

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-94694; File No. SR-NSCC-2022-003]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Proposed Rule Change To Establish the Securities Financing Transaction Clearing Service and Make Other Changes

April 12, 2022.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 28, 2022, National Securities Clearing Corporation (“NSCC”) 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.<sup>3</sup> 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 consists of proposed modifications to the NSCC Rules & Procedures (“Rules”)<sup>4</sup> that would (i) establish new membership categories and requirements for sponsoring members and sponsored members whereby existing Members would be permitted to sponsor certain institutional firms into membership, (ii) establish a new membership category and requirements for agent clearing members whereby existing Members would be permitted to submit, on behalf of their customers, transactions to NSCC for novation, (iii) establish the securities financing transaction clearing service (“Securities Financing Transaction Clearing Service” or “SFT Clearing Service”) to make central clearing available at NSCC for equity securities financing transactions, which are, broadly speaking, transactions where the parties exchange equity securities

against cash and simultaneously agree to exchange the same securities and cash, plus or minus a rate payment, on a future date (collectively, “Securities Financing Transactions” or “SFTs”), and (iv) make other amendments and clarifications to the Rules, as described in greater detail below.

#### 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 (i) establish new membership categories and requirements for sponsoring members and sponsored members whereby existing Members would be permitted to sponsor certain institutional firms into membership, (ii) establish a new membership category and requirements for agent clearing members whereby existing Members would be permitted to submit, on behalf of their customers, transactions to NSCC for novation, (iii) establish the SFT Clearing Service to make central clearing available at NSCC for SFTs, and (iv) make other amendments and clarifications to the Rules, as described in greater detail below.

###### (i) Background

NSCC is proposing to introduce central clearing for SFTs, which are, broadly speaking, securities lending transactions where parties exchange equity securities against cash and simultaneously agree to exchange the same securities and cash, plus or minus a rate payment, on a future date. In particular, the proposed SFT Clearing Service would expand central clearing at NSCC to include SFTs with a one Business Day term (*i.e.*, overnight SFTs) in eligible equity securities that are entered into by Members, institutional firms that are sponsored into NSCC by a Sponsoring Member (as defined below and in the proposed rule change), or Agent Clearing Members (as defined

below and in the proposed rule change) on behalf of Customers (as defined below and in the proposed rule change), as applicable.

SFTs involve the owner of securities (typically a registered investment company, pension plan, sovereign wealth fund or other institutional firm) transferring those securities temporarily to a borrower (typically a hedge fund). SFTs are often facilitated and intermediated by broker-dealers and agent lenders (*i.e.*, custodial banks or other institutions that lend out securities as agent on behalf of institutional firms). In return for the lent securities, the borrower transfers collateral, and a net rate payment is typically transferred to either the lender or the borrower that reflects the liquidity of the lent securities, as well as interest on any cash collateral.<sup>5</sup> NSCC understands that SFTs provide liquidity to markets and facilitates the ability of market participants to make delivery on short-sales, and thereby avoid failures to deliver, “naked” shorts, and similar situations. On a typical Business Day, The Depository Trust Company (“DTC”), an NSCC affiliate, processes deliver orders related to securities lending transactions on securities having a value of approximately \$150 billion.

#### Capital Efficiency Opportunities

The Basel III<sup>6</sup> capital and leverage requirements, as implemented by the U.S. banking regulators, constrain the ability of agent lenders and brokers to intermediate and facilitate SFTs.<sup>7</sup> NSCC believes central clearing of SFTs would be able to address these constraints, which may otherwise impair market participants’ ability to engage in SFTs.

For example, NSCC believes it is uniquely positioned to create balance sheet netting opportunities for market participants (*i.e.*, the ability to offset

<sup>5</sup> This rate payment is typically calculated in a manner similar to interest on the principal balance of a loan and accrues on a daily basis. As a result, the rate payment is typically calculated as the product of a specified balance (typically the amount of cash collateral unless the collateral consists of securities) and a specified rate (reflecting both the liquidity of the securities and the ability of the lender to re-use the cash collateral), divided by 360 or a similar day count fraction.

<sup>6</sup> Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007–2009.

<sup>7</sup> See, *e.g.*, 12 CFR part 3 (Office of the Comptroller of the Currency—Capital Adequacy Standards); 12 CFR part 217 (Federal Reserve—Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks); 12 CFR part 252, subpart Q (Single Counterparty Credit Limits); 12 CFR part 324 (Federal Deposit Insurance Corporation—Capital Adequacy of FDIC-Supervised Institutions).

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> NSCC filed this proposed rule change as an advance notice (SR-NSCC-2022-801) with the Commission 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, 12 U.S.C. 5465(e)(1), and Rule 19b-4(n)(1)(i) under the Act, 17 CFR 240.19b-4(n)(1)(i). A copy of the advance notice is available at <https://www.dtcc.com/legal/sec-rule-filings.aspx>.

<sup>4</sup> Capitalized terms not defined herein are defined in the Rules, available at [https://www.dtcc.com/-/media/Files/Downloads/legal/rules/nsc\\_rules.pdf](https://www.dtcc.com/-/media/Files/Downloads/legal/rules/nsc_rules.pdf).

cash payables and receivables versus NSCC) by becoming the legal counterparty to both pre-novation counterparties to an SFT through novation. Specifically, market participants that borrow securities through NSCC and then onward lend those securities, or other securities, to another NSCC Member through the proposed SFT Clearing Service may have the ability to net down the cash collateral return obligations and entitlements related to such SFTs. By contrast, for bilateral SFTs, market participants may be required to record those payables and receivables on their balance sheets on a gross (rather than netted) basis. A netted balance sheet can create significant capital benefits for market participants because it can reduce the amount of regulatory capital they must hold against SFTs under the U.S. “supplementary leverage ratio” and other capital requirements that favor a netted balance sheet.<sup>8</sup>

In addition, under Basel III, bank holding companies that have broker-dealer subsidiary borrowers are required to reserve capital against their exposures to institutional firm lenders of securities in relation to the cash collateral posted by such borrowers. Those capital requirements can vary depending on the credit profile of the institutional firm lender, and generally are well in excess of those applied to exposures to qualifying central counterparties, such as NSCC.<sup>9</sup> The counterparty risk weight of a qualifying central counterparty, like NSCC, is 2%,<sup>10</sup> which may result in considerable capital savings to these bank holding companies, to the extent they participate in central clearing.

Moreover, agent lending banks and bank holding company parents of broker-dealer borrowers that participate in central clearing could receive beneficial treatment under the single counterparty credit limits, which exempt exposures to qualifying central counterparties.<sup>11</sup>

In light of the potential for central clearing to alleviate the aforementioned capital constraints otherwise applicable to bilateral SFTs, NSCC believes that central clearing of SFTs may increase the capacity of market participants to engage in SFTs.<sup>12</sup>

#### Fire Sale Risk Mitigation

In addition to creating capital efficiency opportunities for market

participants, NSCC believes that broadening the scope of central clearing at NSCC to SFTs would also reduce the potential for market disruption from fire sales.

In the case of securities lending transactions, the primary risk of fire sales<sup>13</sup> relates to the reinvestment of cash collateral by institutional firms that are the lenders in securities lending transactions. Those institutional firms will typically reinvest the cash collateral they receive from the borrower into other securities. If the borrower of the securities thereafter defaults, the institutional firm lenders generally need to quickly liquidate the securities representing the reinvestment in order to raise cash to purchase the originally lent security. A substantial number of disconnected and competing liquidations by multiple lenders can create fire sale conditions for the securities being liquidated, which can harm not only the institutional firm lenders by potentially lowering the amount of cash they can raise in the sale of such securities, but also create market losses for all holders of such securities.<sup>14</sup>

Moreover, if an institutional firm lender should default and fail to return the cash collateral back to its borrowers, the borrowers would typically be looking to liquidate the borrowed securities in order to make themselves whole for the cash collateral they delivered to the institutional firm lender. Competing and disconnected sales of such securities could similarly create fire sale conditions and not only harm the borrowers to the extent the value of the securities decline, but also create market losses for all holders of the borrowed securities.

NSCC believes that broadening the scope of central clearing at NSCC to SFTs would reduce the potential for market disruption from fire sales for a number of reasons. First, in the event of a default, NSCC would conduct a centralized, orderly liquidation of the defaulter’s SFT Positions (as defined below and in the proposed rule change). Such an organized liquidation should

result in substantially less price depreciation and market disruption than multiple independent non-defaulting parties racing against one another to liquidate the positions. Second, NSCC would only need to liquidate the defaulter’s net positions. By contrast, in the context of a default by a broker-dealer intermediary that runs a matched book in the bilateral securities market, both the ultimate lender and the ultimate borrower need to liquidate the defaulter’s gross positions. Limiting the positions that need to be liquidated to the defaulter’s net positions should reduce the volume of required sales activity, which in turn should limit the price and market impact of the close-out of the defaulter’s positions. Lastly, NSCC would use its risk management resources to provide confidence to market participants that they will receive back their cash or securities, as applicable, which should limit the propensity for market participants to seek to unwind their transactions in a stressed market scenario.

#### Liquidity Drain Risk Mitigation

Liquidity risk may also arise if, in the context of a stressed market scenario, borrowers or lenders concerned about their counterparties’ creditworthiness seek to unwind their securities lending transactions and obtain the return of their cash collateral or securities. This occurred to a certain extent in 2008, when borrowers began demanding to return borrowed securities in exchange for the cash collateral the borrowers had posted to institutional firm lenders.<sup>15</sup> These “runs” may require institutional firm lenders to quickly sell off securities that are the subject of their cash reinvestments to raise cash to return to the borrowers, thereby also creating potential fire sale conditions with respect to the reinvestment securities, as described above. Similarly, borrowers may need to purchase or re-borrow securities in stressed market conditions, leading to potentially significant losses.

NSCC believes that having SFTs be centrally cleared by NSCC would lower the risk of a liquidity drain in a stress scenario. Specifically, NSCC believes that having it clear SFT activity would provide confidence to borrowers and lenders that they will receive back their cash or securities and thereby lessen parties’ inclination to rush to unwind their transactions in a stressed market scenario.

<sup>13</sup> Fire sale risk is the risk of rapid sales of assets in large amounts that temporarily depress market prices of such assets and create financial instability.

<sup>14</sup> See Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, at 5 (August 29, 2013) available at [https://www.fsb.org/wp-content/uploads/r\\_130829b.pdf?page\\_moved=1](https://www.fsb.org/wp-content/uploads/r_130829b.pdf?page_moved=1). See also United States Securities and Exchange Commission, *Securities Lending and Short Sale Roundtable Transcript* (September 29, 2009), Former Chairman Schapiro’s Remarks, at 2–3, available at <https://www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf>.

<sup>15</sup> See, e.g., *id.*

<sup>8</sup> See 12 CFR 217.10(c)(4)(ii)(E)–(F).

<sup>9</sup> See 12 CFR 217.32 and 217.37 generally.

<sup>10</sup> See 12 CFR 217.35(c)(3).

<sup>11</sup> See 12 CFR 252.77(a)(3).

<sup>12</sup> Members should discuss this matter with their accounting and regulatory capital experts.

### Addition of New Membership Categories for Institutional Firm SFT Activity

When evaluating the opportunity to expand its cleared offerings to SFTs, NSCC engaged in extensive discussions with numerous market participants, including agent lenders, brokers, institutional firms, and critical third parties, such as matching service providers and books and records service providers. NSCC also organized several industry working groups to discuss the possibility of clearing SFTs. Each constituency has a unique perspective on the proposed SFT Clearing Service. By capturing their differing viewpoints in the design, NSCC has sought to ensure that the proposed SFT Clearing Service would reflect their needs and facilitate industry adoption of the proposed SFT Clearing Service.

There was a considerable amount of discussion between NSCC and market participants regarding the appropriate model(s) through which institutional firms should access central clearing. Some market participants expressed interest in allowing Members to sponsor institutional firms into NSCC membership in a manner similar to that provided for under the sponsoring member/sponsored member program at the Government Securities Division (“GSD”) of Fixed Income Clearing Corporation (“FICC”), an NSCC affiliate (“FICC’s Sponsoring Member/Sponsored Member Program”).<sup>16</sup> Under FICC’s Sponsoring Member/Sponsored Member Program, sponsoring members may submit to FICC transactions entered into on a principal-to-principal basis between the sponsoring member and the sponsored member.<sup>17</sup> On the other hand, certain other market participants, including in particular certain agent lending banks, requested that the central clearing service accommodate agent-style trading (*i.e.*, where the agent lender enters into the transaction on behalf of the institutional firm, rather than as principal counterparty). As NSCC understands it, agent-style trading is the way such agent lenders are typically approved to transact in securities lending transactions on behalf

<sup>16</sup> See Rule 3A (Sponsoring Members and Sponsored Members) of the FICC GSD Rulebook (“GSD Rules”), available at [https://dtcc.com/~media/Files/Downloads/legal/rules/ficc\\_gov\\_rules.pdf](https://dtcc.com/~media/Files/Downloads/legal/rules/ficc_gov_rules.pdf).

<sup>17</sup> FICC’s Sponsoring Member/Sponsored Member Program also allows sponsoring members to submit to FICC transactions entered into between a sponsored member and a third-party netting member. However, based on feedback from market participants, NSCC has decided to address this type of trading via the proposed agent clearing model for SFT.

of their institutional firm clients today.<sup>18</sup>

NSCC considered all of this input, as well as the recent experiences of FICC in expanding the suite of both transactions and participants eligible for FICC’s Sponsoring Member/Sponsored Member Program,<sup>19</sup> and ultimately decided to incorporate both the sponsoring/sponsored membership type (to facilitate principal style trading for institutional firms and their sponsoring members) as well as the Agent Clearing Member membership type (to facilitate agent-style trading by agent lenders on behalf of institutional firm clients) into the proposed SFT Clearing Service.<sup>20</sup> NSCC expects these proposed new membership types would help expand access to central clearing for institutional firms and facilitate industry adoption of the proposed SFT Clearing Service.

The proposed SFT Clearing Service would also allow for the submission of broker-to-broker activity as well as client-to-client activity (credit intermediated by Sponsoring Members and/or Agent Clearing Members) into the NSCC system.

(ii) Key Parameters of the Proposed SFT Clearing Service

Overnight SFTs

NSCC is proposing central clearing for SFTs with a one Business Day term (*i.e.*, overnight SFTs) in eligible equity securities that are entered into by Members, institutional firms that are sponsored into NSCC by Sponsoring Members, or Agent Clearing Members

<sup>18</sup> In addition, certain other agent lenders who are not themselves banks or broker-dealers (and so are not eligible to become Members of NSCC) preferred a model where the institutional firm client becomes the direct member of NSCC with no obligations running between the agent lender and the clearing agency.

<sup>19</sup> See Securities Exchange Act Release Nos. 80563 (May 1, 2017), 82 FR 21284 (May 5, 2017) (SR-FICC-2017-003) (Expand the types of entities that are eligible to participate in FICC as Sponsored Members), 85470 (March 29, 2019), 84 FR 13328 (April 4, 2019) (SR-FICC-2018-013) (Expand Sponsoring Member Eligibility in the GSD Rulebook), and 88262 (February 21, 2020), 85 FR 11401 (February 27, 2020) (SR-FICC-2019-007) (Close-Out and Funds-Only Settlement Processes Associated with the Sponsoring Member/Sponsored Member Service).

<sup>20</sup> NSCC decided at this time not to incorporate a direct model for institutional firm clearing into the proposed SFT Clearing Service because in its experience with a similar model in FICC (the CCIT Service), the requirements that a clearing agency, such as NSCC, would be required to apply to an institutional firm that participated as a direct member (*e.g.*, Clearing Fund and loss allocation) would, as a general matter, not likely be compatible with the regulatory requirements and investment guidelines applicable to many of the regulated institutional firms that NSCC anticipates would be interested in participating in the proposed SFT Clearing Service.

on behalf of customers. NSCC has determined that overnight term SFTs with a daily pair off option are more appropriate for the proposed SFT Clearing Service than open transactions with mark-to-market collections. This is because, as NSCC understands it, open transactions are not eligible for balance sheet netting given they do not have a scheduled off-leg/settlement date. As described above, the proposed SFT Clearing Service is designed to offer both balance sheet netting and capital efficiency opportunities to market participants. NSCC therefore finds it appropriate to make overnight term SFTs with a scheduled date for Final Settlement (as defined below and in the proposed rule change) of the next Business Day, rather than open transactions, eligible for central clearing through the proposed SFT Clearing Service.

For example, assume that a Transferor (as defined below and in the proposed rule change) and Transferee (as defined below and in the proposed rule change) enter into an SFT pursuant to which: (i) In the Initial Settlement (as defined below and in the proposed rule change) on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. After the Initial Settlement occurs on Monday, the Final Settlement of the SFT is novated to NSCC. In the Final Settlement on Tuesday, the Transferee will return 100 shares of security X to the Transferor for \$100 per share. The Rate Payment (as defined below and in the proposed rule change) would be passed by NSCC as between the Transferor and Transferee on Tuesday as part of NSCC’s end-of-day final money settlement process.

SFT Counterparties

The proposed SFT Clearing Service would only be available for SFTs entered into between (i) a Member and another Member, (ii) a Sponsoring Member and its Sponsored Member (as defined below and in the proposed rule change), and (iii) an Agent Clearing Member acting on behalf of a Customer and either (x) a Member or (y) the same or another Agent Clearing Member acting on behalf of a Customer. As used in the Rules, “Member” includes full-service NSCC clearing members, but not Sponsored Members.<sup>21</sup> In addition, as

<sup>21</sup> As defined in Rule 1 (Definitions and Descriptions), the term “Member” means any Person specified in Section 2.(i) of Rule 2 who has qualified pursuant to the provisions of Rule 2A. As

proposed, the only SFTs entered into by Sponsored Members that would be eligible for novation to NSCC would be SFTs between the Sponsored Member and its Sponsoring Member.<sup>22</sup>

#### Approved SFT Submitters

Consistent with the manner in which NSCC accepts cash market transactions, SFTs would be required to be submitted to NSCC on a locked-in/matched basis by an Approved SFT Submitter (as defined below and in the proposed rule change) in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose. Approved SFT Submitters would be selected by the SFT Members (as defined below and in the proposed rule change), subject to NSCC's approval. An Approved SFT Submitter could either be a Member or a third-party vendor. SFTs submitted to NSCC by an Approved SFT Submitter would be valid and binding obligations of each SFT Member designated by the Approved SFT Submitter as a party thereto.

#### Eligible Equity Securities and Per Share Price Minimum

NSCC will maintain eligibility criteria for the securities that may underlie an SFT that NSCC will accept for novation. Consistent with NSCC's general approach to eligibility for securities, the eligibility criteria would not be a rule, but a separate document maintained by NSCC and available to Members. It is currently contemplated that eligible securities for SFTs in the proposed SFT Clearing Service will be limited to CNS-eligible securities.

In light of the fact that central clearing of SFTs would be a new service for NSCC, and market participants would be able to elect which of their eligible SFTs to novate to NSCC (*i.e.*, central clearing of SFTs would not be mandatory for Members), NSCC is not able to anticipate at this time the size and composition of the SFT portfolios that would be novated to NSCC. Due to this lack of history, NSCC would, as an initial matter, provide proposed SFT Clearing Service for only those SFTs where the underlying securities are CNS-eligible equity securities that have a per share price of \$5 or more. NSCC selected \$5 as the per share price minimum for underlying equity securities that could be the subject of a novated SFT because \$5 is a common

such, the term "Member" does not include a Sponsored Member. *Supra* note 4.

<sup>22</sup> See Section 5 of proposed Rule 56, which provides that a Sponsoring Member shall be permitted to submit to NSCC SFTs between itself and its Sponsored Members.

share price minimum adopted in brokerage margin eligibility schedules.

This proposed share price limitation would be implemented systemically by NSCC as one of the eligibility criteria for determining whether an equity security is eligible to be the subject of a novated SFT (rather than as a rule), and such per share price limitation could be modified by NSCC<sup>23</sup> at a later date after NSCC gains more experience with the nature of the SFT portfolios submitted for clearing. In addition, if the share price of underlying securities of an SFT that has already been novated to NSCC falls below \$5, such SFT would continue to be novated to NSCC, but the Required SFT Deposit (as defined below and in the proposed rule change) for the affected Members would include an amount equal to 100% of the market value of such underlying securities until such time as the per share price of the underlying securities equals or exceeds \$5.

#### Cash Collateral

Consistent with the cash market transactions NSCC clears today where cash is used to satisfy Members' purchase obligations in eligible securities, cash would likewise be the only eligible form of collateral for novated SFTs under the proposed SFT Clearing Service.<sup>24</sup> More specifically, NSCC would limit the SFTs that it is willing to novate to SFTs that have SFT Cash (as defined below and in the proposed rule change) equal to or greater than 100% market value of the lent securities, and would not novate any obligations to return collateral consisting of securities.<sup>25</sup>

NSCC would novate the Final Settlement obligations of an SFT as of the time the Initial Settlement of such SFT is completed, unless the SFT is a Bilaterally Initiated SFT (as defined below and in the proposed rule change) or a Sponsored Member Transaction (as defined below and in the proposed rule change), in which case novation of the Final Settlement obligations would occur upon NSCC reporting to the Approved SFT Submitter that the SFT has been validated and novated to NSCC.

As described above, each SFT would be collateralized by cash equal to no less than 100% of the market value of the

<sup>23</sup> The per share price limitation could be modified by NSCC without any regulatory filings; however, any change in the per share price limitation would be announced by NSCC via an Important Notice posted to its website.

<sup>24</sup> This is referred to as "SFT Cash" in the proposed rule text.

<sup>25</sup> See Section 5(a) of proposed Rule 56 and the definition of "Securities Financing Transaction".

lent securities. In addition, in order to address regulatory and investment guideline requirements applicable to certain institutional firms,<sup>26</sup> a Member would be permitted (but not required) to transfer an additional cash haircut above 100% (*e.g.*, 102%) to such institutional firms, *i.e.*, Independent Amount SFT Cash (as defined below and in the proposed rule change), as part of the Initial Settlement of the SFT. The Sponsoring Member or Agent Clearing Member, as applicable, that receives the Independent Amount SFT Cash in the Initial Settlement would also receive a commensurate Clearing Fund call, *i.e.*, an Independent Amount SFT Cash Deposit Requirement (as defined below and in the proposed rule change), from NSCC to reflect the value received by such Member above the market price of the equity security lent. NSCC's novation of Final Settlement obligations related to Independent Amount SFT Cash would be tied to the time the Sponsoring Member or Agent Clearing Member, as applicable, satisfies the related Independent Amount SFT Cash Deposit Requirement in cash.

#### RVP/DVP Settlement at DTC

The Final Settlement obligations of each SFT, other than a Sponsored Member Transaction, that is novated to NSCC would settle receive-versus-payment/delivery-versus-payment ("RVP/DVP") at DTC.<sup>27</sup> SFT deliver orders would be processed in accordance with DTC's rules and procedures, including provisions relating to risk controls. DTC would accept delivery instructions for an SFT from NSCC, as agent for DTC participants that are SFT Members.<sup>28</sup>

Pre-novation counterparties to an SFT that is due to settle may elect to pair off (*i.e.*, offset) the Final Settlement

<sup>26</sup> As an example, a registered investment company that lends securities through an agent may be required under Section 17(f) of the Investment Company Act of 1940 and Rule 17f-2 thereunder to collect cash collateral equal to no less than 102% of the market value of the lent securities. *See, e.g.*, The Adams Express Company, SEC No-Action Letter (Oct. 8, 1984). Other institutional firms may be subject to similar requirements under their established investment guidelines or applicable rules, regulations or guidance.

<sup>27</sup> As described below, the Final Settlement and other obligations of each Sponsored Member Transaction would, at the direction of NSCC, settle on the books and records of the relevant Sponsoring Member.

<sup>28</sup> On March 28, 2022, DTC submitted a proposed rule change to provide DTC participants that are also NSCC Members with settlement services in connection with NSCC's proposed SFT Clearing Service. *See* SR-DTC-2022-002, which was filed with the Commission but has not yet been published in the **Federal Register**. A copy of this proposed rule change is available at <https://www.dtcc.com/legal/sec-rule-filings.aspx>.

obligations of such SFT against the Initial Settlement obligations of a new SFT between the same parties on the same securities. NSCC believes that such offsets would minimize the operational burden of settling overnight obligations. NSCC would calculate and process the difference in cash collateral between the paired off SFTs, *i.e.*, Price Differential (as defined below and in the proposed rule change). Price Differential would also be processed in accordance with DTC rules and procedures, including provisions relating to risk controls. DTC would accept Price Differential payment orders for an SFT from NSCC, as agent for DTC participants that are SFT Members.

Settlement of the Rate Payment obligations and payment obligations arising from certain mandatory corporate actions and cash dividends would be processed as part of NSCC's end-of-day final money settlement process.

As an example of an SFT with a full pair off (*i.e.*, offset), assume that a Transferor and Transferee enter into an SFT pursuant to which: (i) In the Initial Settlement on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. After the Initial Settlement occurs on Monday, the Final Settlement of the SFT is novated to NSCC. At the end of day on Monday, the share price of security X is \$99 per share. On Tuesday, the Approved SFT Submitter, on behalf of the Transferor and the Transferee, instructs NSCC to pair off the parties' Final Settlement obligations on the Settling SFT (as defined below and in the proposed rule change) with a Linked SFT (as defined below and in the proposed rule change) pursuant to which (i) in the Initial Settlement on Tuesday, the Transferor will transfer 100 shares of security X to the Transferee against \$99 per share; and (ii) in the Final Settlement on Wednesday, the Transferee will transfer 100 shares of security X to the Transferor against \$99 per share. NSCC would, on Tuesday, collect \$1 per share in Price Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee in connection with the pair off. In addition, the Rate Payment for the Settling SFT would be passed by NSCC as between the Transferor and Transferee on Tuesday as part of NSCC's end-of-day final money settlement process. In the Final Settlement on Wednesday, the Transferee will return 100 shares of security X to the

Transferor for \$99 per share. The Rate Payment for the Linked SFT would be passed by NSCC as between the Transferor and Transferee on Wednesday as part of NSCC's end-of-day final money settlement process.

As an example of an SFT with a partial pair off (*i.e.*, offset), assume that a Transferor and Transferee enter into an SFT pursuant to which: (i) In the Initial Settlement on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. After the Initial Settlement occurs on Monday, the Final Settlement of the SFT is novated to NSCC. At the end of day on Monday, the share price of security X is \$99 per share. On Tuesday, the Approved SFT Submitter, on behalf of the Transferor and the Transferee, instructs NSCC to partially pair off the parties' Final Settlement obligations on the Settling SFT with a Linked SFT pursuant to which (i) in the Initial Settlement on Tuesday, the Transferor will transfer 25 shares of security X to the Transferee against \$99 per share; and (ii) in the Final Settlement on Wednesday, the Transferee will transfer 25 shares of security X to the Transferor against \$99 per share. In the Final Settlement on Tuesday for the remaining Settling SFT, the Transferee will return 75 shares of security X to the Transferor for \$100 per share. NSCC would, on Tuesday, collect \$1 per share in Price Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee in relation to the shares subject to pair off (*i.e.*, 25 shares of security X). In addition, the Rate Payment for the Settling SFT (*i.e.*, 100 shares of security X) would be passed by NSCC as between the Transferor and Transferee on Tuesday as part of NSCC's end-of-day final money settlement process. In the Final Settlement on Wednesday for the Linked SFT, the Transferee will return 25 shares of security X to the Transferor for \$99 per share. The Rate Payment on the Linked SFT (*i.e.*, 25 shares of security X) would be passed by NSCC as between the Transferor and Transferee on Wednesday as part of NSCC's end-of-day final money settlement process.

#### Buy-In, Recall and Accelerated Settlement

It is occasionally the case in the securities lending market that a borrower is solvent and able to satisfy its general obligations as they become due but unable to deliver the lent securities to the lender within the

timeline requested by the lender. The contractual remedy that has developed in the bilateral securities lending market for these situations is a "buy-in." Under this remedy, the lender may purchase securities equivalent to the borrowed securities in the market and charge the borrower for the cost of this purchase. This serves to benefit the lender because it allows the lender to recover the securities within its required timeline, and it benefits the borrower by avoiding a situation in which the borrower's failure to perform under a single transaction results in an event of default and close-out of all of its securities lending transactions (and potentially other positions through a cross-default). Similarly, in the bilateral space, securities borrowers may have the need to accelerate settlement of securities lending transactions if they lose a "permitted purpose" for such loans under Regulation T. The proposed SFT Clearing Service would seek to retain the buy-in and acceleration mechanisms, as they ensure the smooth functioning of securities markets without causing unnecessary and disorderly defaults or regulatory violations.<sup>29</sup>

Consistent with their rights under industry-standard documentation for bilateral SFTs, as proposed, Transferors would have the right to submit a Recall Notice (as defined below and in the proposed rule change) to NSCC in respect of a novated SFT for which Final Settlement obligations have not yet been satisfied. If the Transferee does not return the lent securities by the Recall Date (as defined below and in the proposed rule change) specified in such notice, and the Transferor would be eligible to Buy-In (as defined below and in the proposed rule change), in accordance with such timeframes and deadlines as established by NSCC for such purpose, such securities.

For example, assume that a Transferor and Transferee enter into an SFT pursuant to which: (i) In the Initial Settlement on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. After the Initial Settlement occurs on

<sup>29</sup> NSCC does not believe retaining the buy-in and acceleration mechanisms would undermine novation because NSCC would remain the obligor and obligee in respect of the Final Settlement, Rate Payment, and Distribution Payment (as defined below and in the proposed rule change) entitlements and obligations. These mechanisms simply affect the timing and manner in which those obligations are discharged.

Monday, the Final Settlement of the SFT is novated to NSCC. At the end of day on Monday, the share price of security X is \$99 per share. On Tuesday, the Approved SFT Submitter, on behalf of the Transferor and the Transferee, instructs NSCC to pair off (*i.e.*, offset) the parties' Final Settlement obligations on the Settling SFT with a Linked SFT pursuant to which (i) in the Initial Settlement on Tuesday, the Transferor will transfer 100 shares of security X to the Transferee against \$99 per share; and (ii) in the Final Settlement on Wednesday, the Transferee will transfer 100 shares of security X to the Transferor against \$99 per share. NSCC would, on Tuesday, collect \$1 per share in Price Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee in connection with the pair off. In addition, the Rate Payment for the Settling SFT would be passed by NSCC as between the Transferor and Transferee on Tuesday as part of NSCC's end-of-day final money settlement process.

Later in the day on Tuesday, the Transferor determines it now needs 100 shares of security X back in its inventory, and so the Approved SFT Submitter submits a Recall Notice to NSCC, prior to the deadline established by NSCC, on behalf of the Transferor for 100 shares of security X with a Recall Date of Thursday. At the end of day on Tuesday, the share price of security X is \$98 per share. Upon receipt of the Recall Notice, the SFT would be treated as a Non-Returned SFT (as defined below and in the proposed rule change) by NSCC pursuant to Section 9(e) of proposed Rule 56 (Securities Financing Transaction Clearing Service). Accordingly, pursuant to Section 9(a) of proposed Rule 56, the Final Settlement Date (as defined below and in the proposed rule change) of the SFT would be rescheduled to Thursday, and NSCC would, on Wednesday collect \$1 per share in Price Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee on the Non-Returned SFT. The Rate Payment for the Non-Returned SFT would also be passed by NSCC as between the Transferor and Transferee on Wednesday as part of NSCC's end-of-day final money settlement process.

Assume further that the Transferee does not transfer the 100 shares of security X on Wednesday and that the end of day price of security X on Wednesday is \$97 per share. On Thursday, NSCC would again collect \$1 per share in Price Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee on the

Non-Returned SFT. The Rate Payment for the Non-Returned SFT would also be passed by NSCC as between the Transferor and Transferee on Thursday as part of NSCC's end-of-day final money settlement process. In addition, since the Recall Notice specified Thursday as the Recall Date, the Transferor would be entitled to purchase (or deem itself to have purchased) 100 shares of security X in accordance with the provisions of Section 9(b) of proposed Rule 56. Assuming that the Transferor paid a price of \$95 per share for security X and submitted a written notice to NSCC of its Buy-In Costs (as defined below and in the proposed rule change) on Thursday, the Transferor would owe NSCC a Buy-In Amount (as defined below and in the proposed rule change) of \$2 per share (\$100 per share of SFT Cash received by the Transferor at the Initial Settlement of the SFT, less the \$95 per share Buy-In Costs of the Transferor, minus \$3 per share Price Differential paid by the Transferor to NSCC), and such Buy-In Amount would be debited by NSCC from the Transferor and credited to the Transferee as part of NSCC's end-of-day final money settlement process on Friday.

Similarly, consistent with their rights under industry-standard documentation for bilateral SFTs, Transferees would have the right to accelerate the scheduled Final Settlement of a novated SFT through notice from the Approved SFT Submitter to NSCC of such accelerated settlement.

