SECURITIES AND EXCHANGE COMMISSION

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change, as Modified by Amendment No. 1, To Expand the Types of Entities That Are Eligible To Participate in Fixed Income Clearing Corporation as Sponsoring Members and Make Other Changes

May 1, 2017.

I. Introduction

On March 1, 2017, Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR–FICC–2017–003, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”) 1 and Rule 19b–4 thereunder. 2 On March 13, 2017, FICC filed Amendment No. 1 to the proposed rule change, which amended and replaced the original filing in its entirety (hereinafter, “Proposed Rule Change”). The Proposed Rule Change was published for comment in the Federal Register on March 17, 2017.3 The Commission received four comment letters 4 to the Proposed Rule Change, including a response letter from FICC. For the reasons discussed below, the Commission is approving the Proposed Rule Change.

II. Description of the Proposed Rule Change

The Proposed Rule Change consists of changes to the Government Securities Division (“GSD”) Rulebook (“Rules”) 5 in order to (i) expand the types of entities that are eligible to participate in FICC’s Sponsored Membership program as Sponsored Members, and (ii) make amendments and clarifications to the Rules relating to the Sponsored Membership service in general.

A. The Proposed Expansion of Sponsored Member Eligibility

Currently, GSD Bank Netting Members that are well-capitalized with at least $5 billion in equity capital are permitted to serve as Sponsoring Members and sponsor certain institutional firms into GSD membership as Sponsored Members.6 A Sponsoring Member is permitted to submit to FICC for comparison, novation, and netting certain types of eligible transactions between itself and its Sponsoring Members (“Sponsored Member Trades”).7 For operational and administrative purposes, FICC interacts solely with the Sponsoring Member as agent for purposes of the day-to-day satisfaction of its Sponsoring Members’ obligations to FICC, including the Sponsoring Members’ securities and funds-only settlement obligations.8 Currently, eligibility to become a Sponsoring Member is limited to investment companies that are registered under the Investment Company Act of 1940 9 (each, a “Registered Investment Company” or “RIC”) and that meet the definition of a qualified institutional buyer (“QIB”), as defined in Rule 144A 10 under the Securities Act of 1933.11

The Proposed Rule Change would eliminate the RIC requirement. However, in order to ensure that Sponsoring Members are financially sophisticated, FICC would retain the QIB requirement to the extent that the Sponsoring Member’s legal entity type falls under one of the enumerated categories of Rule 144A’s QIB definition.12 For institutional firms whose entity types do not clearly fall into one of the enumerated categories in Rule 144A’s QIB definition, FICC proposes to require that such Sponsoring Members satisfy the financial requirements that an entity specifically listed in paragraph (a)(1)(i) of Rule 144A must satisfy in order to be a QIB.13 Because the proposal would newly permit non-U.S. entities to become Sponsoring Members, FICC proposes to amend the GSD Rules to provide that such entities would be considered FFI Members 14 subject to FATCA compliance obligations.15

The proposal would also clarify that the existing requirement on all Sponsoring Members and their Sponsoring Members to comply with all applicable laws includes the requirement to comply with global sanctions laws.

6 Rule 3A, Section 2, supra note 5.
7 The Sponsoring Member is required to establish an omnibus account at FICC for all of its Sponsored Members’ FIIC-cleared activity (“Sponsoring Member Omnibus Account”), which is separate from the Sponsoring Member’s regular netting account. Rule 1; Rule 3A, Section 10, supra note 5.
8 See Rule 3A, Sections 5, 6, 7, 8 and 9, supra note 5.
9 15 U.S.C. 80a–1 et seq.
10 17 CFR 230.144A.
12 17 CFR 2017.44A(a)(1)(i) defines a qualified institutional buyer as an entity— . . . that is treated as a non-U.S. entity for U.S. federal income tax purposes. . . .
13 See Notice, 82 FR at 14266.
14 See Notice, 82 FR at 14267. Pursuant to Rule 1, the term “FFI Member” means “any Person that is treated as a non-U.S. entity for U.S. federal income tax purposes.” Rules, supra note 5. For the avoidance of doubt, the term FFI Member also includes “any Member that is a U.S. branch of an entity that is treated as a non-U.S. entity for U.S. federal income tax purposes.” Id.
15 FATCA is the Foreign Account Tax Compliance Act, 26 U.S.C. 1471 et seq. The Rules define FATCA Compliant to mean that an . . . FFI Member has qualified under such procedures promulgated by the Internal Revenue Service . . . to establish exemption from withholding under FATCA such that [FICC] would not be required to withhold [anything] under FATCA. . . .
16 See Notice, 82 FR at 14267. Any future Sponsoring Member or Sponsored Member that is an FFI Member will be subject to the same FATCA Compliance screening as any other Member that is a non-U.S. entity. Proposed Rule 3A, Section 3.
B. Other Proposed Rule Changes

