCC will eliminate ID Offset from ID transactions that have only been confirmed, but have not yet been affirmed. 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 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 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 ID Offset entirely for all ID transactions. Members will be advised of each proposed implementation date through issuance of NSCC Important Notices, which are publicly available at www.dtcc.com.

III. Discussion

Although Title VIII does not specify a standard of review for an Advance Notice, the stated purpose of Title VIII is instructive.[9] The stated purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market utilities ("FMUs") and providing an enhanced role for the Federal Reserve Board in the supervision of risk management standards for systemically-important FMUs.[10]

Section 805(a)(2) of the Clearing Supervision Act[11] authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of

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[9] 12 U.S.C. 5461(b).

[10] Id.

[11] 12 U.S.C. 5464(a)(2).

designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Clearing Supervision Act[12] states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

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

The Commission adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act on October 22, 2012 ("Clearing Agency Standards").[13] The Clearing Agency Standards became effective on January 2, 2013 and require clearing agencies that perform central counterparty ("CCP") services 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.[14] As such, it is appropriate for the Commission to review Advance Notices against these risk management standards that the Commission promulgated under Section 805(a) and the objectives and principles of these risk management standards as described in Section 805(b).

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[12] 12 U.S.C. 5464(b).

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

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

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

NSCC's proposal to eliminate ID Offsets, as described above, is designed to help mitigate the risk that NSCC will be under-collateralized if it ceases to act for a defaulting Member and is unable to complete the offsetting ID transactions in the time currently contemplated by its Clearing Fund calculation. Consistent with Section 805(a), the Commission believes this proposal promotes robust risk management, as well as the safety and soundness of NSCC's operations, while reducing systemic risks and supporting the stability of the broader financial system, by improving NSCC's risk management systems in preparation for a possible Member default via a more accurate representation of risk in its Clearing Fund calculation. As discussed above, NSCC's calculation of its Clearing Fund margin will be more accurate in that it will not include an assumption of trade closeouts following a Member insolvency with respect to trades for which there is a corresponding ID transaction.

Additionally, Commission Rule 17Ad-22(b)(1) regarding measurement and management of credit exposure,[15] adopted as part of the Clearing Agency Standards,[16] requires a CCP to establish, implement, maintain and enforce written policies and procedures reasonably designed to measure its credit exposures to its participants at least once a day and limit its exposures to potential losses from defaults by its participants under normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be

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[15] 17 CFR 240.17Ad-22(b)(1).

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

exposed to losses that they cannot anticipate or control.[17] Here, as described in detail above, NSCC's proposal to eliminate ID Offsets should help to limit its exposure and non-defaulting members' exposure to potential losses from a defaulting Member, while minimizing disruption to its CCP operations, by more accurately reflecting its risks in the calculation of its Clearing Fund margin.

Furthermore, Commission Rules 17Ad-22(d)(4) regarding identification and mitigation of operational risk,[18] and 17Ad-22(d)(11) regarding default procedures,[19] also both adopted as part of the Clearing Agency Standards,[20] require that registered clearing agencies "establish, implement, maintain and enforce written policies and procedures reasonably designed to, as applicable: …Identify sources of operational risk and minimize them through the development of appropriate systems, controls, and procedures…",[21] and "…establish default procedures that ensure that the clearing agency can take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a participant default,"[22] respectively. Here, as described in detail above, the elimination of ID Offsets should help NSCC better minimize settlement risks and better ensure that it can contain losses and liquidity pressures, and meet its obligations in a timely fashion, by more accurately accounting for those risks in a Clearing Fund calculation that is designed to satisfy potential losses in a timely manner.

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[17] 17 CFR 240.17Ad-22(b)(1).

[18] 17 CFR 240.17Ad-22(d)(4).

[19] 17 CFR 240.17Ad-22(d)(11).

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

[21] 17 CFR 240.17Ad-22(d)(4).

[22] 17 CFR 240.17Ad-22(d)(11).

In its assessment of the Advance Notice, the Commission assessed whether the issues raised by the Lek Letters relate to the level or nature of risks presented by NSCC's proposal, which is designed to mitigate risks to NSCC, as discussed above. After evaluating NSCC's responses to the Lek Letters, the Commission believes that the issues raised in the Lek Letters relate to the potential competitive effects of NSCC's proposal, not the level or nature of risks presented by it.[23] As such, the issues raised by the Lek Letters are not considered within the context of this Notice of No Objection to the Advance Notice under Title VIII; rather, they are considered within an analysis of the proposal's consistency with Section 17A of the Exchange Act and the applicable rules and regulations thereunder, which the Commission did in its "Order Approving Proposed Rule Change to Eliminate the Offset of [NSCC's] 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" (File No. SR-NSCC-2012-10).[24]

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[23] See Lek Letters, supra note 3.

[24] See Release No. 34-69302 (Apr. 4, 2013).

IV. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act,[25] that the Commission DOES NOT OBJECT to the proposed rule change described in the Advance Notice (File No. SR-NSCC-2012-810) and that NSCC be and hereby is AUTHORIZED to implement the proposed rule change as of the date of this notice or the date of the "Order Approving Proposed Rule Change to Eliminate the Offset of [NSCC's] 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" (File No. SR-NSCC-2012-10),[26] whichever is later.

By the Commission.

Kevin M. O'Neill
Deputy Secretary

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[25] 12 U.S.C. 5465(e)(1)(I).

[26] Release No. 34-69302 (Apr. 4, 2013).