For example, assume that a Transferor and Transferee enter into an SFT pursuant to which: (i) In the Initial Settlement on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. After the Initial Settlement occurs on Monday, the Final Settlement of the SFT is novated to NSCC. At the end of day on Monday, the share price of security X is \$99 per share. On Tuesday, the Approved SFT Submitter, on behalf of the Transferor and the Transferee, instructs NSCC to net the parties' Final Settlement obligations on the Settling SFT with a Linked SFT pursuant to which (i) in the Initial Settlement on Tuesday, the Transferor will transfer 100 shares of security X to the Transferee against \$99 per share; and (ii) in the Final Settlement on Wednesday, the Transferee will transfer 100 shares of security X to the Transferor against \$99 per share. NSCC would, on Tuesday, collect \$1 per share in Price

Differential from the Transferor and pay \$1 per share in Price Differential to the Transferee in connection with the pair off. Later in the day on Tuesday, the Transferee loses permitted purpose under Regulation T for the borrowing of 100 shares of security X. Therefore, pursuant to Section 11 of proposed Rule 56 (Securities Financing Transaction Clearing Service), the Approved SFT Submitter submits a notice to NSCC on behalf of the Transferee to accelerate the Final Settlement of the Linked SFT to Tuesday. The Transferee then on Tuesday returns 100 shares of security X to NSCC for \$99 per share, and NSCC returns 100 shares of security X to the Transferor for \$99 per share. The Rate Payment would be passed by NSCC for the Settling SFT as between the Transferor and Transferee on Tuesday as part of NSCC's end-of-day final money settlement process.

#### Risk Management of SFT Positions

Under the proposal, NSCC is requiring a deposit to the Clearing Fund<sup>30</sup> for SFT Positions, *i.e.*, Required SFT Deposit. From a market risk standpoint, SFT activity would, except as otherwise noted below, be risk managed by NSCC in a manner consistent with Members' CNS positions but would be margined independently of the Member's other positions,<sup>31</sup> and a Required SFT Deposit would be collected by NSCC for all SFT activity of an SFT Member, subject to a \$250,000 minimum deposit.<sup>32</sup> Specifically, NSCC is proposing to calculate an SFT Member's Required SFT Deposit by applying the sections of Procedure XV (Clearing Fund Formula and Other Matters) specified in Section 12 of proposed Rule 56 (*i.e.*, Sections I.(A)(1)(a), (b), (c), (e), (f), (g) of Procedure XV as well as the additional Clearing Fund formula in Section I.(B)(5) (Intraday Mark-to-Market Charge) of Procedure XV as such sections apply to CNS Transactions, and the additional Clearing Fund formula in Sections I.(B)(1) (Additional Deposits for Members on the Watch List); (2) (Excess Capital Premium), (3)

<sup>30</sup> As currently defined in Rule 1 (Definitions and Descriptions), the term "Clearing Fund" means the fund created pursuant to Rule 4. *Supra* note 4.

<sup>31</sup> NSCC is not proposing at this time to portfolio margin a Member's SFT Positions with any CNS positions of the Member, except with respect to the MLA charge. NSCC may reconsider this position after it obtains a reasonable amount of experience observing the nature and volume of SFT activity submitted by Members to NSCC for novation through the proposed SFT Clearing Service.

<sup>32</sup> This \$250,000 minimum deposit is a requirement that is separate from a Member's minimum (non-SFT) Clearing Fund deposit requirement, although it is designed to be consistent with such requirement.

(Backtesting Charge), (4) (Bank Holiday Charge); Minimum Clearing Fund and Additional Deposit Requirements in Sections II.(A)1(a)–(b), II.(B), II.(C), and II.(D); as well as Section III (Collateral Value of Eligible Clearing Fund Securities) of Procedure XV, as such sections apply to Members). Furthermore, NSCC would require an additional Required SFT Deposit for Non-Returned SFTs that is intended to mirror the premium charged for CNS Fails Positions. NSCC would also apply the Independent Amount SFT Cash Deposit Requirement for SFTs that have Incremental Additional Independent Amount SFT Cash.

For the purpose of applying Section I.(A)(1)(a)(i) of Procedure XV (Value-at-Risk (VaR) charge), unlike the current calculation of the volatility of a Member's Net Unsettled Positions<sup>33</sup> in CNS Transactions, NSCC is proposing that the volatility of an SFT Member's SFT Positions shall be the sum of (a) the highest resultant value between Section I.(A)(1)(a)(i)I. (Core Parametric Estimation) and Section I.(A)(1)(a)(i)III. (Margin Floor) and (b) the resultant value of Section I.(A)(1)(a)(i)II. (Gap Risk Measure). This proposed change is designed to capture idiosyncratic risk associated with an SFT Member's portfolio by enabling NSCC to apply the Gap Risk Measure more frequently.

NSCC is also proposing that, for the purpose of applying Section I.(A)(1)(g) of Procedure XV (Margin Liquidity Adjustment (MLA) charge), SFT Positions shall be aggregated with Net Unsettled Positions in the same asset group or subgroup; provided, however, in the event such aggregation results in a reduction of the aggregate positions in the relevant asset group or subgroup, NSCC shall apply the greater of (a) the sum of MLA charges separately calculated for SFT Positions and Net Unsettled Positions in the asset group or subgroup and (b) the MLA charge calculated from aggregating the SFT Positions and the Net Unsettled Positions in the asset group or subgroup. This proposed change is designed to enable NSCC to better risk manage the SFT activity by assessing the MLA charge in a circumstance where the combined SFT Positions and Net Unsettled Positions in total trigger the applicable MLA charge thresholds, whereas, if calculated separately, the MLA charge would not be triggered.

<sup>33</sup> "Net Unsettled Positions" means a Member's net of unsettled Regular Way, When-Issued and When-Distributed positions in CNS Securities that have not yet passed Settlement Date and net positions in CNS Securities that did not settle on Settlement Date. See Rule 1, *supra* note 4.

In addition, NSCC is proposing that each SFT Member, other than an SFT Member that is a Sponsored Member, so long as such Member is an SFT Member, would provide Supplemental Liquidity Deposits to the Clearing Fund, as may be required pursuant to Rule 4A (Supplemental Liquidity Deposits).

Consistent with the manner in which clearing fund requirements are satisfied by members of FICC for their cleared securities financing transactions, NSCC would require that (i) a minimum of 40% of an SFT Member's Required SFT Deposit consist of a combination of cash and Eligible Clearing Fund Treasury Securities and (ii) the lesser of \$5,000,000 or 10% of an SFT Member's Required SFT Deposit (but not less than \$250,000) consist of cash.<sup>34</sup><sup>35</sup> NSCC would also have the discretion to require an SFT Member to post its Required SFT Deposit in proportion of cash higher than would otherwise be required as described above. NSCC's determination to impose any such requirement would be made in view of market conditions and other financial and operational capabilities of the relevant SFT Member. For example, as proposed in Section 12 of Rule 56, if NSCC had specific concerns about a particular SFT Member's financial or operational capabilities, but NSCC had not yet come to the determination that ceasing to act for the SFT Member would be appropriate (but could potentially become appropriate within the near term), NSCC may request that a greater portion of the SFT Member's Required SFT Deposit to the Clearing Fund be in the form of cash in order to simplify any potential close-out liquidation required in the event of that

<sup>34</sup> This \$250,000 minimum cash deposit requirement is designed to be consistent with the minimum amount of cash that must be used to satisfy a Member's (non-SFT) Clearing Fund deposit requirement. NSCC believes a \$250,000 minimum cash deposit would serve to strengthen NSCC's liquidity resources. Cash may also be easier to access upon a Member's default, further reducing the risk of losses and using non-defaulting Member's securities or funds, or NSCC funds.

<sup>35</sup> These requirements are designed to be consistent with FICC GSD's clearing fund requirements of its members given that NSCC anticipates that there would be considerable overlap between the membership of FICC GSD that participate in FICC for purposes of clearing their securities financing transaction activity (including in particular sponsored repo activity) and the Members that would elect to participate in the proposed SFT Clearing Service. Specifically, FICC GSD Rule 4, Section 3 requires (i) a minimum of 40 percent of a member's required fund deposit to be in the form of cash and/or eligible clearing fund treasury securities and (ii) the lesser of \$5,000,000 or 10 percent of the required fund deposit, with a minimum of \$100,000, be made and maintained in cash. See Rule 4 (Clearing Fund and Loss Allocation) of the FICC GSD Rulebook, *supra* note 16.

SFT Member's default. Separately, pursuant to Section II.(A)1(a) of Procedure XV, if an SFT Member's deposit of Eligible Clearing Fund Agency Securities or Eligible Clearing Fund Mortgage-Backed Securities is in excess of 25% of the SFT Member's Required Fund Deposit, NSCC would subject the deposit to an additional haircut.

The Sponsoring Member Required Fund Deposits (as defined below and in the proposed rule change) and Agent Clearing Member Required Fund Deposits (as defined below and in the proposed rule change) would each be calculated on a gross basis, and no offsets for netting of positions as between different Sponsored Members or different Customers,<sup>36</sup> as applicable, would be permitted. This is to ensure that NSCC's volatility-based Clearing Fund deposit requirements represent the sum of each individual institutional firm's activity.

As proposed and as described above, the Final Settlement obligations and Price Differential of each SFT, other than a Sponsored Member Transaction, that is novated to NSCC would settle RVP/DVP at DTC.<sup>37</sup> SFT deliver orders would be processed in accordance with DTC's rules and procedures, including provisions relating to risk controls. Therefore each DTC participant's Final Settlement obligation would complete at DTC on a fully collateralized basis, and the associated debits (if any) would be subject to DTC's risk controls.

To the extent the Price Differential is not processed by DTC, for example if a receiver does not satisfy DTC's risk controls, NSCC would debit and credit the Price Differential from and to the SFT Accounts (as defined below and in the proposed rule change) of the SFT Member parties to the SFT as part of its end of day final money settlement.

In the event NSCC ceases to act for a Defaulting SFT Member (as defined below and in the proposed rule change), on the Business Day that NSCC ceased to act, NSCC's daily liquidity need calculation would include all Price Differential debits owed by the Defaulting SFT Member not processed at DTC. On subsequent days of the liquidation of the Defaulting SFT Member's SFT Positions, NSCC's total liquidity need calculations would include all novated SFT activity that has not reached Final Settlement on the Business Day NSCC ceased to act, netted together with all other outstanding

<sup>36</sup> See Section 7(c) of proposed Rule 2C and Section 6(c) of proposed 2D.

<sup>37</sup> *Supra* note 27.



settlement activity of the Defaulting SFT Member at NSCC.

Until NSCC has satisfied the Final Settlement obligations owing to non-defaulting SFT Members, NSCC would continue paying to and receiving from non-defaulting SFT Members the applicable Price Differential (*i.e.*, the change in market value of the relevant securities) with respect to their novated SFTs.<sup>38</sup> By continuing to process these Price Differential payments until Final Settlement occurs, NSCC would ensure that non-defaulting SFT Members are kept in largely the same position as if the Defaulting SFT Member had not defaulted and the pre-novation counterparties had instead agreed to roll the SFTs. This is because even though the non-payment of the Rate Payment in an SFT Member default context may have an impact on non-defaulting SFT Members, such impact is generally de minimis. To the extent NSCC is required to pay a Price Differential, as well as any Final Settlement obligations, to a non-defaulting SFT Member, NSCC would rely on NSCC's liquidity resources, including the Required SFT Deposit and any Supplemental Liquidity Deposits ("SLD") that may be collected, when applicable, in order to cover the liquidity need associated with any such Price Differential and Final Settlement obligations, consistent with the Clearing Agency Liquidity Risk Management Framework.<sup>39 40</sup> In addition, NSCC

<sup>38</sup> See proposed Rule 56, Section 14(b)(ix).

<sup>39</sup> See Securities Exchange Act Release Nos. 82377 (December 21, 2017), 82 FR 61617 (December 28, 2017) (File No. SR-NSCC-2017-005); 90649 (December 11, 2020), 85 FR 81961 (December 17, 2020) (File No. SR-NSCC-2020-021). This framework sets forth the manner in which NSCC measures, monitors and manages the liquidity risks that arise in or are borne by it, and the qualifying liquidity resources that NSCC maintains in order to cover those risks. Such resources include, for example, cash deposits to the Clearing Fund and SLD that may be collected, when applicable.

<sup>40</sup> For example, assume that a Transferor and Transferee enter into an SFT pursuant to which: (i) In the Initial Settlement on Monday, the Transferor will transfer 100 shares of security X to the Transferee against \$100 per share; and (ii) in the Final Settlement on Tuesday, the Transferee will transfer 100 shares of security X to the Transferor against \$100 per share. Assume further that at midnight on Monday, NSCC ceases to act for the Transferor.

On Tuesday, NSCC executes a sale of 100 shares of security X for \$99 per share. In accordance with the normal settlement cycle for purchases and sales of equity securities, this sale will settle on Thursday.

Pursuant to Section 14(b)(viii) of proposed Rule 56 (Securities Financing Transaction Clearing Service), NSCC would likewise settle the Final Settlement obligations of the defaulting Transferor's SFT with the non-defaulting Transferee on Thursday.

Assume further that the end-of-day price of security X on Tuesday is \$99 per share. On Wednesday, NSCC would pay \$1 per share in Price

would anticipate being in regular communication with the non-defaulting SFT Members as to the timing of the satisfaction of any Final Settlement obligations related to a defaulting SFT Member.

#### (iii) Sponsoring Members and Sponsored Members

NSCC is proposing a sponsored membership program to allow Members to play the role of pre-novation counterparty and credit intermediary for their institutional firm clients in clearing.

NSCC has modeled a number of the aspects of the proposed sponsored member program, including the eligibility criteria and many of the risk management requirements, on FICC's Sponsoring Member/Sponsored Member Program. FICC's Sponsoring Member/Sponsored Member Program allows an FICC Netting Member to sponsor an entity that satisfies certain requirements and submit to FICC for novation certain securities transactions between the Netting Member and the sponsored entity. These securities transactions generally include the off-leg of repurchase transactions on U.S. Government or agency securities or straight purchase and sales of such securities. Such transactions present similar risk management, legal, accounting, and operation considerations to SFTs, as both involve an obligation of a sponsored member and a sponsoring member to exchange cash against securities. Since 2005, FICC has worked with its members to improve its Sponsoring Member/Sponsored Member Program to address these considerations. Based on feedback from Members and its own internal assessments, NSCC believes that leveraging the provisions of FICC's Sponsoring Member/Sponsored Member

Differential to the non-defaulting Transferee pursuant to Section 14(b)(ix) of proposed Rule 56. Assume further that the end-of-day price of security X on Wednesday is \$98 per share.

On Thursday, NSCC would pay an additional \$1 per share in Price Differential to the non-defaulting Transferee pursuant to Section 14(b)(ix) of proposed Rule 56. The Transferee would then return 100 shares of security X to NSCC and receive \$98 per share (*i.e.*, the current market price for security X) from NSCC. As such, the non-defaulting Transferee would be made whole by NSCC for the \$100 per share it transferred in the Initial Settlement of the Defaulted-Related SFT (as defined below and in the proposed rule change) since NSCC would have transferred to it \$98 per share in Final Settlement plus an additional \$2 per share in Price Differential. NSCC would incur a net loss of \$1 per share in this example since it would have sold security X for \$99 per share and paid the non-defaulting Transferee a total of \$100 per share (*i.e.*, \$98 per share in Final Settlement proceeds plus \$2 per share in Price Differential). NSCC would be entitled to deduct this amount from the defaulted Transferor's Clearing Fund deposits (including its SFT Deposit).

program and the learning over the past decade and a half would allow NSCC to provide a sponsored member program that has a solid risk management, accounting, legal and operational foundation.

#### Sponsoring Members

Under the proposal, all Members would be eligible to apply to become Sponsoring Members in NSCC, subject to credit criteria that are designed to be substantially similar to those applicable to category 2 sponsoring members in FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members."<sup>41</sup> A Member whose application to become a Sponsoring Member has been approved by the Board of Directors or NSCC, as applicable, pursuant to proposed Rule 2C ("Sponsoring Member") would be permitted to sponsor their institutional firm clients into membership as Sponsored Members. Such Sponsoring Members would then be able to facilitate their institutional firm clients' cleared activity via two back-to-back principal SFTs, *i.e.*, client-to-

<sup>41</sup> If a Member is a Registered Broker-Dealer, then such Member would only be eligible to apply to become a Sponsoring Member if it satisfies the credit criteria in proposed Rule 2C (Sponsoring Members and Sponsored Members) (*i.e.*, if it has (i) Net Worth of at least \$25 million and (ii) excess net capital over the minimum net capital requirement imposed by the SEC (or such higher minimum capital requirement imposed by the Member's designated examining authority) of at least \$10 million). Such credit criteria are comparable to the credit criteria applicable to category 2 sponsoring members that are registered broker-dealers in FICC's Sponsoring Member/Sponsored Member Program. A Sponsoring Member applicant would be viewed and surveilled as the credit counterparty to NSCC in respect to its Sponsored Member Sub-Account(s) (as defined below and in the proposed rule change) in light of its responsibility to NSCC as the processing agent and unconditional guarantor of its Sponsored Members' performance to NSCC.

In addition, NSCC may require that a Person be a Member for a time period deemed necessary by NSCC before that Person may be considered to become a Sponsoring Member. This requirement may be imposed by NSCC on a new Member that has yet to demonstrate a track record of financial responsibility and operational capability.

Furthermore, as proposed, the application of a Member to be a Sponsoring Member at NSCC that is an Agent Clearing Member or an existing FICC sponsoring member would not be required to be approved by the NSCC Board of Directors. NSCC believes this approach to Board of Director's approval for Sponsoring Members is appropriate in light of the fact that the critical components of the FICC sponsoring member application as well as the NSCC Sponsoring Member and Agent Clearing Member applications and the criteria that the respective boards assess when determining whether to admit a Member in such respective capacities are substantially similar. Nonetheless, NSCC would apply the same rigorous counterparty credit review process to any Member applying to be a Sponsoring Member at NSCC, whether or not the Member is an existing FICC sponsoring member.



Sponsoring Member and Sponsoring Member-to-broker (or to another institutional firm client that the Sponsoring Member has sponsored into membership), and each of such transactions would be eligible for novation to NSCC.

Consistent with the requirements applicable to sponsoring members in FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," a Sponsoring Member would be responsible for (i) submitting data on its Sponsored Members' SFTs to NSCC or appointing a third-party Approved SFT Submitter to do so, (ii) posting to NSCC all of the Clearing Fund associated with the SFT activity of its Sponsored Members, which would be calculated on a gross basis (*i.e.*, SFT activity would not be netted across Sponsored Members for Clearing Fund purposes), (iii) providing an unconditional guaranty to NSCC for its Sponsored Members' Final Settlement and other obligations to NSCC, and (iv) covering any default loss allocable to its Sponsored Members (in addition to its own default loss allocation as a Member).

Specifically, as proposed, a Sponsoring Member would be permitted to submit to NSCC for novation Sponsored Member Transactions, subject to an activity limit designed to be substantially similar to that applicable to category 2 sponsoring members in FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members." Under the proposal, if the sum of the Volatility Charges (as defined below and in the proposed rule change) applicable to a Sponsoring Member's Sponsored Member Sub-Accounts (as defined below and in the proposed rule change) and its other accounts at NSCC exceeds its Net Member Capital (as defined below and in the proposed rule change), the Sponsoring Member would not be permitted to submit activity into its Sponsored Member Sub-Accounts, unless otherwise determined by NSCC in order to promote orderly settlement. As defined in Section 5 of proposed Rule 2C, Sponsored Member Transactions are SFTs between a Sponsoring Member and its Sponsored Members.

The Sponsoring Member would establish one or more accounts at NSCC for its Sponsored Members' positions arising from such Sponsored Member Transactions, *i.e.*, Sponsored Member Sub-Accounts, which would be separate

from the Sponsoring Member's proprietary accounts. For operational and administrative purposes, NSCC would interact solely with the Sponsoring Member as agent of its Sponsored Members.

Sponsoring Members would be responsible for providing NSCC with a Sponsoring Member Guaranty (as defined below and in the proposed rule change) whereby the Sponsoring Member guarantees to NSCC the payment and performance by its Sponsored Members of their obligations under the Sponsored Member Transactions submitted by the Sponsoring Member for novation. Although Sponsored Members are principally liable to NSCC for their own settlement obligations under such transactions in accordance with the Rules, the Sponsoring Member Guaranty requires the Sponsoring Member to satisfy those settlement obligations on behalf of a Sponsored Member if the Sponsored Member defaults and fails to perform its settlement obligations.

In addition, a Sponsoring Member would be responsible for posting to NSCC all of the Clearing Fund associated with the Sponsored Member Transactions (which would not be netted across Sponsored Members for Clearing Fund purposes) and covering any default loss allocable to its Sponsored Members, as well as its own default loss allocation as a Member.<sup>42</sup>

As proposed, consistent with FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," NSCC would also provide a mechanism by which a Sponsoring Member may cause the termination and liquidation of a Sponsored Member's positions arising from Sponsored Member Transactions between the Sponsoring Member and

such Sponsored Member that have been novated to NSCC.<sup>43</sup>

#### Sponsored Members

Consistent with the requirements applicable to sponsored members in FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," any Person that has been approved by NSCC to be sponsored into membership by a Sponsoring Member pursuant to proposed Rule 2C ("Sponsored Member") would be required to be either a "qualified institutional buyer" as defined by Rule 144A<sup>44</sup> under the Securities Act of 1933, as amended ("Securities Act"),<sup>45</sup> or a legal entity that, although not organized as an entity specifically listed in paragraph (a)(1)(i)(H) of Rule 144A under the Securities Act, satisfies the financial requirements necessary to be a "qualified institutional buyer" as specified in that paragraph.

(iv) Agent Clearing Members and Customers

NSCC is proposing an agent clearing membership designed to allow Members to play the role of agent and credit intermediary for their institutional firm clients in clearing. This membership type is being proposed in response to the request of certain market participants, including in particular certain agent lending banks, that the proposed SFT Clearing Service accommodate agent-style trading (*i.e.*, where the agent lender enters into the transactions on behalf of its institutional firm clients with a third-party market participant, rather than acting as its institutional firm clients' principal pre-novation counterparty). Agent-style trading is the manner in which such agent lenders are typically approved to transact in securities lending transactions on behalf of their institutional firm clients. Under the proposal, a Member that enters into transactions on behalf of its institutional firm clients in accordance with the provisions of proposed Rule 2D ("Agent Clearing Member") would be permitted to submit SFTs executed by it (as agent on behalf of its institutional firm clients, with each such client referred to as a "Customer") with a Member participating in the proposed SFT Clearing Service (which could include a Member acting in a proprietary capacity within the proposed SFT Clearing

<sup>42</sup> The following example illustrates how loss allocation would occur with respect to Sponsoring Members and Sponsored Members: Assume NSCC incurs a \$100 million aggregate loss from a Defaulting Member Event. In addition, assume that the Corporate Contribution amount that NSCC would first apply to any loss from a Defaulting Member Event is \$25 million. This means NSCC would allocate the remaining \$75 million losses (*i.e.*, \$100 million minus \$25 million) to Members pursuant to Section 4 of Rule 4 (Clearing Fund), including Sponsored Member Sub-Accounts as if each were a Member. If the allocated losses to a Sponsoring Member's Sponsored Member Sub-Accounts is \$1 million and the allocated losses to its Sponsoring Member in its capacity as a Member is \$2 million, the Sponsoring Member would be responsible for a total of \$3 million loss allocation (\$1 million for its Sponsored Member Sub-Account loss allocation amount and \$2 million for its own default loss allocation as a Member).

<sup>43</sup> See Section 14 of proposed Rule 2C (Sponsoring Members and Sponsored Members).

<sup>44</sup> 17 CFR 230.144A.

<sup>45</sup> 15 U.S.C. 77a *et seq.*

Service as well as an Agent Clearing Member).

All Members would be eligible to apply to become Agent Clearing Members in NSCC, subject to credit criteria that are substantially similar to those applicable to Sponsoring Members as well as category 2 sponsoring members in FICC's Sponsoring Member/Sponsored Member Program.<sup>46</sup>

Under the proposal, the requirements to be imposed on Agent Clearing Members would largely mirror those imposed on Sponsoring Members. However, NSCC is not proposing to impose the same types of requirements on an Agent Clearing Member's Customers as it does on Sponsored Members because a Customer would not be a direct member of NSCC.

Specifically, as proposed, an Agent Clearing Member would be permitted to submit to NSCC for novation Agent Clearing Member Transactions (as defined below and in the proposed rule change), on behalf of one or more of its Customers, subject to an activity limit. Specifically, under the proposal, if the sum of the Volatility Charges applicable to an Agent Clearing Member's Agent Clearing Member Customer Omnibus

<sup>46</sup> If a Member is a Registered Broker-Dealer, then such Member would only be eligible to apply to become an Agent Clearing Member if it satisfies the credit criteria in proposed Rule 2D (*i.e.*, if it has (i) Net Worth of at least \$25 million and (ii) excess net capital over the minimum net capital requirement imposed by the SEC (or such higher minimum capital requirement imposed by the Member's designated examining authority) of at least \$10 million). Such credit criteria are comparable to the credit criteria applicable to sponsoring members that are registered broker-dealers in FICC's Sponsoring Member/Sponsored Member Program. Similar to the review of a Sponsoring Member applicant, an Agent Clearing Member applicant would also be viewed and surveilled as the credit counterparty to NSCC in light of its role as the Member with respect to its Agent Clearing Member Customer Omnibus Account(s).

In addition, NSCC may require a Person be a Member for a time period deemed necessary by NSCC before that Person may be considered to become an Agent Clearing Member. This requirement may be imposed by NSCC on a new Member that has yet to demonstrate a track record of financial responsibility and operational capability.

Furthermore, as proposed, the application of a Member to be an Agent Clearing Member at NSCC that is a Sponsoring Member or an existing FICC sponsoring member would not be required to be approved by the NSCC Board of Directors. NSCC believes this approach to the Board of Director's approval for Agent Clearing Members is appropriate in light of the fact that the critical components of the FICC sponsoring member application as well as the NSCC Sponsoring Member and Agent Clearing Member applications and the criteria that the respective boards assess when determining whether to admit a Member in such respective capacities are substantially similar. Nonetheless, NSCC would apply the same rigorous counterparty credit review process to any Member applying to be an Agent Clearing Member at NSCC, whether or not the Member is an existing FICC sponsoring member.

Account(s) (as defined below and in the proposed rule change) and its other accounts at NSCC exceeds its Net Member Capital, the Agent Clearing Member would not be permitted to submit activity into its Agent Clearing Member Customer Omnibus Account(s), unless otherwise determined by NSCC in order to promote orderly settlement. As defined in Section 4 of proposed Rule 2D, Agent Clearing Member Transactions are SFTs that an Agent Clearing Member submits to NSCC on behalf of one or more Customers.

The Agent Clearing Member would establish one or more accounts at NSCC for its Customers' positions, *i.e.*, an Agent Clearing Member Customer Omnibus Account, that would be in the name of the Agent Clearing Member for the benefit of its Customers; however, each Agent Clearing Member Customer Omnibus Account may only contain activity where the Agent Clearing Member is acting as Transferor on behalf of its Customers, or as Transferee on behalf of its Customers, but not both (*i.e.*, activity would not be netted across Customers for Clearing Fund purposes). Under the proposal, the Agent Clearing Member would act solely as agent of its Customers in connection with the clearing of Agent Clearing Member Transactions; however, the Agent Clearing Member would remain fully liable for the performance of all obligations to NSCC arising in connection with Agent Clearing Member Transactions.

In addition, as proposed under the sponsoring/sponsored membership model, the Agent Clearing Member would be responsible for posting to NSCC all of the Clearing Fund and any applicable SLD associated with the activity of its Customers and covering any default loss allocable to its Customers, as well as its own default loss allocation as a Member;<sup>47</sup> however, unlike a Sponsoring Member, an Agent

<sup>47</sup> The following example illustrates how loss allocation would occur with respect to Agent Clearing Members: Assume NSCC incurs a \$100 million aggregate loss from a Defaulting Member Event. In addition, assume that the Corporate Contribution amount that NSCC would first apply to any loss from a Defaulting Member Event is \$25 million. This means NSCC would allocate the remaining \$75 million losses (*i.e.*, \$100 million minus \$25 million) to Members pursuant to Section 4 of Rule 4 (Clearing Fund), including Agent Clearing Member Customer Omnibus Accounts as if each were a Member. If the allocated losses to an Agent Clearing Member's Agent Clearing Member Customer Omnibus Account is \$1 million and the allocated losses to the Agent Clearing Member in its capacity as a Member is \$2 million, the Agent Clearing Member would be responsible for a total of \$3 million loss allocation (\$1 million for its Agent Clearing Member Customer Omnibus Account loss allocation amount and \$2 million for its own default loss allocation as a Member).

Clearing Member would not be required to provide an unconditional guaranty to NSCC for its Customer's obligations. This is because, as described above, the Agent Clearing Member would be fully liable for all obligations of its Customers under the Agent Clearing Member Transactions that it submitted to NSCC as the Member.

As proposed, NSCC would also provide a mechanism by which an Agent Clearing Member may, upon a default of a Customer and consent of NSCC, transfer Agent Clearing Member Transactions of the Customer established in one or more of the Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts from such Agent Clearing Member Customer Omnibus Accounts to the Agent Clearing Member's proprietary account at NSCC as a Member.<sup>48</sup>

(v) Sponsoring Member/Sponsored Member vs. Agent Clearing Member/Customers

The direct costs of central clearing (*i.e.*, Clearing Fund, loss allocation, fees and performance on behalf of an institutional firm clients) would be largely equivalent as between what NSCC proposes to apply to a Sponsoring Member and what NSCC proposes to apply to an Agent Clearing Member. Likewise, the capital costs to Sponsoring Members and Agent Clearing Members of intermediating institutional firm activity as between the two buy-side clearing models would be largely equivalent. That being said, because Sponsoring Members would be required to ensure that (i) each of their clients separately onboard with NSCC as a Sponsored Member (which NSCC understands is generally required from an accounting perspective in order for the Sponsoring Member to net on its balance sheet its SFTs with Sponsored Members against the Sponsoring Member's other NSCC-cleared SFTs),<sup>49</sup> (ii) each of their client's SFTs is individually submitted to NSCC for clearing, and (iii) each Sponsored Member continues to remain in compliance with the financial standards applicable to Sponsored Members throughout the course of its membership, Sponsoring Members may incur more legal, onboarding, operational and ongoing administrative costs than Agent Clearing Members with respect to their institutional firm clearing activity.

However, the sponsoring/sponsored membership model allows for principal-

<sup>48</sup> See Section 11 of proposed Rule 2D (Agent Clearing Members).

<sup>49</sup> *Supra* note 12.

style trading between a Sponsoring Member and its Sponsored Member where the Sponsoring Member and Sponsored Member are pre-novation counterparties, which would generally create the opportunity for a Sponsoring Member to make an economic spread between its trade with its Sponsored Member and its offsetting trades with other NSCC Members or Sponsored Members. The opportunity for such economic spread and the ability of a Sponsoring Member to achieve balance sheet netting and capital efficiency on such trading activity through the novation of SFTs to NSCC could, for some market participants, offset the indirect additional costs associated with acting as a Sponsoring Member, rather than acting as an Agent Clearing Member.

On the other hand, as NSCC understands it, for some market participants, particularly agent lenders, their business models are not typically predicated on principal-style trading. Rather, these agency businesses typically charge fees for their services (rather than taking economic spreads) and their business models and their agreed upon investment guidelines with their institutional firm customers may only permit agent (rather than principal-style) trading for securities lending transactions. So, for such market participants, participating in clearing at NSCC as an Agent Clearing Member may be a better fit for their overall business model.

From the perspective of an institutional firm client, the costs of clearing that may be passed through to it by its intermediary (depending on their commercial arrangements) would be largely equivalent. That said, some institutional firms that engage in securities lending may be prohibited from acting as Sponsored Members and engaging in principal-style trading with their intermediary in clearing for regulatory and/or investment guideline reasons. For those institutional firms, being able to transact SFTs as a Customer within an Agent Clearing Member Customer Omnibus Account would offer them a means to access central clearing that would otherwise not be available to them if the sponsoring/sponsored membership model were the only model available for buy-side clearing.

#### (vi) Proposed Rule Changes

##### (A) Proposed Rule 2C—Sponsoring Members and Sponsored Members

NSCC is proposing to add Rule 2C, entitled “Sponsoring Members and Sponsored Members.” This new rule

would govern the proposed sponsored membership and would be comprised of 14 sections, each of which is described below.

##### Proposed Rule 2C, Section 1 (General)

Section 1 of proposed Rule 2C would be a general provision regarding the Rules applicable to Sponsoring Members and Sponsored Members.

Section 1 of proposed Rule 2C would provide that NSCC will permit the establishment of a sponsored membership relationship between a Member that is approved as a Sponsoring Member and one or more Persons that are accepted by NSCC as Sponsored Members of that particular Sponsoring Member. Section 1 of proposed Rule 2C would further provide that the rights, liabilities and obligations of Sponsoring Members and Sponsored Members shall be governed by proposed Rule 2C, and that references to the term “Member” in other Rules would not apply to Sponsoring Members and to Sponsored Members, in their respective capacities as such, unless specifically noted as such in proposed Rule 2C or in such other Rules.

Section 1 of proposed Rule 2C would also provide that a Sponsoring Member shall continue to have all of the rights, liabilities and obligations as set forth in the Rules and in any agreement between it and NSCC pertaining to its status as a Member, and such rights, liabilities and obligations shall be separate from its rights, liabilities and obligations as a Sponsoring Member except as contemplated under Sections 7, 8 and 9 of proposed Rule 2C and under the Sponsoring Member Guaranty.

##### Proposed Rule 2C, Section 2 (Qualifications of Sponsoring Members, the Application Process and Continuance Standards)

Section 2 of proposed Rule 2C would establish the eligibility requirements for Members that wish to become Sponsoring Members, the membership application process that would be required of each Member to become a Sponsoring Member, the on-going membership requirements that would apply to Sponsoring Members, as well as the requirements regarding a Sponsoring Member’s election to voluntarily terminate its membership.

