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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-83457; File No. SR-FICC-2018-004]

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

June 18, 2018.

On May 8, 2018, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2018-004, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder.[2] The proposed rule change was published for comment in the Federal Register on May 17, 2018.[3] The Commission did not receive any comment letters on the proposed rule change. For the reasons discussed below, the Commission approves the proposed rule change.

I. Description of the Proposed Rule Change

The proposed rule change would update FICC's Government Securities Division ("GSD") Rulebook ("GSD Rules") and FICC's Mortgage-Backed Securities Division ("MBSD") Clearing Rules ("MBSD Rules")[4] to (i) introduce a floor of one percent to the calculation of the existing fails charge rules, (ii) clarify the target rate that may be used in

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

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 83222 (May 11, 2018), 83 FR 23032 (May 17, 2018) (SR-FICC-2018-004) ("Notice").

4 The GSD Rules and the MBSD Rules are available at http://www.dtcc.com/legal/rules-and-procedures.

the fails charge calculations under certain circumstances, and (iii) make certain technical changes to the fails charge provisions to ensure consistent use of defined terms.[5] The proposed rule change would also update the MBSD Rules to clarify that a cap applies to the MBSD fails charge.[6] Each of these proposed changes are described below.

A. Proposed One Percent Floor

In a securities transaction, a settlement fail occurs when the seller does not deliver the securities to the buyer on the agreed upon settlement date. FICC states that although settlement fails are generally not treated as contractual default events, provided that the failing seller delivers the securities soon after the settlement date, persistent elevated levels of settlement fails create market inefficiencies and increase credit risk for market participants.[7]

To help mitigate settlement fails, FICC maintains a fails charge in both the GSD Rules and the MBSD Rules.[8] However, FICC states that under the current GSD Rules and MBSD Rules, the respective fails charge calculations could result in a zero charge.[9] Specifically, under the GSD version of the current fails charge, if the federal funds target rate would rise to three percent, then the calculation of the charge would result in a zero

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5 Notice, 83 FR at 23032-34.

6 Id.

7 See Notice, 83 FR at 23033. See also 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").

8 GSD Rule 11; MBSD Rule 12, supra note 4.

9 Id.; Notice, 83 FR at 23034.

charge.[10] Similarly, under the MBSD version of the current fails charge, if the federal funds target rate would rise to two percent, then the calculation of the charge would result in a zero charge.[11] To address this issue, FICC proposes to amend the GSD Rules and the MBSD Rules to add a one percent floor to the respective GSD and MBSD fails charge calculations.[12]

FICC's proposal comes in response to a recent announcement by the Treasury Market Practices Group ("TMPG"),[13] in which the TMPG proposed the same change to its recommended best practices to help ensure that there is always a minimum fails charge amount.[14] The TMPG states that its recommendation of a one percent floor is driven by the concern that market participants would discontinue their fails charge operational processes in a prolonged zero charge scenario.[15] Adding the one percent

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10 Id.

11 Id.

12 Id.

13 The TMPG was formed in 2007, under the sponsorship of the Federal Reserve Bank of New York, to help address settlement fails and other issues affecting the U.S. Government debt and mortgage-backed securities markets. The Treasury Market Practices Group: Creation and Early Initiatives (August 2017) at 3, available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr822.pdf. The TMPG is a group of market professionals that periodically issues recommended trading practices for market participants. Id.

14 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.

15 Id.

floor would help maintain a fails charge during elevated federal funds target rate levels, and thereby help ensure that market participants do not discontinue their fails charge operational processes.[16]

FICC states that as one of the largest participants in U.S. Government securities market, it is imperative that FICC implement the TMPG's recommendation to help maintain consistency and symmetry within the market.[17]

B. Federal Funds Level Target Range Clarification

Pursuant to 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.[18] Further, if the FOMC were to terminate its policy of specifying or announcing a federal funds rate target level or range, then the rate used to calculate the fails charge would be a successor rate and source recommended by the TMPG.[19]

While FICC states that it would follow the TMPG guidelines in this regard,[20] this practice is currently not stated in the fails charge rule provisions in each of the GSD Rules and the MBSD Rules. Therefore, FICC proposes to update the relevant provisions

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16 Id.

17 Notice, 83 FR at 23034.

18 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").

19 Id.

20 Notice, 83 FR at 23034.

to reflect that FICC would follow this practice if those circumstances arose.[21] Additionally, FICC proposes to add defined terms for "FOMC" and "TMPG" in each of GSD Rule 1 and MBSD Rule 1.[22]

C. Technical Changes

FICC proposes to make a technical change regarding references to the federal funds rate in the fails charge calculation in both the GSD Rules and the MBSD Rules. Specifically, FICC would replace 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 with the new term "target level for the federal funds rate," which is the term used by the TMPG in its guidance.[23] FICC states that this non-substantive change would enhance clarity across the GSD Rules and MBSD Rules and enhance consistency with the TMPG guidance.[24]

FICC also proposes 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 rules. Specifically, in GSD Rule 11, Section 14, and in MBSD Rule 12, FICC would replace the term "Fedwire" with the defined term "FedWire."[25] In MBSD Rule 12, FICC would replace each reference to the terms "pool delivery obligation" and "pool deliver obligation" with the defined term "Pool Deliver

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21 Id.