The Proposed Rule Change also contains proposed changes that are unrelated to the proposed expansion of entity types eligible to be Sponsored Members. FICC notes that it has decided to address these changes separately from the proposal to facilitate FICC’s Sponsored Membership program in general. FICC states that these proposed changes are designed to provide specificity, clarity, and additional transparency to the Rules. Specifically, FICC proposes to:

- Clarify that the Sponsoring Member Omnibus Account refers to an Account, as defined in Rule 1;
- amend Section 7 of Rule 3A to reference the application of fails charges to a Sponsoring Member Omnibus Account in the same manner as such charges are applied to Netting Members pursuant to Rule 11 and to correct certain typographical errors;
- amend Section 9 of Rule 3A to correct an out-of-date cross-reference to Rule 13;
- amend Section 10 of Rule 3A to reflect the current Clearing Fund calculation procedures applicable to a Sponsoring Member Omnibus Account; and
- amend Section 10 of Rule 3A to specify that, for purposes of calculating the Unadjusted GSD Margin Portfolio Amount applicable to a Sponsoring Member Omnibus Account, FICC would apply the higher of the Required Fund Deposit calculation as of the beginning of the current Business Day and intraday on the current Business Day;
- amend Section 10 of Rule 3A to correct certain out-of-date cross-references to Rule 4;
- amend Section 12 of Rule 3A to reflect the current loss allocation process applicable to Sponsored Member Trades in the event that the Sponsoring Member is insolvent or otherwise in default to FICC;
- amend Section 12 of Rule 3A to correct certain out-of-date cross-references to Rule 4 and to correct certain typographical errors;
- amend Section 13 of Rule 3A to correct certain out-of-date cross-references to Rule 21; and
- amend Section 15 of Rule 3A to specify the standard with respect to which a Sponsoring Member is deemed by FICC to have knowledge that one of its Sponsored Members is insolvent or is otherwise unable to perform on any of its material contracts, obligations, or agreements for purposes of the Sponsoring Member’s obligation to inform FICC of such matter.

III. Summary of Comments Received

The Commission received four comment letters in response to the proposal: One from State Street supporting the proposal, one from Ronin opposing the proposal, one from FICC in response to Ronin, and a second from Ronin in response to FICC. State Street raises a number of points of concern in support of the proposal. Specifically, State Street argues that, if adopted, the proposal would (i) provide institutional investors with access to central clearing services through FICC, without material changes to FICC’s operational or risk management practices; (ii) permit greater use of netting to offset Sponsoring Member transactions against a direct GSD member’s other eligible transactions, thereby substantially reducing required amounts of leveraged capital; (iii) better enable global systemically important banks to meet supplementary leverage ratio requirements; and (iv) enhance the liquidity and efficiency of collateral and financing markets.

Ronin raises a number of points in opposition to the proposal. Specifically, Ronin argues that the proposal would increase risks and have an anti-competitive impact. FICC’s letter responds to the concerns raised by Ronin.

A. Comments Regarding the Proposal’s Potential To Increase Risks

Ronin notes that the proposed expansion would allow certain entities such as hedge funds and other types of counterparties that Ronin believes are risk-taking and leveraged to participate in FICC as Sponsored Members. Ronin argues that by allowing such entities to participate in GSD as Sponsored Members, the proposal would (i) increase concentration risk in Sponsored Members because the proposal would encourage entities to become Sponsored Members rather than full Netting Members that could then gravitate to one or just a few Sponsored Members; (ii) increase settlement risk for Sponsored Members who take on Sponsored Members; and (iii) increase the amount of leverage used by Sponsored Members, which would increase the risk of liquidity drain and fire sales in the event of a Sponsoring Member default.