Under Section 2(a) of proposed Rule 2C, any Member would be eligible to apply to become a Sponsoring Member; however, if a Member is a Registered Broker-Dealer, such Member would only be permitted to apply to become a Sponsoring Member if it has (1) Net Worth (as defined below and in the proposed rule change) of at least \$25

million and (2) excess net capital over the minimum net capital requirement imposed by the Commission (or such higher minimum capital requirement imposed by the Member’s designated examining authority) of at least \$10 million.<sup>50</sup> In connection therewith, NSCC is proposing “Net Worth” to mean, as of a particular date, the amount equal to the excess of the assets of a Person over the liabilities of such Person, computed in accordance with generally accepted accounting principles, and for Registered Broker-Dealers, Net Worth shall include liabilities that are subordinated to the claims of creditors pursuant to a satisfactory subordination agreement, as defined in Appendix D to Rule 15c3–1 of the Act.<sup>51</sup> As proposed, NSCC may require that a Person be a Member for a certain time period before that Person may be considered to become a Sponsoring Member.

Section 2(b) of proposed Rule 2C would provide that each Member applicant to become a Sponsoring Member would be required to provide an application and other information requested by NSCC. Sponsoring Member applications shall first be reviewed by NSCC and would require the Board of Directors’ approval, unless the Member applicant is already an Agent Clearing Member under proposed Rule 2D or a sponsoring member of FICC.<sup>52</sup> NSCC believes this approach to the Board of Director’s approval for Sponsoring Members is appropriate in light of the fact that the critical components of the FICC sponsoring member application as well as the NSCC Sponsoring Member and Agent Clearing Member

<sup>50</sup> NSCC is proposing these financial minimums for Registered Broker-Dealer Sponsoring Member applicants to reflect the additional responsibility that the applicant would undertake as a Sponsoring Member. These financial minimums are determined based on NSCC’s assessment of the minimum capital that would be necessary for a broker-dealer to conduct meaningful level of NSCC-cleared activity while serving as a credit counterparty in respect of others’ trades. In its assessment, NSCC considered various factors, such as the amount of a Registered Broker-Dealer Member’s capital and its impact on such Member’s financial responsibility and operational capability, comparability with the financial requirements of other clearing agencies, and the desire to strike a balance between credit risk mitigation and member accessibility. For the reasons described above in Item II(A)1(iii) “Sponsoring Members and Sponsored Members,” these financial minimums are also designed to be consistent with the requirements applicable to registered broker-dealers that are sponsoring members in FICC’s Sponsoring Member/Sponsored Member Program.

<sup>51</sup> 17 CFR 240.15c3–1d.

<sup>52</sup> It is NSCC’s understanding that FICC is evaluating a change to the GSD Rules to provide that the application of an FICC sponsoring member applicant that is already an NSCC Sponsoring Member or Agent Clearing Member would not require approval of FICC’s board of directors.

applications and the criteria that the respective boards assess when determining whether to admit a Member in such respective capacities are substantially similar.

Under Section 2(c) of proposed Rule 2C, if the Sponsoring Member application is denied, such denial would be handled in accordance with Section 1 of Rule 2A (Initial Membership Requirements).

As proposed in Section 2(d) of proposed Rule 2C, NSCC may impose additional financial requirements on a Sponsoring Member applicant based upon the level of the anticipated positions and obligations of such applicant, the anticipated risk associated with the volume and types of transaction such applicant proposes to process through NSCC as a Sponsoring Member and the overall financial condition of such applicant. Under the proposal, with respect to an application of a Member to become a Sponsoring Member that requires the Board of Directors' approval, the Board of Directors shall also approve any increased financial requirements imposed by NSCC in connection with the approval of the application, and NSCC would thereafter regularly review such Sponsoring Member regarding its compliance with the increased financial requirements.<sup>53</sup>

In addition, under Section 2(e) of proposed Rule 2C, NSCC may require each Sponsoring Member or any Sponsoring Member applicant to furnish adequate assurances of such Sponsoring Member or Sponsoring Member applicant's financial responsibility and operational capability within the meaning of Rule 15 (Assurances of Financial Responsibility and Operational Capability), as NSCC may at any time or from time to time deem necessary or advisable in order to protect NSCC, its participants, creditors or investors, to safeguard securities and funds in the custody or control of NSCC and for which NSCC is responsible, or to promote the prompt and accurate

<sup>53</sup> If the increased financial requirements are imposed in connection with a Sponsoring Member application that does not require the Board of Directors' approval, the increased financial requirements would not be subject to the Board of Directors' approval. Nonetheless, once a Sponsoring Member application is approved with increased financial requirements, NSCC would thereafter regularly review such Sponsoring Member regarding its continued adherence to such increased financial requirements as well as determine whether such increased financial requirements are still appropriate. If the Sponsoring Member is unable to adhere to the increased financial requirements, the Board of Directors may, pursuant to Section 10 of proposed Rule 2C, suspend, prohibit or limit the Sponsoring Member's access to NSCC's services.

clearance, settlement and processing of securities transactions.<sup>54</sup>

Section 2(f) of proposed Rule 2C would provide that each Member whose Sponsoring Member application is approved would sign and deliver to NSCC (i) an agreement between NSCC and the Member and specifies the terms and conditions deemed by NSCC to be necessary in order to protect itself and its participants ("Sponsoring Member Agreement"), (ii) a guaranty, in the form and substance acceptable to NSCC, whereby the Member, in its capacity as a Sponsoring Member, guarantees to NSCC the payment and performance by its Sponsored Members of their obligations under the Rules in respect of the Sponsoring Member's Sponsored Member Sub-Accounts, including, without limitation all of the settlement obligations of its Sponsored Members in respect of such Sponsored Member Sub-Accounts ("Sponsoring Member Guaranty"), and a related legal opinion in a form satisfactory to NSCC. In addition, Section 2(f) of proposed Rule 2C would provide that nothing in the Rules shall prohibit a Sponsoring Member from seeking reimbursement from a Sponsored Member for payments made by the Sponsoring Member (whether pursuant to the Sponsoring Member Guaranty, out of Clearing Fund deposits or otherwise) with respect to obligations as to which the Sponsored Member is a principal obligor under the Rules, or as otherwise may be agreed by the Sponsored Member and Sponsoring Member.

Section 2(g) of proposed Rule 2C would provide that each Sponsoring Member shall submit to NSCC, within the timeframes and in the formats required by NSCC, the reports and information that all Members are required to submit regardless of type of Member and the reports and information required to be submitted for its respective type of Member, all pursuant to Section 2 of Rule 2B (Ongoing Membership Requirements and Monitoring) and, if applicable, Addendum O (Admission of Non-US Entities as Direct NSCC Members).

Section 2(h) of proposed Rule 2C would provide that a Sponsoring Member's books and records, insofar as they relate to the Sponsored Member Transactions submitted to NSCC, shall be open to the inspection of the duly

<sup>54</sup> As an example, NSCC may require a Sponsoring Member or a Sponsoring Member applicant to furnish adequate assurances of such Sponsoring Member or Sponsoring Member applicant's financial responsibility and operational capability if NSCC has concerns about such Sponsoring Member or Sponsoring Member applicant's overall financial health or credit rating.

authorized representatives of NSCC to the same extent provided in Rule 2A (Initial Membership Requirements) for other Members.

Section 2(i) of proposed Rule 2C would provide that a Sponsoring Member shall promptly inform NSCC, both orally and in writing, if it is no longer in compliance with the relevant standards and qualifications for applying to become a Sponsoring Member set forth in the proposed Rule 2C. Notification must take place immediately and in no event later than 2 Business Days from the date on which the Sponsoring Member first learns of its non-compliance. As proposed, NSCC would assess a fine in accordance with the Fine Schedule in Addendum P against any Sponsoring Member that fails to so notify NSCC.<sup>55</sup> If the Sponsoring Member fails to remain in compliance with the relevant standards and qualifications, NSCC would, if necessary, undertake appropriate action to determine the status of the Sponsoring Member and its continued eligibility as such. In addition, NSCC may review the financial responsibility and operational capability of the Sponsoring Member, and otherwise require from the Sponsoring Member additional reports of its financial or operational condition at such intervals and in such detail as NSCC shall determine. In addition, if NSCC has reason to believe that a Sponsoring Member may fail to comply with any of the Rules applicable to Sponsoring Members, it may require the Sponsoring Member to provide it, within such timeframe, and in such detail, and pursuant to such manner as NSCC shall determine, with assurances in writing of a credible nature that the Sponsoring Member shall not, in fact, violate any of the Rules.

Section 2(j) of proposed Rule 2C would provide that in the event that a Sponsoring Member fails to remain in compliance with the relevant requirements of the Rules, the Sponsoring Member Agreement or the Sponsoring Member Guaranty, NSCC shall have the right to cease to act for the Sponsoring Member in its capacity as a Sponsoring Member pursuant to Section 10 of proposed Rule 2C, unless the Sponsoring Member requests that such action not be taken and NSCC determines that, depending upon the specific circumstances and the record of the Sponsoring Member, it is appropriate instead to establish for such Sponsoring Member a time period, which shall be determined by NSCC and

<sup>55</sup> See Addendum P (Fine Schedule), *supra* note 4.

which shall be no longer than 30 calendar days unless otherwise determined by NSCC, during which the Sponsoring Member must resume compliance with such requirements. As proposed, in the event that the Sponsoring Member is unable to satisfy such requirements within the time period specified by NSCC, NSCC shall, pursuant to the Rules, cease to act for the Sponsoring Member in its capacity as a Sponsoring Member pursuant to Section 10 of the proposed Rule 2C.

Section 2(k) of proposed Rule 2C would provide that if the sum of the Volatility Charges applicable to a Sponsoring Member's Sponsored Member Sub-Accounts and its other accounts at NSCC exceeds its Net Member Capital (as defined below and in the proposed rule change), the Sponsoring Member shall not be permitted to submit activity into its Sponsored Member Sub-Accounts, unless otherwise determined by NSCC in order to promote orderly settlement.<sup>56</sup> As proposed, "Volatility Charge" would mean, in respect to a Member, the amount of its Required Fund Deposit calculated by NSCC by applying Sections I.(A)(1)(a)(i)–(iii) of Procedure XV (Clearing Fund Formula and Other Matters); "Net Member Capital" would mean Net Capital (as defined below and in the proposed rule change), net assets or equity capital, as applicable to a Member, based on the type of regulation, and in particular the capital requirements, to which the Member is subject; and "Net Capital" would mean, as of a particular date, the amount equal to the net capital of a Registered Broker-Dealer as defined in Rule 15c3–1(c)(2) of the Act,<sup>57</sup> or any successor rule or regulation thereto.

Section 2(l) of proposed Rule 2C would provide that a Sponsoring Member may voluntarily elect to terminate its status as a Sponsoring Member, with respect to all Sponsored Members or with respect to one or more Sponsored Members from time to time, by providing NSCC with a written notice from a Sponsoring Member to NSCC that the Sponsoring Member is voluntarily electing to terminate its status as a Sponsoring Member with respect to all of its Sponsored Members

or with respect to one or more of its Sponsored Members ("Sponsoring Member Voluntary Termination Notice"). The Sponsoring Member shall specify in the Sponsoring Member Voluntary Termination Notice the Sponsored Member(s) in respect of which the Sponsoring Member is terminating its status (the "Former Sponsored Members") and a desired date for such termination, which date shall not be prior to the scheduled Final Settlement Date of any remaining obligation owed by the Sponsoring Member to NSCC with respect to the Former Sponsored Members as of the time such Sponsoring Member Voluntary Termination Notice is submitted to NSCC, unless otherwise approved by NSCC.

Section 2(l) of proposed Rule 2C would also provide that such termination would not be effective until accepted by NSCC, which shall be no later than 10 Business Days after the receipt of the Sponsoring Member Voluntary Termination Notice from such Sponsoring Member. NSCC's acceptance shall be evidenced by a notice to NSCC's participants announcing the termination of the Sponsoring Member's status as such with respect to the Former Sponsored Members and the date on which the termination of the Sponsoring Member's status as a Sponsoring Member becomes effective ("Sponsoring Member Termination Date"). As proposed, after the close of business on the Sponsoring Member Termination Date, the Sponsoring Member shall no longer be eligible to submit Sponsored Member Transactions on behalf of the Former Sponsored Members, and each Former Sponsored Member shall cease to be a Sponsored Member unless it is the Sponsored Member of another Sponsoring Member. If any Sponsored Member Transactions is submitted to NSCC by the Sponsoring Member on behalf of a Former Sponsored Member that is scheduled to settle after the Sponsoring Member Termination Date, such Sponsoring Member's Sponsoring Member Voluntary Termination Notice would be deemed void, and the Sponsoring Member would remain subject to the proposed Rule 2C as if it had not given such Sponsoring Member Voluntary Termination Notice.

Section 2(m) of proposed Rule 2C would provide that a Sponsoring Member's voluntary termination of its status as such, in whole or in part, shall not affect its obligations to NSCC, or the rights of NSCC, including under the Sponsoring Member Guaranty, with respect to Sponsored Member Transactions submitted to NSCC before

the applicable Sponsoring Member Termination Date. Any such Sponsored Member Transactions that have been novated to NSCC shall continue to be processed by NSCC. The return of the Sponsoring Member's Clearing Fund deposit shall be governed by Section 7 of Rule 4 (Clearing Fund). If an Event Period were to occur after a Sponsoring Member has submitted the Sponsoring Member Voluntary Termination Notice but on or prior to the Sponsoring Member Termination Date, in order for the Sponsoring Member to benefit from its Loss Allocation Cap pursuant to Section 4 of Rule 4, the Sponsoring Member would need to comply with the provisions of Section 6 of Rule 4 and submit a Loss Allocation Withdrawal Notice, which notice, upon submission, shall supersede and void any pending Sponsoring Member Voluntary Termination Notice previously submitted by the Sponsoring Member.

Section 2(n) of proposed Rule 2C would provide that any non-public information furnished to NSCC pursuant to proposed Rule 2C shall be held in confidence as may be required under the laws, rules and regulations applicable to NSCC that relate to the confidentiality of records. Section 2(n) would also provide that each Sponsoring Member shall maintain DTCC Confidential Information in confidence to the same extent and using the same means it uses to protect its own confidential information, but no less than a reasonable standard of care, and shall not use DTCC Confidential Information or disclose DTCC Confidential Information to any third party except as necessary to perform such Sponsoring Member's obligations under the Rules or as otherwise required by applicable law. Section 2(n) would further provide that each Sponsoring Member acknowledges that a breach of its confidentiality obligations under the Rules may result in serious and irreparable harm to NSCC and/or DTCC for which there is no adequate remedy at law. In addition, Section 2(n) would provide that in the event of such a breach by the Sponsoring Member, NSCC and/or DTCC shall be entitled to seek any temporary or permanent injunctive or other equitable relief in addition to any monetary damages thereunder.<sup>58</sup>

<sup>58</sup> Section 2(n) of proposed Rule 2C is designed to be consistent with provisions in the Rules relating to the confidentiality of information furnished by participants. See Rule 2A (Initial Membership Requirements), *supra* note 4.

<sup>56</sup> NSCC selected the Volatility Charges and Net Member Capital as the criteria for purposes of establishing the activity limit for Sponsoring Members. This is because a Sponsoring Member's total Volatility Charges being in excess of its Net Member Capital is an important indicator that the Sponsoring Member's financial resources, as measured by its Net Capital, net assets or equity capital, may be insufficient to meet the largest component of its Required Fund Deposit (*i.e.*, Volatility Charges).

<sup>57</sup> 17 CFR 240.15c3–1(c)(2).

Proposed Rule 2C, Section 3 (Qualifications of Sponsored Members, Approval Process and Continuance Standards)

Section 3 of proposed Rule 2C would establish the eligibility requirements for Sponsored Members, the membership application process that would be required of each Sponsored Member, the on-going membership requirements that would apply to Sponsored Members, as well as the requirements regarding a Sponsored Member's election to voluntarily terminate its membership.

Section 3(a) of proposed Rule 2C would provide that a Person shall be eligible to apply to become a Sponsored Member if: (x) It is sponsored into membership by a Sponsoring Member, and (y) it (1) is a "qualified institutional buyer" as defined by Rule 144A<sup>59</sup> under the Securities Act,<sup>60</sup> or (2) is a legal entity that, although not organized as an entity specifically listed in paragraph (a)(1)(i)(H) of Rule 144A under the Securities Act, satisfies the financial requirements necessary to be a "qualified institutional buyer" as specified in that paragraph. NSCC would have the right to rely on the representation provided by the Sponsoring Member regarding satisfaction of (y).

Section 3(b) of proposed Rule 2C would provide that each time that a Sponsoring Member wishes to sponsor a Person into membership, it shall provide NSCC with the representation referred to in Section 3(a) of proposed Rule 2C, as well as any additional information in such form as may be prescribed by NSCC. NSCC shall approve or disapprove Persons as Sponsored Members. If NSCC denies the request of a Sponsoring Member to add a Person as a Sponsored Member, such denial shall be handled in the same manner as set forth in Section 1 of Rule 2A (Initial Membership Requirements) with respect to membership applications except that the written statement referred to therein shall be provided to both the Sponsoring Member and the Person seeking to become a Sponsored Member.

Section 3(c) of proposed Rule 2C would provide that each Person to become a Sponsored Member shall sign and deliver to NSCC an agreement whereby the Person shall agree to any terms and conditions deemed by NSCC to be necessary in order to protect itself and its participants (the "Sponsored Member Agreement"). Each Person to become a Sponsored Member that shall

be an FFI Member must be FATCA Compliant.

Section 3(d) of proposed Rule 2C would provide that a Sponsored Member shall immediately inform its Sponsoring Member, both orally and in writing, if the Sponsored Member is no longer in compliance with the requirements of Section 3(a) of proposed Rule 2C. A Sponsoring Member shall promptly inform NSCC, both orally and in writing, if a Sponsored Member is no longer in compliance with the requirements of Section 3(a) of proposed Rule 2C. Notification to NSCC by the Sponsoring Member must take place within one (1) Business Day from the date on which the Sponsoring Member first learns of the Sponsored Member's non-compliance. NSCC would assess a fine in accordance with the Fine Schedule in Addendum P against any Sponsoring Member that fails to so notify NSCC.<sup>61</sup>

Section 3(e) of proposed Rule 2C would provide that a Sponsored Member may voluntarily elect to terminate its membership by providing NSCC with a written notice from the Sponsored Member to NSCC that the Sponsored Member is voluntarily electing to terminate its membership ("Sponsored Member Voluntary Termination Notice"). The Sponsored Member shall specify in the Sponsored Member Voluntary Termination Notice a desired date for the termination, which date shall not be prior to the scheduled Final Settlement Date of any remaining obligation owed by the Sponsored Member to NSCC as of the time such Sponsored Member Voluntary Termination Notice is submitted to NSCC, unless otherwise approved by NSCC.

In addition, Section 3(e) of proposed Rule 2C would provide that such termination would not be effective until accepted by NSCC, which shall be no later than 10 Business Days after the receipt of the Sponsored Member Voluntary Termination Notice from such Sponsored Member. NSCC's acceptance shall be evidenced by a notice to NSCC's participants announcing the termination of the Sponsored Member and the date on which the termination of the Sponsored Member becomes effective ("Sponsored Member Termination Date"). After the close of business on the Sponsored Member Termination Date, the relevant Sponsoring Member shall no longer be eligible to submit Sponsored Member Transactions on behalf of the Sponsored Member. If any Sponsored Member

Transaction is submitted to NSCC by the relevant Sponsoring Member on behalf of the Sponsored Member that is scheduled to settle after the Sponsored Member Termination Date, such Sponsored Member's Sponsored Member Voluntary Termination Notice would be deemed void, and the Sponsored Member would remain subject to the proposed Rule 2C as if it had not given such Sponsored Member Voluntary Termination Notice.

Section 3(f) of proposed Rule 2C would provide that a Sponsored Member's voluntary termination shall not affect its obligations to NSCC, or the rights of NSCC, including under the Sponsoring Member Guaranty, with respect to Sponsored Member Transactions submitted to NSCC before the Sponsored Member Termination Date, and the Sponsoring Member Guaranty shall remain in effect to cover all outstanding obligations of the Sponsored Member to NSCC that are within the scope of such Sponsoring Member Guaranty.

Proposed Rule 2C, Section 4 (Compliance With Laws)

Section 4 of proposed Rule 2C would provide that each Sponsoring Member and Sponsored Member shall comply in all material respects with all applicable laws, including applicable laws relating to securities, taxation and money laundering, as well as global sanctions laws, in connection with the use of NSCC's services.

Proposed Rule 2C, Section 5 (Sponsored Member Transactions)

Section 5 of proposed Rule 2C would provide that a Sponsoring Member shall be permitted to submit to NSCC SFTs between itself and its Sponsored Members ("Sponsored Member Transactions") in accordance with proposed Rule 56, as described below. Section 5 of proposed Rule 2C would further provide that NSCC directs each Sponsored Member and Sponsoring Member to settle all Final Settlement, Rate Payment, Price Differential, and other securities delivery and payment obligations arising under a Sponsored Member Transaction that has been novated to NSCC by causing the relevant cash and securities to be transferred to the Transferor or Transferee, as applicable, on the books and records of the Sponsoring Member, and each Sponsored Member and Sponsoring Member agrees that any such transfer shall satisfy NSCC's corresponding obligation with respect to such Sponsored Member Transaction.

<sup>59</sup> 17 CFR 230.144A.

<sup>60</sup> 15 U.S.C. 77a et seq.

<sup>61</sup> See Addendum P (Fine Schedule), *supra* note 4.



Proposed Rule 2C, Section 6  
(Sponsoring Member Agent Obligations)

Section 6 of proposed Rule 2C would provide that a Sponsored Member shall appoint its Sponsoring Member to act as agent with respect to the Sponsored Member's satisfaction of its settlement obligations arising under Sponsored Member Transactions between the Sponsored Member and the Sponsoring Member and for performing all functions and receiving reports and information set forth in the Rules. NSCC's provision of such reports and information to the Sponsoring Member shall constitute satisfaction of any obligation of NSCC to provide such reports and information to the affected Sponsored Members. As proposed, notwithstanding the foregoing and any other activities the Sponsoring Member may perform in its capacity as agent for Sponsored Members, each Sponsored Member shall be obligated as principal to NSCC with respect to all settlement obligations under the Rules, and the Sponsoring Member shall not be a principal under the Rules with respect to settlement obligations of its Sponsored Members.

Proposed Rule 2C, Section 7 (Clearing Fund Obligations)

Section 7 of proposed Rule 2C would set forth the Clearing Fund obligations.

Section 7(a) of proposed Rule 2C would provide that NSCC shall maintain a ledger maintained on the books and records of NSCC for a Sponsoring Member that reflects the outstanding SFTs that a Sponsoring Member enters into in respect of a Sponsored Member and that have been novated to NSCC, the SFT Positions or SFT Cash associated with those transactions and any debits or credits of cash associated with such transactions effected pursuant to Rule 12 (Settlement) (each a "Sponsored Member Sub-Account"). Each Sponsoring Member shall make and maintain so long as such Member is a Sponsoring Member a deposit to the Clearing Fund as a Required Fund Deposit to support the activity in its Sponsored Member Sub-Accounts (the "Sponsoring Member Required Fund Deposit").

Under Section 7(a), each Sponsoring Member, so long as such Member is a Sponsoring Member, shall also provide SLD to the Clearing Fund, as may be required pursuant to Rule 4A (Supplemental Liquidity Deposits); however, the Supplemental Liquidity Deposits shall be calculated without regard to Sponsored Member Transactions. This is because Sponsored

Member Transactions do not independently create liquidity risk for NSCC as NSCC would not be required to complete settlement of any Sponsored Member Transactions in the event that either the Sponsoring Member or Sponsored Member defaults. In the event that the Sponsoring Member defaults, Section 12(b) of proposed Rule 2C (as described below) would permit NSCC to closeout (rather than settle) the Sponsored Member Transactions of the defaulter's Sponsored Members. Likewise, if the Sponsored Member defaults, NSCC would also not be required to complete settlement. Rather, under Section 8 of proposed Rule 2C (as described below), NSCC may offset its settlement obligations to the Sponsoring Member against the Sponsoring Member's obligations under the Sponsoring Member Guaranty to perform on behalf of its defaulted Sponsored Member.

Section 7(a) would also propose that deposits to the Clearing Fund would be held by NSCC or its designated agents, to be applied as provided in the Rules.

Section 7(b) of proposed Rule 2C would provide that, in the ordinary course, for purposes of satisfying the Sponsoring Member's Clearing Fund requirements under the Rules for its Member activity, its Sponsoring Member activity, and, to the extent applicable, its Agent Clearing Member activity, the Sponsoring Member's proprietary accounts, its Sponsored Member Sub-Accounts, and its Agent Clearing Member Customer Omnibus Account(s), if any, shall be treated separately, as if they were accounts of separate entities. Notwithstanding the previous sentence, however, NSCC may, in its sole discretion, at any time and without prior notice to the Sponsoring Member (but being obligated to give notice to the Sponsoring Member as soon as possible thereafter) and whether or not the Sponsoring Member or any of its Sponsored Members is in default of its obligations to NSCC, treat the Sponsoring Member's accounts as a single account for the purpose of applying Clearing Fund deposits; apply Clearing Fund deposits made by the Sponsoring Member with respect to any account as necessary to ensure that the Sponsoring Member meets all of its obligations to NSCC under any other account(s); and otherwise exercise all rights to offset and net against the Clearing Fund deposits any net obligations among any or all of the accounts, whether or not any other

Person is deemed to have any interest in such account.<sup>62</sup>

Section 7(c) of proposed Rule 2C would provide that the Sponsoring Member Required Fund Deposit for each Sponsored Member Sub-Account shall be calculated separately based on the Sponsored Member Transactions in such Sponsored Member Sub-Account, and the Sponsoring Member shall, as principal, be required to satisfy the Sponsoring Member Required Fund Deposit for each of the Sponsoring Member's Sponsored Member Sub-Accounts.

Section 7(d) of proposed Rule 2C would provide that Sections 1, 2, 4, 5, 6, 7, 8, 9, 10, 11 and 12 of Rule 4 (Clearing Fund) shall apply to the Sponsoring Member Required Fund Deposit with respect to obligations of a Sponsoring Member under the Rules, including its obligations arising under the Sponsored Member Sub-Accounts, and the obligations of a Sponsoring Member under its Sponsoring Member

<sup>62</sup> NSCC believes it unlikely that it would exercise this authority, as the Clearing Fund deposits associated with each Sponsored Member Sub-Account, Agent Clearing Member Customer Omnibus Account and proprietary account of a Sponsoring Member are designed to be sufficient to cover the obligations of such account or sub-account. However, if a Sponsoring Member defaults or fails to perform and the Clearing Fund deposits associated with a given account or sub-account of such Sponsoring Member are not sufficient to discharge the Sponsoring Member's obligations in relation to such account or sub-account, NSCC would look to the Clearing Fund deposits related to the Sponsoring Member's other accounts or sub-accounts. For example, if NSCC ceased to act for a Sponsoring Member and the close-out of the SFT Positions established in the Sponsoring Member's Sponsored Member Sub-Accounts resulted in a loss to NSCC in excess of the Clearing Fund previously posted by the Sponsoring Member in relation to such SFT Positions, NSCC may apply to the excess any other Clearing Fund deposits posted by the Sponsoring Member to NSCC, such as Clearing Fund posted in connection with the proprietary positions of the Sponsoring Member. Similarly, if a Sponsoring Member failed to perform under the Sponsoring Member Guaranty outside the context of a cease-to-act situation and the Clearing Fund previously posted by the Sponsoring Member in relation to the SFT Positions established in the Sponsoring Member's Sponsored Member Sub-Accounts was not sufficient to satisfy the obligations under the Sponsoring Member Guaranty, NSCC may apply to the remainder any other Clearing Fund deposits posted by the Sponsoring Member to NSCC.

NSCC believes this is appropriate because the Clearing Fund deposits of a Sponsoring Member are the proprietary assets of the Sponsoring Member, and NSCC generally has the right to apply the Clearing Fund deposits of a Member to any of the Member's obligations to NSCC, regardless of whether those were the obligations that generated the Clearing Fund deposit requirement. NSCC therefore believes that, consistent with the FICC Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," a Sponsoring Member's Clearing Fund deposits should be available to satisfy any of the Sponsoring Member's guaranty or other obligations to NSCC.



Guaranty to the same extent as such sections apply to any Required Fund Deposit and any other obligations of a Member. For purposes of Section 1 of Rule 4, obligations and liabilities of a Member to NSCC that shall be secured shall include, without limitation, a Member's obligations as a Sponsoring Member under the Rules, including, without limitation, any obligation of any such Sponsoring Member to provide the Sponsoring Member Required Fund Deposit, such Sponsoring Member's obligations arising under the Sponsored Member Sub-Accounts of such Sponsoring Member and such Sponsoring Member's obligations under its Sponsoring Member Guaranty.

Section 7(e) of proposed Rule 2C would provide that a Sponsoring Member shall be subject to such fines as may be imposed in accordance with the Rules for any late satisfaction of a Clearing Fund deficiency call.

#### Proposed Rule 2C, Section 8 (Right of Offset)

Section 8 of proposed Rule 2C would provide that in the ordinary course, with respect to satisfaction of any Sponsored Member's obligations under the Rules, the Sponsoring Member's Sponsored Member Sub-Accounts, the Sponsoring Member's proprietary accounts, and the Sponsoring Member's Agent Clearing Member Customer Omnibus Accounts, if any, at NSCC shall be treated separately, as if they were accounts of separate entities. Notwithstanding the previous sentence, however, NSCC may, in its sole discretion, at any time any obligation of the Sponsoring Member arises under the Sponsoring Member Guaranty to pay or perform thereunder with respect to any Sponsored Member, exercise a right of offset and net any such obligation of the Sponsoring Member under its Sponsoring Member Guaranty against any obligations of NSCC to the Sponsoring Member in respect of such Sponsoring Member's proprietary accounts at NSCC.<sup>63</sup> NSCC would generally anticipate exercising this right if, upon a Sponsoring Member default, the Sponsoring Member owed an amount under the Sponsoring Member

Guaranty and was owed an amount by NSCC in relation to the Sponsoring Member's proprietary or other obligations.

#### Proposed Rule 2C, Section 9 (Loss Allocation Obligations)

Section 9 of proposed Rule 2C would establish loss allocation obligations under the sponsored membership model.

Section 9(a) of proposed Rule 2C would provide that Sponsored Members shall not be obligated for allocations, pursuant to Rule 4 (Clearing Fund), of loss or liability incurred by NSCC. To the extent that a loss or liability is determined by NSCC to arise in connection with Sponsored Member Transactions (*i.e.*, in connection with the insolvency or default of a Sponsoring Member), the Sponsored Members shall not be responsible for or considered in the loss allocation calculation, but rather such loss shall be allocated to other Members in accordance with the principles set forth in Section 4 of Rule 4.

Section 9(b) of proposed Rule 2C would provide that, to the extent NSCC incurs a loss or liability from a Defaulting Member Event or a Declared Non-Default Loss Event and a loss allocation obligation arises, that would be the responsibility of a Sponsored Member Sub-Account as if the Sponsored Member Sub-Account were a Member, NSCC shall calculate such loss allocation obligation as if the affected Sponsored Member were subject to such allocations pursuant to Section 4 of Rule 4, but the Sponsoring Member shall be responsible for satisfying such obligations.

Section 9(c) of proposed Rule 2C would provide that the entire amount of the Required Fund Deposit associated with the Sponsoring Member's proprietary accounts at NSCC and the entire amount of the Sponsoring Member Required Fund Deposit may be used to satisfy any amount allocated against a Sponsoring Member, whether in its capacity as a Member, a Sponsoring Member, or otherwise. With respect to an obligation to make payment due to any loss allocation amounts assessed on a Sponsoring Member pursuant to Section 9(b) of proposed Rule 2C, the Sponsoring Member may instead elect to terminate its membership in NSCC pursuant to Section 6 of Rule 4 and thereby benefit from its Loss Allocation Cap pursuant to Section 4 of Rule 4; however, for the purpose of determining the Loss Allocation Cap for such Sponsoring Member, its Required Fund Deposit shall be the sum of its Required Fund

Deposits associated with its proprietary accounts at NSCC (including its proprietary SFT Account pursuant to proposed Rule 56), its Sponsoring Member Required Fund Deposit, and its Agent Clearing Member Required Fund Deposits, if any, for each of its Agent Clearing Member Customer Omnibus Accounts.

#### Proposed Rule 2C, Section 10 (Restrictions on Access to Services by a Sponsoring Member)

Section 10 of proposed Rule 2C would establish the rights of NSCC to restrict a Sponsoring Member's access to NSCC's services.

Section 10(a) of proposed Rule 2C would provide that the Board of Directors may at any time, upon NSCC providing notice to a Sponsoring Member pursuant to Section 5 of Rule 45 (Notices), suspend a Sponsoring Member in its capacity as a Sponsoring Member from any service provided by NSCC either with respect to a particular transaction or transactions or with respect to transactions generally or prohibit or limit such Sponsoring Member's access to services offered by NSCC in the event that one or more of the factors set forth in Section 1 of Rule 46 (Restrictions on Access to Services) is present with respect to the Sponsoring Member.

