

*Additional Information or Comments:* Copies of the forms and supporting documents can be obtained from Dana Hickman at (312) 751-4981 or [Dana.Hickman@RRB.GOV](mailto:Dana.Hickman@RRB.GOV).

Comments regarding the information collection should be addressed to Brian Foster, Railroad Retirement Board, 844 North Rush Street, Chicago, Illinois, 60611-1275 or [Brian.Foster@rrb.gov](mailto:Brian.Foster@rrb.gov) and to the OMB Desk Officer for the RRB, Fax: 202-395-6974, Email address: [OIRA\\_Submission@omb.eop.gov](mailto:OIRA_Submission@omb.eop.gov).

**Brian D. Foster,**  
Clearance Officer.

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-81545; File No. SR-NSCC-2017-804]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to an Advance Notice To Expand the Application of the Family-Issued Securities Charge

September 7, 2017.

On July 10, 2017, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2017-804 (“Advance Notice”) pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”) <sup>1</sup> and Rule 19b-4(n)(1)(i) <sup>2</sup> under the Securities Exchange Act of 1934 (“Exchange Act”). <sup>3</sup> The Advance Notice was published for comment in the **Federal Register** on August 8, 2017. <sup>4</sup> The

<sup>1</sup> 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 Clearing Supervision Act and file advance notices with the Commission. See 12 U.S.C. 5465(e).

<sup>2</sup> 17 CFR 240.19b-4(n)(1)(i).

<sup>3</sup> 15 U.S.C. 78s(b)(1).

<sup>4</sup> Securities Exchange Act Release No. 81286 (August 2, 2017), 82 FR 37141 (August 8, 2017) (SR-NSCC-2017-804) (“Notice”). NSCC also filed a related 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. The proposed rule change was published in the **Federal Register** on July 31, 2017. Securities Exchange Act Release No. 81203

Commission did not receive any comments on the Advance Notice. This publication serves as notice that the Commission does not object to the changes set forth in the Advance Notice.

### I. Description of the Advance Notice

The Advance Notice is a proposal by NSCC to further address specific wrong-way risk <sup>5</sup> that is present when NSCC acts as central counterparty to a transaction with an NSCC member (“Member”) where the underlying securities are securities issued by such Member or an affiliate of such Member (“family-issued securities”). <sup>6</sup> Currently, NSCC applies a targeted margin charge to address the specific wrong-way risk of family-issued securities transactions (“FIS Charge”) where the Member is on NSCC’s Watch List. <sup>7</sup> NSCC believes that Members on the Watch List present a higher credit risk (*i.e.*, a greater risk of defaulting on their settlement obligations), compared to Members not on the Watch List. As such, the family-issued securities of Members on the Watch List currently receive a FIS Charge because of the increased credit risk presented by such Members. As described in detail below, NSCC proposes in the Advance Notice to expand the application of the FIS Charge to all Members, regardless of a Member’s Watch List status, but still maintain a higher FIS Charge for Members that present a greater credit risk to NSCC, such as Members on the Watch List.

Currently, in calculating a Watch List Member’s overall margin charge (*i.e.*, a Watch List Member’s required deposit to NSCC’s clearing fund), NSCC

(July 25, 2017), 82 FR 35563 (July 31, 2017) (SR-NSCC-2017-010). The Commission did not receive any comments on that proposal.

<sup>5</sup> Specific wrong-way risk is the risk that an exposure to a counterparty is highly likely to increase when the creditworthiness of that counterparty is deteriorating. See *Principles for financial market infrastructures*, issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions 47 n.65 (April 2012), available at <http://www.bis.org/publ/cpss101a.pdf>.

<sup>6</sup> As part of this proposal, NSCC proposes to define in its rules that, for a given Member, a family-issued security is a security that was issued by such Member or an affiliate of such Member.

