This document is scheduled to be published in the
Federal Register on 11/01/2016 and available online at
https://federalregister.gov/d/2016-26303, and on **FDsys.gov**

8011-01
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-79167; File Nos. SR-FICC-2016-006; SR-NSCC-2016-004)

October 26, 2016

Self-Regulatory Organizations; Fixed Income Clearing Corporation; National Securities Clearing Corporation; Order Granting Approval of Proposed Rule Changes to Describe the Backtesting Charge and the Holiday Charge that May Be Imposed on Members

On September 2, 2016, Fixed Income Clearing Corporation ("FICC") and National Securities Clearing Corporation ("NSCC," collectively "Clearing Agencies") filed with the Securities and Exchange Commission ("Commission") proposed rule changes SR-FICC-2016-006 and SR-NSCC-2016-004, respectively, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The proposed rule changes were published for comment in the Federal Register on September 15, 2016.[3] The Commission did not receive any comment letters on the proposed rule changes. For the reasons discussed below, the Commission is granting approval of the proposed rule changes.

I. Description of the Proposed Rule Changes

The proposed rule changes provide transparency in the FICC Government Securities Division ("GSD") Rulebook ("GSD Rules"), the FICC Mortgage-Backed Securities Division ("MBSD") Clearing Rules ("MBSD Rules"), and the NSCC Rules

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release Nos. 78807 (September 9, 2016), 81 FR 63538 (September 15, 2016) (SR-FICC-2016-006); 78808 (September 9, 2016), 81 FR 63511 (September 15, 2016) (SR-NSCC-2016-004) ("Notices").

and Procedures ("NSCC Rules," collectively "Clearing Agency Rules")[4] with respect to certain margin charges that the Clearing Agencies may temporarily impose on a Clearing Agency member ("Member") as part of such Member's Required Deposit. The charges proposed are the FICC Backtesting Charge and the NSCC Backtesting Charge (collectively, "Backtesting Charge"), and the FICC Holiday Charge and the NSCC Bank Holiday Charge (collectively, "Holiday Charge").

A Clearing Agency may impose the Backtesting Charge on a Member when the Clearing Agency has observed deficiencies in the backtesting of such Member's Required Deposit over the prior 12-month period, such that the Clearing Agency determines the value-at-risk ("VaR") margin charge being calculated for that Member may not fully address the projected liquidation losses estimated from that Member's settlement activity.

The Holiday Charge addresses the risk exposure that occurs on certain Holidays[5] when the Clearing Agency is unable to collect Required Deposit from its Members because the Board of Governors of the Federal Reserve System and banks are closed. The Clearing Agencies may impose the Holiday Charge on all Members to cover the

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4 The GSD Rules, MBSD Rules, and NSCC Rules are available at http://www.dtcc.com/legal/rules-and-procedures. Capitalized terms used herein and not otherwise defined shall have the meaning assigned to such terms in the Clearing Agency Rules, as applicable.

5 For NSCC, "Holiday" means any day on which equities markets are open for trading, but the Board of Governors of the Federal Reserve System observes a holiday and banks are closed. Exhibit 5 for SR-NSCC-2016-004, available at https://www.sec.gov/rules/sro/nscc/2016/34-78808-ex5.pdf. For FICC, "Holiday" means any day on which FICC is closed, but the day is not observed as a holiday by the Securities Industry and Financial Markets Association and the bond markets are open. Exhibit 5 for SR-FICC-2016-006, available at https://www.sec.gov/rules/sro/ficc/2016/34-78807-ex5.pdf.

additional day of exposure that is not contemplated in the prior day's VaR charge.[6]