Section 10(b) of proposed Rule 2C would provide that Rule 46 shall apply with respect to a Sponsoring Member in the same way as it applies to Members, including the Board of Directors' right to summarily suspend the Sponsoring Member and to cease to act for such Sponsoring Member. As under Rule 46, the Board of Directors would need to make the determination of whether to suspend, prohibit or limit a Sponsoring Member's access to services offered by NSCC on the basis of the factors set forth in that rule.

Section 10(c) of proposed Rule 2C would provide that if NSCC ceases to act for a Sponsoring Member in its capacity as a Sponsoring Member, Section 14 of proposed Rule 56 shall apply and NSCC shall decline to accept or process data from the Sponsoring Member on Sponsored Member Transactions and NSCC shall cease to act for all of the Sponsored Members of the affected Sponsoring Member (unless such Sponsored Members are also Sponsored Members of other Sponsoring Members). Section 10(c) would also provide that if NSCC suspends, prohibits or limits a Sponsoring Member in its capacity as a Sponsoring Member with respect to such Sponsoring Member's access to services offered by NSCC, NSCC shall

<sup>63</sup> NSCC believes the most likely circumstance in which it would exercise this authority would be in the context of a Sponsoring Member default. If, in such circumstance, NSCC realizes a profit in closing out the positions associated with a proprietary account of the Sponsoring Member, but incurs a loss in closing out the positions associated with the Sponsored Member Sub-Accounts of the Sponsoring Member, it would offset its obligation to turn over to the Sponsoring Member the gains in relation to the Sponsoring Member's proprietary account against the obligations of the Sponsoring Member under the Sponsoring Member Guaranty.

decline to accept or process data from the Sponsoring Member on Sponsored Member Transactions and shall suspend the Sponsored Members of the affected Sponsoring Member (unless they are also Sponsored Members of other Sponsoring Members) for so long as NSCC is suspending, prohibiting or limiting the Sponsoring Member. Any Sponsored Member Transactions which have been novated to NSCC shall continue to be processed by NSCC. In addition, Section 10(c) would provide that NSCC, in its sole discretion, shall determine whether to close-out the affected Sponsored Member Transactions or permit the Sponsored Members to complete their settlement.

This is different from how NSCC would treat Agent Clearing Member Transactions of an Agent Clearing Member under Section 9 of proposed Rule 2D if NSCC ceased to act for the Agent Clearing Member. Specifically, for Agent Clearing Member Transactions, as proposed, NSCC would close-out any Agent Clearing Member Transactions which have been novated to NSCC; however, with respect to Sponsored Member Transactions, consistent with FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," NSCC would have the option to either terminate or settle a Sponsored Member's novated positions after ceasing to act for the Sponsoring Member. NSCC would have the practical and legal capability to make such an election because each Sponsored Member would be a limited-purpose member of NSCC. Accordingly, NSCC would have the requisite information about each of the Sponsored Member's novated positions (by virtue of each Sponsored Member's novated portfolio represented as a different sub-account of the Sponsoring Member (*i.e.*, Sponsored Member Sub-Account) on the books and records of NSCC) to make such an election. By contrast, an Agent Clearing Member's Customers would not be limited-purpose members of NSCC nor would NSCC know which transactions within an Agent Clearing Member Customer Omnibus Account belong to which Customers. As such, NSCC would not be able to separately terminate or complete settlement with respect to Customers' novated positions.

Proposed Rule 2C, Section 11  
(Restrictions on Access to Services by a Sponsored Member)

Section 11 of proposed Rule 2C would establish the rights of NSCC to restrict

a Sponsored Member's access to NSCC's services.

Section 11(a) of proposed Rule 2C would provide that the Board of Directors may at any time upon NSCC providing notice to a Sponsored Member and its Sponsoring Member pursuant to Section 5 of Rule 45 (Notices), suspend a Sponsored Member from any service provided by NSCC either with respect to a particular transaction or transactions or with respect to transactions generally, or prohibit or limit such Sponsored Member with respect to access to services offered by NSCC in the event that one or more of the factors set forth in Section 1 of Rule 46 (Restrictions on Access to Services) is present with respect to the Sponsored Member.

Section 11(b) of proposed Rule 2C would provide that Rule 46 shall apply with respect to a Sponsored Member in the same way as it applies to Members, including the Board of Directors' right to summarily suspend a Sponsored Member and to cease to act for such Sponsored Member. As under Rule 46, the Board of Directors would need to make the determination of whether to suspend, prohibit or limit a Sponsored Member's access to services offered by NSCC on the basis of the factors set forth in that rule.

Section 11(c) of proposed Rule 2C would provide that if NSCC ceases to act for a Sponsored Member, Section 14 of proposed Rule 56 shall apply.

Section 11(d) of proposed Rule 2C would provide that NSCC shall cease to act for a Sponsored Member that is no longer in compliance with the requirements of Section 3(a) of proposed Rule 2C.

Proposed Rule 2C, Section 12  
(Insolvency of a Sponsoring Member)

Section 12(a) of proposed Rule 2C would provide that a Sponsoring Member shall be obligated to immediately notify NSCC that (a) it fails, or is unable, to perform its contracts or obligations or (b) it is insolvent, as required by Section 1 of Rule 20 (Insolvency) for other Members. A Sponsoring Member shall be treated by NSCC in all respects as insolvent under the same circumstances set forth in Section 2 of Rule 20 for other Members. Section 3 of Rule 20 shall apply, in the same manner in which such section applies to other Members, in the case where NSCC treats a Sponsoring Member as insolvent.

Section 12(b) of proposed Rule 2C would provide that in the event that NSCC determines to treat a Sponsoring Member as insolvent pursuant to Rule 20 (Insolvency), NSCC shall have the

right to cease to act for the insolvent Sponsoring Member pursuant to Section 10 of the proposed Rule 2C. If NSCC ceases to act for the insolvent Sponsoring Member, NSCC shall decline to accept or process data from the Sponsoring Member, including Sponsored Member Transactions, and NSCC shall terminate the membership of all of the insolvent Sponsoring Member's Sponsored Members unless they are the Sponsored Members of another Sponsoring Member. Any Sponsored Member Transactions which have been novated to NSCC shall continue to be processed by NSCC. NSCC, in its sole discretion, shall determine whether to close-out the affected Sponsored Member Transactions and/or permit the Sponsored Members to complete their settlement. This is different from how NSCC would treat Agent Clearing Member Transactions. As described above, NSCC would close-out any Agent Clearing Member Transactions which have been novated to NSCC. However, with respect to Sponsored Member Transactions, consistent with FICC's Sponsoring Member/Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," NSCC would have the option to either terminate or settle a Sponsored Member's novated positions after ceasing to act for the Sponsoring Member. This is because NSCC would have the practical and legal capability to make such an election because each Sponsored Member would be a limited-purpose member of NSCC. Accordingly, NSCC would have the requisite information about each of the Sponsored Member's novated positions (by virtue of each Sponsored Member's novated portfolio represented as a different sub-account of the Sponsoring Member (*i.e.*, Sponsored Member Sub-Account) on the books and records of NSCC) to make such an election. By contrast, an Agent Clearing Member's Customers would not be limited-purpose members of NSCC nor would NSCC know which transactions within an Agent Clearing Member Customer Omnibus Account belong to which Customers. As such, NSCC would not be able to separately terminate or complete settlement with respect to Customers' novated positions.

Proposed Rule 2C, Section 13  
(Insolvency of a Sponsored Member)

Section 13 of proposed Rule 2C would establish NSCC's rights in the event of an insolvency of a Sponsored Member.

Section 13(a) of proposed Rule 2C would provide that a Sponsored Member and its Sponsoring Member (to

the extent it has knowledge thereof) shall be obligated to immediately notify NSCC that the Sponsoring Member is insolvent or that the Sponsored Member would be unable to perform any of its material contracts, obligations or agreements in the same manner as required by Section 1 of Rule 20 (Insolvency) for other Members. For purposes of Section 13 of proposed Rule 2C, a Sponsoring Member shall be deemed to have knowledge that a Sponsored Member is insolvent or would be unable to perform on any of its material contracts, obligations or agreements if one or more duly authorized representatives of the Sponsoring Member, in its capacity as such, has knowledge of such matters. A Sponsored Member shall be treated by NSCC in all respects as insolvent under the same circumstances set forth in Section 2 of Rule 20 for other Members. Section 3 of Rule 20 shall apply, in the same manner in which such section applies to other Members, in the case where NSCC treats a Sponsored Member as insolvent.

Section 13(b) of proposed Rule 2C would provide that in the event that NSCC determines to treat a Sponsored Member as insolvent pursuant to Rule 20 (Insolvency), NSCC shall have the right to cease to act for the insolvent Sponsored Member pursuant to Section 11 of the proposed Rule 2C. If NSCC ceases to act for the insolvent Sponsored Member, Section 14 of proposed Rule 56 shall apply with respect to the close-out of the insolvent Sponsored Member's Sponsored Member Transactions.

#### Proposed Rule 2C, Section 14 (Liquidation of Sponsored Member and Related Sponsoring Member Positions)

Section 14 of proposed Rule 2C would provide a mechanism by which a Sponsoring Member may cause the termination and liquidation of a Sponsored Member's positions arising from Sponsored Member Transactions between the Sponsoring Member and its Sponsored Member that have been novated to NSCC. Specifically, in the event (i) the Sponsoring Member triggers the termination of a Sponsored Member's positions or (ii) NSCC ceases to act for the Sponsored Member and the Sponsoring Member does not continue to perform the obligations of the Sponsored Member, both the Sponsored Member's positions and the Sponsoring Member's corresponding positions arising from the Sponsored Member Transactions between the Sponsoring Member and the Sponsored Member would be terminated. Thereupon, the Sponsoring Member would calculate a net liquidation value

of such terminated positions, which liquidation value would be paid either to or by the Sponsored Member by or to the Sponsoring Member. NSCC would not, as a practical matter, be involved in such settlement and would not need to take any market action because the termination of the Sponsored Member's positions and the corresponding Sponsoring Member's positions would leave NSCC flat. Additionally, the Sponsoring Member would indemnify NSCC for any claim by a Sponsored Member arising out of the Sponsoring Member's calculation of the net liquidation value.

Section 14(a) of proposed Rule 2C would specify the scope of positions to which Section 14 of proposed Rule 2C applies. It would state that Section 14 only applies with respect to the liquidation of positions resulting from Sponsored Member Transactions that have been novated to NSCC.

Section 14(a) of proposed Rule 2C would further state that such section would only apply if (i) a Sponsoring Member is a Defaulting Member and NSCC has not ceased to act for the Sponsoring Member and (ii) a Corporation Default has not occurred. This is because, as described above in Section 12(b) of proposed Rule 2C, NSCC would have discretion in the event it ceases to act for a Sponsoring Member to close-out the positions of Sponsored Members for which the defaulting Sponsoring Member was responsible or to allow them to settle. If NSCC does close-out such positions, it would do so in accordance with Section 14 of proposed Rule 56. If a Corporation Default has occurred with respect to NSCC, each Sponsored Member's positions would be closed out in accordance with Section 17 of proposed Rule 56.

Section 14(b) of proposed Rule 2C would set out the process by which a Sponsoring Member or NSCC may cause the termination of a Sponsored Member's positions. It would provide that on any Business Day, the Sponsoring Member or NSCC may cause such termination by delivering a notice to NSCC or the Sponsoring Member, respectively. NSCC anticipates that each Sponsored Member and Sponsoring Member would agree in the bilateral documentation between them as to what circumstances or events give rise to the ability of the Sponsoring Member to deliver a notice to NSCC terminating the Sponsored Member's positions.<sup>64</sup>

<sup>64</sup> It bears noting in this regard that termination of the Sponsored Member's positions would not be the exclusive mechanism by which a Sponsoring Member may limit its credit risk. As described

The notice submitted by a Sponsoring Member to NSCC (or vice versa) would cause the termination of all of the SFT Positions of the Sponsored Member established in the Sponsored Member Sub-Account. The notice would also cause the immediate termination of the corresponding SFT Positions of the Sponsoring Member established in the Sponsoring Member's proprietary SFT Account. The effect of such terminations would be to leave NSCC flat.

Section 14(b) of proposed Rule 2C would also provide that the termination of the Sponsored Member's positions (and the Sponsoring Member's corresponding positions) would be effected by the Sponsoring Member's establishment of a final net settlement position for each eligible security with a distinct CUSIP number ("Final Net Settlement Position").

Section 14(c) of proposed Rule 2C would specify how the Final Net Settlement Positions established pursuant to Section 14(b) of proposed Rule 2C would be liquidated (*i.e.*, how such positions would be converted into an amount payable). It would also provide how the amount payable arising from the liquidation of the Final Net Settlement Positions would be discharged.

Specifically, Section 14(c) of proposed Rule 2C would first provide that the Sponsoring Member would liquidate the Final Net Settlement Positions established pursuant to Section 14(b) of proposed Rule 2C by establishing (i) a single liquidation amount in respect of the Sponsored Member's Final Net Settlement Positions (a "Sponsored Member Liquidation Amount") and (ii) a single liquidation amount in respect of the Sponsoring Member's Final Net Settlement Positions (a "Sponsoring Member Liquidation Amount"). The Sponsored Member Liquidation Amount would be owed either by NSCC to the Sponsored Member or by the Sponsored Member to NSCC because it would relate to the Sponsored Member's Final

above, under Section 2(m) of proposed Rule 2C, a Sponsoring Member may voluntarily elect to terminate its status as a Sponsoring Member in respect of one or more Sponsored Members. Such a termination would not affect the settlement of the Sponsored Member's existing positions but would restrict the ability of the Sponsored Member to have its future trades accepted for novation by NSCC through such Sponsoring Member. The proposed rule change in Section 14(b) of proposed Rule 2C would not affect the functioning of the proposed rule change in Section 2(m) of proposed Rule 2C or the general ability of a Sponsoring Member and the Sponsored Member to agree on the circumstances of when the Sponsoring Member may terminate its status as Sponsoring Member for the Sponsored Member.

Net Settlement Positions with NSCC, while the Sponsoring Member Liquidation Amount would be owed either by NSCC to the Sponsoring Member or by the Sponsoring Member to NSCC because it would relate to the Sponsoring Member's Final Net Settlement Positions with NSCC.

Because the Final Net Settlement Positions of the Sponsoring Member would be identical to, but in the opposite direction of, the Final Net Settlement Positions of the Sponsored Member, the Sponsored Member Liquidation Amount would equal the Sponsoring Member Liquidation Amount. Therefore, if NSCC were to owe the Sponsored Member Liquidation Amount to the Sponsored Member, the Sponsoring Member would owe the Sponsoring Member Liquidation Amount to NSCC. By the same token, if the Sponsored Member were to owe the Sponsored Member Liquidation Amount to NSCC, NSCC would owe the Sponsoring Member the Sponsoring Member Liquidation Amount. In all instances, NSCC would owe and be owed the same amount of money.

Section 14(c) of proposed Rule 2C would also provide how the Sponsoring Member may calculate the Sponsoring Member Liquidation Amount. It would state that the Sponsoring Member may calculate the Sponsoring Member Liquidation Amount based on prevailing market prices of the relevant securities and/or the gains realized and losses incurred by the Sponsoring Member in hedging its risk associated with the liquidation of the Sponsoring Member's Final Net Settlement Positions. Section 14(c) of proposed Rule 2C would further clarify that such Sponsoring Member Liquidation Amount may also take into account any losses and expenses incurred by the Sponsoring Member in connection with the liquidation of the positions.

Section 14(c) of proposed Rule 2C would further provide that, if a Sponsored Member Liquidation Amount is due to NSCC, the Sponsoring Member would be obligated to pay such Sponsored Member Liquidation Amount to NSCC under the Sponsoring Member Guaranty and that this obligation would, automatically and without further action, be set off against the obligation of NSCC to pay the corresponding Sponsoring Member Liquidation Amount to the Sponsoring Member. By virtue of such setoff, the Sponsored Member's obligation to NSCC would be discharged, as would NSCC's obligation to the Sponsoring Member. The Sponsoring Member would, however, have a reimbursement claim against the Sponsored Member in an amount equal

to the Sponsored Member Liquidation Amount. This reimbursement claim would arise as a matter of law by virtue of the Sponsoring Member's performance under Sponsoring Member Guaranty, though Sponsoring Members and Sponsored Members may specify terms related to the reimbursement claim in their bilateral submission. NSCC would have no rights or obligations in respect of any such reimbursement claim.

If a Sponsored Member Liquidation Amount were owed by NSCC to the Sponsored Member, Section 14(c) of proposed Rule 2C would provide for the Sponsoring Member to satisfy that obligation by transferring the Sponsored Member Liquidation Amount to the Sponsoring Member's account at its Settling Bank ("Sponsoring Member Settling Bank Omnibus Account"). Section 14(c) of proposed Rule 2C would state that, to the extent the Sponsoring Member makes such a transfer, it would discharge NSCC's obligation to transfer the Sponsored Member Liquidation Amount to the Sponsored Member and the Sponsoring Member's corresponding obligation to transfer the Sponsoring Member Liquidation Amount to NSCC.

Section 14(d) of proposed Rule 2C would provide for the Sponsoring Member to indemnify NSCC and its employees, officers, directors, shareholders, agents, and Members (collectively, the "Sponsoring/Sponsored Membership Program Indemnified Parties" or "SMP Indemnified Parties") for any and all losses, liability, or expenses arising from any claim by an affected Sponsored Member disputing the Sponsoring Member's calculation of any Sponsored Member Liquidation Amount or Sponsoring Member Liquidation Amount.

Section 14(e) of proposed Rule 2C would provide that NSCC acknowledges that a Sponsoring Member may take a security interest in NSCC's obligations to a Sponsored Member in respect of its transactions that have been novated to NSCC by such Sponsoring Member and established in the Sponsoring Member's Sponsored Member Sub-Account for the Sponsored Member. Such security interest would not impose new obligations on NSCC but could allow the Sponsoring Member to direct NSCC to submit payments due to the Sponsored Member to the Sponsoring Member, so that the Sponsoring Member can apply such amounts to the Sponsored Member's unsatisfied obligations to the Sponsoring Member.

(B) Proposed Rule 2D—Agent Clearing Members

NSCC is proposing to add Rule 2D, entitled "Agent Clearing Members." This new rule would govern the proposed agent clearing membership and would be comprised of 12 sections, each of which is described below.

Proposed Rule 2D, Section 1 (General)

Section 1 of proposed Rule 2D would be a general provision regarding the Rules applicable to Agent Clearing Members.

Section 1 of proposed Rule 2D would provide that NSCC will permit a Member that is approved to be an Agent Clearing Member to submit transactions to NSCC for novation on behalf of one or more of the Agent Clearing Member's Customers. Section 1 of proposed Rule 2D would further provide that the rights, liabilities and obligations of Agent Clearing Members shall be governed by proposed Rule 2D, and that references to the term "Member" in other Rules would not apply to Agent Clearing Members, in their respective capacities as such, unless specifically noted as such in proposed Rule 2D or in such other Rules.

Section 1 of proposed Rule 2D would also provide that an Agent Clearing Member shall continue to have all of the rights, liabilities and obligations as set forth in the Rules and in any agreement between it and NSCC pertaining to its status as a Member, and such rights, liabilities and obligations shall be separate from its rights, liabilities and obligations as an Agent Clearing Member except as contemplated under Sections 6, 7 and 8 of proposed Rule 2D.

Proposed Rule 2D, Section 2 (Qualifications of Agent Clearing Members, the Application Process and Continuance Standards)

Section 2 of proposed Rule 2D would establish the eligibility requirements for Members that wish to become Agent Clearing Members, the membership application process that would be required of each Member to become an Agent Clearing Member, the on-going membership requirements that would apply to Agent Clearing Members, as well as the requirements regarding an Agent Clearing Member's election to voluntarily terminate its membership.

Under Section 2(a) of proposed Rule 2D, any Member would be eligible to apply to become an Agent Clearing Member; however, if a Member is a Registered Broker-Dealer, such Member would only be permitted to apply to become an Agent Clearing Member if it has (1) Net Worth of at least \$25 million

and (2) excess net capital over the minimum net capital requirement imposed by the Commission (or such higher minimum capital requirement imposed by the Member's designated examining authority) of at least \$10 million.<sup>65</sup> As proposed, NSCC may require that a Person be a Member for a certain time period before that Person may be considered to become an Agent Clearing Member.

Section 2(b) of proposed Rule 2D would provide that each Member applicant to become an Agent Clearing Member would be required to provide an application and other information requested by NSCC. Agent Clearing Member applications shall first be reviewed by NSCC and would require the Board of Directors' approval, unless the Member applicant is already a Sponsoring Member under proposed Rule 2C or a sponsoring member of FICC. NSCC believes this approach to the Board of Directors' approval for Agent Clearing Members is appropriate in light of the fact that the critical components of the FICC sponsoring member applications as well as the NSCC Agent Clearing Member and Sponsoring Member applications and the criteria that the respective boards assess when determining whether to admit a Member in such respective capacities are substantially similar.

Under Section 2(c) of proposed Rule 2D, if the Agent Clearing Member application is denied, such denial would be handled in accordance with Section 1 of Rule 2A (Initial Membership Requirements).

As proposed in Section 2(d) of proposed Rule 2D, NSCC may impose additional financial requirements on an

Agent Clearing Member applicant based upon the level of the anticipated positions and obligations of such applicant, the anticipated risk associated with the volume and types of transaction such applicant proposes to process through NSCC as an Agent Clearing Member and the overall financial condition of such applicant. Under the proposal, with respect to an application of a Member to become an Agent Clearing Member that requires the Board of Directors' approval, the Board of Directors shall also approve any increased financial requirements imposed by NSCC in connection with the approval of the application, and NSCC would thereafter regularly review such Agent Clearing Member regarding its compliance with the increased financial requirements.<sup>66</sup>

In addition, under Section 2(e) of proposed Rule 2D, NSCC may require each Agent Clearing Member or any Agent Clearing Member applicant to furnish adequate assurances of such Agent Clearing Member or Agent Clearing Member applicant's financial responsibility and operational capability within the meaning of Rule 15 (Assurances of Financial Responsibility and Operational Capability), as NSCC may at any time or from time to time deem necessary or advisable in order to protect NSCC, its participants, creditors or investors, to safeguard securities and funds in the custody or control of NSCC and for which NSCC is responsible, or to promote the prompt and accurate clearance, settlement and processing of securities transactions.<sup>67</sup>

Section 2(f) of proposed Rule 2D would provide that each Member whose Agent Clearing Member application is approved would sign and deliver to NSCC an agreement between NSCC and the Member and specifies the terms and

conditions deemed by NSCC to be necessary in order to protect itself and its participants ("Agent Clearing Member Agreement") and a related legal opinion in a form satisfactory to NSCC.

Section 2(g) of proposed Rule 2D would provide that each Agent Clearing Member shall submit to NSCC, within the timeframes and in the formats required by NSCC, the reports and information that all Members are required to submit regardless of type of Member and the reports and information required to be submitted for its respective type of Member, all pursuant to Section 2 of Rule 2B (Ongoing Membership Requirements and Monitoring) and, if applicable, Addendum O (Admission of Non-US Entities as Direct NSCC Members).

Section 2(h) of proposed Rule 2D would provide that an Agent Clearing Member's books and records, insofar as they relate to the Agent Clearing Member Transactions submitted to NSCC, shall be open to the inspection of the duly authorized representatives of NSCC to the same extent provided in Rule 2A (Initial Membership Requirements) for other Members.

Section 2(i) of proposed Rule 2D would provide that an Agent Clearing Member shall promptly inform NSCC, both orally and in writing, if it is no longer in compliance with the relevant standards and qualifications for applying to become an Agent Clearing Member set forth in the proposed Rule 2D. Notification must take place immediately and in no event later than 2 Business Days from the date on which the Agent Clearing Member first learns of its non-compliance. As proposed, NSCC would assess a fine in accordance with the Fine Schedule in Addendum P against any Agent Clearing Member that fails to so notify NSCC.<sup>68</sup> If the Agent Clearing Member fails to remain in compliance with the relevant standards and qualifications, NSCC would, if necessary, undertake appropriate action to determine the status of the Agent Clearing Member and its continued eligibility as such. In addition, NSCC may review the financial responsibility and operational capability of the Agent Clearing Member, and otherwise require from the Agent Clearing Member additional reports of its financial or operational condition at such intervals and in such detail as NSCC shall determine. In addition, if NSCC has reason to believe that an Agent Clearing Member may fail to comply with any of the Rules applicable to Agent Clearing Members, it may require the Agent

<sup>65</sup> NSCC is proposing these financial minimums for Registered Broker-Dealer Agent Clearing Member applicants to reflect the additional responsibility that the applicant would undertake as an Agent Clearing Member. These financial minimums are determined based on NSCC's assessment of the minimum capital that would be necessary for a broker-dealer to conduct meaningful level of NSCC-cleared activity while serving as a credit counterparty in respect of others' trades. In addition, NSCC is proposing these financial minimums for Registered Broker-Dealer Agent Clearing Member applicants to be consistent with proposed requirements applicable to Registered Broker-Dealer Sponsoring Member applicants. NSCC believes this approach to financial minimums is appropriate because both Sponsoring Members and Agent Clearing Members would be viewed and surveilled as the credit counterparties to NSCC in respect of the transactions that they submit for clearing in respect of Sponsoring Member Sub-Accounts and Agent Clearing Member Customer Omnibus Accounts, respectively. Although the model of clearing would differ as between Sponsoring Members and Agent Clearing Members, both would be types of Members that would be standing behind the credit of their clients. Accordingly, NSCC believes it is appropriate to use consistent financial minimums.

<sup>66</sup> If the increased financial requirements are imposed in connection with an Agent Clearing Member application that does not require the Board of Directors' approval, the increased financial requirements would not be subject to the Board of Directors' approval. Nonetheless, once an Agent Clearing Member application is approved with increased financial requirements, NSCC would thereafter regularly review such Agent Clearing Member regarding its continued adherence to such increased financial requirements as well as determine whether such increased financial requirements are still appropriate. If the Agent Clearing Member is unable to adhere to the increased financial requirements, the Board of Directors may, pursuant to Section 9 of proposed Rule 2D, suspend, prohibit or limit the Agent Clearing Member's access to NSCC's services.

<sup>67</sup> As an example, NSCC may require an Agent Clearing Member or an Agent Clearing Member applicant to furnish adequate assurances of such Agent Clearing Member or Agent Clearing Member applicant's financial responsibility and operational capability if NSCC has concerns about such Agent Clearing Member or Agent Clearing Member applicant's overall financial health or credit rating.

<sup>68</sup> See Addendum P (Fine Schedule), *supra* note 4.

Clearing Member to provide it, within such timeframe, and in such detail, and pursuant to such manner as NSCC shall determine, with assurances in writing of a credible nature that the Agent Clearing Member shall not, in fact, violate any of the Rules.

Section 2(j) of proposed Rule 2D would provide that in the event that an Agent Clearing Member fails to remain in compliance with the relevant requirements of the Rules or the Agent Clearing Member Agreement, NSCC shall have the right to cease to act for the Agent Clearing Member in its capacity as an Agent Clearing Member in accordance with Section 9 of proposed Rule 2D or as a Member more generally, unless the Agent Clearing Member requests that such action not be taken and NSCC determines that, depending upon the specific circumstances and the record of the Agent Clearing Member, it is appropriate instead to establish for such Agent Clearing Member a time period, which shall be determined by NSCC and which shall be no longer than 30 calendar days unless otherwise determined by NSCC, during which the Agent Clearing Member must resume compliance with such requirements. As proposed, in the event that the Agent Clearing Member is unable to satisfy such requirements within the time period specified by NSCC, NSCC shall, pursuant to the Rules, cease to act for the Agent Clearing Member in its capacity as an Agent Clearing Member pursuant to Section 9 of the proposed Rule 2D or as a Member more generally.

Section 2(k) of proposed Rule 2D would provide that if the sum of the Volatility Charges applicable to an Agent Clearing Member's Agent Clearing Member Customer Omnibus Account(s) and its other accounts at NSCC exceeds its Net Member Capital, the Agent Clearing Member shall not be permitted to submit activity into its Agent Clearing Member Customer Omnibus Account(s), unless otherwise determined by NSCC in order to promote orderly settlement.<sup>69</sup> As proposed, an "Agent Clearing Member Customer Omnibus Account" would mean a ledger maintained on the books and records of NSCC that reflects the outstanding Agent Clearing Member

<sup>69</sup> NSCC selected the Volatility Charges and Net Member Capital as the criteria for purposes of establishing the activity limit for Agent Clearing Members. This is because an Agent Clearing Member's total Volatility Charges being in excess of its Net Member Capital is an important indicator that the Agent Clearing Member's financial resources, as measured by its Net Capital, net assets or equity capital, may be insufficient to meet the largest component of its Required Fund Deposit (*i.e.*, Volatility Charges).

Transactions that an Agent Clearing Member enters into on behalf of Customers and that have been novated to NSCC, the SFT Positions or SFT Cash associated with those transactions, and any debits or credits of cash associated with such transactions effected pursuant to Rule 12 (Settlement).

Section 2(l) of proposed Rule 2D would provide that an Agent Clearing Member may voluntarily elect to terminate its status as an Agent Clearing Member by providing NSCC with a written notice from an Agent Clearing Member to NSCC that the Agent Clearing Member is voluntarily electing to terminate its status as an Agent Clearing Member ("Agent Clearing Member Voluntary Termination Notice"). The Agent Clearing Member shall specify in the Agent Clearing Member Voluntary Termination Notice a desired date for such termination, which date shall not be prior to the scheduled Final Settlement Date of any remaining obligation owed by the Agent Clearing Member to NSCC as of the time such Agent Clearing Member Voluntary Termination Notice is submitted to NSCC, unless otherwise approved by NSCC.

Section 2(l) of proposed Rule 2D would also provide that such termination would not be effective until accepted by NSCC, which shall be no later than 10 Business Days after the receipt of the Agent Clearing Member Voluntary Termination Notice from such Agent Clearing Member. NSCC's acceptance shall be evidenced by a notice to NSCC's participants announcing the termination of the Agent Clearing Member's status as such and the date on which the termination of the Agent Clearing Member's status as an Agent Clearing Member becomes effective ("Agent Clearing Member Termination Date"). As proposed, after the close of business on the Agent Clearing Member Termination Date, the Agent Clearing Member shall no longer be eligible to submit Agent Clearing Member Transactions. If any Agent Clearing Member Transaction is submitted to NSCC by the Agent Clearing Member that is scheduled to settle after the Agent Clearing Member Termination Date, such Agent Clearing Member's Agent Clearing Member Voluntary Termination Notice would be deemed void, and the Agent Clearing Member would remain subject to the proposed Rule 2D as if it had not given such Agent Clearing Member Voluntary Termination Notice.

Section 2(m) of proposed Rule 2D would provide that an Agent Clearing Member's voluntary termination of its status as such shall not affect its

obligations to NSCC, or the rights of NSCC, with respect to Agent Clearing Member Transactions submitted to NSCC before the applicable Agent Clearing Member Termination Date. Any such Agent Clearing Member Transactions that have been novated to NSCC shall continue to be processed by NSCC. The return of the Agent Clearing Member's Clearing Fund deposit shall be governed by Section 7 of Rule 4 (Clearing Fund). If an Event Period were to occur after an Agent Clearing Member has submitted the Agent Clearing Member Voluntary Termination Notice but on or prior to the Agent Clearing Member Termination Date, in order for the Agent Clearing Member to benefit from its Loss Allocation Cap pursuant to Section 4 of Rule 4, the Agent Clearing Member would need to comply with the provisions of Section 6 of Rule 4 and submit a Loss Allocation Withdrawal Notice, which notice, upon submission, shall supersede and void any pending Agent Clearing Member Voluntary Termination Notice previously submitted by the Agent Clearing Member.

Section 2(n) of proposed Rule 2D would provide that any non-public information furnished to NSCC pursuant to proposed Rule 2D shall be held in confidence as may be required under the laws, rules and regulations applicable to NSCC that relate to the confidentiality of records. Section 2(n) would also provide that each Agent Clearing Member shall maintain DTCC Confidential Information in confidence to the same extent and using the same means it uses to protect its own confidential information, but no less than a reasonable standard of care, and shall not use DTCC Confidential Information or disclose DTCC Confidential Information to any third party except as necessary to perform such Agent Clearing Member's obligations under the Rules or as otherwise required by applicable law. Section 2(n) would further provide that each Agent Clearing Member acknowledges that a breach of its confidentiality obligations under the Rules may result in serious and irreparable harm to NSCC and/or DTCC for which there is no adequate remedy at law. In addition, Section 2(n) would provide that in the event of such a breach by the Agent Clearing Member, NSCC and/or DTCC shall be entitled to seek any temporary or permanent injunctive or other equitable relief in addition to any monetary damages thereunder.<sup>70</sup>

<sup>70</sup> Section 2(n) of proposed Rule 2D is designed to be consistent with provisions in the Rules

Proposed Rule 2D, Section 3  
(Compliance With Laws)

Section 3 of proposed Rule 2D would provide that each Agent Clearing Member shall comply in all material respects with all applicable laws, including applicable laws relating to securities, taxation and money laundering, as well as global sanctions laws, in connection with the use of NSCC's services.

Proposed Rule 2D, Section 4 (Agent Clearing Member Transactions)

Section 4 of proposed Rule 2D would provide that an Agent Clearing Member shall be permitted to submit to NSCC on behalf of one or more Customers' Securities Financing Transactions ("Agent Clearing Member Transactions") in accordance with proposed Rule 56, as described below.