In response to Ronin’s concerns regarding concentration risk, FICC states that the Rules already incorporate risk management practices into the Sponsored Membership program (e.g., capital requirements, clearing Member Guaranty, and Clearing Fund deposits), which the proposal would not change. Moreover, FICC notes that because Sponsored Members are banks, they are subject to extensive prudential supervision and regulation, which further mitigates the risk that a Sponsoring Member would be unable to meet its obligations associated with the default of a Sponsored Member. FICC also notes that neither the Sponsoring Member Guaranty nor the Sponsoring

25 See Ronin Letter I at 1–6; Ronin Letter II at 2.
26 As noted above, FICC requires a Sponsoring Member to be a well-capitalized GSD Bank Netting Member with at least $5 billion in equity capital. FICC Letter at 2; see also Rule 3A, Section 2(a), supra note 5.
27 FICC requires a Sponsoring Member to provide FICC a guaranty regarding the management and performance of each of its Sponsored Member’s obligations to FICC. FICC Letter at 2; see also Rule 1 (definition of “Sponsoring Member Guaranty”) and Rule 3A, Section 2(c), supra note 5.
28 FICC requires a Sponsoring Member to post all of the Clearing Fund deposits associated with the activity of its Sponsored Member Omnibus Account. FICC Letter at 2; see also Rule 3A, Section 10, supra note 5.
29 See FICC Letter at 2–3; Rule 1 definition of “Sponsoring Member Guaranty” and Rule 3A, Sections 2 and 10, Rules, supra note 5.
30 See Rule 2A, Section 2, Rules, supra note 5.
31 See State Street Letter at 1–3.
Member’s Clearing Fund deposits would be available to FICC to cover potential default losses if hedge funds were permitted to become full Netting Members.30

In response to Ronin’s concerns regarding settlement risk, FICC argues that the proposal would reduce settlement risk because Sponsoring Members would be able to take advantage of additional netting that results from increased participation in FICC, and as discussed more fully below, FICC would have access to additional margin in connection with Sponsored Member accounts.31

Finally, in response to Ronin’s concerns regarding increased leverage, FICC states that it is unlikely that the proposal would cause an increase in Sponsoring Members’ leverage because the prudential regulation of the Sponsoring Member and the Sponsoring Member Guaranty incentivize the Sponsoring Member to monitor and manage Sponsored Member activity to ensure that inappropriate risks are not presented.32

B. Comments Regarding the Proposal’s Potential To Burden Competition

Ronin argues that the proposed expansion of the Sponsored Membership program would unfairly burden non-participating Netting Members by (i) allowing Sponsoring Members to benefit from centralized clearing without bearing the risk or cost (e.g., the cost associated with FICC’s proposed capped contingency liquidity facility (“CCLF”))33 of loss mutualization that is borne by full Netting Members; and (ii) favoring only GSD Bank Netting Members with balance sheet offsets and reduced capital charges afforded through Sponsored Member trading activity.34

In response to Ronin’s concerns regarding loss mutualization, FICC acknowledges that the proposal would not make Sponsored Members responsible for default loss mutualization or CCLF contributions, but emphasizes that such responsibilities would be borne by the Sponsoring Member.35 Moreover, FICC states that the risk of potential losses resulting from Sponsored Membership activity would be adequately mitigated without placing undue burdens on non-participating Netting Members for a number of reasons.36 First, a Sponsoring Member is required to post all of the Clearing Fund associated with the activity of its Sponsored Members, calculated on a gross basis (i.e., Sponsored Member activity is not netted for margin purposes).37 Second, FICC has the right to apply all of the Sponsored Member’s Clearing Fund deposits (i.e., both the deposits of the Sponsoring Member Omnibus Account and the Sponsored Member’s own netting account) against any obligations owed to FICC by the Sponsoring Member. Third, loss mutualization would only occur after FICC had exhausted all Clearing Fund deposits of the defaulting Sponsoring Member and other applicable resources.38 Finally, FICC notes that while an increase in the CCLF size would affect the CCLF contribution amounts of Netting Members that present the highest liquidity needs to FICC (i.e., those Netting Members whose liquidity needs over a 6-month look-back period exceed $15 billion), it would not affect the CCLF contribution amounts of approximately 80 percent of Netting Members, whose liquidity needs over a 6-month look-back period are less than $15 billion.39

In response to Ronin’s concerns that balance sheet offsets and reduced capital charges would only accrue to Sponsoring Members, FICC argues that all Netting Members would benefit from additional balance sheet and capital efficiencies to the extent that such members are counterparties to Sponsoring Members in new Sponsored Member activity cleared through FICC.40

IV. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act41 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. After carefully considering the Proposed Rule Change, the comments received, and FICC’s responses thereto, the Commission finds that the Proposed Rule Change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to FICC. In particular, the Commission finds that the Proposed Rule Change is consistent with Section 17A(b)(3)(F) of the Act.42