<sup>7</sup> 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/nsc\\_rules.pdf](http://dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf).

excludes the Member’s net, unsettled long position in family-issued securities from the volatility component of the margin calculation (“VaR Charge”). Instead, for such unsettled long positions, NSCC calculates the required margin (*i.e.*, the FIS Charge) by multiplying the position value by a set percentage, which is determined based on a Member’s rating on NSCC’s internal credit risk rating matrix. <sup>8</sup> NSCC applies this separate margin calculation to deal with specific wrong-way risk that arises from these positions because NSCC has to liquidate the unsettled family-issued security long positions in the Member’s portfolio to manage the default. <sup>9</sup> Given that the Member’s default would likely adversely affect NSCC’s ability to liquidate such positions at full value (because the value of the family-issued securities will decline in response to the Member’s default), NSCC applies the FIS Charge to try to address the risk of a shortfall. According to NSCC, the FIS Charge constitutes a more conservative approach to collecting margin on family-issued security positions than what may be achieved by applying the VaR Charge, which does not recognize the relationship between the Member and the family-issued securities.

Although the risk of default by Members that are not on the Watch List is lower than Members on the Watch List, NSCC believes that it is appropriate to apply the FIS Charge to all Members because all Members’ long positions in family-issued securities present specific wrong-way risk. However, the proposal would still maintain the relation between the FIS Charge and the Member’s risk of default (*i.e.*, the Member’s credit risk), while at the same time addressing the difference in risk posed by equity and fixed-income securities. As such, NSCC proposes in the Advance Notice to apply the FIS Charge to fixed-income securities that are family-issued securities of non-Watch List Members at a rate of no less than 40 percent, and to equities that are family-issued securities of non-Watch

<sup>8</sup> More specifically, fixed-income securities that are family-issued securities are charged a rate of no less than 80 percent for firms that are rated 6 or 7 on the credit risk rating matrix, and no less than 40 percent for firms that are rated 5 on the credit risk rating matrix. Equity securities that are family-issued securities are charged a rate of 100 percent for firms that are rated 6 or 7 on the credit risk rating matrix, and no less than 50 percent for firms that are rated 5 on the credit risk rating matrix.

<sup>9</sup> In a default scenario, NSCC would receive the family-issued securities from a Member’s guaranteed long transactions and would have to liquidate the holding to unwind NSCC’s position.

List Members at a rate of no less than 50 percent.<sup>10</sup>

## II. Discussion and Commission Findings

Although the Clearing Supervision Act does not specify a standard of review for an advance notice, its stated purpose is instructive: 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 financial market utilities.<sup>11</sup> Section 805(a)(2) of the Clearing Supervision Act<sup>12</sup> authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency. Section 805(b) of the Clearing Supervision Act<sup>13</sup> provides the following objectives and principles for the Commission's risk management standards prescribed under Section 805(a):

- 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 Clearing Supervision Act<sup>14</sup> and Section 17A of the Exchange Act ("Rule 17Ad-22").<sup>15</sup> Rule 17Ad-22 requires 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 basis.<sup>16</sup> Therefore, it is appropriate for the Commission to review proposed changes in advance notices against the objectives and principles of these risk management standards as described in

Section 805(b) of the Clearing Supervision Act<sup>17</sup> and against Rule 17Ad-22.<sup>18</sup>

The Commission believes the proposal in the Advance Notice is consistent with the objectives and principles described in Section 805(b) of the Act,<sup>19</sup> and Rule 17Ad-22, in particular Rule 17Ad-22(e)(4)(i)<sup>20</sup> and Rule 17Ad-22(e)(6)(i) and (v)<sup>21</sup> under the Exchange Act, as described in detail below.

### A. Consistency With Section 805(b) of the Clearing Supervision Act

As discussed below, the Commission believes that the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act because they: (i) Are designed to reduce systemic risk; (ii) are designed to support the stability of the financial system; (iii) are designed to promote robust risk management; and (iv) are consistent with promoting safety and soundness.

The Commission believes that the proposal is designed to help promote robust risk management. As described above, the FIS Charge is calculated and collected to help mitigate NSCC's loss exposure to specific wrong-way risk that NSCC may face when liquidating family-issued security positions that are depreciating in value in response to a Member's default. By expanding the FIS Charge to family-issued security transactions presented to NSCC by all Members, the proposal would assist NSCC in collecting margin and maintaining a clearing fund amount that more accurately reflects NSCC's overall risk exposure to its Members. Therefore, the proposal is designed to help better promote robust risk management at NSCC by reducing NSCC's loss exposure to the specific wrong-way risk that NSCC faces from Member transactions in family-issued securities.