Proposed Rule 2D, Section 5 (Agent Clearing Member Agent Obligations)

Section 5 of proposed Rule 2D would establish rules-based obligations for Agent Clearing Members and the establishment of Agent Clearing Member Customer Omnibus Accounts.

Section 5(a) of proposed Rule 2D would provide that an Agent Clearing Member shall be permitted to submit to NSCC for novation Agent Clearing Member Transactions entered into by the Agent Clearing Member as agent on behalf of one or more Customers. Any such submission shall be in accordance with proposed Rule 2D. As proposed, subject to the provisions of the Rules, an Agent Clearing Member's clearing of Agent Clearing Member Transactions for Customers ("Customer Clearing Service") may be provided by an Agent Clearing Member to its Customers on any terms and conditions mutually agreed to by the Agent Clearing Member and its Customers; provided, that each Agent Clearing Member shall, before providing Customer Clearing Service to any Customer, enter into an agreement with that Customer that binds the Customer to the provisions of the Rules applicable to Agent Clearing Member Transactions and Customers.

Section 5(b) of proposed Rule 2D would provide that, with respect to an Agent Clearing Member that submits Agent Clearing Member Transactions to NSCC for novation on behalf of its Customers, NSCC shall maintain one or more Agent Clearing Member Customer Omnibus Accounts in the name of the Agent Clearing Member for the benefit of its Customers. Each Agent Clearing

Member Customer Omnibus Account would be permitted to contain only (i) SFTs entered into by the Agent Clearing Member, on behalf of a Customer, as Transferor or (ii) SFTs entered into by the Agent Clearing Member, on behalf of a Customer, as Transferee. An Agent Clearing Member would not be permitted to combine SFTs entered into as Transferee and Transferor in the same Agent Clearing Member Customer Omnibus Account. This is designed to ensure that NSCC's volatility-based Clearing Fund deposit requirements represent the sum of each individual Customer's activity (*i.e.*, that the positions are margined on a gross basis).<sup>71</sup>

Section 5(c) of proposed Rule 2D would provide that an Agent Clearing Member shall act solely as agent of its Customers in connection with the clearing of Agent Clearing Member Transactions; provided that the Agent Clearing Member shall remain fully liable for the performance of all obligations to NSCC arising in connection with Agent Clearing Member Transactions; and provided further, that the liabilities and obligations of NSCC with respect to Agent Clearing Member Transactions entered into by the Agent Clearing Member shall extend only to the Agent Clearing Member. Section 5(c) of proposed Rule 2D would further provide that, without limiting the generality of the foregoing, NSCC shall not have any liability or obligation arising out of or with respect to any Agent Clearing Member Transaction to any Customer on behalf of whom an Agent Clearing Member entered into the Agent Clearing Member Transaction.

Section 5(d) of proposed Rule 2D would provide that nothing in the Rules shall prohibit an Agent Clearing Member from seeking reimbursement from a Customer for payments made by the Agent Clearing Member (whether out of Clearing Fund deposits or otherwise) under the Rules, or as otherwise may be agreed between the Agent Clearing Member and the Customer.

Proposed Rule 2D, Section 6 (Clearing Fund Obligations)

Section 6 of proposed Rule 2D would set forth the Clearing Fund obligations.

Section 6(a) of proposed Rule 2D would provide that NSCC shall

maintain one or more Agent Clearing Member Customer Omnibus Accounts for an Agent Clearing Member. Each Agent Clearing Member shall make and maintain so long as such Member is an Agent Clearing Member a deposit to the Clearing Fund as a Required Fund Deposit to support the activity in its Agent Clearing Member Customer Omnibus Account(s) (the "Agent Clearing Member Required Fund Deposit"). Each Agent Clearing Member, so long as such Member is an Agent Clearing Member, shall also provide SLD to the Clearing Fund, as may be required pursuant to Rule 4A (Supplemental Liquidity Deposits), to support the activity in its Agent Clearing Member Customer Omnibus Account(s). Deposits to the Clearing Fund would be held by NSCC or its designated agents, to be applied as provided in the Rules.

Section 6(b) of proposed Rule 2D would provide that, in the ordinary course, for purposes of satisfying the Agent Clearing Member's Clearing Fund requirements under the Rules for its Member activity, its Agent Clearing Member activity, and, to the extent applicable, its Sponsoring Member activity, the Agent Clearing Member's proprietary accounts, its Agent Clearing Member Customer Omnibus Account(s), and its Sponsored Member Sub-Accounts, if any, shall be treated separately, as if they were accounts of separate entities. Notwithstanding the previous sentence, however, NSCC may, in its sole discretion, at any time and without prior notice to the Agent Clearing Member (but being obligated to give notice to the Agent Clearing Member as soon as possible thereafter) and whether or not the Agent Clearing Member is in default of its obligations to NSCC, treat the Agent Clearing Member's accounts as a single account for the purpose of applying Clearing Fund deposits; apply Clearing Fund deposits made by the Agent Clearing Member with respect to any account as necessary to ensure that the Agent Clearing Member meets all of its obligations to NSCC under any other account(s); and otherwise exercise all rights to offset and net against the Clearing Fund deposits any net obligations among any or all of the accounts, whether or not any other Person is deemed to have any interest in such account.<sup>72</sup>

relating to the confidentiality of information furnished by participants. See Rule 2A (Initial Membership Requirements), *supra* note 4.

<sup>71</sup> If an Agent Clearing Member were permitted to maintain SFTs entered into as both Transferee and Transferor in the same Agent Clearing Member Customer Omnibus Account, the Required Fund Deposit obligations of the Agent Clearing Member could potentially be reduced by offsetting SFT Positions of different Customers in the same SFT Security.

<sup>72</sup> NSCC believes this is appropriate because the Clearing Fund deposits of an Agent Clearing Member are the proprietary assets of the Agent Clearing Member and NSCC generally has the right to apply the Clearing Fund deposits of a Member to any of the Member's obligations to NSCC.



Section 6(c) of proposed Rule 2D would provide that the Agent Clearing Member Required Fund Deposit for each Agent Clearing Member Customer Omnibus Account shall be calculated separately based on the Agent Clearing Member Transactions in such Agent Clearing Member Customer Omnibus Account, and the Agent Clearing Member shall, as principal, be required to satisfy the Agent Clearing Member Required Fund Deposit for each of the Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts.

Section 6(d) of proposed Rule 2D would provide that Sections 1, 2, 4, 5, 6, 7, 8, 9, 10, 11 and 12 of Rule 4 (Clearing Fund) shall apply to the Agent Clearing Member Required Fund Deposit with respect to obligations of an Agent Clearing Member under the Rules, including its obligations arising under the Agent Clearing Member Customer Omnibus Account(s), to the same extent as such sections apply to any Required Fund Deposit and any other obligations of a Member. For purposes of Section 1 of Rule 4, obligations and liabilities of a Member to NSCC that shall be secured shall include, without limitation, a Member's obligations as an Agent Clearing Member under the Rules, including, without limitation, any obligation of any such Agent Clearing Member to provide the Agent Clearing Member Required Fund Deposit and such Agent Clearing Member's obligations arising under SFTs established in the Agent Clearing Member Customer Omnibus Accounts of such Agent Clearing Member.

Section 6(e) of proposed Rule 2D would provide that an Agent Clearing Member shall be subject to such fines as may be imposed in accordance with the Rules for any late satisfaction of a Clearing Fund deficiency call.

#### Proposed Rule 2D, Section 7 (Right of Offset)

Section 7 of proposed Rule 2D would provide that in the ordinary course, with respect to satisfaction of any Agent Clearing Member's obligations under the Rules, the Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts, the Agent Clearing Member's proprietary accounts, and the Agent Clearing Member's Sponsored

regardless of whether those were the obligations that generated the Clearing Fund deposit requirement. NSCC therefore believes that, consistent with the FICC Sponsoring Member/ Sponsored Member Program for the reasons described above in Item II(A)1(iii) "Sponsoring Members and Sponsored Members," an Agent Clearing Member's Clearing Fund deposits should be available to satisfy any of the Agent Clearing Member's obligations to NSCC.

Member Sub-Accounts, if any, at NSCC shall be treated separately, as if they were accounts of separate entities. Notwithstanding the previous sentence, however, NSCC may, in its sole discretion, at any time any obligation of the Agent Clearing Member arises in respect of any Agent Clearing Member Customer Omnibus Account, exercise a right of offset and net any such obligation against any obligations of NSCC to the Agent Clearing Member in respect of such Agent Clearing Member's proprietary accounts at NSCC.

#### Proposed Rule 2D, Section 8 (Loss Allocation Obligations)

Section 8 of proposed Rule 2D would establish loss allocation obligations for Agent Clearing Members.

Section 8(a) of proposed Rule 2D would provide that, to the extent NSCC incurs a loss or liability from a Defaulting Member Event or a Declared Non-Default Loss Event and a loss allocation obligation arises, that would be the responsibility of the Agent Clearing Member Customer Omnibus Account as if the Agent Clearing Member Customer Omnibus Account were a Member, NSCC shall calculate such loss allocation obligation and the Agent Clearing Member shall be, as principal, responsible for satisfying such obligations.

Section 8(b) of proposed Rule 2D would provide that the entire amount of the Required Fund Deposit associated with the Agent Clearing Member's proprietary accounts at NSCC and the entire amount of the Agent Clearing Member Required Fund Deposit may be used to satisfy any amount allocated against an Agent Clearing Member, whether in its capacity as a Member, an Agent Clearing Member, or otherwise. With respect to an obligation to make payment due to any loss allocation amounts assessed on an Agent Clearing Member pursuant to Section 8(a) of proposed Rule 2D, the Agent Clearing Member may instead elect to terminate its membership in NSCC pursuant to Section 6 of Rule 4 and thereby benefit from its Loss Allocation Cap pursuant to Section 4 of Rule 4; however, for the purpose of determining the Loss Allocation Cap for such Agent Clearing Member, its Required Fund Deposit shall be the sum of its Required Fund Deposits associated with its proprietary accounts at NSCC (including its proprietary SFT Account pursuant to proposed Rule 56), its Agent Clearing Member Required Fund Deposit for each of its Agent Clearing Member Customer Omnibus Accounts, and its Sponsoring Member Required Fund Deposit, if any.

#### Proposed Rule 2D, Section 9 (Restrictions on Access to Services by an Agent Clearing Member)

Section 9 of proposed Rule 2D would establish the rights of NSCC to restrict an Agent Clearing Member's access to NSCC's services.

Section 9(a) of proposed Rule 2D would provide that the Board of Directors may at any time upon NSCC providing notice to an Agent Clearing Member pursuant to Section 5 of Rule 45 (Notices), suspend an Agent Clearing Member in its capacity as an Agent Clearing Member from any service provided by NSCC either with respect to a particular transaction or transactions or with respect to transactions generally, or prohibit or limit such Agent Clearing Member's access to services offered by NSCC in the event that one or more of the factors set forth in Section 1 of Rule 46 (Restrictions on Access to Services) is present with respect to the Agent Clearing Member.

Section 9(b) of proposed Rule 2D would provide that Rule 46 shall apply with respect to an Agent Clearing Member in the same way as it applies to Members, including the Board of Directors' right to summarily suspend the Agent Clearing Member and to cease to act for such Agent Clearing Member. As under Rule 46, the Board of Directors would need to make the determination of whether to suspend, prohibit or limit an Agent Clearing Member's access to services offered by NSCC on the basis of the factors set forth in that rule.

Section 9(c) of proposed Rule 2D would provide that if NSCC ceases to act for an Agent Clearing Member in its capacity as an Agent Clearing Member, Section 14 of proposed Rule 56 shall apply and NSCC shall decline to accept or process data from the Agent Clearing Member on Agent Clearing Member Transactions and close-out any Agent Clearing Member Transactions that have been novated to NSCC. Section 9(c) would also provide that if NSCC suspends, prohibits or limits an Agent Clearing Member in its capacity as an Agent Clearing Member with respect to such Agent Clearing Member's access to services offered by NSCC, NSCC shall decline to accept or process data from the Agent Clearing Member on Agent Clearing Member Transactions for so long as NSCC is suspending, prohibiting or limiting the Agent Clearing Member. Furthermore, Section 9(c) would state that, in addition, NSCC would close-out any Agent Clearing Member Transactions which have been novated to NSCC.

This is different from how NSCC would treat Sponsored Member

Transactions of a Sponsoring Member under Section 10 of proposed Rule 2C if NSCC ceases to act for the Sponsoring Member. With respect to such transactions, NSCC would have the option to either terminate or settle a Sponsored Member's positions after ceasing to act for the Sponsoring Member. The reason for this difference is that NSCC would have the practical and legal capability to make such an election because each Sponsored Member would be a limited-purpose member of NSCC. Accordingly, NSCC would have the requisite information about each of the Sponsored Member's novated positions (by virtue of each Sponsored Member's novated portfolio represented as a different sub-account of the Sponsoring Member (*i.e.*, Sponsored Member Sub-Account) on the books and records of NSCC) to make such an election. By contrast, an Agent Clearing Member's Customers would not be limited-purpose members of NSCC nor would NSCC know which transactions within an Agent Clearing Member Customer Omnibus Account belong to which Customers. As such, NSCC would not be able to separately terminate or complete settlement with respect to Customer's novated positions.

Proposed Rule 2D, Section 10 (Insolvency of an Agent Clearing Member)

Section 10(a) of proposed Rule 2D would provide that an Agent Clearing Member shall be obligated to immediately notify NSCC that (a) it fails, or is unable, to perform its contracts or obligations or (b) it is insolvent as required by Section 1 of Rule 20 (Insolvency) for other Members. An Agent Clearing Member shall be treated by NSCC in all respects as insolvent under the same circumstances set forth in Section 2 of Rule 20 for other Members. Section 3 of Rule 20 shall apply, in the same manner in which such section applies to other Members, in the case where NSCC treats an Agent Clearing Member as insolvent.

Section 10(b) of proposed Rule 2D would provide that in the event that NSCC determines to treat an Agent Clearing Member as insolvent pursuant to Rule 20 (Insolvency), NSCC shall have the right to cease to act for the insolvent Agent Clearing Member pursuant to Section 9 of proposed Rule 2D. If NSCC ceases to act for the insolvent Agent Clearing Member, NSCC shall decline to accept or process data from the Agent Clearing Member, including Agent Clearing Member Transactions. As proposed, NSCC would close-out any Agent Clearing

Member Transactions which have been novated to NSCC.

This is different from how NSCC would treat Sponsored Member Transactions. As described above, NSCC would have the option to either terminate or settle a Sponsored Member's novated positions after ceasing to act for the Sponsoring Member. However, with respect to Agent Clearing Member Transactions, NSCC would close-out any such transactions which have been novated to NSCC. This is because NSCC would have the practical and legal capability to make such an election with respect to Sponsored Member Transactions because each Sponsored Member would be a limited-purpose member of NSCC. Accordingly, NSCC would have the requisite information about each of the Sponsored Member's novated positions (by virtue of each Sponsored Member's novated portfolio represented as a different sub-account of the Sponsoring Member (*i.e.*, Sponsored Member Sub-Account) on the books and records of NSCC) to make such an election. By contrast, an Agent Clearing Member's Customers would not be limited-purpose members of NSCC nor would NSCC know which transactions within an Agent Clearing Member Customer Omnibus Account belong to which Customers. As such, NSCC would not be able to separately terminate or complete settlement with respect to Customers' novated positions.

Proposed Rule 2D, Section 11 (Transfer of Agent Clearing Member Transactions in Agent Clearing Member Customer Omnibus Accounts)

Section 11 of proposed Rule 2D would (i) permit an Agent Clearing Member, upon a default of a Customer and consent of NSCC, to transfer Agent Clearing Member Transactions of the Customer established in one or more of the Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts from such Agent Clearing Member Customer Omnibus Accounts to the Agent Clearing Member's proprietary account at NSCC as a Member and (ii) govern how the transfer would be effectuated.

Section 11(a) of proposed Rule 2D would clarify the scope to which Section 11 of proposed Rule 2D applies. It would state that Section 11 would not apply if either (i) the relevant Agent Clearing Member is a Defaulting Member or (ii) a Corporation Default has occurred. This is because, as described above with respect to Section 10(b) of proposed Rule 2D, NSCC would close-out all Agent Clearing Member Transactions for which the defaulting

Agent Clearing Member was responsible. If a Corporation Default has occurred with respect to NSCC, each Agent Clearing Member's positions would be closed out in accordance with Section 17 of proposed Rule 56.

Section 11(b) of proposed Rule 2D would set out the process by which an Agent Clearing Member may transfer the Agent Clearing Member Transactions of a defaulting Customer in one or more of Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts. It would provide that, to the extent permitted under applicable laws and regulations, an Agent Clearing Member may, upon a default of a Customer and the consent of NSCC, transfer the Agent Clearing Member Transactions of the Customer established in one or more of the Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts from such Agent Clearing Member Customer Omnibus Accounts to the Agent Clearing Member's proprietary account at NSCC as a Member. As proposed, any such transfer shall occur by novation, such that the obligations between NSCC and the relevant Customer in respect of the Agent Clearing Member Transactions shall be terminated and replaced with identical obligations between NSCC and the Agent Clearing Member, acting as principal. Section 11(b) would also provide the Agent Clearing Member shall indemnify NSCC, and its employees, officers, directors, shareholders, agents, and Members, for any and all losses, liability, or expenses incurred by them arising from, or in relation to, any such transfer.

Proposed Rule 2D, Section 12 (Customer Acknowledgments)

Section 12 of proposed Rule 2D would provide that each Agent Clearing Member on behalf of each of its Customers agrees that such Customer, by participating in and entering into Agent Clearing Member Transactions through the Agent Clearing Member, understands, acknowledges, and agrees that: (a) The service provided by NSCC with regard to the Customer Clearing Service would be subject to and governed by the Rules; (b) the Rules shall govern the novation of Agent Clearing Member Transactions and all transactions between the Customer and its Agent Clearing Member resulting in the novation of such transactions, and at the time of novation of an Agent Clearing Member Transaction, the Customer on whose behalf it was submitted would be bound by the Agent Clearing Member Transaction automatically and without any further

action by the Customer or by its Agent Clearing Member, and the Customer agrees to be bound by the applicable provisions of the Rules in all respects; (c) NSCC shall be under no obligation to deal directly with the Customer, and NSCC may deal exclusively with the Customer's Agent Clearing Member; (d) NSCC shall have no obligations to the Customer with respect to any Agent Clearing Member Transactions submitted by an Agent Clearing Member on behalf of the Customer, including with respect to any payment or delivery obligations; and (e) the Customer shall have no right to receive from NSCC, or any right to assert a claim against NSCC with respect to, nor shall NSCC be liable to the Customer for, any payment or delivery obligation in connection with any Agent Clearing Member Transactions submitted by an Agent Clearing Member on behalf of the Customer, and NSCC shall make any such payments or redeliveries solely to the relevant Agent Clearing Member.

(C) Proposed Rule 56—Securities Financing Transaction Clearing Service

NSCC is proposing to add Rule 56, entitled "Securities Financing Transaction Clearing Service." This new rule would govern the proposed SFT Clearing Service and would be comprised of 18 sections, each of which is described below.

In connection with the proposed SFT Clearing Service, NSCC is proposing to add the following terms and definitions, as described below.

The term "Aggregate Net SFT Close-out Value" would mean, with respect to an SFT Member, the sum of the SFT Close-out Value (as defined below and in the proposed rule change) for each SFT Position to which the SFT Member is a party.

The term "Approved SFT Submitter" would mean a provider of transaction data on an SFT that the parties to the SFT have selected and NSCC has approved, subject to such terms and conditions as to which the Approved SFT Submitter and NSCC may agree.

The term "Bilaterally Initiated SFT" would mean an SFT, the Initial Settlement of which occurred prior to the submission of such SFT to NSCC.

The term "Buy-In Amount" would mean a net amount equal to (x) the Buy-In Costs or Deemed Buy-In Costs (as defined below and in the proposed rule change) of the SFT Securities (as defined below and in the proposed rule change) in respect of which a Transferor has effected a Buy-In, less (y) the amount of the SFT Cash for the relevant SFT (unless the Transferor effected a Buy-In in respect of some, but not all,

of the SFT Securities that are the subject of the SFT, in which case (y) shall be the amount of the Corresponding SFT Cash (as defined below and in the proposed rule change)).

The term "Contract Price" would mean, with respect to SFT Securities subject to an SFT, the price of such securities at the time the SFT is submitted to NSCC for novation, which price shall be determined by the SFT Member parties to the relevant SFT and provided by an Approved SFT Submitter to NSCC in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose; provided that if no such price is provided by the time required by NSCC, the "Contract Price" shall be the Current Market Price of the SFT Securities.

The term "Corresponding SFT Cash" would mean (a) in respect of a Recalled SFT (as defined below and in the proposed rule change) for which a Transferor has effected a Buy-In in respect of some, but not all, of the SFT Securities that are the subject of the SFT, the portion of the SFT Cash for such SFT equal to the product of (i) the percentage of the SFT Securities in respect of which the Transferor effected a Buy-In and (ii) the SFT Cash of the SFT; and (b) in respect of a Settling SFT which has a greater quantity of SFT Securities as its subject than the corresponding Linked SFT, the portion of the SFT Cash of the Settling SFT equal to the product of (i) the percentage of the SFT Securities of the Settling SFT that the Linked SFT has as its subject and (ii) the SFT Cash of the Settling SFT.

The term "Deemed Buy-In Costs" would mean the product of the number of SFT Securities subject to the relevant Buy-In and the per-share price therefor on the date of the Buy-In obtained from a generally recognized source or the last bid quotation from such a source at the most recent close of trading for the SFT Security.

The term "Defaulting SFT Member" would mean an SFT Member for which NSCC has ceased to act in accordance with Section 14 of proposed Rule 56, as described below.

The term "Distribution" would mean, with respect to any SFT Security at any time, any cash payment of amounts equivalent to dividends and other distributions on the SFT Security.

The term "Distribution Amount" would mean, in respect of an SFT, an amount of cash equal to the product of: (a) The amount per security in respect of (x) a cash dividend on the SFT Securities that are the subject of the SFT or (y) an exchange of the SFT Securities

that are the subject of the SFT for cash; and (b) the number of the relevant SFT Securities subject to the SFT.

The term "Distribution Payment" would mean an amount payable by one party to an SFT to the other party to the SFT during the term of the SFT in respect of a Distribution on the SFT Securities subject to the SFT.

The term "Existing Master Agreement" would mean, in respect of an SFT, a written agreement that (i) exists at the time transaction data for the SFT is submitted to NSCC by an Approved SFT Submitter, (ii) provides for, among other things, terms governing the payment and delivery obligations of the parties and (iii) the parties have established (by written agreement, oral agreement, course of conduct or otherwise) would govern such SFT.

The term "Final Settlement" would mean the exchange of SFT Securities for SFT Cash described in clause (b) of the proposed definition of Securities Financing Transaction.

The term "Final Settlement Date" would mean the Business Day on which the final settlement of a transaction is scheduled to occur. If the transaction is an SFT, the Final Settlement Date means the Business Day on which the Final Settlement of the SFT is scheduled to occur in accordance with proposed Rule 56 or, if the SFT is accelerated in accordance with proposed Rule 56, the date to which the Final Settlement obligations have been accelerated.

The term "Incremental Additional Independent Amount SFT Cash" would mean, (a) in respect of a Linked SFT, the excess, if any, of the Independent Amount SFT Cash of the Linked SFT over the Independent Amount SFT Cash of the Settling SFT; (b) in respect of a Non-Returned SFT, the portion of the Price Differential payable by the Transferee, if any, that is attributable to the Independent Amount SFT Cash of the SFT (which shall be calculated by multiplying such Priced Differential by the excess, if any, of the Independent Amount Percentage (as defined below and in the proposed rule change) over 100%); and (c) in respect of any other SFT, the Independent Amount SFT Cash of such SFT.

The term "Independent Amount Percentage" would mean, in respect of an SFT, a percentage obtained by dividing the SFT Cash of such SFT by the Market Value SFT Cash (as defined below and in the proposed rule change) of such SFT.

The term "Independent Amount SFT Cash" would mean the portion, if any, of the SFT Cash for an SFT equal to the amount by which the SFT Cash for such

SFT at the time of the Initial Settlement exceeds the Contract Price of the SFT Securities that are the subject of such SFT.

The term “Ineligibility Date” would mean, with respect to an SFT, the date on which the SFT Security that is the subject of the SFT becomes an Ineligible SFT Security (as defined below and in the proposed rule change).

The term “Ineligible SFT” would mean an SFT that has, as its subject, SFT Securities that have become Ineligible SFT Securities.

The term “Ineligible SFT Security” would mean an SFT Security that is not eligible to be the subject of a novated SFT.

The term “Initial Settlement” would mean the exchange of SFT Securities for SFT Cash described in clause (a) of the proposed definition of Securities Financing Transaction.

The term “Linked SFT” would mean an SFT entered into by the pre-novation SFT Member parties to a Settling SFT that has the same Transferor, Transferee and subject SFT Securities (including CUSIP) as the Settling SFT. As proposed, a Linked SFT would include an SFT that has as its subject fewer SFT Securities than the corresponding Settling SFT but would not include an SFT that has as its subject more SFT Securities than the corresponding Settling SFT.

The term “Market Value SFT Cash” would mean the portion of the SFT Cash for an SFT equal to the amount of the SFT Cash for such SFT minus the Independent Amount SFT Cash of such SFT.

The term “Price Differential” would mean (a) for purposes of the discharge of offsetting Final Settlement and Initial Settlement obligations, (i) the SFT Cash for the Settling SFT (or if the Settling SFT has a greater quantity of SFT Securities as its subject than the corresponding Linked SFT, the Corresponding SFT Cash) minus (ii) the SFT Cash for the Linked SFT; and (b) for all other purposes, (i) the SFT Cash for the SFT minus (ii) the product of the Independent Amount Percentage, if any, and the Current Market Price of the SFT Securities.

The term “Rate Payment” would mean an amount payable from one party to an SFT to the other party to the SFT at the Final Settlement expressed as a percentage of the amount of SFT Cash for the SFT. As an example, if the Rate Payment is specified as 0.02%, the amount payable would be the product 0.02% and the SFT Cash for the SFT.

The term “Recall Date” would mean, in respect of a Recall Notice, the second

Business Day following NSCC’s receipt of such Recall Notice.

The term “Recall Notice” would mean a notice that triggers the provisions of Section 9(b) of proposed Rule 56, relating to a Buy-In in respect of an SFT and that is submitted by an Approved SFT Submitter on behalf of a Transferor in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose.

The term “Recalled SFT” would mean an SFT that has been novated to NSCC in respect of which a Recall Notice has been submitted.

The term “Securities Financing Transaction” or “SFT” would mean a transaction between two SFT Members pursuant to which (a) one SFT Member agrees to transfer specified SFT Securities to another SFT Member versus the SFT Cash; and (b) the Transferee agrees to retransfer such specified SFT Securities or equivalent SFT Securities (including quantity and CUSIP) to the Transferor versus the SFT Cash on the following Business Day.

The term “Settling SFT” would mean, as of any Business Day, an SFT that has been novated to NSCC, the Final Settlement of which is scheduled to occur on that Business Day.

The term “SFT Account” would mean a ledger maintained on the books and records of NSCC that reflects the outstanding SFTs that an SFT Member enters into and that have been novated to NSCC, the SFT Positions or SFT Cash associated with those transactions and any debits or credits of cash associated with such transactions effected pursuant to Rule 12 (Settlement). As proposed, the term “SFT Account” would include any Agent Clearing Member Customer Omnibus Account and any Sponsored Member Sub-Account.

The term “SFT Cash” would mean the specified amount of U.S. dollars that the Transferee agrees to transfer to the Transferor at the Initial Settlement of an SFT, (i) plus any Price Differential paid by NSCC to the SFT Member as Transferor or by the SFT Member as Transferee to NSCC during the term of the SFT and (ii) less any Price Differential paid by NSCC to the SFT Member as Transferee or by the SFT Member as Transferor to NSCC during the term of the SFT.

The term “SFT Close-out Value” would mean, with respect to an SFT Position of an SFT Member, an amount equal to: (i) If the SFT Member is the Transferor of the SFT Securities that are the subject of such SFT, (a) the CNS Market Value of the SFT Securities that are the subject of such SFT minus (b) the SFT Cash for such SFT; and (ii) if the SFT Member is a Transferee of the

SFT Securities that are the subject of such SFT, (a) the SFT Cash for such SFT minus (b) the CNS Market Value of the SFT Securities that are the subject of such SFT.

The term “SFT Long Position” would mean the number of units of an SFT Security which an SFT Member is entitled to receive from NSCC at Final Settlement of an SFT against payment of the SFT Cash.

The term “SFT Member” would mean any Member, Sponsored Member acting in its principal capacity, Sponsoring Member acting in its principal capacity or Agent Clearing Member acting on behalf of a Customer, in each case that is a party to an SFT, permitted to participate in NSCC’s SFT Clearing Service.

The term “SFT Position” would mean an SFT Member’s SFT Long Position or SFT Short Position (as defined below and in the proposed rule change) in an SFT Security that is the subject of an SFT that has been novated to NSCC.

The term “SFT Security” would mean a security that is eligible to be the subject of an SFT novated to NSCC and is included in the list for which provision is made in proposed Section 1(g) of Rule 3 (Lists to be Maintained), as described below. As proposed, if any new or different security is exchanged for any SFT Security in connection with a recapitalization, merger, consolidation or other corporate action, such new or different security shall, effective upon such exchange, become an SFT Security in substitution for the former SFT Security for which such exchange is made.

The term “SFT Short Position” would mean the number of units of an SFT Security that an SFT Member is obligated to deliver to NSCC at Final Settlement of an SFT against payment of the SFT Cash.

The term “Transferee” would mean the SFT Member party to an SFT that agrees to receive SFT Securities from the other SFT Member party to the SFT in exchange for SFT Cash in connection with the Initial Settlement of the SFT.

The term “Transferor” would mean the SFT Member party to an SFT that agrees to transfer SFT Securities to the other SFT Member party to the SFT in exchange for SFT Cash in connection with the Initial Settlement of the SFT.

#### Proposed Rule 56, Section 1 (General)

Section 1 of proposed Rule 56 would be a general provision regarding the SFT Clearing Service applicable to Members, Sponsoring Members and Agent Clearing Members that participate in the proposed SFT Clearing Service.

Section 1(a) of proposed Rule 56 would establish that NSCC may accept for novation SFTs entered into between (i) a Member and another Member, (ii) a Sponsoring Member and its Sponsored Member, or (iii) an Agent Clearing Member acting on behalf of a Customer and either (x) a Member or (y) the same or another Agent Clearing Member acting on behalf of a Customer.

Section 1(b) of proposed Rule 56 would provide that any SFT that is submitted to NSCC for novation, and any Member and Sponsored Member that enters into an SFT (and any Customer on behalf of whom an Agent Clearing Member enters into an SFT) shall be subject to the provisions of proposed Rule 56; provided that Sections 15 and 16 of proposed Rule 56 shall only apply to Sponsoring Members, Agent Clearing Members, Sponsored Members and Customers, as applicable.

Section 1(c) of proposed Rule 56 would further provide that any amount of cash described in proposed Rule 56 may be rounded up to the nearest one cent, five cents, 10 cents, 25 cents or dollar according to the rounding convention requested by the SFT Member parties to the relevant SFT as conveyed to NSCC in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose.

Proposed Rule 56, Section 2 (Eligibility for SFT Clearing Service: SFT Member)

Section 2 of proposed Rule 56 would establish the eligibility requirements for using the proposed SFT Clearing Service.

Under Section 2 of proposed Rule 56, NSCC may permit any Member acting in its principal capacity, Sponsored Member acting in its principal capacity, or Agent Clearing Member acting on behalf of a Customer to be an SFT Member and participate in the proposed SFT Clearing Service.

Section 2 of proposed Rule 56 would provide that the rights, liabilities and obligations of SFT Members in their capacity as such shall be governed by the proposed Rule 56. References to a Member would not apply to an SFT Member in its capacity as such, unless specifically noted in the proposed Rule 56 or in such other Rules as applicable to an SFT Member.

Section 2 of proposed Rule 56 would also provide that an SFT Member that participates in NSCC in another capacity pursuant to another Rule, or which has entered into an agreement with NSCC independent from proposed Rule 56, shall continue to have all the rights, liabilities and obligations set

forth in such other Rule or pursuant to such agreement, and such rights, liabilities and obligations shall be separate from its rights, liabilities and obligations as an SFT Member, except as contemplated under Sections 15 and 16 of proposed Rule 56, as described below.

Proposed Rule 56, Section 3 (Membership Documents)

Section 3 of proposed Rule 56 would govern the documents that SFT Member applicants would be required to complete and deliver to NSCC. Specifically, Section 3 of proposed Rule 56 would provide that to become an SFT Member, each applicant shall complete and deliver to NSCC documents in such forms as may be prescribed by NSCC from time to time and any other information requested by NSCC.

Proposed Rule 56, Section 4 (Securities Financing Transaction Data Submission)

Section 4 of proposed Rule 56 would govern the submission of transaction data for SFTs into NSCC for novation by Approved SFT Submitters on behalf of Transferors (e.g., lenders) and Transferees (e.g., borrowers).

Section 4(a) of proposed Rule 56 would provide that in order for an SFT to be submitted to NSCC, the transaction data for the SFT must be submitted to NSCC by an Approved SFT Submitter in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose.