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions.43 As described above, eligibility to be a Sponsoring Member currently is limited to RICs that are QIBs and that have a Sponsoring Member. Entities other than RICs that otherwise meet the Sponsor Member eligibility requirements and engage in the same type of eligible trading activity outside of a central counterparty are unable to avail themselves of the guaranteed settlement, novation, and independent risk management offered by FICC through the Sponsored Membership program. To address this issue, the proposal would remove the RIC requirement and modify the QIB requirement such that an entity not described in Rule 144A would still be able to become a Sponsoring Member if it met the financial requirements listed in paragraph (a)(1)(i) of Rule 144A. As described above, Ronin argues that such an expansion of the Sponsored Membership program would create a competitive burden because Sponsoring Members would not bear the risk or cost of loss mutualization in the event of GSD member default, as full Netting Members do, and any increased balance sheet offsets and reduced capital charges afforded by the expansion would only benefit bank Netting Members.45 The Commission does not find that the proposed expansion of the Sponsored Membership program would create a competitive burden. Although it is true that Sponsoring Members would not directly bear the risk and cost of loss mutualization, Sponsoring Members

30 Id.
31 FICC Letter at 4.
32 Id.
33 On March 1, 2017, FICC filed with the Commission an advance notice and proposed rule change that would establish CCLF to provide FICC with additional liquid financial resources to meet its cash settlement obligations in the event of a default of the largest family of affiliated Netting Members; and (ii) favoring only its cash settlement obligations in the event of a default of the largest family of affiliated Netting Members. See Securities Exchange Act Release No. 80191 (March 9, 2017), 82 FR 13876 (March 15, 2017) (SR–FICC–2017–802); Securities Exchange Act Release No. 80234 (March 14, 2017), 82 FR 14401 (March 20, 2017) (SR–FICC–2017–002). The proposed CCLF would be sized based on the trading activity of the largest family of affiliated Netting Members. Ronin argues that the Sponsoring Members of an entity within the largest family of affiliated Netting Members could increase the size of the CCLF obligations for other GSD Netting Members. Ronin Letter I at 1–2; Ronin Letter II at 1–2.
34 Ronin Letter I at 1–6.
35 Id.
36 Id.
37 Id.
38 Id.
40 FICC Letter at 4–5.
43 Id.
44 Ronin Letter I at 4–5; see also Ronin Letter II at 1–2.
45 Ronin Letter I at 1–6.
would, and the Commission believes that Sponsoring Members are fully aware of this outcome and are capable of addressing it by passing on any risk and cost to their Sponsoring Members. The Commission also believes that benefits from the expansion would not necessarily fall solely to bank Netting Members, but, as FICC explains, to all GSD members, where such members are counterparties to Sponsoring Members with new Sponsoring Member Trades.

In addition, the Commission believes that the proposal’s expansion of the Sponsoring Membership program would make the risk-reducing benefits of central clearing available to a wider range of entity types. In turn, increased trading activity through the expanded Sponsoring Membership program would likely (1) lower the risk of diminished liquidity in the U.S. repo market caused by a large scale exit of participants from the market in a stress scenario (through FICC’s guaranty of completion of settlement for a greater number of eligible transactions); (2) protect against fire sale risk (through FICC’s ability to centralize and control the liquidation of a greater portion of a failed counterparty’s portfolio); and (3) decrease settlement and operational risk (by making a greater number of transactions eligible to be netted and subject to guaranteed settlement, novation, and independent risk management through FICC).

Therefore, the Commission believes that by removing the RIC requirement and adjusting the QIB requirement, the Proposed Rule Change would remove an impediment to and help perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules also be designed to promote the prompt and accurate clearance and settlement of securities transactions. In addition to the proposed changes related specifically to the proposed expansion of entity types eligible to be Sponsoring Members, the Proposed Rule Change also would make a number of changes to the Rules that relate to Sponsoring Membership in general, as described above. These changes are designed to provide specificity, clarity, and additional transparency to the Rules by (i) removing ambiguities in definitions and other Rule provisions to provide greater clarity regarding how such definitions and provisions apply to the Sponsoring Membership program; (ii) updating Rule provisions to correct outdated terminology; and (iii) correcting typographical errors and out-of-date cross-references. Collectively, these changes would ensure that the relevant Rules remain transparent, accurate, and clear, which would enable all stakeholders to better understand their rights and obligations in connection with the Sponsoring Membership program.

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

Eduardo A. Aleman, Assistant Secretary.

[FR Doc. 2017-09059 Filed 5–4–17; 8:45 am]

BILLING CODE 8011–01–P

SECURITIES AND EXCHANGE COMMISSION


Self-Regulatory Organizations; ICE Clear Europe Limited; Notice of Designation of Longer Period for Commission Action on Proposed Rule Change, Security-Based Swap Submission, or Advance Notice Relating to the CDS End-of-Day Price Discovery Policy

May 1, 2017.