The Commission also believes that the proposal is designed to promote safety and soundness, as well as support the stability of the financial system, and reduce systemic risk. By providing for the collection by NSCC of margin amounts that contemplate and help address the specific wrong-way risk presented by all Members, the proposal would assist NSCC in helping to ensure that it maintains sufficient margin in the event that a Member holding family-issued securities defaults and such positions significantly decrease in

value. Without this increased margin, NSCC is at a greater risk of not having enough margin to offset potential losses from the reduced value of family-issued securities in a default scenario. Such losses could threaten NSCC's ability to continue operations of its critical clearance and settlement services. Because the proposal would generally increase the level of financial resources available to NSCC, better enabling NSCC to continue operating in default scenarios, the proposal would help NSCC operate more safely and soundly and reduce the systemic risk associated with NSCC not providing critical clearance and settlement services in the event of a Member default. Therefore, the Commission believes that the changes proposed in the Advance Notice are consistent with Section 805(b) of the Clearing Supervision Act.<sup>22</sup>

### B. Consistency With Rule 17Ad-22(e)(4)(i)

The Commission believes that the changes proposed in the Advance Notice are consistent with Rule 17Ad-22(e)(4)(i) under the Exchange Act, which requires, in part, that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.<sup>23</sup>

As described above, NSCC is exposed to specific wrong-way risk where it acts as central counterparty for its Members for transactions in family-issued securities. The expanded application of the FIS Charge to all Members would help further mitigate NSCC's loss exposure to this risk. The charge is calculated and imposed based on the value and type of family-issued securities in each Member's portfolio and in consideration of the Members' credit rating, as calculated by NSCC's internal credit risk matrix. Although the FIS Charge may not fully reflect the recovery rate on a family-issue security when a Member defaults, the Commission understands that expanding the FIS Charge to non-Watch List Members, as proposed, would enable NSCC to collect more margin on such positions than would a VaR Charge, more accurately reflecting the risks those positions present. Thus, the

<sup>10</sup> According to NSCC, it calibrated the FIS Charge rates based on historical corporate-issue recovery-rate data. The rate applicable to equities is higher than the rate applicable to fixed-income securities because NSCC determined that equities present a greater risk than fixed-income securities of having a value at or near zero when a Member defaults. The Commission understands that NSCC calculated the 40 and 50 percent rates based on a weighted value of the probability of a Member defaulting and the potential loss that NSCC may realize when liquidating family-issued securities after a Member default.

<sup>11</sup> See 12 U.S.C. 5461(b).

<sup>12</sup> 12 U.S.C. 5464(a)(2).

<sup>13</sup> 12 U.S.C. 5464(b).

<sup>14</sup> 12 U.S.C. 5464(a)(2).

<sup>15</sup> 15 U.S.C. 78q-1.

<sup>16</sup> 17 CFR 240.17Ad-22.

<sup>17</sup> 12 U.S.C. 5464(b).

<sup>18</sup> 17 CFR 240.17Ad-22.

<sup>19</sup> 12 U.S.C. 5464(b).

<sup>20</sup> 17 CFR 240.17Ad-22(e)(4)(i).

<sup>21</sup> 17 CFR 240.17Ad-22(e)(6)(i) and (v).

<sup>22</sup> *Id.*

<sup>23</sup> 17 CFR 240.17Ad-22(e)(4)(i).

expanded FIS Charge is designed to help NSCC collect sufficient financial resources to help cover the specific risk exposure, with a high degree of confidence, which is presented by all Members seeking to clear and settle transactions in family-issued securities. Therefore, the Commission believes that the proposal to expand the FIS Charge to all Members is consistent with Rule 17Ad-22(e)(4)(i) under the Exchange Act.<sup>24</sup>

### C. Consistency With Rule 17Ad-22(e)(6)(i) and (v)

The Commission believes that the changes proposed in the Advance Notice are consistent with Rule 17Ad-22(e)(6)(i) and (v) under the Exchange Act, which require, in part, that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market; and uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.<sup>25</sup>

As described above, NSCC faces specific wrong-way risk where it acts as central counterparty to Member transactions in family-issued securities. To help address this risk, NSCC applies the FIS Charge in calculating the Member's required margin. Specifically, the FIS Charge is a component of the margin that NSCC calculates and collects using a risk-based margin methodology that is designed to help maintain the coverage of NSCC's credit exposures to its Members at a confidence level of at least 99 percent. The FIS Charge is tailored to consider both the value and type of family-issued securities held by the Member, as well as the credit risk presented by the Member, as calculated by NSCC.