A. Calculation of the Backtesting Charge

The objective of the Backtesting Charge is to increase Required Deposits for Members that are likely to experience backtesting deficiencies by an amount sufficient to maintain such Member's backtesting coverage above the 99 percent confidence threshold. Because the settlement activity and size of the backtesting deficiencies varies among impacted Members, the Clearing Agencies must assess a Backtesting Charge that is specific to each impacted Member. To do so, the Clearing Agencies examine each impacted Member's historical backtesting deficiencies observed over the prior 12-month period to identify the three largest backtesting deficiencies that have occurred during that time. The presumptive Backtesting Charge amount equals that Member's third largest historical backtesting deficiency, subject to adjustment as further described below. The Clearing Agencies stated in the Notices that they believe that applying an additional margin charge equal to the third largest historical backtesting deficiency to a Member's Required Deposit would bring the Member's historically-observed backtesting coverage above the 99 percent target.[7] If assessed, the resulting Backtesting Charge is added to the Required Deposit for such Member determined pursuant to each Clearing Agency's risk-based margining methodology, and is imposed on a daily basis for a one-month period.

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6 The description of the proposed rule changes herein is based on the statements prepared by the Clearing Agencies in the Notices. Notices, supra note 3, 81 FR at 63538–40 and 63512–13.

7 Each occurrence of a backtesting deficiency reduces a Member's overall backtesting coverage by 0.4 percent (1 exception / 250 observation days). Accordingly, an increase equal to the third largest backtesting deficiency would bring backtesting coverage up to 99.2 percent. Notices, supra note 3, 81 FR at 63539 and 63512.

This charge is only applicable to those Members whose overall 12-month trailing backtesting coverage falls below the 99 percent coverage target.

Although the third largest historical backtesting deficiency for a Member is used as the Backtesting Charge in most cases, each Clearing Agency retains discretion to adjust the charge amount based on other circumstances that may be relevant for assessing whether an impacted Member is likely to experience future backtesting deficiencies and the estimated size of such deficiencies. Examples of relevant circumstances that would be considered in calculating the final, applicable Backtesting Charge amount include material differences in the three largest backtesting deficiencies observed over the prior 12-month period, variability in the net settlement activity after the collection of the Member's Required Deposit, seasonality in observed backtesting deficiencies and observed market price volatility in excess of the Member's historical VaR charge. Based on the Clearing Agencies' assessment of the impact of these circumstances on the likelihood of, and estimated size of, future backtesting deficiencies for a Member, the Clearing Agencies may, in their discretion, adjust the Backtesting Charge for such Member in an amount that the Clearing Agencies determine to be more appropriate for maintaining such Member's backtesting results above the 99 percent coverage threshold (including a reasonable buffer).

B. Communication with Members and Imposition of the Backtesting Charge

If the Clearing Agencies determine that a Backtesting Charge should apply to a Member that was not assessed a Backtesting Charge during the immediately preceding month or that the Backtesting Charge applied to a Member during the previous month should be increased, the Clearing Agencies will notify the Member on or around the 25th

calendar day of the month prior to the assessment of the Backtesting Charge, or prior to the increase to the Backtesting Charge.

Each Clearing Agency imposes the Backtesting Charge as an additional charge applied to each impacted Member's Required Deposit on a daily basis for a one month period, and reviews each applied Backtesting Charge each month. If an impacted Member's trailing 12-month backtesting coverage exceeds 99 percent (without taking into account historically-imposed Backtesting Charges), the Backtesting Charge is removed.

C. Holidays and the Required Deposit

As described above, the Clearing Agencies determine their Members' Required Deposit amounts in each Clearing Agency using a risk-based margin methodology that is intended to capture market price risk, assuming that a portfolio would take three days to liquidate or hedge in normal market conditions.

The Holiday Charge may be applied on the business day prior to any Holiday. This charge approximates the exposure that a Member's trading activity on the applicable Holiday could pose to the Clearing Agency. Because the Clearing Agencies cannot collect margin on the Holiday, the Holiday Charge is due on the business day prior to the applicable Holiday.