Any such transaction data shall be submitted to NSCC on a locked-in basis. In determining whether to accept transaction data from an Approved SFT Submitter, NSCC may require the Approved SFT Submitter to provide a Cybersecurity Confirmation. This is consistent with the existing requirement in Section 6 of Rule 7 (Comparison and Trade Recording Operation (Including Special Representative/Index Receipt Agent)) for organizations reporting trade data to NSCC.<sup>73</sup>

Section 4(b) of proposed Rule 56 would provide that NSCC would not act upon any instruction received from an Approved SFT Submitter in respect of an SFT unless each SFT Member (other than an SFT Member that is a Sponsored Member) designated by the Approved SFT Submitter as a party to such SFT has consented, in a writing

delivered to NSCC, to the Approved SFT Submitter acting on behalf of the SFT Member in respect of SFTs.

Section 4(c) of proposed Rule 56 would provide that the obligations reflected in the transaction data on an SFT shall be deemed to have been confirmed and acknowledged by each SFT Member designated by the Approved SFT Submitter as a party thereto and to have been adopted by such SFT Member and, for the purposes of determining the rights and obligations between NSCC and such SFT Member under the proposed Rule 56 and such other Rules applicable to SFTs, shall be valid and binding upon such SFT Member. In addition, Section 4(c) would provide that an SFT Member which has been so designated by an Approved SFT Submitter shall resolve any differences or claims regarding the rights and obligations reflected in the transaction data submitted by the Approved SFT Submitter with the Approved SFT Submitter, and NSCC shall have no responsibility in respect thereof or to adjust its records or the accounts of the SFT Member in any way, other than pursuant to the instructions of the Approved SFT Submitter. Section 4(c) would also provide that any such adjustment shall be in the sole discretion of NSCC.

Section 4(d) of proposed Rule 56 would provide that NSCC makes no representation, whether expressed or implied, as to the complete and timely performance of an Approved SFT Submitter's duties and obligations. Section 4(d) would also provide that NSCC assumes no liability to any SFT Member for any act or failure to act by an Approved SFT Submitter in connection with any information received by NSCC or given to the SFT Member by NSCC via the Approved SFT Submitter, as the case may be.

Section 4(e) of proposed Rule 56 would provide that the submission of each SFT to NSCC and the performance of any obligation under such SFT shall constitute a representation to NSCC and covenant by the Transferor and the Transferee, any Sponsoring Member that is acting on behalf of the Transferor or Transferee and any Agent Clearing Member that is acting on behalf of a Customer in connection with such SFT that its participation in such SFT is in compliance, and would continue to comply, with all applicable laws and regulations, including without limitation Rule 15c3-3 and all other applicable rules and regulations of the Commission, any applicable provisions of Regulation T, Regulation U and Regulation X of the Board of Governors of the Federal Reserve System, and the

<sup>73</sup> Section 6 of Rule 7 (Comparison and Trade Recording Operation (Including Special Representative/Index Receipt Agent)) provides that NSCC may require organizations that deliver trade data to NSCC as described in that Rule to provide a Cybersecurity Confirmation before agreeing to accept such trade data. *Supra* note 4.

rules of FINRA and any other regulatory or self-regulatory organization to which the Transferor, the Transferee, any Sponsoring Member that is acting on behalf of the Transferor or Transferee or any Agent Clearing Member that is acting on behalf of a Customer is subject.

Section 4(f) of proposed Rule 56 would provide that the submission of each SFT to NSCC shall constitute an authorization to NSCC by the Transferor, the Transferee and any Agent Clearing Member that is acting on behalf of a Customer for NSCC to give instructions regarding the SFT to DTC in respect of the relevant accounts of the Transferor, Transferee and Agent Clearing Member at DTC.

Proposed Rule 56, Section 5 (Novation of Securities Financing Transactions)

Section 5 of proposed Rule 56 would govern the nature and timing of the novation to NSCC of obligations related to an SFT.

Section 5(a) of proposed Rule 56 would provide that NSCC to only novate an SFT if, at the time of novation, the Final Settlement of such transaction is scheduled to occur one Business Day following the Initial Settlement and the SFT Cash is no less than 100% of the Contract Price of the SFT.

Section 5(b) of proposed Rule 56 would provide that each SFT that is a Bilaterally Initiated SFT, including any Sponsored Member Transaction, and validated pursuant to the Rules shall be novated to NSCC as of the time NSCC provides the Approved SFT Submitter for such SFT a report confirming such novation in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose. Section 5(b) would also provide that each SFT that is neither a Bilaterally Initiated SFT nor a Sponsored Member Transaction and that is validated pursuant to the Rules shall be novated to NSCC as of the time (x) the Initial Settlement of such SFT has completed by (i) the Transferor instructing DTC to deliver from the relevant DTC account of the Transferor to NSCC's account at DTC the subject SFT Securities versus payment of the amount of the SFT Cash, (ii) NSCC instructing DTC to deliver from NSCC's account at DTC to the relevant DTC account of the Transferee the subject SFT Securities versus payment of the amount of SFT Cash and (iii) DTC processes the deliveries in accordance with the rules and procedures of DTC, or (y) the Initial Settlement obligations of such SFT have been discharged in accordance with Section 8 of proposed Rule 56, as described below. In

addition, Section 5(b) would provide that if the Initial Settlement obligations of an SFT that is neither a Bilaterally Initiated SFT nor a Sponsored Member Transaction are not discharged in accordance with clause (x) or (y), then such SFT shall be deemed void *ab initio*.

Section 5(c) of proposed Rule 56 would provide that, subject to Sections 5(d) and 5(e) of proposed Rule 56 as described below, the novation of SFTs shall consist of the termination of the Final Settlement, Rate Payment and Distribution Payment obligations and entitlements between the parties to the SFT with respect to such SFT and their replacement with obligations and entitlements to and from NSCC to perform, in accordance with the Rules, the Final Settlement, Rate Payment, and Distribution Payment obligations and entitlements under the SFT.

Section 5(d) of proposed Rule 56 would govern the novation of SFTs having Incremental Additional Independent Amount SFT Cash and provides when the obligation to return Independent Amount SFT Cash for which an associated Clearing Fund deposit has not been made will be novated away from a Transferor to NSCC. Specifically, Section 5(d)(i) of proposed Rule 56 would provide that if an SFT has Incremental Additional Independent Amount SFT Cash, then, unless the SFT is a Sponsored Member Transaction and the Sponsoring Member is the Transferee,<sup>74</sup> the obligation of the Transferor to return the Incremental Additional Independent Amount SFT Cash to the Transferee shall not be terminated and novated to NSCC (nor shall NSCC otherwise be required to return such Incremental Additional Independent Amount SFT Cash), except to the extent that the Transferor, Sponsoring Member or Agent Clearing Member, as applicable, has satisfied the associated Independent Amount SFT Cash Deposit Requirement. As proposed, to the extent the associated Clearing Fund deposit has not been made in respect of Independent Amount SFT Cash at the time of the Initial Settlement, the obligation to return the Independent Amount SFT Cash would not be novated to NSCC.

<sup>74</sup> Where the Transferor is a Sponsored Member receiving Independent Amount SFT Cash, NSCC would not be requiring Independent Amount SFT Cash Deposit Requirement. This is because in the case of the Sponsored Member's default, the party giving the Independent Amount SFT Cash, *i.e.*, Sponsoring Member, is the guarantor of the settlement obligation of the Sponsored Member Independent Amount SFT Cash back to NSCC.

Section 5(d)(ii) of proposed Rule 56 would provide that to the extent the Transferor, Sponsoring Member or Agent Clearing Member has not satisfied the associated Independent Amount SFT Cash Deposit Requirement, the Transferor's (or in the case of a Non-Returned SFT, NSCC's) obligation to return the Incremental Additional Independent Amount SFT Cash shall: (1) If the SFT is an Agent Clearing Member Transaction for which the Agent Clearing Member, acting on behalf of the Customer, is the Transferor, be terminated and replaced with an obligation of the Agent Clearing Member, in its capacity as principal, to return the Incremental Additional Independent Amount SFT Cash to the Transferee; or (2) otherwise, remain (or in the context of a Non-Returned SFT, be terminated and replaced with) a bilateral obligation of the Transferor to the Transferee. As proposed, if the associated Clearing Fund deposit has not been made in respect of Independent Amount SFT Cash, the Independent Amount SFT Cash would be owed by the Transferor to the Transferee as a bilateral principal-to-principal obligation, unless the Transferor is a Customer of an Agent Clearing Member, in which case the obligation to return the Independent Amount SFT Cash in respect of which the Clearing Fund has not been made would be novated from the Customer to the Agent Clearing Member, and the Agent Clearing Member would owe the Independent Amount SFT Cash back to the Transferee as principal.<sup>75</sup>

Section 5(d)(iii) of proposed Rule 56 would provide that each SFT Member agrees that any obligation to return Incremental Additional Independent Amount SFT Cash that is novated to an Agent Clearing Member or that remains (or becomes) a bilateral obligation of the Transferor to the Transferee in accordance with Section 5(d)(ii) of proposed Rule 56, is a binding and enforceable obligation of the Agent Clearing Member or Transferor, as applicable, regardless of whether the Transferee has entered into an Existing Master Agreement with the Agent Clearing Member or Transferor. In addition, Section 5(d)(iii) would provide that each SFT Member further agrees that any such obligation shall only be due and payable to the Transferee upon the final discharge of NSCC's Final Settlement obligations to

<sup>75</sup> This interim novation is designed to avoid any credit concerns that would manifest if the Customer and the Transferee had to have a principal bilateral obligation to each other for the Independent Amount SFT Cash.

the Transferor under the portion of the SFT that has been novated to NSCC in accordance with Section 5(b) of proposed Rule 56, as described above.

Section 5(d)(iv) of proposed Rule 56 would provide that, until the Transferor, Sponsoring Member or Agent Clearing Member has satisfied in full its Independent Amount SFT Cash Deposit Requirement, the SFT Cash of the SFT shall, for purposes of determining the obligations owing to and from NSCC under such SFT, equal the SFT Cash of the SFT less the Incremental Additional Independent Amount SFT Cash.

Section 5(d)(v) of proposed Rule 56 would provide that once the Transferor, Sponsoring Member or Agent Clearing Member, as applicable, has satisfied in full its Independent Amount SFT Cash Deposit Requirement, the obligation of the Transferor to return the Incremental Additional Independent Amount SFT Cash to the Transferee (or, in the case of an SFT that is an Agent Clearing Member Transaction, any obligation of the Agent Clearing Member to return the Incremental Additional Independent Amount SFT Cash to the Transferee) shall be novated to NSCC, and the SFT Cash of the SFT shall, for purposes of determining the obligations owing to and from NSCC under the SFT, include the full amount of the SFT Cash of such SFT.

Section 5(e) of proposed Rule 56 would govern novation in respect of certain corporate actions and provide that NSCC would (i) have an obligation to pay the cash distribution to the Transferor and the Transferee would have an obligation to pay the cash distribution to NSCC, and (ii) not novate any obligations related to unsupported corporate actions and distributions. Specifically, Section 5(e)(i) of proposed Rule 56 would provide that regardless of anything to the contrary in any Existing Master Agreement (including a provision addressing when an issuer pays different amounts to different security holders due to withholding tax or other reasons), the Distribution Payment obligations and entitlements between NSCC and each party to an SFT that has been novated to NSCC shall be the obligation of NSCC to pay to the Transferor and the obligation of the Transferee to pay to NSCC the Distribution Amount in respect of each Distribution and the corresponding entitlements of the Transferor and NSCC, in each case, in accordance with the Rules.

Section 5(e)(ii) of proposed Rule 56 would provide that NSCC shall maintain a list of corporate actions and distributions that NSCC does not support with respect to SFTs. Section

5(e)(ii) would further provide that no Final Settlement, Rate Payment, Distribution Payment or other obligation resulting from a corporate action or distribution that is not supported by NSCC shall be novated to NSCC. In addition, Section 5(e)(ii) would provide that none of such unsupported corporate action shall modify the Final Settlement, Rate Payment, Distribution Payment or other obligations of NSCC, Transferor and Transferee under an SFT that has been novated to NSCC. Section 5(e)(ii) would also provide that each SFT Member agrees that any obligation under an SFT resulting from a corporate action or distribution not supported by NSCC shall remain a binding and enforceable bilateral obligation between the Transferor and the Transferee, regardless of whether the Transferor and Transferee have entered into an Existing Master Agreement.

Section 5(f) of proposed Rule 56 would provide that the novation of SFTs shall not affect the fundamental substance of the SFT as a transfer of securities by one party in exchange for a transfer of cash by the other party and an agreement by each party to return the property it received and shall not affect the economic obligations or entitlements of the parties under the SFT except that following novation, the Final Settlement, Rate Payment and Distribution Payment obligations and entitlements shall be owed to and by NSCC rather than the original counterparty under the SFT.

Section 5(g) of proposed Rule 56 would provide that the representations and warranties made by each of the parties to an SFT that has been novated to NSCC under the parties' Existing Master Agreement, if any, shall (x) to the extent that they are inconsistent with the Rules, be eliminated and replaced with the Rules and (y) to the extent that they are not inconsistent with the Rules, remain in effect as between the parties to the original SFT, but shall not impose any additional obligations on NSCC.

Proposed Rule 56, Section 6 (Rate and Distributions)

Section 6 of proposed Rule 56 would govern the settlement of Rate Payments and supported Distributions by NSCC for novated SFTs. Section 6(a) of proposed Rule 56 would provide that NSCC shall debit and credit the Rate Payment from and to the SFT Accounts of the SFT Member parties to an SFT that has been novated to NSCC as part of its end of day final money settlement process in accordance with Rule 12 (Settlement) and Procedure VIII (Money Settlement Service) on the scheduled

Final Settlement Date for the SFT, irrespective of whether Final Settlement of such SFT occurs on such date.

Section 6(b) of proposed Rule 56 would provide that if (x) a cash dividend is made on or in respect of an SFT Security that is the subject of an SFT that has been novated to NSCC or (y) cash is exchanged, in whole or in part, for such an SFT Security in a merger, consolidation or similar transaction, and the Transferor under the SFT would have been entitled to a cash payment related to the event described in clause (x) or (y) had it not transferred the SFT Securities that are the subject of the SFT to the Transferee in the Initial Settlement, then NSCC shall, within the time period determined by NSCC from time to time, credit the Distribution Amount to the Transferor's SFT Account and debit the Distribution Amount from the Transferee's SFT Account as part of its end of day final money settlement process in accordance with Rule 12 and Procedure VIII. Section 6(b) would further provide that if cash is exchanged in whole for such an SFT Security, then the completion of the actions described in the preceding sentence shall discharge NSCC's Final Settlement obligations to the relevant Transferor and the Transferee's Final Settlement obligations to NSCC.

Proposed Rule 56, Section 7 (Final Settlement of Securities Financing Transactions)

Section 7 of proposed Rule 56 would govern the mechanics of Final Settlement of SFTs by providing that, subject to Section 11 of proposed Rule 56, as described below, the Final Settlement of an SFT that has been novated to NSCC shall be scheduled to occur on the Business Day immediately following the date the SFT was novated to NSCC. Section 7 would further provide that unless the Final Settlement obligations under such an SFT are discharged in accordance with Section 8 of proposed Rule 56, as described below, Final Settlement of the SFT shall occur by (x) NSCC instructing DTC to (i) deliver from the relevant DTC account of the Transferee to NSCC's account at DTC the subject SFT Securities versus payment of the amount of SFT Cash and (ii) deliver from NSCC's account at DTC to the relevant DTC account of the Transferor the subject SFT Securities versus payment of the amount of SFT Cash, and (y) the processing of such deliveries by DTC in accordance to the rules and procedures of DTC; provided that if such transfers do not occur and a Buy-In does not occur in respect of the SFT, then the Final Settlement Date



shall be rescheduled for the following Business Day as described in Section 9 of proposed Rule 56, as described below. The obligation of a Transferor (or a Sponsoring Member that guarantees to NSCC the obligation of a Transferor or an Agent Clearing Member that is responsible for the performance of the obligation under an SFT that is an Agent Clearing Member Transaction to return SFT Cash to NSCC) in respect of the Final Settlement of an SFT that has been novated to NSCC shall be to pay the SFT Cash and, if applicable, the Rate Payment to NSCC against the transfer of the relevant SFT Securities by NSCC. The obligation of a Transferee (or a Sponsoring Member that guarantees to NSCC the obligation of a Transferee or an Agent Clearing Member that is responsible for the performance of the obligation under an SFT that is an Agent Clearing Member Transaction to return SFT Securities to NSCC) in respect of the Final Settlement of an SFT that has been novated to NSCC shall be to transfer the SFT Securities and, if applicable, the Rate Payment to NSCC against the transfer of SFT Cash by NSCC.

Section 7 of proposed Rule 56 would also provide that an SFT, or a portion thereof, shall be deemed complete and final upon Final Settlement of the SFT, or such portion, whether pursuant to Sections 7, 8, 9(d) or 13(c) of proposed Rule 56. Section 7 would also provide that from and after the Final Settlement of an SFT, or a portion thereof, pursuant to any Sections 7, 8, 9(d) or 13(c) of proposed Rule 56, NSCC shall be discharged from its obligations to the Transferor and the Transferee, and NSCC shall have no further obligation in respect of the SFT or such portion. This is to make it clear to SFT Members the point at which settlement of an SFT is deemed to be complete and final.<sup>76</sup>

Proposed Rule 56, Section 8 (Discharge of Offsetting Final Settlement and Initial Settlement Obligations)

Section 8 of proposed Rule 56 would govern the “roll” (*i.e.*, pair off or offset) process whereby the Final Settlement obligations on one SFT (*i.e.*, the Settling SFT) between two parties can be offset with the Initial Settlement obligations on another SFT between the same parties (*i.e.*, the Linked SFT) through the

debiting and crediting of the difference in cash collateral between the two offsetting SFTs (*i.e.*, the Price Differential).

Section 8(a) of proposed Rule 56 would provide that, subject to the provisions of Section 13(c) of proposed Rule 56, as described below, if, on any Business Day, the pre-novation SFT Member parties to a Settling SFT enter into a Linked SFT and the Approved SFT Submitter provides an appropriate instruction to NSCC in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose, the Final Settlement obligations of the parties to the Settling SFT and the Initial Settlement obligations of the parties to the Linked SFT shall be discharged once NSCC has instructed DTC to debit and credit the relevant DTC accounts, of the SFT Member parties, as described below in Section 8(b) of proposed Rule 56, and DTC processes such debits and credits in accordance with the rules and procedures of DTC. To the extent the Price Differential is not processed by DTC in accordance with the rules and procedures of DTC, NSCC shall debit and credit the Price Differential from and to the SFT Accounts of the SFT Member parties as part of its end of day final money settlement process in accordance with Rule 12 (Settlement) and Procedure VIII (Money Settlement Service). If the Price Differential is positive, NSCC shall (x) credit an amount equal to the Price Differential to the Transferee’s SFT Account and (y) debit an amount equal to the Price Differential from the Transferor’s SFT Account. If the Price Differential is negative, NSCC shall (x) credit an amount equal to the absolute value of the Price Differential to the Transferor’s SFT Account and (y) debit an amount equal to the absolute value of the Price Differential from the Transferee’s SFT Account. However, if the Linked SFT has as its subject fewer SFT Securities than the Settling SFT, then only the following Final Settlement obligations under the Settling SFT shall be discharged in accordance with Section 8 of proposed Rule 56: (i) The Transferee’s and NSCC’s Final Settlement obligations in respect of a quantity of SFT Securities equal to the quantity of SFT Securities that are the subject of the Linked SFT and (ii) the Transferor’s and NSCC’s Final Settlement obligations in respect of the Corresponding SFT Cash.

Section 8(b) of proposed Rule 56 would provide that if the Price Differential is positive, NSCC shall (x) instruct DTC to debit an amount equal to the Price Differential from NSCC’s account at DTC and credit such amount

to the relevant DTC account of the Transferee and (y) instruct DTC to debit an amount equal to the Price Differential from the relevant DTC account of the Transferor and credit such amount to NSCC’s account at DTC. If the Price Differential is negative, NSCC shall (x) instruct DTC to debit an amount equal to the absolute value of the Price Differential from NSCC’s account at DTC and credit such amount to the relevant DTC account of the Transferor and (y) instruct DTC to debit an amount equal to the absolute value of the Price Differential from the relevant DTC account of the Transferee and credit such amount to NSCC’s account at DTC.

Proposed Rule 56, Section 9 (Non-Returned Securities Financing Transactions and Recalls)

Section 9 of proposed Rule 56 would govern the processing of a novated SFT for which the Final Settlement obligations have not been discharged either through Final Settlement in accordance with Section 7 of proposed Rule 56 (as described above) or a pair off in accordance with Section 8 of proposed Rule 56 (as described above), and the recall and buy-in process for such an SFT.

Specifically, Section 9(a) of proposed Rule 56 would provide that if (x) the Transferee does not satisfy its Final Settlement obligations in respect of an SFT that has been novated to NSCC on the Final Settlement Date, (y) such Final Settlement obligations have not been discharged in accordance with the provisions of Section 8 of proposed Rule 56, as described above, and (z) a Buy-In has not occurred in respect of such SFT or a portion thereof (such SFT, a “Non-Returned SFT”), the Final Settlement Date of the Non-Returned SFT shall be rescheduled for the following Business Day, and NSCC shall instruct DTC to debit and credit the relevant DTC accounts of the SFT Member parties, as described in subsection (b) of Section 8 above. To the extent the Price Differential is not processed by DTC in accordance with the rules and procedures of DTC, NSCC shall debit and credit the Price Differential from and to the SFT Accounts of the SFT Member parties to the Non-Returned SFT as part of its end of day final money settlement process in accordance with Rule 12 (Settlement) and Procedure VIII (Money Settlement Service). Section 9(a) would further provide that if the Price Differential is positive, NSCC shall (x) credit an amount equal to the Price Differential to the Transferee’s SFT Account and (y) debit an amount equal to the Price Differential from the Transferor’s SFT

<sup>76</sup> With respect to an SFT between a Sponsoring Member and its Sponsored Member, the SFT would settle on the books of the Sponsoring Member because the Sponsored Member are not participants at DTC and thus would not have accounts at DTC. Accordingly, the finality of the settlement of such SFT would occur when the Sponsoring Member credits the securities and cash on its or the relevant custodian’s books and records.

Account; if the Price Differential is negative, NSCC shall (x) credit an amount equal to the absolute value of the Price Differential to the Transferor's SFT Account and (y) debit an amount equal to the absolute value of the Price Differential from the Transferee's SFT Account. This process would continue until Final Settlement, a pair off in accordance with Section 8 of proposed Rule 56 (as discussed above), or a Buy-In.

Section 9(b) of proposed Rule 56 would provide that if NSCC receives a Recall Notice in respect of an SFT that has been novated to NSCC and the Transferee does not satisfy its Final Settlement obligations by the Recall Date for the Recall Notice, the Transferor may, in a commercially reasonable manner,<sup>77</sup> purchase some or all of the SFT Securities that are the subject of the SFT<sup>78</sup> or elect to be deemed to have purchased the SFT Securities, in each case in accordance with such timeframes and deadlines as established by NSCC for such purpose (a "Buy-In"); provided that in the case of a Default-Related SFT (as defined below and in the proposed rule change), the commercial reasonableness of a Buy-In shall be determined by NSCC based on whether, in the opinion of NSCC, such Buy-In would create a disorderly market in the relevant SFT Security. Following such purchase or deemed purchase, the Transferor shall (x) give written notice to NSCC of the Transferor's costs to purchase the relevant SFT Securities (including the price paid by the Transferor and any broker's fees and commissions and reasonable out-of-pocket transaction costs, fees or interest expenses incurred in connection with such purchase) (such costs, the "Buy-In Costs") or, if the Transferor elects to be deemed to have purchased the SFT Securities, the Deemed Buy-In Costs, and (y) indemnify NSCC, and its employees, officers, directors, shareholders, agents and Members (collectively the "Buy-In Indemnified Parties"), for any and all losses, liability or expenses of a Buy-In Indemnified Party arising from any claim disputing

<sup>77</sup> The requirement that a party exercising buy-in rights do so in a "commercially reasonable manner" is market standard. See, e.g., Section 13.1 of the Master Securities Loan Agreement published by Securities Industry and Financial Markets Association ("SIFMA"). NSCC has proposed to include this language in order to align the standards applicable to an exercise of remedies in relation to SFTs with those applicable in the bilateral uncleared space. NSCC believes that such alignment will increase certainty for SFT Members and allow them to follow standards with which they are familiar.

<sup>78</sup> The Transferor would purchase these securities from one or more third parties.

the calculation of the Buy-In Costs, the Deemed Buy-In Costs or the method or manner of effecting the Buy-In. Section 9(b) would further provide that each SFT Member acknowledges and agrees that each SFT Security is of a type traded in a recognized market and that, in the absence of a generally recognized source for prices or bid or offer quotations for any SFT Security, the Transferor may, for purposes of a Buy-In, establish the source therefor in its commercially reasonable discretion. In addition, Section 9(b) would provide that each SFT Member further acknowledges and agrees that NSCC would not calculate any Buy-In Costs or Deemed Buy-In Costs and shall have no liability for any such calculation. Section 9(b) would also provide that NSCC would assign to any Transferee whose SFT is subject to a Buy-In any rights it may have against the Transferor to dispute the Transferor's calculation of the Buy-In Costs or Deemed Buy-In Costs.

Section 9(c) of proposed Rule 56 would provide that on the Business Day following NSCC's receipt of written notice of the Transferor's Buy-In Costs, NSCC shall debit and credit the Buy-In Amount from and to the SFT Accounts of the SFT Member parties to the SFT as part of its end of day final money settlement process in accordance with Rule 12 (Settlement) and Procedure VIII (Money Settlement Service). Section 9(c) would provide that if the Buy-In Amount is positive, NSCC would (x) credit the value of the Buy-In Amount to the Transferor's SFT Account and (y) debit the value of the Buy-In Amount from the Transferee's SFT Account. Section 9(c) would further provide that if the Buy-In Amount is negative, NSCC would (x) credit the value of the Buy-In Amount to the Transferee's SFT Account and (y) debit the value of the Buy-In Amount from the Transferor's SFT Account.

Section 9(d) of proposed Rule 56 would provide that following the application of such Buy-In Amount, the Final Settlement obligations under the SFT shall be discharged; provided that if the Transferor effected a Buy-In in respect of some but not all of the SFT Securities that are the subject of an SFT, then only the following obligations shall be discharged: (i) The Transferee's and NSCC's Final Settlement obligations in respect of the SFT Securities for which the Transferor effected the Buy-In and (ii) the Transferor's and NSCC's Final Settlement obligations in respect of the Corresponding SFT Cash.

Section 9(e) of proposed Rule 56 would provide that a Recalled SFT shall be treated as a Non-Returned SFT by

NSCC until the earlier of the time that the SFT settles or a Buy-In is processed by NSCC in accordance with Section 9 of proposed Rule 56, except that the additional SFT Deposit required for Non-Returned SFTs under Section 12(c) of proposed Rule 56, as described below, shall not apply. Section 9(e) would further provide that if the Transferor effects the Buy-In in respect of some, but not all, of the SFT Securities that are the subject of a Recalled SFT, the Final Settlement obligations of the Recalled SFT that are not discharged in accordance with Section 9(d) of proposed Rule 56 shall be treated as a Non-Returned SFT until the SFT settles or a Buy-In is processed by NSCC in accordance with Section 9 of proposed Rule 56, and the additional SFT Deposit required under Section 12(c) of proposed Rule 56, as described below, for Non-Returned SFTs shall apply.

Proposed Rule 56, Section 10 (Cancellation, Modification and Termination of Securities Financing Transactions)

Section 10 of proposed Rule 56 would govern the process for cancellations, modifications and terminations of SFTs in NSCC's systems.

Section 10(a) of proposed Rule 56 would provide that transaction data on an SFT that has not been novated to NSCC may be cancelled upon receipt by NSCC of appropriate instructions from the Approved SFT Submitter with respect to such SFT on behalf of both SFT Member parties thereto, submitted in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose. Section 10(a) would further provide that an SFT that is so cancelled by NSCC would be deemed to be void *ab initio*.

Section 10(b) of proposed Rule 56 would provide the Rate Payment on an SFT that has been novated to NSCC may be modified upon receipt by NSCC of appropriate instructions from the Approved SFT Submitter with respect to such SFT, submitted in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose. Section 10(b) would further provide that any instructions submitted by an Approved SFT Submitter to modify the Rate Payment of an SFT must be submitted on behalf of both SFT Member parties to the SFT.

Section 10(c) of proposed Rule 56 would provide an SFT that has been novated to NSCC in accordance with Section 5 of proposed Rule 56, as described above, may be terminated upon receipt by NSCC of appropriate

instructions from the Approved SFT Submitter with respect to such SFT on behalf of both SFT Member parties thereto, submitted in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purposes. Section 10(c) would further provide that following any such termination, no amounts or further obligations shall be owing in respect of the SFT between NSCC and Transferor or NSCC and the Transferee.

Proposed Rule 56, Section 11  
(Accelerated Final Settlement)

Section 11 of proposed Rule 56 would allow a Transferee (*i.e.*, the borrower) to do a same day return of borrowed securities, if necessary, to satisfy its regulatory purpose requirements by accelerating the Final Settlement of an SFT that has been novated to NSCC. Specifically, Section 11 would provide that the Transferee may accelerate the scheduled Final Settlement of an SFT that has been novated to NSCC upon receipt by NSCC of appropriate instruction from the Approved SFT Submitter with respect to such SFT, submitted in accordance with the communication links, formats, timeframes and deadlines established by NSCC for such purpose. Section 11 would further provide that such accelerated Final Settlement shall be effected by NSCC in accordance with the provisions of Section 7 of proposed Rule 56, as described above.

Proposed Rule 56, Section 12 (Clearing Fund Obligations)

Section 12 of proposed Rule 56 would set out the Clearing Fund obligations for SFT Members with respect to their SFT activity.

Section 12(a) of proposed Rule 56 would provide each SFT Member, other than an SFT Member that is a Sponsored Member, shall make and maintain on an ongoing basis a deposit to the Clearing Fund with respect to its SFT Positions (the "SFT Deposit"). Section 12(a) would provide that, for the avoidance of doubt, the SFT Positions for an SFT Member that is a Sponsoring Member shall include all SFT Positions held in its Sponsored Member Sub-Account(s) in addition to its proprietary account(s).

Section 12(b) of proposed Rule 56 would provide that the SFT Deposit shall be held by NSCC or its designated agents as part of the Clearing Fund, to be applied as provided in Sections 1 through 12 of Rule 4 (Clearing Fund).

Section 12(c) of proposed Rule 56 would provide that NSCC shall calculate the amount of each such SFT Member's required deposit for SFT

Positions, subject to a \$250,000<sup>79</sup> minimum (excluding the minimum contribution to the Clearing Fund as required by Procedure XV (Clearing Fund Formula and Other Matters), Section II.(A)), by applying the Clearing Fund formula for CNS Transactions in Sections I.(A)(1)(a), (b), (c), (e) (f), (g) of Procedure XV as well as the additional Clearing Fund formula in Section I.(B)(5) (Intraday Mark-to-Market Charge) of Procedure XV, except as noted otherwise, in the same manner as such sections apply to CNS Transactions submitted to NSCC for regular way settlement, plus, with respect to any Non-Returned SFT, an additional charge that is calculated by (x) multiplying the Current Market Price of the SFT Securities that are the subject of such Non-Returned SFTs by the number of such SFT Securities that are the subject of the SFT and (y) multiplying such product by (i) 5% for SFT Members rated 1 through 4 on the Credit Risk Rating Matrix, (ii) 10% for SFT Members rated 5 or 6 on the Credit Risk Rating Matrix, or (iii) 20% for SFT Members rated 7 on the Credit Risk Rating Matrix shall be applied to each SFT Member that is a party thereto<sup>80</sup> (collectively and includes any and all Independent Amount SFT Cash Deposit Requirements, the "Required SFT Deposit"); provided, however, notwithstanding anything to the

<sup>79</sup> *Supra* note 32.

<sup>80</sup> The Required SFT Deposit multipliers proposed for Non-Returned SFTs are identical to the Required Fund Deposit multipliers applied to CNS Fails Positions. *See* Procedure XV (Clearing Fund Formula and Other Matters), Section I.(A)(1)(d), *supra* note 4. While the concept of a "fail" does not exist in the securities lending market in the same manner as it does in the cash market, to the extent that the Final Settlement of an SFT is scheduled on a particular date but does not occur, whether directly or through a pair off as described in Section 8 of proposed Rule 56 (as discussed above), that could potentially be a result of a "squeeze" or other market dislocation whereby NSCC may face increased market risk in the event of the default of either the Transferor or the Transferee. As a result, NSCC believes it is prudent to apply the same Required Fund Deposit multiplier to a Non-Returned SFT as it does to CNS Fails Positions.