22 Id.

23 Id.

24 Id.

25 Id.

Obligation."[26] In MBSD Rule 12, FICC would capitalize the word "contractual" in the term "contractual Settlement Date."[27] Finally, FICC would replace the term "business day" with the capitalized and defined term "Business Day."[28]

D. MBSD Fails Charge Cap Clarification

While the GSD Rules expressly set forth the fails charge cap (i.e., three percent per annum), the MBSD Rules currently do not.[29] The MBSD fails charge cap follows the same convention as the GSD fails charge cap, which is the percentage that is applied to the target federal funds rate.[30] For MBSD, this cap is two percent per annum.[31] FICC proposes to clarify the MBSD fails charge provision by adding language regarding the two percent per annum cap on the fails charge.[32]

E. Implementation Timeframe

FICC proposes to implement the proposed changes on July 2, 2018.[33] FICC states that it would announce such implementation date by Important Notice.[34]

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26 Id.

27 Id.

28 Id.

29 GSD Rule 11; MBSD Rule 12, supra note 4.

30 Id.

31 MBSD Rule 12, supra note 4.

32 Notice, 83 FR at 23034.

33 Id.

34 Id.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization.[35] The Commission believes the proposal is consistent with Act, specifically Section 17A(b)(3)(F) of the Act[36] and Rule 17Ad-22(e)(23)(ii)[37] under the Act.

A. Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, in part, that the rules of a clearing agency, such as FICC, be designed to promote the prompt and accurate clearance and settlement of securities transactions.[38]

As discussed above, the proposed rule change would update both the GSD Rules and the MBSD Rules of FICC to add a one percent floor to the respective GSD and MBSD fails charge calculations. In the absence of such a floor, during periods of elevated target levels for the federal funds rate, the current GSD and MBSD fails charge calculations could result in a zero charge to a seller that fails to deliver securities to a buyer promptly.

As discussed above, persistent elevated levels of settlement fails can create market inefficiencies and increase credit risk for market participants, which could

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35 15 U.S.C. 78s(b)(2)(C).

36 15 U.S.C. 78q-1(b)(3)(F).

37 17 CFR 240.17Ad-22(e)(23)(ii).

38 15 U.S.C. 78q-1(b)(3)(F).

negatively affect the prompt and accurate clearance and settlement of securities transactions. Fails charges are designed to address such negative effects by encouraging market participants to complete their securities settlement obligations promptly.

FICC's proposal to implement a one percent floor to the fails charge calculations would advance FICC's efforts to discourage settlement fails by ensuring that the fails charge calculation would not produce a zero charge, particularly during periods of elevated target levels for the federal funds rate. In turn, ensuring that the respective GSD and MBSD fails charge calculations do not produce a zero charge would encourage market participants to maintain their fails charge operational processes. Accordingly, the Commission finds that the proposed rule change is designed to help ensure that settlement in the applicable markets covered by FICC's processes occurs on a timely basis, and thereby promotes the prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.[39]

B. Rule 17Ad-22(e)(23)(ii) under the Act

Rule 17Ad-22(e)(23)(ii) under the Act requires each covered clearing agency[40] to establish, implement, maintain and enforce written policies and procedures reasonably

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[39] Id.

[40] A "covered clearing agency" means, among other things, a clearing agency registered with the Commission under Section 17A of the Act (15 U.S.C. 78q-1 et seq.) that is designated systemically important by the Financial Stability Oversight Committee ("FSOC") pursuant to the Payment, Clearing, and Settlement Supervision Act of 2010 (12 U.S.C. 5461 et seq.). See 17 CFR 240.17Ad-22(a)(5)-(6). Because FICC is a registered clearing agency with the Commission that has been designated systemically important by FSOC, FICC is a covered clearing agency.

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.[41]

As discussed above, the proposed rule change would update both the GSD Rules and the MBSD Rules to clarify the target rate that may be used in the fails charge calculations under certain circumstances and make certain technical changes to the fails charge provisions to ensure consistent use of defined terms. The proposed rule change also would update the MBSD Rules to clarify that a cap applies to the MBSD fails charge.

These clarifications are designed help ensure that the GSD and MBSD fails charges are transparent and clear to market participants. Increasing transparency and clarity around these charges would help market participants better understand the operation of the fails charges, and thereby provide market participants with increased predictability and certainty regarding their obligations to FICC. Accordingly, the Commission finds that the proposed rule change would help establish, implement, and maintain FICC's rules in a manner 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 FICC, consistent with Rule 17Ad-22(e)(23)(ii) under the Act.[42]

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act, in particular the requirements of Section 17A of the

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[41] 17 CFR 240.17Ad-22(e)(23)(ii).

[42] Id.

Act[43] and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule change SR-FICC-2018-004 be, and hereby is, APPROVED.[44]

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[45]

Eduardo A. Aleman,
Assistant Secretary.

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43 15 U.S.C. 78q-1.

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

45 17 CFR 200.30-3(a)(12).

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