D. Calculation and Notification of the Holiday Charge

Each Clearing Agency would determine the appropriate methodology for calculating the Holiday Charge in advance of each applicable Holiday. Potential methodologies for calculating the Holiday Charge include, for example, time scaling of

the VaR charge[8] or application of stress scenarios that cover potential market price risk exposure that may not be appropriately covered by scaling the VaR charge. The Clearing Agencies would establish a methodology for calculating each Holiday Charge that would take into consideration the market conditions prevailing at that time in order to permit the Clearing Agencies to calculate a Holiday Charge that appropriately estimates the risk that may be presented to the Clearing Agency on the applicable Holiday, when Members' Required Deposit cannot be collected. The Holiday Charge would represent a percentage increase of the volatility charge on the business day prior to the Holiday, and such percentage increase applies uniformly to all Members. This means that if the Holiday Charge is levied, the same methodology (i.e., formula) is applied to all Members (that is, the Holiday Charge is not a set dollar amount applied to all Members).

Members would be notified of the applicable methodology by an Important Notice issued no later than 10 business days prior to the application the Holiday Charge, and the charge is collected on the business day prior to the applicable Holiday. The Holiday Charge is removed from the Required Deposit on the business day following the Holiday.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act[9] directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is

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8 Market price risk and volatility increase with time as there is a greater potential for loss. This additional risk exposure is often approximated by time scaling of volatility by multiplying square root of the additional period of risk (e.g., if the VaR charge is calibrated to a 3-day risk horizon, an additional day of exposure could be approximated by $\sqrt{4/3}$ * VaR charge).

9 15 U.S.C. 78s(b)(2)(C).

consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. The Commission believes the proposal is consistent with Section 17A(b)(3)(F) of the Act and Rules 17Ad-22(b)(1) and (b)(2),[10] as described in detail below.

A. Consistency with Section 17A

Section 17A(b)(3)(F) of the Act requires, in part, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds that are within the custody or control of the clearing agency.[11] By incorporating the Backtesting Charge and Holiday Charge into the Rules, the proposed changes help protect the Clearing Agencies from potential losses in the event that a Member defaults. Specifically, the Backtesting Charge enables the Clearing Agencies to collect additional funds when their current margin collections may be insufficient, as indicated by backtesting deficiencies. Meanwhile, the Holiday Charge enables the Clearing Agencies to collect margin in advance of Holidays when the Clearing Agencies would be unable to collect margin. Therefore, by enabling the Clearing Agencies to better assess and collect funds, as the Clearing Agencies deem necessary, the charges would promote the safeguarding of securities and funds that are within the custody or control of the clearing agency, consistent with the requirements of the Exchange Act, in particular Section 17A(b)(3)(F).

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

Rule 17Ad-22(b)(1) under the Act requires a clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to

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[10] 15 U.S.C. 78q-1(b)(3)(F); 17 C.F.R. § 240.17Ad-22(b)(1); 17 C.F.R. § 240.17Ad-22(b)(2).

[11] 15 U.S.C. 78q-1(b)(3)(F).

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 clearing agency would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.[12] The Backtesting Charge and Holiday Charge are enhancements to the way the Clearing Agencies measure their credit exposure to Members and, ultimately, account for potential increases in exposure by collecting additional margin, as deemed necessary by the Clearing Agencies, to help limit potential losses from a Member default in normal market conditions. Therefore, the proposed rule changes are consistent with Rule 17Ad-22(b)(1) under the Act.[13]

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

Rule 17Ad-22(b)(2) under the Act requires a clearing agency to maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions.[14] The Backtesting Charge and Holiday Charge are components of the margin requirement that the Clearing Agencies collect from Members, in the form of Required Deposits, to help limit the Clearing Agencies' credit exposure to Members in normal market conditions. Therefore, the proposed rule changes are consistent with Rule 17Ad-22(b)(2) under the Act.[15]

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12 17 C.F.R. § 240.17Ad-22(b)(1).

13 Id.

14 17 C.F.R. § 240.17Ad-22(b)(2).

15 Id.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposals are consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act[16] and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule changes SR-FICC-2016-006 and SR-NSCC-2016-004 be, and hereby are, APPROVED.[17]

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[18]

Brent J. Fields
Secretary

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16 15 U.S.C. 78q-1.

17 In approving the proposed rule change, the Commission considered the proposals' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

18 17 CFR 200.30-3(a)(12).

[FR Doc. 2016-26303 Filed: 10/31/2016 8:45 am; Publication Date: 11/1/2016]