The Credit Risk Rating Matrix is a financial model utilized by NSCC in its ongoing monitoring of Members based on various risk criteria. Each Member is rated by the Credit Risk Rating Matrix on a 7-point rating system, with "1" being the strongest credit rating and "7" being the weakest credit rating. As described above, to the extent that the Final Settlement of an SFT is scheduled on a particular date but does not occur, NSCC, as a central counterparty, is exposed to market risks. Such exposures generally increase when the SFT Member's risk of default increases, as reflected by the SFT Member's Credit Risk Rating Matrix credit rating. As such, the Required SFT Deposit multipliers proposed for Non-Returned SFTs vary based on the SFT Member's credit rating to reflect the potential increase in market risk from SFT Members with higher risk of default.

contrary, (A) a minimum of 40% of an SFT Member's Required SFT Deposit shall be made in the form of cash and/or Eligible Clearing Fund Treasury Securities and (y) the lesser of \$5,000,000 or 10% of an SFT Member's Required SFT Deposit, with a minimum of \$250,000, must be made and maintained in cash;<sup>81</sup> provided, further, the additional Clearing Fund formula in Sections I.(B)(1) (Additional Deposits for Members on the Watch List); (2) (Excess Capital Premium); (3) (Backtesting Charge); (4) (Bank Holiday Charge); Minimum Clearing Fund and Additional Deposit Requirements in Sections II.(A)1(a)–(b), II.(B), II.(C), and II.(D); as well as Section III (Collateral Value of Eligible Clearing Fund Securities) of Procedure XV shall apply to SFT Members in the same manner as such sections apply to Members. As noted in the proposed rule text, for the purpose of applying Section I.(A)(1)(a)(i) of Procedure XV (Value-at-Risk (VaR) charge), the volatility of an SFT Member's SFT Positions shall be the sum of (a) the highest resultant value between Section I.(A)(1)(a)(i)I. (Core Parametric Estimation) and Section I.(A)(1)(a)(i)III. (Margin Floor) and (b) the resultant value of Section I.(A)(1)(a)(i)II. (Gap Risk Measure). Also, as noted in the proposed rule text, for the purpose of applying Section I.(A)(1)(g) of Procedure XV (Margin Liquidity Adjustment (MLA) charge), SFT Positions shall be aggregated with Net Unsettled Positions, as defined in Rule 1,<sup>82</sup> in the same asset group or subgroup; provided, however, in the event such aggregation results in a reduction of the aggregate positions in the relevant asset group or subgroup, NSCC shall apply the greater of (a) the sum of MLA charges separately calculated for SFT Positions and Net Unsettled Positions in the asset group or subgroup and (b) the MLA charge calculated from aggregating the SFT Positions and the Net Unsettled Positions in the asset group or subgroup.

Section 12(d) of proposed Rule 56 would provide that NSCC shall have the discretion to require an SFT Member to post its Required SFT Deposit in proportion of cash higher than as required under subsection (c) of proposed Section 12, as determined by NSCC from time to time in view of market conditions and other financial and operational capabilities of the SFT Member. Section 12(d) would further provide that NSCC shall make any such determination based on such factors as

<sup>81</sup> *Supra* note 34.

<sup>82</sup> *Supra* note 33.

NSCC determines to be appropriate from time to time.

Section 12(e) of proposed Rule 56 would provide that if an SFT has Incremental Additional Independent Amount SFT Cash, the Transferor shall make an additional deposit to the Clearing Fund that equals the amount of the Incremental Additional Independent Amount SFT Cash for such SFT (“Independent Amount SFT Cash Deposit, and such requirement the “Independent Amount SFT Cash Deposit Requirement”). Section 12(e) would also provide that the Independent Amount SFT Cash Deposit Requirement must be satisfied in cash and may, at the discretion of NSCC, be satisfied using Independent Amount SFT Cash Deposits that have previously been made by the Transferor in respect of SFTs with the same Transferee that have since settled.<sup>83</sup> Section 12(e) would further provide that the Transferor shall satisfy any Independent Amount SFT Cash Deposit Requirement in respect of an SFT on the date that the SFT is novated to NSCC pursuant to the timeframes and deadlines established by NSCC for such purpose. In addition, Section 12(e) would provide that if, on a given day, the Transferor satisfies its Independent Amount SFT Cash Deposit Requirement for some, but not all, SFTs novated to NSCC on that day, NSCC will consider the Transferor to have satisfied its Independent Amount SFT Cash Deposit Requirement for none of the SFTs that were novated to NSCC on that day.

Section 12(f) of proposed Rule 56 would provide that each SFT Member, other than an SFT Member that is a Sponsored Member, so long as such Member is an SFT Member, shall also provide Supplemental Liquidity Deposits to the Clearing Fund, as may be required pursuant to Rule 4A. In addition, Section 12(f) would also provide that references to Clearing Fund in the other Rules shall include and apply to SFT Deposit, and references to Required Fund Deposit shall include and apply to Required SFT Deposit, unless specifically noted otherwise in proposed Rule 56 or in such other Rules.

<sup>83</sup> This could occur in a situation in which an existing SFT settles and then the Transferor enters into a new SFT with the same Transferee (e.g., in a pair off as described in Section 8 of proposed Rule 56, discussed above). In that situation, if the Transferee (or Sponsoring Member or Agent Clearing Member) has not yet called back the Independent Amount SFT Cash Deposit it posted in respect of the Settling SFT, then NSCC may apply the deposit to the Independent Amount SFT Cash Deposit obligation associated with the new SFT.

Proposed Rule 56, Section 13 (Ineligible SFT Securities and Supported Corporate Actions)

Section 13 of proposed Rule 56 would govern the processing of SFTs where the underlying securities become ineligible SFT Securities and the processing of SFTs in the context of supported corporate actions.

Specifically, Section 13(a) of proposed Rule 56 would provide that NSCC would remove an Ineligible SFT Security from the list maintained by NSCC as set forth in Rule 3 (Lists to be Maintained); provided that NSCC may not be able to identify that an SFT Security is an Ineligible SFT Security and remove such SFT Security from the list maintained by NSCC if the reason for the ineligibility is that the SFT Security is undergoing a corporate action or distribution not supported by NSCC and NSCC is not in receipt of reasonably advanced notice of such corporate action or distribution.

Section 13(b) of proposed Rule 56 would provide that notwithstanding Section 12 of proposed Rule 56, as described above, if an SFT Security becomes an Ineligible SFT Security because the Current Market Price of the SFT Security falls below the threshold established by NSCC from time to time, the Required SFT Deposit of each SFT Member party to an SFT which has such Ineligible SFT Security as its subject shall include an additional amount equal to the product of 100% of the Current Market Price of such Ineligible SFT Security and the number of such Ineligible SFT Securities that the SFT has as its subject.<sup>84</sup> The threshold that would be established by NSCC is currently \$5.00, which could be modified by NSCC<sup>85</sup> at a later date after NSCC gains more experience with the nature of the SFT portfolios submitted for clearing, as discussed above.

Section 13(c) of proposed Rule 56 would provide that if NSCC declares that an SFT Security has or would become an Ineligible SFT Security because the security is or would become ineligible for processing or is or would be undergoing a corporate action or distribution that is not supported by NSCC, the Final Settlement of all SFTs that have been novated to NSCC and have such SFT Security as their subject must occur before the Ineligibility Date.<sup>86</sup> In addition, Section 13(c) would

<sup>84</sup> If the Current Market Price of the SFT Security falls below the threshold established by NSCC from time to time, NSCC would assess the additional amount as part of the Required SFT Deposit.

<sup>85</sup> *Supra* note 23.

<sup>86</sup> The duration between the declaration and Ineligibility Date would vary. If the ineligibility is

provide that if following such declaration the Transferee does not satisfy its Final Settlement obligations in respect of any such SFT as provided in Section 7 of proposed Rule 56, as described above, by the Ineligibility Date, NSCC shall, unless NSCC has previously debited and credited the Price Differential from and to the SFT Accounts of the SFT Member parties to the SFT in accordance with Section 8 of proposed Rule 56, as described above, on Ineligibility Date, debit and credit the Price Differential from and to the SFT Accounts of the SFT Member parties to the SFT as part of its end of day final money settlement process in accordance with Rule 12 (Settlement) and Procedure VIII (Money Settlement Service).<sup>87</sup> Section 13(c) would further provide that if the Price Differential is positive, NSCC shall (x) credit an amount equal to the Price Differential to the Transferee’s SFT Account and (y) debit an amount equal to the Price Differential from the Transferor’s SFT Account. Section 13(c) would also provide that if the Price Differential is negative, NSCC shall (x) credit an amount equal to the absolute value of the Price Differential to the Transferor’s SFT Account and (y) debit an amount equal to the absolute value of the Price Differential from the Transferee’s SFT Account. Furthermore, Section 13(c) would provide that following the application of Price Differential to an Ineligible SFT on or after the relevant Ineligibility Date, all rights and obligations as between NSCC and the SFT Member parties thereto with respect to such SFT shall be discharged.

Section 13(d) of proposed Rule 56 would provide that if a corporate action supported by NSCC in respect of the SFT Securities that are the subject of an SFT is scheduled to occur, NSCC may

because the SFT Security will become ineligible for processing (*i.e.*, no longer CNS eligible), the duration would depend on the timing of the CNS ineligibility triggering event (e.g., compliance with regulatory orders, risk concerns, trading suspension, etc.).

If the ineligibility is because the SFT Security will be undergoing an unsupported corporate action or distribution, then it would depend on when the issuer of the relevant SFT Security announces the particular corporate action or distribution event and the record date for such corporate action or distribution. Specifically, when announcements from the issuers are received by DTC, DTC would announce the corporate action or distribution event. NSCC would notify Members of such event when it is announced by DTC and would generally tie the Ineligibility Date to shortly before or on the record date for the corporate action or distribution.

<sup>87</sup> NSCC is proposing this simplified process for applying Price Differentials to Ineligible SFTs because NSCC anticipates such instances would occur on a much less frequent basis than those in connection with Linked SFTs pursuant to Section 8(a) of proposed Rule 56 and Non-Returned SFTs pursuant to Section 9(a) of proposed Rule 56.

cease to permit the discharge of the SFT's Final Settlement obligations, whether pursuant to Section 8 of proposed Rule 56, as described above, or otherwise, and treat the SFT as a Non-Returned SFT for such period of time determined by NSCC as necessary to process the corporate action, except that the additional SFT Deposit required for Non-Returned SFTs under Section 12(c) of proposed Rule 56, as described above, shall not apply. Section 13(d) would further provide that notwithstanding the foregoing, NSCC shall not limit the ability of a Member to accelerate the Final Settlement of an SFT in accordance with Section 11 of proposed Rule 56, as described above, provided that any Price Differential for the SFT has settled in accordance with Section 9(a) of proposed Rule 56, as described above, and that such accelerated Final Settlement is permitted in accordance with the rules and procedures of DTC.

Proposed Rule 56, Section 14 (Cease to Act Procedures for SFT Members With Open Securities Financing Transactions)

Section 14 of proposed Rule 56 would establish NSCC's procedures for when it ceases to act for an SFT Member with open SFTs, including recalling a non-defaulting SFT Member that is a Transferee and liquidating the Defaulting SFT Member's SFT Positions by deeming NSCC to have bought in or sold out some or all the SFT Securities that are the subject of such SFTs at prevailing market price or by crossing.

Section 14(a) of proposed Rule 56 would provide that the provisions of Rule 18 (Procedures for When the Corporation Ceases to Act) shall not apply to the SFTs except for Sections 1 and 8 of Rule 18.

Section 14(b) of proposed Rule 56 would provide that if NSCC has ceased to act for an SFT Member and subject to Section 14 of proposed Rule 2C, as described above:

(i) Except as otherwise may be determined by the Board of Directors, any SFT entered into by the SFT Member that, at the time NSCC ceased to act for such SFT Member, has not been novated to NSCC pursuant to proposed Rule 56, shall be excluded from all operations of NSCC applicable to such SFT.

(ii) NSCC may decline to act upon any instructions, transaction data or notices submitted by such SFT Member or an Approved SFT Submitter on behalf of such SFT Member.

(iii) NSCC shall close-out such SFT Member's proprietary SFT Positions as well as any SFT Positions established in

the SFT Member's Agent Clearing Member Customer Omnibus Account by (x) buying in or selling out, as applicable, some or all of the SFT Securities that are the subject of each SFT of the SFT Member that has been novated to NSCC but for which the Final Settlement has not occurred, (y) deeming NSCC to have bought in or sold out some or all such SFT Securities at the bid or ask price therefor, respectively, from a generally recognized source or at such price or prices as NSCC is able to purchase or sell, respectively, some such SFT Securities, or (z) otherwise liquidating such SFT Member's SFT Positions.

(iv) Any Sponsored Member Transactions for which a Defaulting SFT Member is the Sponsoring Member and which have been novated to NSCC shall continue to be processed by NSCC. NSCC, in its sole discretion, would determine whether to close-out the SFT Positions established in a Defaulting SFT Member's Sponsored Member Sub-Accounts (if any), which close out shall be effected in accordance with the provisions of Section 14(b)(iii), as described above, or instead permit the relevant Sponsored Members to complete settlement of the relevant Sponsored Member Transactions.

(v) If, in the aggregate, the close-out of a Defaulting SFT Member's proprietary SFT Positions results in a profit to NSCC, such profit shall be applied to any loss to NSCC arising from the closing out of such Defaulting SFT Member (including losses arising from closing out the SFT Positions established in any of the Defaulting SFT Member's Agent Clearing Member Customer Omnibus Accounts or Sponsored Member Sub-Accounts or losses arising from closing out any Net Close Out Positions of the Defaulting SFT Member). If, in the aggregate, the close-out of a Defaulting SFT Member's proprietary SFT Positions results in a loss to NSCC, such loss shall be netted against, or otherwise applied to, any amounts owed by NSCC to such SFT Member in its proprietary capacity and thereafter debited from such Defaulting SFT Member's Clearing Fund deposit at NSCC.

(vi) If, in the aggregate, the close-out of the SFT Positions established in the Agent Clearing Member Customer Omnibus Accounts of a Defaulting SFT Member results in a profit to NSCC, such profit shall be credited to the Agent Clearing Member Customer Omnibus Accounts. If, in the aggregate, the close-out of the SFT Positions established in the Agent Clearing Member Customer Omnibus Accounts of a Defaulting SFT Member results in

a loss to NSCC, such loss shall be netted against, or otherwise applied to, any amounts owed by the NSCC to such SFT Member in its proprietary capacity, and thereafter debited from the Defaulting SFT Member's Clearing Fund deposit at NSCC.

(vii) If, in the aggregate, the close-out of the SFT Positions established in a Defaulting SFT Member's Sponsored Member Sub-Accounts results in a profit to NSCC, such profit shall be credited to the Sponsored Member Sub-Accounts. If, in the aggregate, the closing out of the SFT Positions established in a Defaulting SFT Member's Sponsored Member Sub-Accounts results in a loss to NSCC, such loss shall be netted against, or otherwise applied to, any amounts owed by NSCC to such SFT Member in its proprietary capacity and thereafter debited from such Defaulting SFT Member's Clearing Fund deposit at NSCC.

(viii) The Final Settlement Date of each SFT that has been novated to NSCC and that, prior to novation, was with a Defaulting SFT Member (each, a "Default-Related SFT") shall be the Business Day following the day on which NSCC ceased to act for the Defaulting SFT Member.

(ix) Until Final Settlement, each Default-Related SFT shall be treated as a Non-Returned SFT, and NSCC would pay and collect the Price Differential amounts described in Section 9(a) of proposed Rule 56, as described above. NSCC shall have all of the rights of a Transferor in relation to any Default-Related SFT in respect of which the Defaulting SFT Member was the Transferor, including the ability to deliver a Recall Notice in relation to such Default-Related SFT and to effect a Buy-In, and all of the rights of a Transferee in relation to any Default-Related SFT in respect of which the Defaulting SFT Member was the Transferee, including the ability to accelerate the scheduled Final Settlement Date of the Default-Related SFT. However, no additional SFT Deposit required for Non-Returned SFTs under Section 12(c) of proposed Rule 56, as described above, shall apply to any Default-Related SFT, and no Rate Payments shall accrue on Default-Related SFTs after the date on which NSCC ceases to act for the Defaulting SFT Member.

Proposed Rule 56, Section 15 (Sponsored Member SFT Clearing)

Section 15 of proposed Rule 56 would govern the requirements for Sponsored Member participation in the proposed SFT Clearing Service.

Section 15(a) of proposed Rule 56 would provide that a Sponsoring Member shall be permitted to submit, either directly as an Approved SFT Submitter or via another Approved SFT Submitter, to NSCC Sponsored Member Transactions between itself and its Sponsored Member in accordance with the provisions of proposed Rule 56 and proposed Rule 2C.

Section 15(b) of proposed Rule 56 would provide that NSCC shall maintain for the Sponsoring Member one or more Sponsored Member Sub-Accounts. Section 15(b) would further provide that the SFT Deposits for each Sponsored Member Sub-Account shall be calculated separately based on the SFT Positions in such Sponsored Member Sub-Account, and the Sponsoring Member, as principal, shall be required to satisfy the SFT Deposits for each of the Sponsoring Member's Sponsored Member Sub-Accounts.

Section 15(c) of proposed Rule 56 would provide that settlement of the Final Settlement, Rate Payment, Price Differential, Distribution Payment and other obligations of a Sponsored Member Transaction that have been novated to NSCC shall be effected by the Sponsoring Member, as settlement agent for the relevant Sponsored Member, crediting and debiting the account the Sponsoring Member maintains for the Sponsored Member on the Sponsoring Member's books and records.

Proposed Rule 56, Section 16 (Customer SFT Clearing)

Section 16 of proposed Rule 56 would govern the requirements for participation by Agent Clearing Members and their Customers in the proposed SFT Clearing Service.

Section 16(a) of proposed Rule 56 would provide that an Agent Clearing Member shall be permitted to submit, either directly as an Approved SFT Submitter or via another Approved SFT Submitter, to NSCC for novation SFTs that are Agent Clearing Member Transactions. Section 16(a) would further provide that any such submission shall be in accordance with proposed Rule 56 and proposed Rule 2D.

Section 16(b) of proposed Rule 56 would provide that with respect to an Agent Clearing Member that submits SFTs to NSCC for novation on behalf of its Customers, NSCC shall maintain one or more Agent Clearing Member Customer Omnibus Accounts in the name of the Agent Clearing Member for the benefit of its Customers in which all SFT Positions and SFT Cash carried by the Agent Clearing Member on behalf of its Customers are reflected; provided,

that each Agent Clearing Member Customer Omnibus Account may only contain activity where the Agent Clearing Member is acting as Transferor on behalf of its Customers, or as Transferee on behalf of its Customers, but not both.

Section 16(c) of proposed Rule 56 would provide that with respect to SFTs entered into on behalf of its Customers and maintained in the Agent Clearing Member Customer Omnibus Account, the Agent Clearing Member shall act solely as agent of its Customers in connection with the clearing of such SFTs; provided, that the Agent Clearing Member shall remain fully liable for the performance of all obligations to NSCC arising in connection with such SFTs; and provided further, that the liabilities and obligations of NSCC with respect to such SFTs entered into by the Agent Clearing Member on behalf of its Customers shall extend only to the Agent Clearing Member. Without limiting the generality of the foregoing, NSCC shall not have any liability or obligation arising out of or with respect to any SFT to any Customer of an Agent Clearing Member.

Section 16(d) of proposed Rule 56 would provide the SFT Deposits for each Agent Clearing Member Customer Omnibus Account shall be calculated separately based on the SFT Positions in such Agent Clearing Member Customer Omnibus Account, and the Agent Clearing Member shall, as principal, be required to satisfy the SFT Deposit for each of Agent Clearing Member's Agent Clearing Member Customer Omnibus Accounts.

Proposed Rule 56, Section 17 (Corporation Default)

Section 17 of proposed Rule 56 would govern the close-out netting process that would apply with respect to SFTs that have been novated to NSCC in the event of a default of NSCC.

Section 17(a) of proposed Rule 56 would provide that if a "Corporation Default" occurs pursuant to Section 2 of Rule 41 (Corporation Default), all SFTs that have been novated to NSCC but not yet settled, and all obligations and rights arising thereunder which have been assumed by NSCC pursuant to proposed Rule 56, shall be immediately terminated, and the Board of Directors shall determine the Aggregate Net SFT Close-out Value owed by or to each SFT Member with respect to each of its SFT Positions.

Section 17(b) of proposed Rule 56 would provide that for purposes of Section 17 of proposed Rule 56, a Member shall be considered a different SFT Member in respect of each of (i) its

proprietary SFT Positions; (ii) the SFT Positions established in its Agent Clearing Member Customer Omnibus Accounts (if any); and (iii) the SFT Positions established in its Sponsored Member Sub-Accounts (if any).

Section 17(c) of proposed Rule 56 would provide that each SFT Member's Aggregate Net SFT Close-out Value shall be netted and offset as described in Section 14(b)(v) through Section 14(b)(vii) of proposed Rule 56, as though NSCC had ceased to act for each SFT Member.

Section 17(d) of proposed Rule 56 would provide that the Board of Directors shall notify each SFT Member of the Aggregate SFT Close-out Value, taking into account the netting and offsetting provided for above. SFT Members that have been notified that they owe an amount to NSCC shall pay that amount on or prior to the date specified by the Board of Directors, subject to any applicable setoff rights. SFT Members who have a net claim against NSCC shall be entitled to payment thereof along with other Members' and any other creditors' claims pursuant to the underlying contracts with respect thereto, the Rules and applicable law. Section 17(d) would further provide that nothing therein shall limit the rights of NSCC upon an SFT Member default (including following a Corporation Default), including any rights under any Clearing Agency Cross-Guaranty Agreement or otherwise.

Proposed Rule 56, Section 18 (Other Applicable Rules, Procedures, and Addendums)

Section 18 of proposed Rule 56 would establish certain other Rules as being applicable to SFTs and SFT Members, unless expressly stated otherwise.

Specifically, Section 18 of proposed Rule 56 would provide that Rule 1 (Definitions and Descriptions), Rule 2 (Members, Limited Members and Sponsored Members), Rule 5 (General Provisions), Rule 12 (Settlement), Rule 13 (Exception Processing), Rule 17 (Fine Payments), Rule 19 (Miscellaneous Rights of the Corporation), Rule 21 (Honest Broker), Rule 22 (Suspension of Rules), Rule 23 (Action by the Corporation), Rule 24 (Charges for Services Rendered), Rule 26 (Bills Rendered), Rule 27 (Admission to Premises of the Corporation—Powers of Attorney, Etc.), Rule 28 (Forms), Rule 29 (Qualified Securities Depositories), Rule 32 (Signatures), Rule 33 (Procedures), Rule 34 (Insurance), Rule 35 (Financial Reports), Rule 36 (Rule Changes), Rule 37 (Hearing Procedures), Rule 38 (Governing Law and Captions), Rule 39



(Reliance on Instructions), Rule 40 (Wind-Down of a Member, Fund Member or Insurance Carrier/Retirement Services Member), Rule 41 (Corporation Default), Rule 42 (Wind-down of the Corporation), Rule 45 (Notice), Rule 47 (Interpretation of Rules), Rule 48 (Disciplinary Proceedings), Rule 49 (Release of Clearing Data and Clearing Fund Data), Rule 55 (Settling Banks and AIP Settling Banks), Rule 58 (Limitations on Liability), Rule 60 (Market Disruption and Force Majeure), Rule 60A (Systems Disconnect: Threat of Significant Impact to the Corporation's Systems), Rule 63 (SRO Regulatory Reporting), Procedure I (Introduction), Procedure VIII (Money Settlement Service), Procedure XII (Time Schedule), Procedure XIII (Definitions), Procedure XIV (Forms, Media and Technical Specifications), Procedure XV (Clearing Fund Formula and Other Matters), Addendum B (Qualifications and Standards of Financial Responsibility, Operational Capability and Business History), Addendum H (Interpretation of the Board of Directors Release of Clearing Data), Addendum L (Statement of Policy Pertaining to Information Sharing), and Addendum P (Fine Schedule) shall apply to SFTs and SFT Members, unless the context otherwise requires.

#### (D) Other Rule Changes

In connection with proposed Rules 2C, 2D and 56, NSCC is also proposing to make conforming and technical changes to the following Rules to accommodate the proposed introduction of the new membership categories and the proposed SFT Clearing Service.

##### Rule 1 (Definitions and Descriptions)

In connection with proposed Rules 2C, 2D and 56, NSCC is proposing to add the following defined terms to Rule 1, in alphabetical order: Agent Clearing Member, Agent Clearing Member Agreement, Agent Clearing Member Customer Omnibus Account, Agent Clearing Member Required Fund Deposit, Agent Clearing Member Termination Date, Agent Clearing Member Transaction, Agent Clearing Member Voluntary Termination Notice, Aggregate Net SFT Close-out Value, Approved SFT Submitter, Bilaterally Initiated SFT, Buy-In, Buy-In Amount, Buy-In Costs, Buy-In Indemnified Parties, Contract Price, Corresponding SFT Cash, Customer, Customer Clearing Service, Deemed Buy-In Costs, Defaulting SFT Member, Default-Related SFT, Distribution, Distribution Amount, Distribution Payment, Existing Master Agreement, Final Net Settlement Position, Final Settlement, Final

Settlement Date, Former Sponsored Member, Incremental Additional Independent Amount SFT Cash, Independent Amount Percentage, Independent Amount SFT Cash, Independent Amount SFT Cash Deposit, Independent Amount SFT Cash Deposit Requirement, Ineligibility Date, Ineligible SFT, Ineligible SFT Security, Initial Settlement, Linked SFT, Market Value SFT Cash, Net Capital, Net Member Capital, Net Worth, Non-Returned SFT, Price Differential, Rate Payment, Recall Date, Recall Notice, Recalled SFT, Required SFT Deposit, Securities Financing Transaction or SFT, Securities Financing Transaction Clearing Service or SFT Clearing Service, Settling SFT, SFT Account, SFT Cash, SFT Close-out Value, SFT Deposit, SFT Long Position, SFT Member, SFT Position, SFT Security, SFT Short Position, Sponsored Member, Sponsored Member Agreement, Sponsored Member Liquidation Amount, Sponsored Member Sub-Account, Sponsored Member Termination Date, Sponsored Member Transaction, Sponsored Member Voluntary Termination Notice, Sponsoring Member, Sponsoring Member Agreement, Sponsoring Member Guaranty, Sponsoring Member Liquidation Amount, Sponsoring Member Required Fund Deposit, Sponsoring Member Settling Bank Omnibus Account, Sponsoring Member Termination Date, Sponsoring Member Voluntary Termination Notice, Sponsoring/Sponsored Membership Program Indemnified Parties or SMP Indemnified Parties, Transferee, Transferor and Volatility Charge.

In addition, NSCC is proposing to add three defined terms: "CNS Market Value", which is already defined in Rule 41 (Corporation Default), "CNS Transaction", which is already defined in Rule 11 (CNS System), and "Corporation Default", which is already defined in Rule 41 (Corporation Default).

NSCC is also proposing to add the defined term "FICC" to mean Fixed Income Clearing Corporation. The term "FICC" is already used in Addendum P (Fine Schedule) but has not been defined.

Furthermore, NSCC is proposing to reorder the defined term Index Receipt Agent so it would be in alphabetical order.

In connection with proposed Rules 2C, 2D and 56, NSCC is also proposing to modify the definitions for the following defined terms in Rule 1, in alphabetical order: Clearing Fund, FFI Member, Qualified Securities Depository, and Required Fund Deposit.

Specifically, NSCC is proposing to expand the definition of Clearing Fund to include SFT Deposit, unless noted otherwise in the Rules. NSCC is also proposing to revise the definition of FFI Member and the definition of Tax Certification<sup>88</sup> to add references to Sponsored Members. Furthermore, NSCC is proposing to revise the definition of Qualified Securities Depository to include a reference to transfer of securities in respect of the proposed SFT Clearing Service. Lastly, NSCC is proposing to expand the definition of Required Fund Deposit to include Sponsoring Member Required Fund Deposit, the Agent Clearing Member Required Fund Deposit, and the Required SFT Deposit, unless noted otherwise in the Rules.

##### Rule 2 (Members and Limited Members)

NSCC is proposing to revise the title of Rule 2 to include a reference to Sponsored Members. As proposed, Rule 2 would be retitled as "Members, Limited Members and Sponsored Members".

NSCC is also proposing to revise Section 2 of Rule 2. Specifically, NSCC is proposing to clarify in Section 2(i) that a Member shall include a Member in its capacity as a Sponsoring Member to the extent specified in proposed Rule 2C and an Agent Clearing Member to the extent specified in proposed Rule 2D. In addition, NSCC is proposing to add a new subsection (iii) to Section 2 that would describe Sponsored Members as any Person that has been approved by NSCC to become a Sponsored Member and only participates in NSCC's SFT Clearing Service as provided for in proposed Rule 56. In addition, NSCC is proposing to add references to Sponsored Members in the last paragraph of Section 2, Sections 4(i) and 4(ii).

##### Rule 2B (Ongoing Membership Requirements and Monitoring)

NSCC is proposing to add references to Sponsored Member in Section 5<sup>89</sup> of Rule 2B.

##### Rule 3 (Lists To Be Maintained)

NSCC is proposing to add subsection (g) to Section 1 of Rule 3 to provide that NSCC shall maintain a list of the securities that may be the subject of a

<sup>88</sup> NSCC recently added Tax Certification as a defined term in Rule 1 (Definitions and Descriptions). See Securities Exchange Act Release No. 92682 (August 17, 2021), 86 FR 47172 (August 23, 2021) (SR-NSCC-2021-009).

<sup>89</sup> NSCC recently added Section 5 to Rule 2B (Ongoing Membership Requirements and Monitoring). See Securities Exchange Act Release No. 93278 (October 8, 2021), 86 FR 57229 (October 14, 2021) (SR-NSCC-2021-007).



novated SFT and may from time to time add securities to such list or remove securities therefrom.

NSCC is also proposing to modify Sections 3(b) and 4 of Rule 3 to include references to Sponsored Members.

#### Rule 4 (Clearing Fund)

NSCC is proposing to modify Section 1 of Rule 4 in order to make it clear that the minimum Required Fund Deposit amount provided therein shall not include Required SFT Deposit, which is subject to a separate minimum \$250,000 deposit requirement pursuant to Section 12(c) of proposed Rule 56, as described above.

#### Rule 5 (General Provisions)

NSCC is proposing to modify Section 1 of Rule 5 in order to provide that delivery of SFT Securities and SFT Cash to NSCC shall be made through the facilities of a Qualified Securities Depository. In addition, NSCC is also proposing changes in Section 1 of Rule 5 to provide that delivery and payment with respect to SFT Securities and SFT Cash shall be effected as prescribed in the Rules and regulations as NSCC may from time to time adopt.

#### Rule 24 (Charges for Services Rendered)

NSCC is proposing to modify Section 1 of Rule 24 to include a reference to Sponsored Members. In addition, NSCC is proposing to add an additional paragraph in Section 1 to clarify that Members shall be responsible for all fees pertaining to their respective Sponsoring Member activity or Agent Clearing Member activity, if applicable, as set forth in NSCC's Fee Structure.<sup>90</sup>

#### Rule 26 (Bills Rendered)

NSCC is proposing to modify the first paragraph of Rule 26 to include a reference to Sponsored Members. In addition, NSCC is proposing to add a sentence in that paragraph to clarify that Members shall receive bills for their respective aggregate Sponsoring Member activity and Agent Clearing Member activity, if applicable, as set forth in NSCC's Fee Structure.<sup>91</sup>

#### Rule 32 (Signatures)

NSCC is proposing to modify Rule 32 to include a reference to Sponsored Member. Specifically, NSCC is proposing to modify Rule 32 to provide that the use of an electronic signature shall have the same validity and effect as the use of a signature affixed by hand with respect to any and all agreements and other documents entered into

between a Sponsored Member and NSCC.

#### Rule 38 (Governing Law and Captions)

NSCC is proposing to modify Section 1 of Rule 38 to include a reference to Sponsored Member. Specifically, NSCC is proposing to modify Section 1 of Rule 38 to provide that Rules and all agreements and other documents entered into between a Sponsored Member and NSCC or otherwise delivered to or by NSCC pursuant to the Rules, and the rights and obligations under the Rules thereunder, shall be governed by, and construed in accordance with, the laws of the State of New York applicable to contracts executed and performed therein, unless otherwise provided.

#### Rule 39 (Reliance on Instructions)

NSCC is proposing to modify Rule 39 to include references to Sponsored Member and Approved SFT Submitter, where applicable. Specifically, NSCC is proposing to modify the first paragraph of Rule 39 to provide that NSCC may accept or rely upon instructions given to NSCC by a Sponsored Member or Approved SFT Submitter, in addition to the various participant types currently provided in Rule 39. Similarly, NSCC is proposing to add references to Approved SFT Submitter in the second and last paragraphs of Rule 39 so that those paragraphs would also apply to instructions submitted by an Approved SFT Submitter.

#### Rule 42 (Wind-Down of the Corporation)

NSCC is proposing to modify Rule 42 to include references to Sponsored Members. Specifically, for purposes of Rule 42, NSCC is proposing to revise the defined term "Limited Member" to include Sponsored Members.

#### Rule 49 (Release of Clearing Data and Clearing Fund Data)

NSCC is proposing to modify Rule 49 to clarify that NSCC would release Clearing Data of a Sponsored Member to its Sponsoring Member upon the Sponsoring Member's written request. Specifically, as proposed, Section (a) of Rule 49 would provide that if the participant is a Sponsored Member, NSCC would also release Clearing Data relating to transactions of such participant to such participant's Sponsoring Member upon the Sponsoring Member's written request.

#### Rule 58 (Limitations on Liability)

NSCC is proposing to modify Rule 58 to clarify that NSCC would not be responsible for the completeness or

accuracy of the transaction data received from the Approved SFT Submitters, nor shall NSCC, absent gross negligence on NSCC's part, be responsible for any errors, omissions or delays that may occur in the transmission of transaction data from an Approved SFT Submitter.

