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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-83222; File No. SR-FICC-2018-004]

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Introduce a Floor to the Calculation of the Fails Charges and Make Other Changes

May 11, 2018.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on May 8, 2018, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the clearing agency. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would update (a) both the FICC Government Securities Division ("GSD") Rulebook ("GSD Rules") and the FICC Mortgage-Backed Securities Division ("MBSD") Clearing Rules ("MBSD Rules")[3] to (i) introduce a floor of one (1) percent to the calculation of the existing fails charge rules; (ii) clarify the target rate that may be used in the fails charge calculations under certain circumstances; (iii) add two defined terms to effectuate the proposed target-rate clarification; and (iv) make certain

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

2 17 CFR 240.19b-4.

3 Capitalized terms not defined herein are defined in the GSD Rules and the MBSD Rules, as applicable, available at http://www.dtcc.com/legal/rules-and-procedures.

technical changes to the fails-charge provisions to ensure consistent use of defined terms; and (b) the MBSD Rules only, to clarify that a cap applies to the MBSD fails charge.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the clearing agency included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The clearing agency has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of this proposed rule change is to update (a) both the GSD Rules and the MBSD Rules[4] to (i) introduce a floor of one (1) percent to the calculation of the existing fails charge rules; (ii) clarify the target rate that may be used in the fails charge calculations under certain circumstances; (iii) add two defined terms to effectuate the proposed target-rate clarification; and (iv) make certain technical changes to the fails-charge provisions to ensure consistent use of defined terms; and (b) the MBSD Rules only, to clarify that a cap applies to the MBSD fails charge. Each of these proposed changes is described in detail below.

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[4] Id.

(i) Background

In 2009, the Commission approved FICC's proposal to implement a fails charge in the GSD Rules[5] to be compliant with best practice guidelines issued by the Treasury Market Practices Group ("TMPG"). As described on the website of the Federal Reserve Bank of New York, the TMPG is a group of market professionals committed to supporting the integrity and efficiency of the Treasury, agency debt (i.e., debentures of certain U.S. government agencies and government-sponsored enterprises) and agency mortgage-backed securities markets.[6] The TMPG meets regularly to discuss and promote best practices related to trading, settlement and risk management in the Treasury, agency debt and agency mortgage-backed securities markets. From time to time, the TMPG publishes guidance to market participants, including the *Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets* and *Fails Charge Trading Practice* recommendations for the Treasury, agency debt, and agency mortgage-backed securities markets.[7]

The TMPG fails charge guidelines were aimed at addressing persistent settlement fails in Treasury securities transactions that had arisen in the market. As noted in TMPG's *Frequently Asked Questions: TMPG Fails Charges*, persistent elevated fail levels create market inefficiencies, increase credit risk for market participants and

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5 Securities Exchange Act Release No. 59802 (April 20, 2009), 74 FR 19248 (April 28, 2009) (SR-FICC-2009-03).

6 See https://www.newyorkfed.org/tmpg. The TMPG is composed of senior business managers and legal and compliance professionals from a variety of institutions – including securities dealers, banks, buy-side firms, market utilities and others – and is sponsored by the Federal Reserve Bank of New York. Id.

7 See https://www.newyorkfed.org/tmpg/about.html.

heighten overall systemic risk.[8] In order to encourage market participants to resolve fails promptly, the TMPG had proposed to adopt a market-wide best practice of assessing a charge on failed positions. As part of the implementation of this best practice, the TMPG requested GSD to impose the fails charge on failed positions within GSD, which became the subject of FICC's 2009 proposed rule change.[9] As one of the largest participants in the Treasury market, FICC believes that it was imperative that FICC adhere to these best practice recommendations and help maintain consistency and symmetry within this market.

