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8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76075; File No. SR-NSCC-2015-803)

October 5, 2015

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice Filing to Enhance NSCC's Margining Methodology as Applied to Family-Issued Securities of Certain NSCC Members

National Securities Clearing Corporation ("NSCC") filed on August 14, 2015 with the Securities and Exchange Commission ("Commission") advance notice SR-NSCC-2015-803 ("Advance Notice") pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act")[1] and Rule 19b-4(n)(1)(i)[2] under the Securities Exchange Act of 1934 ("Exchange Act") to change its margin charge with respect to a member's positions in securities that are issued by such member or its affiliate (i.e., "family-issued securities") by excluding positions in these securities, when the member is on NSCC's Watch List,[3]

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1 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).

2 17 CFR 240.19b-4(n)(1)(i).

3 As part of its ongoing monitoring of its membership, NSCC utilizes an internal credit risk rating matrix to rate its risk exposures to its members based on a scale from 1 (the strongest) to 7 (the weakest). Members that fall within the weakest three rating categories (i.e., 5, 6, and 7) are placed on NSCC's "Watch List" and, as provided under NSCC's Rules and Procedures ("Rules"), may be subject to enhanced surveillance or additional margin charges. See Section 4 of Rule 2B and Section I(B)(1) of Procedure XV of NSCC's Rules, available at http://dtcc.com/~/media/Files/Downloads/legal/rules/nscc_rules.pdf.

from its volatility margining model. The Advance Notice was published for comment in the Federal Register on September 17, 2015.[4] The Commission did not receive any comments on the Advance Notice. This publication serves as notice of no objection to the Advance Notice.

I. Description of the Advance Notice

As described by NSCC in the Advance Notice, NSCC has proposed to enhance its margin methodology as applied to the family-issued securities of its members that are on its Watch List[5] by excluding these securities from the volatility component, or "VaR" charge, and then charging an amount calculated by multiplying the absolute value of the long net unsettled positions in that member's family-issued securities by a percentage that is no less than 40%. The haircut rate to be charged will be determined based on the member's rating on the credit risk rating matrix and the type of family-issued security submitted to NSCC. Fixed income securities that are family-issued securities will be charged a haircut rate of no less than 80% for firms that are rated 6 or 7 on the credit risk rating matrix, and no less than 40% for firms that are rated 5 on the credit risk rating matrix; and equity securities that are family-issued securities will be charged a haircut rate of 100% for firms that are rated 6 or 7 on the credit risk rating matrix, and no less

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4 See Securities Exchange Act Release No. 75899 (September 11, 2015), 80 FR 55883 (September 17, 2015) (File No. SR-NSCC-2015-803). NSCC also filed a 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. This proposed rule change was published in the Federal Register on September 2, 2015. Securities Exchange Act Release No. 75768 (August 27, 2015), 80 FR 53219 (September 2, 2015) (SR-NSCC-2015-003).

5 See Section 4 of Rule 2B and Section I(B)(1) of Procedure XV of NSCC's Rules, supra Note 3.

than 50% for firms that are rated 5 on the credit risk rating matrix. NSCC will have the authority to adjust these haircut rates from time to time within these parameters as described in Procedure XV of NSCC's Rules without filing a proposed rule change with the Commission pursuant to Section 19(b)(1) of the Exchange Act,[6] and the rules thereunder, or an advance notice with the Commission pursuant to Section 806(e)(1) of the Payment, Clearing and Settlement Supervision Act,[7] and the rules thereunder.

As described by NSCC in the Advance Notice, NSCC, as a central counterparty ("CCP"), 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. The effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical to achieving these risk-reducing goals. In that context, NSCC continuously reviews its margining methodology in order to ensure the reliability of its margining in achieving the desired coverage. In order to be most effective, NSCC must take into consideration the risk characteristics specific to certain securities when margining those securities.

Among the various risks that NSCC considers when evaluating the effectiveness of its margining methodology are its counterparty risks and identification and mitigation of "wrong-way" risk, particularly specific wrong-way risk, defined as the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of that counterparty deteriorates.[8] NSCC has identified an exposure to wrong-way risk when it

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[6] 15 U.S.C. 78s(b)(1).

[7] 12 U.S.C. 5465(e)(1).

[8] See Principles for financial market infrastructures, issued by the Committee on Payment and Settlement Systems and the Technical Committee of the

acts as a CCP to a member with respect to positions in securities that are issued by that member or that member's affiliate. These positions are referred to as "family-issued securities." In the event that a member with unsettled long positions in family-issued securities defaults, NSCC would close out those positions following a likely drop in the credit-worthiness of the issuer, possibly resulting in a loss to NSCC.

Therefore, the overall impact of NSCC's proposal, as described above, on risks presented by NSCC will be to reduce NSCC's exposure to this type of wrong-way risk by enhancing its margin methodology as applied to the family-issued securities of its members that are on its Watch List, and present a heightened credit risk to the clearing agency or have demonstrated higher risk related to their ability to meet settlement. NSCC believes a reduction in its exposures to wrong-way risk through a margining methodology that more effectively captures the risk characteristics of these positions will contribute to the goal of maintaining financial stability in the event of a member default and reduce systemic risk overall. Because NSCC members that are on its Watch List present a heightened credit risk to the clearing agency or have demonstrated higher risk related to their ability to meet settlement, NSCC believes that this charge will more effectively capture the risk characteristics of these positions and can help mitigate NSCC's exposure to wrong-way risk.