However, currently, the FIS Charge is assessed only against Members on the Watch List because of the additional credit risk presented by such Members. Nevertheless, all Members, not just Members on the Watch List, present specific wrong-way risk. As such, NSCC proposes to expand the FIS Charge to all Members, while maintaining the relation between the FIS Charge and the Member's credit risk. Specifically, NSCC proposes to apply the FIS Charge to fixed-income securities that are

family-issued securities of non-Watch List Members at a rate of no less than 40 percent, and to equities that are family-issued securities of non-Watch List Members at a rate of no less than 50 percent. Although NSCC proposes to apply a lesser percentage rate to non-Watch List Members than some Watch List Members, the proposed rate is designed to more accurately reflect the risks posed than what is reflected in a VaR Charge.

Because the expanded FIS Charge also would be a tailored component of the margin that NSCC collects from non-Watch List Members to help cover NSCC credit exposure to such Members, as the charge would be based on different product risk factors with respect to equity and fixed-income securities, as described above, the Commission believes that the proposed changes in the Advance Notice are consistent with Rule 17Ad-22(e)(6)(i) and (v) under the Exchange Act.<sup>26</sup>

### III. Conclusion

*It is therefore noticed*, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act,<sup>27</sup> that the Commission *does not object* to Advance Notice (SR-NSCC-2017-804) and that NSCC is *authorized* to implement the proposed change as of the date of this notice or the date of an order by the Commission approving the proposed rule change (SR-NSCC-2017-010) that reflects rule changes that are consistent with this Advance Notice, whichever is later.

By the Commission.

**Eduardo A. Aleman,**  
Assistant Secretary.

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## SECURITIES AND EXCHANGE COMMISSION

### Submission for OMB Review; Comment Request

Upon Written Request, Copies Available From: Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE., Washington, DC 20549-2736.

Extension: Rule 10b-17, SEC File No. 270-427, OMB Control No. 3235-0476.

Notice is hereby given that pursuant to the Paperwork Reduction Act of 1995 ("PRA") (44 U.S.C. 3501 *et seq.*), the Securities and Exchange Commission ("Commission") has submitted to the Office of Management and Budget

("OMB") a request for approval of extension of the previously approved collection of information provided for in Rule 10b-17 (17 CFR 240.10b-17), under the Securities Exchange Act of 1934 (15 U.S.C 78a *et seq.*).

Rule 10b-17 requires any issuer of a class of securities publicly traded by the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to give notice of the following specific distributions relating to such class of securities: (1) A dividend or other distribution in cash or in kind other than interest payments on debt securities; (2) a stock split or reverse stock split; or (3) a rights or other subscription offering. Notice shall be either given to the Financial Industry Regulatory Authority, Inc. as successor to the National Association of Securities Dealers, Inc. or in accordance with the procedures of the national securities exchange upon which the securities are registered. The Commission may exempt an issuer of over-the-counter (but not listed) securities from the notice requirement. The requirements of 10b-17 do not apply to redeemable securities of registered open-end investment companies or unit investment trusts.

The information required by Rule 10b-17 is necessary for the execution of the Commission's mandate under the Securities Exchange Act of 1934 to prevent fraudulent, manipulative, and deceptive acts and practices. The Commission has found that not requiring formal notices of the types of distributions covered by Rule 10b-17 has led to a number of abuses including purchasers not being aware of their rights to such distributions. It is only through formal notice of the distribution, including the date of the distribution, that current holders, potential buyers, or potential sellers of the securities at issue will know their rights to the distribution. Therefore, it is only through formal notice that investors can make an informed decision as to whether to buy or sell a security.

There are approximately 12,127 respondents per year. These respondents make approximately 27,144 responses per year. Each response takes approximately 10 minutes to complete. Thus, the total compliance burden per year is 4,524 burden hours. The total internal labor cost of compliance for the respondents, associated with producing and filing the reports, is approximately \$317,991.96.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information

<sup>24</sup> *Id.*

<sup>25</sup> 17 CFR 240.17Ad-22(e)(6)(i) and (v).

<sup>26</sup> *Id.*

<sup>27</sup> 12 U.S.C. 5465(e)(1)(I).