In 2011, FICC amended the GSD Rules to expand the fails charge provision to agency debt transactions.[10] Therefore, the charge now applies to fails of Deliver Obligations[11] of Treasury securities or debentures issued by Fannie Mae, Freddie Mac or the Federal Home Loan Banks.[12] The charge is applied daily and is a debit (or a credit for those with fails to receive) on the member's GSD monthly bill.

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8 *Frequently Asked Questions: TMPG Fails Charges* (April 23, 2018) at 1, available at https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/TMPG-Fails-Charge-FAQ-04-23-2018.pdf ("FAQ").

9 Securities Exchange Act Release No. 59802 (April 20, 2009), 74 FR 19248 (April 28, 2009) (SR-FICC-2009-03).

10 Securities Exchange Act Release No. 65910 (December 8, 2011), 76 FR 77861 (December 14, 2011) (SR-FICC-2011-08).

11 "Deliver Obligation" means a Netting Member's obligation to deliver Eligible Netting Securities to FICC at the appropriate Settlement Value either in satisfaction of all or a part of a Net Short Position or to implement a collateral substitution in connection with a Repo Transaction with a Right of Substitution. GSD Rule 1, supra note 3.

12 GSD Rule 11, Section 14, supra note 3.

The current fails charge calculation, which was approved by the Commission, and remains as such in the GSD Rules is equal to the product of the (i) funds associated with a failed position and (ii) the greater of (a) 0 percent or (b) 3 percent per annum minus the Target Fed funds target rate that is effective at 5 p.m. EST on the Business Day prior to the originally scheduled settlement date, capped at 3 percent per annum.[13] The following example illustrates the manner in which the current fails charge applies: Assume that Member A fails today on a $50 million position on which he is owed $50.1 million. Assume further that the Target Fed funds rate yesterday at 5 p.m. was 1 percent. The fails charge will be 2 percent per annum and it will be applied to the funds amount of $50.1 million, thus equaling a charge of $2,783.33 for that day. The member's bill will reflect a debit of $2,783.33. The debits and credits will be accrued and will apply to the member's monthly bill.

In 2012, the Commission approved the implementation of a fails charge in the MBSD Rules, as part of a larger proposed rule change to make MBSD a central counterparty.[14] The fails charge calculation in MBSD is identical to the GSD calculation with the exception of the percent per annum amount from which the federal funds target rate is subtracted—in GSD, this is 3 percent per annum and in MBSD, it is 2 percent per annum.[15] The TMPG has explained its reasons for recommending the 3 percent rate level for Treasury and agency debt and the 2 percent rate level for agency mortgage-backed securities. Specifically, the TMPG has stated the TMPG recommendation is designed to

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[13] Id.

[14] Securities Exchange Act Release No. 66550 (March 9, 2012), 77 FR 15155 (March 14, 2012) (SR-FICC-2008-01).

[15] MBSD Rule 12, supra note 3.

give sellers an economic incentive to deliver securities even when the federal funds rate is low. Experience shows that Treasury and agency debt fails have rarely become widespread and chronic if the fed funds rate is above about 3 percent. This suggests that market participants generally act to cure settlement fails reasonably promptly as long as the economic cost of a fail is not less than about 3 percent.[16] The TMPG also stated that it recommended a lower charge cap level of 2 percent for the agency mortgage-backed securities market, given structural differences in this market compared to the agency debt and Treasury markets. These differences include monthly settlement conventions that make fails more persistent and more challenging to resolve quickly.[17] In 2013, following a new TMPG recommendation,[18] the Commission approved FICC's proposal to delete the two-day grace period from the original 2012 implementation of the fails charge in the MBSD Rules.[19]

Under both the GSD and MBSD versions of the current fails charge, the calculation of the charge could result in a zero charge. Under the GSD version of the current fails charge, if the fails charge is 3 percent and the federal funds target rate is 3 percent, then the calculation of the charge in this case would result in a zero charge. Similarly, under the MBSD version of the current fails charge, if the fails charge is 2

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16 FAQ at 6, supra note 8.