NSCC stated in the Advance Notice that it will continue to evaluate its exposures to wrong-way risk, specifically wrong-way risk presented by family-issued securities, including by reviewing the impact of expanding the application of the proposed margining methodology to the family-issued securities of those members that are not on

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International Organization of Securities Commissions 47 n.65 (April 2012), available at http://www.bis.org/publ/cpss101a.pdf.

the Watch List. NSCC is proposing to apply the enhanced margining methodology to the family-issued securities of members that are on the Watch List at this time because, as stated above, these members present a heightened credit risk to the clearing agency or have demonstrated higher risk related to their ability to meet settlement. As such, there is a clear and more urgent need to address NSCC's exposure to wrong-way risk presented by these firms' family-issued securities. However, any future change to the margining methodology as applied to the family-issued securities of members that are not on the Watch List would be subject to a separate proposed rule change pursuant to Section 19(b)(1) of the Exchange Act,[9] and the rules thereunder and an advance notice pursuant to Section 806(e)(1) of the Payment, Clearing and Settlement Supervision Act,[10] and the rules thereunder.

II. Discussion and Commission Findings

Although the Payment, Clearing and Settlement Supervision Act does not specify a standard of review for an advance notice, the Commission believes that the stated purpose of the Payment, Clearing and Settlement Supervision Act is instructive.[11] The stated purpose of the Payment, Clearing and Settlement Supervision Act 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 and strengthening the liquidity of systemically important

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[9] 15 U.S.C. 78s(b)(1).

[10] 12 U.S.C. 5465(e)(1).

[11] See 12 U.S.C. 5461(b).

financial market utilities.[12]

Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act [13] authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of 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 Payment, Clearing and Settlement Supervision Act [14] 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 has adopted risk management standards under Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act ("Clearing Agency Standards") and the Exchange Act.[15] The Clearing Agency Standards became effective on January 2, 2013, and 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

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12 Id.

13 12 U.S.C. 5464(a)(2).

14 12 U.S.C. 5464(b).

15 17 CFR 240.17Ad-22.

basis.[16] As such, it is appropriate for the Commission to review advance notices against these Clearing Agency Standards, and the objectives and principles of these risk management standards as described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.[17]

The Commission believes the proposal in the Advance Notice is consistent with the objectives and principles described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act,[18] and the Clearing Agency Standards, in particular, Rule 17Ad-22(b)(1)[19] and Rule 17Ad-22(b)(2)[20] under the Exchange Act, as described in detail below.

Consistency with Section 805(b) of the Act. The objectives and principles of Section 805(b) of the Payment, Clearing and Settlement Supervision Act are to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system.[21] By enhancing the margin methodology applied to family-issued securities of members that are on NSCC's Watch

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16 The Clearing Agency Standards are substantially similar to the risk management standards established by the Board of Governors of the Federal Reserve System governing the operations of designated financial market utilities 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 (August 2, 2012).

17 12 U.S.C. 5464(b).

18 Id.

19 17 CFR 240.17Ad-22(b)(1).

20 17 CFR 240.17Ad-22(b)(2).

21 12 U.S.C. 5464(b).

List, the proposal will assist NSCC in collecting margin that more accurately reflects NSCC's exposure to a clearing member that clears family-issued securities and will assist NSCC in its continuous efforts to improve the reliability and effectiveness of its risk-based margining methodology by taking into account specific wrong-way risk. As such, the proposal will help NSCC, as a CCP, promote robust risk management, and thus contributing to the goal of maintaining financial stability in the event of a member default.

Consistency with Rule 17Ad-22(b)(1). Rule 17Ad-22(b)(1)[22] under the Exchange Act requires a CCP, such as NSCC, to "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 . . . ." NSCC faces specific wrong-way risk in all circumstances where a member submits family-issued securities to NSCC for clearance, including under normal market conditions. By enhancing the margin methodology applied to family-issued securities of NSCC's members that are on its Watch List, the proposal will limit NSCC's exposure to potential losses from the default of a member on NSCC's Watch List with family-issued securities under normal market conditions. As such, the Commission believes that the proposal is consistent with Rule 17Ad-22(b)(1).

Consistency with Rule 17Ad-22(b)(2). Rule 17Ad-22(b)(2)[23] under the Exchange Act requires a CCP, such as NSCC, to "establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [u]se margin requirements to

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

[23] 17 CFR 240.17Ad-22(b)(2).

limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements . . . .” By enhancing the margin methodology applied to family-issued securities of NSCC’s members that are on its Watch List, the proposal will better account for and cover NSCC’s credit exposure to less creditworthy members. In addition, by taking into account specific wrong-way risk arising from family-issued securities submitted to NSCC, the proposal is consistent with using risk based models and parameters to set margin requirements. As such, the Commission believes that the proposal is 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,[24] that the Commission DOES NOT OBJECT to Advance Notice and that NSCC is AUTHORIZED to implement the proposal.

By the Commission.

Robert W. Errett,
Deputy Secretary.

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[24] 12 U.S.C. 5465(e)(1)(I).