17 Id.

18 Press Release, Federal Reserve Bank of New York, *TMPG Revises Agency MBS Fails Charge Trading Practice* (March 1, 2013), available at https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/03_01_2013_Fails_charges_press_release.pdf.

19 Securities Exchange Act Release No. 69708 (June 6, 2013), 78 FR 35333 (June 12, 2013) (SR-FICC-2013-01).

percent and the federal funds target rate is 2 percent, then the calculation of the charge in this case would result in a zero charge.

(ii) Proposed Amendments to the GSD and MBSD Fails Charges

On February 28, 2018, the TMPG announced a proposed change to its best practice regarding the fails charge to introduce a floor of one (1) percent so that a minimum charge amount would result from the calculation of the charge.[20] The TMPG has stated that this proposed change in best practices is to help ensure that processes and resourcing to address the fails charges at firms remain in place so that during times of increased applicability of the fails charges the firms have the staff and systems to handle the charges. There is a concern that if the fails charge is permitted to go to zero for a prolonged period, firms will begin to deploy resources elsewhere.

The TMPG has requested that FICC amend the GSD and MBSD fails charges to mirror the TMPG's revised recommendation regarding the imposition of the floor. As one of the largest participants in the Treasury, agency and mortgage-backed securities markets, FICC believes that it is imperative that FICC adhere to these best practice recommendations and help maintain consistency and symmetry among the markets. FICC agrees with the TMPG recommendation regarding the imposition of the floor and proposes to amend the GSD Rules and the MBSD Rules to implement such change.

For the GSD Rules, the proposed rule change would consist of deleting the "0" in the calculation of the fails charge in GSD Rule 11, Section 14 and replacing it with "1."

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[20] See Press Release, Federal Reserve Bank of New York, *Treasury Market Practices Group Seeks Public Comment on Proposed Updates to its Fails Charge Practice Recommendation* (February 28, 2018), available at https://www.newyorkfed.org/medialibrary/Microsites/tmpg/files/PressRelease_022818.

For the MBSD Rules, the proposed rule change would also consist of deleting the "0" in the calculation of the fails charge in MBSD Rule 12 and replacing it with "1."

(iii) Proposed Clarifications Regarding the GSD and MBSD Fails Charges and Additional Defined Terms to Effectuate Certain of These Clarifications

FICC is also proposing to clarify the target rate that is referenced in the calculation of both the GSD and MBSD fails charges. Both divisions' fails charges reference the federal funds target rate. Per the TMPG guidelines, if the Federal Open Market Committee ("FOMC") specifies a target range in lieu of a target level, the lower limit of the target range announced by the FOMC would be used in the calculation of the fails charge.[21] Further, if the FOMC were to terminate its policy of specifying or announcing a target level or range for the federal funds rate, then the rate that is used for the calculation of the fails charge would be a successor rate and source recommended by the TMPG.[22] While FICC would follow the TMPG guidelines in this regard, the fails charge rule provisions in each of the GSD Rules and the MBSD Rules do not state this. Therefore, for clarity and transparency, FICC proposes to update the relevant provisions to reflect that FICC would follow this practice if those circumstances arose. In order to effectuate these clarifications, FICC is proposing to add defined terms for "FOMC" and "TMPG" in each of GSD Rule 1 and MBSD Rule 1.

In addition, while the GSD Rules expressly set forth the fails charge cap (i.e., 3 percent per annum), the MBSD Rules do not. The MBSD fails charge cap follows the

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[21] *U.S. Treasury Securities: Fails Charge Trading Practice* (July 13, 2016), at 3, available at https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/Fails-Charge-Trading-Practice-2016-07-13.pdf ("Fails Charge Trading Practice").

[22] Id.

same convention as the GSD one, which is the percentage that is applied to the target federal funds rate. In the case of MBSD, this cap is 2 percent per annum. FICC proposes to clarify the MBSD fails charge provision by adding language regarding the cap on the fails charge.

(iv) Technical Changes

FICC is proposing to make a technical change regarding references to the federal funds rate in the fails charge calculation in the GSD Rules and the MBSD Rules. The current term "Target Fed funds target rate" in Section 14 of GSD Rule 11 and the current term "fed funds target rate" in MBSD Rule 12 would be replaced with the new term "target level for the federal funds rate," which is the term used by the TMPG in its guidance. FICC believes that this non-substantive change would enhance clarity across the GSD Rules and MBSD Rules and enhance consistency with the TMPG guidance.

FICC is also proposing to amend certain terms in the fails charge provisions of both the GSD Rules and MBSD Rules in order to use defined terms and to enhance clarity and consistency within the GSD Rules and MBSD Rules. Specifically, in GSD Rule 11, Section 14 and in MBSD Rule 12, the term "Fedwire" would be replaced with the defined term "FedWire." In MBSD Rule 12, the terms "pool delivery obligation" and "pool deliver obligation" would be replaced each time it appears with the defined term "Pool Deliver Obligation." In MBSD Rule 12, the word "contractual" in the term "contractual Settlement Date" would be capitalized to use the defined term "Contractual Settlement Date" and the term "business day" would be replaced with the defined term "Business Day."

Implementation Timeframe

Pending SEC approval, FICC would implement this proposal on July 2, 2018. FICC would announce such implementation date by Important Notice. As proposed, a legend would be added to each of GSD Rule 1, GSD Rule 11, MBSD Rule 1, and MBSD Rule 12 stating that there are changes that have been approved by the Commission but have not yet been implemented. The proposed legend also would include a date on which such changes would be implemented and the file number of this proposal, and state that, once this proposal is implemented, the legend would automatically be removed from such rule.

2. Statutory Basis

FICC believes that this proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a registered clearing agency. Specifically, FICC believes that this proposal is consistent with Section 17A(b)(3)(F) of the Act[23] and Rule 17Ad-22(e)(23)(ii),[24] as promulgated under the Act, for the reasons described below.

Section 17A(b)(3)(F) of the Act requires, in part, that the GSD Rules and the MBSD Rules be designed to promote the prompt and accurate clearance and settlement of securities transactions.[25] FICC believes the proposed rule changes to amend the GSD and MBSD fails charges to include a floor in the calculation of the charges would encourage firms to complete their securities settlement obligations on a timely basis. By

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[23] 15 U.S.C. 78q-1(b)(3)(F).

[24] 17 CFR 240.17Ad-22(e)(23)(ii).

[25] 15 U.S.C. 78q-1(b)(3)(F).

doing so, settlement in the applicable markets covered by FICC's processes would occur on a timely basis and thereby promote the prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.[26]

This proposal is also consistent with Rule 17Ad-22(e)(23)(ii) under the Act. Rule 17Ad-22(e)(23)(ii) under the Act requires FICC to establish, implement, maintain and enforce written policies and procedures reasonably designed to provide sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency.[27] The proposed rule changes would update: (a) both the GSD Rules and the MBSD Rules to (i) clarify the target rate that may be used in the fails charge calculations under certain circumstances; (ii) add two defined terms to effectuate the proposed target-rate clarification; and (iii) make certain technical changes to the fails-charge provisions to ensure consistent use of defined terms; and (b) the MBSD Rules only, to clarify that a cap applies to the MBSD fails charge. FICC believes these proposed rule changes would help ensure that the GSD and MBSD fails charges are transparent and clear to members. Having transparent and clear provisions in this regard would enable members to better understand the operation of the fails charges in GSD and MBSD and would provide members with increased predictability and certainty regarding their obligations. As such, FICC believes that the proposed rule changes are consistent with Rule 17Ad-22(e)(23)(ii) under the Act.[28]

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[26] Id.

[27] 17 CFR 240.17Ad-22(e)(23)(ii).

[28] Id.

(B) Clearing Agency's Statement on Burden on Competition

FICC believes that the proposed rule changes to amend the calculation of the fails charge in each of the GSD Rules and the MBSD Rules to implement a floor could have an impact on competition because the implementation of the floor would result in higher fail charges for members that incur the charge.[29] Specifically, FICC believes this proposed rule change could burden competition by negatively affecting such members' operating costs. While such members may experience increases in their fails charges, FICC does not believe such change would in and of itself mean that the burden on competition is significant. Even though the amount of the increase may be significant, FICC believes the increase in the charge would similarly affect all members that tend to incur the fails charge. Regardless of whether the burden on competition is deemed significant, FICC believes any burden on competition that is created by the proposed rule changes to implement the proposed floor would be necessary and appropriate in furtherance of the purposes of the Act, as permitted by Section 17A(b)(3)(I) of the Act.[30]

FICC believes the proposed rule changes to amend the calculation of the fails charge in each of the GSD Rules and the MBSD Rules to implement a floor would be necessary in furtherance of the purposes of the Act.[31] FICC believes that persistent elevated fail levels create overall systemic risk because they (i) do not permit members and FICC to complete timely settlement and (ii) create uncertainty regarding the timing of settlement. The proposed rule changes to implement the floor would further discourage

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[29] 15 U.S.C. 78q-1(b)(3)(I).

[30] Id.

[31] Id.

fails and therefore mitigate against this systemic risk. Therefore, FICC believes the proposed rule changes to amend the calculation of the fails charge in each of the GSD Rules and the MBSD Rules to implement a floor would be necessary in furtherance of the purposes of the Act, as permitted by Section 17A(b)(3)(I) of the Act.[32]

FICC also believes any burden on competition that is created by the proposed rule changes to amend the calculation of the fails charge in each of the GSD Rules and the MBSD Rules to implement a floor would be appropriate in furtherance of the purposes of the Act.[33] Under the proposal, the fails charge would continue to apply to those members that engage in fails, and the application of the charge as such would not be changed by the proposed rule change. The proposed change to impose the floor would result in a charge being realized each time that a member engages in a fail, but this would apply equally to all members who do so. As such, FICC believes that the proposed rule changes to amend the calculation of the fails charge in each of the GSD Rules and the MBSD Rules to implement a floor would be appropriate in furtherance of the purposes of the Act, as permitted by Section 17A(b)(3)(I) of the Act.[34]

FICC does not believe there would be an impact on competition with the proposed rule changes that would update (a) both the GSD Rules and the MBSD Rules to (i) clarify the target rate that may be used in the fails charge calculations under certain circumstances; (ii) add two defined terms to effectuate the target-rate clarification; and (iii) make certain technical changes to the fails-charge provisions to ensure consistent use

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[32] Id.

[33] Id.

[34] Id.

of defined terms; and (b) the MBSD Rules only, to clarify that a cap applies to the MBSD fails charge.[35] These changes would ensure that the GSD Rules and the MBSD Rules remain clear and would facilitate members' understanding regarding the applicability of the GSD and MBSD fails charges. These changes would not affect members' rights and obligations. As such, FICC believes that these proposed rule changes would not have any impact on competition.

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments relating to this proposed rule change have not been solicited or received. FICC will notify the Commission of any written comments received by FICC.

III. Date of Effectiveness of the Proposed Rule Change, and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve or disapprove such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

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[35] Id.

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FICC-2018-004 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

All submissions should refer to File Number SR-FICC-2018-004. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/sro.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of FICC and on DTCC's website (http://dtcc.com/legal/sec-rule-filings.aspx). All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information

from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FICC-2018-004 and should be submitted on or before **[INSERT DATE 21 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[36]

Eduardo A. Aleman,
Assistant Secretary.

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[36] 17 CFR 200.30-3(a)(12).

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