#### Rule 64 (DTCC Shareholders Agreement)

The proposed changes to Section 4 of Rule 64 and footnote 4 thereto would provide that Rule 64 would not be applicable to a Sponsored Member. However, if the Sponsored Member is also a member or participant of another clearing agency subsidiary of DTCC, the Sponsored Member may be a Mandatory Purchaser Participant or a Voluntary Purchaser Participant pursuant to the terms of the Shareholders Agreement and the rules and procedures of such other subsidiary.

#### Procedure XV (Clearing Fund Formula and Other Matters)

NSCC is proposing to modify subsection A of Section II (Minimum Clearing Fund and Additional Deposit Requirements) in Procedure XV in order to make it clear that the minimum contribution amount provided therein shall not include Required SFT Deposit, which is subject to a separate minimum \$250,000 deposit requirement pursuant to Section 12(c) of proposed Rule 56, as described above. In addition, NSCC is proposing to modify Section II.A of Procedure XV to make it clear that calculation of a Member's Required Fund Deposit amount that must be in cash shall exclude the Required SFT Deposit, which is subject to a separate \$250,000 minimum cash requirement pursuant to Section 12(c) of proposed Rule 56, as described above.

#### Addendum B (Qualifications and Standards of Financial Responsibility, Operational Capability and Business History)

NSCC is proposing an additional section for the Sponsored Members. Specifically, NSCC is proposing to add Section 12 to Addendum B that would describe the qualification and operational capability that NSCC would require from Sponsored Members.

In addition, NSCC is proposing a conforming change to replace "net worth" in Section 3.B.4. with "Net Worth" to reflect the proposed defined term in Rule 1 (Definitions).

#### Addendum P (Fine Schedule)

NSCC is proposing to modify paragraph (2) of Addendum P to reflect the proposed notification obligations of

<sup>90</sup> See Addendum A (Fee Structure), *supra* note 4.

<sup>91</sup> *Id.*

Sponsoring Members, Sponsored Members and Agent Clearing Members as proposed under Sections 2(i) and 3(d) of proposed Rule 2C and Section 2(i) of proposed Rule 2D.

(vii) Impact of the Proposed SFT Clearing Service on Various Persons

The proposed SFT Clearing Service would be voluntary. Institutional firm clients that wish to become Sponsored Members, and Members that wish to participate in the proposed SFT Clearing Service would have an opportunity to review the proposed rule change and determine if they would like to participate. Choosing to participate would make these entities subject to all of the rule changes that would be applicable to the proposed SFT Clearing Service and membership type, as described below.

The proposed SFT Clearing Service would affect institutional firm clients that choose to become Sponsored Members because it would impose various requirements on them. These requirements include, but are not limited to, proposed Rule 56 and the following sections of proposed Rule 2C: (1) Eligibility, approval process and ongoing membership requirements as specified in Sections 3 and 4, (2) requirements related to restriction on access to NSCC services in Section 11, (3) requirements related to insolvency of a Sponsored Member in Section 13, and (4) requirements related to liquidation of positions resulting from Sponsored Member Transactions in Section 14. Specific details on the requirements and the manner in which the proposed SFT Clearing Service would affect institutional firm clients that choose to become Sponsored Members can be found above in Item II(A)1(vi)(A)—Proposed Rule Changes—Proposed Rule 2C—Sponsoring Members and Sponsored Members.

The proposed SFT Clearing Service would affect Members that choose to participate in the service because it would impose various requirements on them, depending on whether they are participating in the service as a Sponsoring Member, an Agent Clearing Member and/or as a Member. These requirements include, but are not limited to, the requirements specified in proposed Rule 2C for Members participating in the service as a Sponsoring Member; the requirements specified in proposed Rule 2D for Members participating in the service as an Agent Clearing Member; and for all Members participating in the service, the requirements specified in proposed Rule 56. Specific details on these requirements and the manner in which

the proposed SFT Clearing Service would affect Members that choose to participate in the proposed SFT Clearing Service are described above in Sections 3(a)(vi)(A)—Proposed Rule Changes—Proposed Rule 2C—Sponsoring Members and Sponsored Members, (vi)(B)—Proposed Rule Changes—Proposed Rule 2D—Agent Clearing Members, and (vi)(C)—Proposed Rule Changes—Proposed Rule 56—Securities Financing Transaction Clearing Service.

The proposed SFT Clearing Service would not materially affect existing Members that do not choose to participate in it. First, the proposed SFT Clearing Service would not materially affect the operation of CNS or any other services offered by NSCC. In addition, SFT Members would be subject to the same or higher credit standards and market risk management requirements as those applicable to Members that choose not to participate in the proposed SFT Clearing Service, as described above. Moreover, although Members who choose not to participate in the proposed SFT Clearing Service would be subject to potential loss allocation in the event of an SFT Member default (just as SFT Members would be subject to potential loss allocation in the event of the default of a Member that chooses not to participate in the proposed SFT Clearing Service), the underlying securities that would be subject of any such default-related liquidation of an SFT Member are a subset of the same CNS-eligible securities with respect to which NSCC today guarantees settlement in the cash equity market, thus not materially affecting the nature of the loss allocation risk applicable to Members.

## 2. Statutory Basis

NSCC believes this proposal is consistent with the requirements of the Act, and the rules and regulations thereunder applicable to a registered clearing agency for the reasons described below.

### Establishing New Membership Categories and Requirements for Sponsoring Members and Sponsored Members

NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members are consistent with Section 17A(b)(3)(F)<sup>92</sup> of the Act and Rule 17Ad-22(e)(18),<sup>93</sup> as promulgated under the Act.

<sup>92</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>93</sup> 17 CFR 240.17Ad-22(e)(18).

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and settlement of securities transactions.<sup>94</sup> NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members are consistent with these requirements for the reasons described below.

### Safeguarding of Securities and Funds

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.<sup>95</sup> NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would allow NSCC to help assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible. Specifically, as proposed, all Sponsoring Member applicants would be subject to an approval process that is separate from their original Member applications, ongoing credit surveillance in their capacity as Sponsoring Members, as well as the calculation of the Sponsoring Member Required Fund Deposits on a gross basis with no offsets for netting of positions as between different Sponsored Members.

In addition, as proposed, all Sponsoring Member applicants would be subject to the same or higher financial requirements as those that apply to them with respect to their respective Member category. Furthermore, NSCC would reserve the right to impose greater financial requirements based upon the level of the anticipated positions and obligations of such applicant, the anticipated risk associated with the volume and types of transactions such applicant proposes to process through NSCC, and the overall financial condition of such applicant. An activity limit would also be imposed on a Sponsoring Member's Sponsored

<sup>94</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>95</sup> *Id.*

Member activity so that the Sponsoring Member would only be permitted to submit new Sponsored Member activity to NSCC to the extent its aggregate Volatility Charges do not exceed its Net Member Capital, unless otherwise determined by NSCC in order to promote orderly settlement.

Moreover, as proposed, NSCC would reserve the right to require each Sponsoring Member, or any Member applicant to become such, to furnish to NSCC such adequate assurances of its financial responsibility and operational capability within the meaning of Rule 15 as NSCC may at any time or from time to time deem necessary or advisable in order to protect NSCC, its participants, creditors or investors, to safeguard securities and funds in the custody or control of NSCC and for which NSCC is responsible, or to promote the prompt and accurate clearance, settlement and processing of securities transactions.

By structuring the proposal in a way that addresses potential market and credit risks, NSCC believes that the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible, consistent with Section 17A(b)(3)(F) of the Act.<sup>96</sup>

Remove Impediments to and Perfect the Mechanism of a National System; Protect Investors and Public Interest

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, and, in general, to protect investors and the public interest.<sup>97</sup> NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would allow NSCC to help remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions and, in general, to protect investors and the public interest.

Specifically, NSCC believes the proposal would help alleviate capital constraints and decrease settlement and operational risk that market participants would otherwise face. This is because the proposal would expand access to

central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty. As described above, NSCC believes that having securities transactions cleared through a central counterparty may create capital benefits for market participants and thereby help alleviate capital constraints otherwise applicable to bilateral securities transactions. In addition, by having a greater number of securities transactions cleared through a central counterparty, the proposal would decrease the settlement and operational risks that market participants would otherwise face to the extent they were required to clear and settle their securities transactions bilaterally because those securities transactions would be subject to novation and independent risk management by the central counterparty. By alleviating capital constraints and decreasing settlement and operational risk that market participants would otherwise face, NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would remove impediments to and 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.<sup>98</sup>

The proposal would also protect investors and the public interest by lowering the risk of liquidity drain and protecting against fire sale risks as it would expand access to central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty. Specifically, NSCC believes that having securities transactions cleared and settled by a central counterparty would lower the risk of liquidity drain in the U.S. financial market by lessening counterparties' likely inclination to unwind transactions in a stressed market scenario. The central counterparty would use its risk management resources to provide confidence to market participants that they will receive back their cash or securities, as applicable, which should limit the propensity for market participants to seek to unwind their transactions in a stressed market scenario. In addition, NSCC believes that having securities transactions cleared and settled by a central counterparty would protect against fire sale risk through the central

counterparty's ability to centralize and control the hedging and liquidation of a defaulting counterparty's portfolio. By lowering the risk of liquidity drain in the U.S. financial market and protecting against fire sale risk, NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would protect investors and the public interest, consistent with the Section 17(A)(b)(3)(F) of the Act.<sup>99</sup>

Promote Prompt and Accurate Clearance and Settlement

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>100</sup> NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would allow NSCC to help promote the prompt and accurate clearance and settlement of securities transactions. Specifically, by expanding the access of central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty, NSCC believes the proposal would help decrease settlement and operational risk that market participants would otherwise face to the extent they were required to clear and settle their securities transactions bilaterally because those securities transactions would be subject to novation and independent risk management by the central counterparty. By decreasing settlement and operational risk, NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would promote the prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.<sup>101</sup>

By structuring the proposal in a way that would allow NSCC to help (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

settlement of securities transactions, NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members are consistent with Section 17A(b)(3)(F) of the Act.<sup>102</sup>

Rule 17Ad-22(e)(18) under the Act requires, in part, that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to establish objective, risk-based, and publicly disclosed criteria for participation.<sup>103</sup> NSCC believes the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members would establish objective, risk-based, and publicly disclosed criteria for participation in NSCC as Sponsoring Members and Sponsored Members. Specifically, as proposed, in order for an applicant to become a Sponsoring Member, the applicant would be required to satisfy a number of objective and risk-based eligibility criteria. First, the applicant must be a Member. In addition, if the applicant is a Registered-Broker-Dealer, then it would be required to have (i) Net Worth of at least \$25 million and (ii) excess net capital over the minimum net capital requirement imposed by the SEC (or such higher minimum capital requirement imposed by the applicant's designated examining authority) of at least \$10 million. Likewise, in order for an applicant to become a Sponsored Member, the applicant would be required to meet certain objective, risk-based eligibility criteria. Specifically, an applicant would be eligible to apply to become a Sponsored Member if it is either a "qualified institutional buyer" as defined by Rule 144A<sup>104</sup> under the Securities Act,<sup>105</sup> or a legal entity that, although not organized as an entity specifically listed in paragraph (a)(1)(i)(H) of Rule 144A under the Securities Act, satisfies the financial requirements necessary to be a "qualified institutional buyer" as specified in that paragraph. If approved, the requirements for proposed new Sponsoring Member and Sponsored Member membership categories would become part of the Rules, which are publicly available on DTCC's website ([www.dtcc.com](http://www.dtcc.com)), and market participants would be able to review them in connection with their evaluation of potential participation in NSCC as Sponsoring Members and

Sponsored Members. Therefore, NSCC believes that the proposed changes to establish new membership categories and requirements for Sponsoring Members and Sponsored Members are consistent with Rule 17Ad-22(e)(18) under the Act.<sup>106</sup>

#### Establishing a New Membership Category and Requirements for Agent Clearing Members

NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members are consistent with Section 17A(b)(3)(F)<sup>107</sup> of the Act and Rule 17Ad-22(e)(18),<sup>108</sup> as promulgated under the Act.

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and settlement of securities transactions.<sup>109</sup> NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members are consistent with these requirements for the reasons described below.

#### Safeguarding of Securities and Funds

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.<sup>110</sup> NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would allow NSCC to help assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible. Specifically, as proposed, all Agent Clearing Member applicants would be subject to an approval process that is separate from their original Member applications, ongoing credit surveillance in their capacity as Agent Clearing Members, as well as the calculation of the Agent Clearing Member Required Fund Deposits on a gross basis with no offsets for netting of

positions as between different Customers.

In addition, as proposed, all Agent Clearing Member applicants would be subject to the same or higher financial requirements as those that apply to them with respect to their respective Member category. Furthermore, NSCC would reserve the right to impose greater financial requirements based upon the level of the anticipated positions and obligations of such applicant, the anticipated risk associated with the volume and types of transactions such applicant proposes to process through NSCC, and the overall financial condition of such applicant. An activity limit would also be imposed on an Agent Clearing Member's Customer activity so that the Agent Clearing Member would only be permitted to submit new Customer activity to NSCC to the extent its aggregate Volatility Charges do not exceed its Net Member Capital, unless otherwise determined by NSCC in order to promote orderly settlement.

Moreover, as proposed, NSCC would reserve the right to require each Agent Clearing Member, or any Member applicant to become such, to furnish to NSCC such adequate assurances of its financial responsibility and operational capability within the meaning of Rule 15 as NSCC may at any time or from time to time deem necessary or advisable in order to protect NSCC, its participants, creditors or investors, to safeguard securities and funds in the custody or control of NSCC and for which NSCC is responsible, or to promote the prompt and accurate clearance, settlement and processing of securities transactions.

By structuring the proposal in a way that addresses potential market and credit risks, NSCC believes that the proposed changes to establish a new membership category and requirements for Agent Clearing Members would assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible, consistent with Section 17A(b)(3)(F) of the Act.<sup>111</sup>

#### Remove Impediments to and Perfect the Mechanism of a National System; Protect Investors and Public Interest

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, and, in general, to protect

<sup>102</sup> *Id.*

<sup>103</sup> 17 CFR 240.17Ad-22(e)(18).

<sup>104</sup> 17 CFR 230.144A.

<sup>105</sup> 15 U.S.C. 77a *et seq.*

<sup>106</sup> 17 CFR 240.17Ad-22(e)(18).

<sup>107</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>108</sup> 17 CFR 240.17Ad-22(e)(18).

<sup>109</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

investors and the public interest.<sup>112</sup> NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would allow NSCC to help remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions and, in general, to protect investors and the public interest.

Specifically, NSCC believes the proposal would help alleviate capital constraints and decrease settlement and operational risk that market participants would otherwise face. This is because the proposal would expand access to central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty. As described above, NSCC believes that having securities transactions cleared through a central counterparty may create capital benefits for market participants and thereby help alleviate capital constraints otherwise applicable to bilateral securities transactions. In addition, by having a greater number of securities transactions cleared through a central counterparty, the proposal would decrease the settlement and operational risks that market participants would otherwise face to the extent they were required to clear and settle their securities transactions bilaterally because those securities transactions would be subject to novation and independent risk management by the central counterparty. By alleviating capital constraints and decreasing settlement and operational risk that market participants would otherwise face, NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would remove impediments to and 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.<sup>113</sup>

The proposal would also protect investors and the public interest by lowering the risk of liquidity drain and protecting against fire sale risks as it would expand access to central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty. Specifically, NSCC believes that having securities transactions cleared and settled by a central counterparty would lower the risk of liquidity drain in the U.S.

financial market by lessening counterparties' likely inclination to unwind transactions in a stressed market scenario. The central counterparty would use its risk management resources to provide confidence to market participants that they will receive back their cash or securities, as applicable, which should limit the propensity for market participants to seek to unwind their transactions in a stressed market scenario. In addition, NSCC believes that having securities transactions cleared and settled by a central counterparty would protect against fire sale risk through the central counterparty's ability to centralize and control the hedging and liquidation of a defaulting counterparty's portfolio. By lowering the risk of liquidity drain in the U.S. financial market and protecting against fire sale risk, NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would protect investors and the public interest, consistent with the Section 17(A)(b)(3)(F) of the Act.<sup>114</sup>

#### Promote Prompt and Accurate Clearance and Settlement

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>115</sup> NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would allow NSCC to help promote the prompt and accurate clearance and settlement of securities transactions. Specifically, by expanding the access of central clearing for institutional firms and thus enable a greater number of securities transactions to be cleared and settled by a central counterparty, NSCC believes the proposal would help decrease settlement and operational risk that market participants would otherwise face to the extent they were required to clear and settle their securities transactions bilaterally because those securities transactions would be subject to novation and independent risk management by the central counterparty. By decreasing settlement and operational risk, NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members would promote the prompt and accurate clearance and settlement of securities

transactions, consistent with Section 17A(b)(3)(F) of the Act.<sup>116</sup>

By structuring the proposal in a way that would allow NSCC to help (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and settlement of securities transactions, NSCC believes the proposed changes to establish a new membership category and requirements for Agent Clearing Members are consistent with Section 17A(b)(3)(F) of Act.<sup>117</sup>

Rule 17Ad-22(e)(18) under the Act requires, in part, that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to establish objective, risk-based, and publicly disclosed criteria for participation.<sup>118</sup> NSCC believes the proposed changes to establish new a membership category and requirements for Agent Clearing Members would establish objective, risk-based, and publicly disclosed criteria for participation in NSCC as Agent Clearing Members. Specifically, as proposed, in order for an applicant to become an Agent Clearing Member, the applicant would be required to satisfy a number of objective and risk-based eligibility criteria. First, the applicant must be a Member. In addition, if the applicant is a Registered-Broker-Dealer, then it would be required to have (i) Net Worth of at least \$25 million and (ii) excess net capital over the minimum net capital requirement imposed by the SEC (or such higher minimum capital requirement imposed by the applicant's designated examining authority) of at least \$10 million. If approved, the requirements for proposed new Agent Clearing Member membership category would become part of the Rules, which are publicly available on DTCC's website ([www.dtcc.com](http://www.dtcc.com)), and market participants would be able to review them in connection with their evaluation of potential participation in NSCC as Agent Clearing Members. Therefore, NSCC believes that the proposed changes to establish a new membership category and requirements for Agent Clearing Members are

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> 17 CFR 240.17Ad-22(e)(18).

consistent with Rule 17Ad-22(e)(18) under the Act.<sup>119</sup>

#### Establishing the SFT Clearing Service

NSCC believes the proposed changes to establish the SFT Clearing Service are consistent with Section 17A(b)(3)(F)<sup>120</sup> of the Act and Rules 17Ad-22(e)(7) and (8),<sup>121</sup> as promulgated under the Act.

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and settlement of securities transactions.<sup>122</sup> NSCC believes the proposed changes to establish the SFT Clearing Service are consistent with these requirements for the reasons described below.

#### Safeguarding of Securities and Funds

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible.<sup>123</sup> NSCC believes that the proposed changes to establish the SFT Clearing Service would allow NSCC to help assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible.

The proposal is structured in a manner that allows NSCC to protect itself from associated market risk. Specifically, as described above, except with respect to the VaR charge, SFT activity would be risk managed by NSCC in a manner consistent with Members' CNS positions. Moreover, except with respect to the MLA charge, all SFT Positions would be margined independently of the Member's other positions, *i.e.*, Required SFT Deposit. The Required SFT Deposit would generally be calculated using the same procedure applicable to CNS positions, but with a separate \$250,000 minimum.<sup>124</sup>

Moreover, consistent with the manner in which clearing fund requirements are satisfied by members of FICC for their cleared securities financing

transactions, NSCC would require that (i) a minimum of 40% of an SFT Member's Required SFT Deposit consist of a combination of cash and Eligible Clearing Fund Treasury Securities and (ii) the lesser of \$5,000,000 or 10% of an SFT Member's Required SFT Deposit (but not less than \$250,000) consist of cash.<sup>125</sup> NSCC would also have the discretion to require a Member to post its Required SFT Deposit in proportion of cash higher than would otherwise be required.<sup>127</sup> NSCC's determination to impose any such requirement would be made in view of market conditions and other financial and operational capabilities of the relevant SFT Member.

Furthermore, NSCC would require additional Clearing Fund deposits to address two situations that may present unique risk. First, if the share price of underlying securities of an SFT that has already been novated to NSCC falls below the threshold established by NSCC from time to time, NSCC would require both pre-novation counterparties to the SFT to post Clearing Fund equal to 100% of the market value of such underlying securities until such time as the per share price of the underlying securities equals or exceeds such threshold.<sup>128</sup> Second, in the event an SFT is subject to a collateral haircut (*i.e.*, the SFT Cash exceeds the market value of the securities), NSCC would require the Transferor (or in the case of an Agent Clearing Member Transaction, the Agent Clearing Member) to post Clearing Fund equal to such excess.<sup>129</sup>

Additionally, the Sponsoring Member Required Fund Deposits and Agent Clearing Member Required Fund Deposits would each be calculated on a gross basis, and no offsets for netting of positions as between different Sponsored Members or different Customers, as applicable, would be permitted. Moreover, any Member that opts to apply to become a Sponsoring Member or an Agent Clearing Member would be subject to an activity limit (as described above).

NSCC is also proposing to limit the SFTs eligible for clearing to overnight transactions on securities that are CNS-eligible equity securities with a share price that equals or exceeds the threshold established by NSCC from time to time and that are fully collateralized by cash. NSCC believes these limitations, in addition to the Clearing Fund requirements, would

limit the potential market risk associated with SFTs.

The proposal is also structured in a manner that allows NSCC to protect itself from associated liquidity risk. Specifically, the proposal would provide that the Final Settlement obligations and Price Differential of each SFT, other than a Sponsored Member Transaction, that is novated to NSCC would settle RVP/DVP at DTC.<sup>130</sup> SFT deliver orders would be processed in accordance with DTC's rules and procedures, including provisions relating to risk controls. Therefore each DTC participant's Final Settlement obligation would complete at DTC on a fully collateralized basis, and the associated debit (if any) would be subject to DTC's risk controls.

To the extent the Price Differential is not processed by DTC, for example if a receiver does not satisfy DTC's risk controls, NSCC would debit and credit the Price Differential from and to the SFT Accounts of the SFT Member parties to the SFT as part of its end of day final money settlement.

In the event NSCC ceases to act for a Defaulting SFT Member, on the Business Day that NSCC ceased to act, NSCC's daily liquidity need calculation would include all Price Differential debits owed by the Defaulting SFT Member not processed at DTC. On subsequent days of the liquidation of the Defaulting SFT Member's SFT Positions, NSCC's total liquidity need calculations would include all novated SFT activity that has not reached Final Settlement on the Business Day NSCC ceased to act, netted together with all other outstanding settlement activity of the Defaulting SFT Member at NSCC.

Until NSCC has satisfied the Final Settlement obligations owing to non-defaulting SFT Members, NSCC would continue paying to and receiving from non-defaulting SFT Members the applicable Price Differential (*i.e.*, the change in market value of the relevant securities) with respect to their novated SFTs.<sup>131</sup> NSCC would take into account such Price Differential payment obligations, as well as any Final Settlement obligations to non-defaulting SFT Members, when calculating the amount of liquidity resources that NSCC may require in the event of the default of the participant family that would generate the largest aggregate payment obligation for NSCC in extreme but plausible market conditions.<sup>132</sup> <sup>133</sup> By

<sup>119</sup> *Id.*

<sup>120</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>121</sup> 17 CFR 240.17Ad-22(e)(7) and (8).

<sup>122</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>123</sup> *Id.*

<sup>124</sup> See Section 12(c) of proposed Rule 56.

<sup>125</sup> *Supra* note 34.

<sup>126</sup> *Supra* note 35.

<sup>127</sup> See Section 12(d) of proposed Rule 56.

<sup>128</sup> See Section 13(b) of proposed Rule 56.

<sup>129</sup> See Section 12(e) of proposed Rule 56.

<sup>130</sup> *Supra* note 27.

<sup>131</sup> See proposed Rule 56, Section 14(b)(ix).

<sup>132</sup> *Id.*

<sup>133</sup> 17 CFR 240.17Ad-22(e)(7).

continuing to process these Payment Differential payments until Final Settlement occurs, NSCC would ensure that non-defaulting SFT Members are kept in largely the same position as if the Defaulting SFT Member had not defaulted and the pre-novation counterparties had instead agreed to roll the SFTs. This is because even though the non-payment of the Rate Payment in an SFT Member default context may have an impact on non-defaulting SFT Members, such impact is generally de minimis. To the extent NSCC is required to pay a Price Differential, as well as any Final Settlement obligations, to a non-defaulting SFT Member, NSCC would rely on NSCC's liquidity resources, including the Required SFT Deposit and any SLD that may be collected, when applicable, in order to cover the liquidity need associated with any such Price Differential and Final Settlement obligations, consistent with the Clearing Agency Liquidity Risk Management Framework.<sup>134</sup>

The proposal is also structured in a manner that allows NSCC to protect itself from associated credit risk. In addition to the Clearing Fund requirements discussed above, any Member that elects to participate in the proposed SFT Clearing Service would be subject to the same initial membership requirements and ongoing membership requirements and monitoring as any other Member. Moreover, any Member that opts to apply to become a Sponsoring Member or an Agent Clearing Member would be subject to an activity limit (as described above) in addition to an approval process that is separate from its original Member applications, as well as ongoing credit surveillance in its capacity as a Sponsoring Member or Agent Clearing Member, as applicable.

The proposal is also structured in a manner that allows NSCC to protect itself from associated operational risk. NSCC proposes to utilize to a significant extent the same processes and infrastructure as it has used for many years to clear and settle cash market transactions for purposes of clearing and settling SFTs. NSCC staff is well versed in such processes and infrastructure and has been actively involved in the development of the proposed SFT Clearing Service, thereby allowing for ready integration of support for the proposed SFT Clearing Service into NSCC staff's current workflows.

By structuring the proposal in a way that addresses potential market, liquidity, credit and operational risks, NSCC believes that the proposed

changes to establish the SFT Clearing Service would help assure the safeguarding of securities and funds which are in the custody or control of NSCC or for which it is responsible, consistent with Section 17A(b)(3)(F) of the Act.<sup>135</sup>

Remove Impediments to and Perfect the Mechanism of a National System; Protect Investors and Public Interest

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, and, in general, to protect investors and the public interest.<sup>136</sup> NSCC believes the proposed changes to establish the SFT Clearing Service would allow NSCC to help remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions and, in general, to protect investors and the public interest.

Specifically, NSCC believes the proposal would help alleviate capital constraints and decrease settlement and operational risk that market participants would otherwise face. As described above, NSCC believes, by expanding the availability of NSCC's infrastructure to SFTs via the proposed SFT Clearing Service, the proposal may create capital benefits for market participants and thereby help alleviate capital constraints otherwise applicable to bilateral SFTs. In addition, the proposal would decrease settlement and operational risk that market participants would otherwise face by making a greater number of securities transactions eligible to be cleared, settled and risk managed through NSCC via the proposed SFT Clearing Service. By alleviating capital constraints and decreasing settlement and operational risk that market participants would otherwise face, NSCC believes the proposed changes to establish the SFT Clearing Service would remove impediments to and 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.<sup>137</sup>

The proposal would also protect investors and the public interest by lowering the risk of liquidity drain and protecting against fire sale risks. Specifically, the proposal would lower

the risk of liquidity drain in the U.S. equity securities financing market by lessening counterparties' likely inclination to unwind transactions in a stressed market scenario. NSCC would use its risk management resources to provide confidence to market participants that they will receive back their cash or securities, as applicable, which should limit the propensity for market participants to seek to unwind their transactions in a stressed market scenario.

In addition, the proposal would protect against fire sale risk. As described above, in the event of a default, NSCC would conduct a centralized, orderly liquidation of the defaulter's SFT Positions. Such an organized liquidation should result in substantially less price depreciation and market disruption than multiple independent non-defaulting parties racing against one another to liquidate the positions. In addition, NSCC would only need to liquidate the defaulter's net positions. Limiting the positions that need to be liquidated to the defaulter's net positions should reduce the volume of required sales activity, which in turn should limit the price and market impact of the close-out of the defaulter's positions. NSCC would also use its risk management resources to provide confidence to market participants that they will receive back their cash or securities, as applicable, which should limit the propensity for market participants to seek to unwind their transactions in a stressed market scenario. By lowering the risk of liquidity drain in the U.S. equity securities financing market and protecting against fire sale risk, NSCC believes the proposed changes to establish the SFT Clearing Service would protect investors and the public interest, consistent with the Section 17(A)(b)(3)(F) of the Act.<sup>138</sup>

Promote Prompt and Accurate Clearance and Settlement

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>139</sup> NSCC believes the proposed changes to establish the SFT Clearing Service would allow NSCC to help promote the prompt and accurate clearance and settlement of securities transactions. Specifically, by expanding the availability of NSCC's infrastructure to SFTs via the proposed SFT Clearing Service, NSCC believes the proposal

<sup>135</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>136</sup> *Id.*

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*

<sup>134</sup> *Supra* note 39.



would help decrease settlement and operational risk that market participants would otherwise face by making a greater number of securities transactions eligible to be cleared, settled and risk managed through NSCC. By decreasing settlement and operational risk, NSCC believes the proposed changes to establish the SFT Clearing Service would promote the prompt and accurate clearance and settlement of securities transactions, consistent with Section 17A(b)(3)(F) of the Act.<sup>140</sup>

By structuring the proposal in a way that would allow NSCC to help (i) assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, (ii) remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest, and (iii) promote the prompt and accurate clearance and settlement of securities transactions, NSCC believes the proposed changes to establish the SFT Clearing Service are consistent with Section 17A(b)(3)(F) of the Act.<sup>141</sup>

Rule 17Ad-22(e)(7) under the Act requires NSCC to establish, implement, maintain, and enforce written policies and procedures reasonably designed to effectively measure, monitor, and manage the liquidity risk that arises in or is borne by the covered clearing agency.<sup>142</sup> NSCC believes that the proposed changes to establish the SFT Clearing Service are consistent with Rule 17Ad-22(e)(7) because, as described above, the proposal is structured in a manner that allows NSCC to protect itself from associated liquidity risk. Specifically, the proposal would provide that the Final Settlement obligations and Price Differential of each SFT, other than a Sponsored Member Transaction, that is novated to NSCC would settle RVP/DVP at DTC.<sup>143</sup> SFT deliver orders would be processed in accordance with DTC's rules and procedures, including provisions relating to risk controls. Therefore each DTC participant's Final Settlement obligation would complete at DTC on a fully collateralized basis, and the associated debits (if any) would be subject to DTC's risk controls.

To the extent the Price Differential is not processed by DTC, for example if a receiver does not satisfy DTC's risk controls, NSCC would debit and credit

the Price Differential from and to the SFT Accounts of the SFT Member parties to the SFT as part of its end of day final money settlement.

In the event NSCC ceases to act for a Defaulting SFT Member, on the Business Day that NSCC ceased to act, NSCC's daily liquidity need calculation would include all Price Differential debits owed by the Defaulting SFT Member not processed at DTC. On subsequent days of the liquidation of the Defaulting SFT Member's SFT Positions, NSCC's total liquidity need calculations would include all novated SFT activity that has not reached Final Settlement on the Business Day NSCC ceased to act, netted together with all other outstanding settlement activity of the Defaulting SFT Member at NSCC.

Until NSCC has satisfied the Final Settlement obligations owing to non-defaulting SFT Members, NSCC would continue paying to and receiving from non-defaulting SFT Members the applicable Price Differential (*i.e.*, the change in market value of the relevant securities) with respect to their novated SFTs.<sup>144</sup> NSCC would take into account such Price Differential payment obligations, as well as any Final Settlement obligations to non-defaulting SFT Members, when calculating the amount of liquidity resources that NSCC may require in the event of the default of the participant family that would generate the largest aggregate payment obligation for NSCC in extreme but plausible market conditions.<sup>145 146</sup> By continuing to process these Price Differential payments until Final Settlement occurs, NSCC would ensure that non-defaulting SFT Members are kept in largely the same position as if the Defaulting SFT Member had not defaulted and the pre-novation counterparties had instead agreed to roll the SFTs. This is because even though the non-payment of the Rate Payment in an SFT Member default context may have an impact on non-defaulting SFT Members, such impact is generally de minimis. To the extent NSCC is required to pay a Price Differential, as well as any Final Settlement obligations, to a non-defaulting SFT Member, NSCC would rely on NSCC's liquidity resources, including the Required SFT Deposit and any SLD that may be collected, when applicable, in order to cover the liquidity need associated with any such Price Differential and Final Settlement obligations, consistent with the Clearing Agency Liquidity Risk Management

Framework.<sup>147</sup> Therefore, NSCC believes that the proposed changes to establish the SFT Clearing Service are consistent with Rule 17Ad-22(e)(7) under the Act.<sup>148</sup>

Rule 17Ad-22(e)(8) under the Act<sup>149</sup> requires NSCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to define the point at which settlement is final to be no later than the end of the day on which the payment or obligation is due. NSCC believes that the proposed changes to establish the SFT Clearing Service are consistent with Rule 17Ad-22(e)(8)<sup>150</sup> because, as described above, the proposal would make it clear to SFT Members the point at which settlement is final with respect to SFTs cleared through NSCC. Specifically, Section 7 in the proposed Rule 56 (Securities Financing Transaction Clearing Service) provides that an SFT, or a portion thereof, shall be deemed complete and final upon Final Settlement of the SFT, or such portion. Having clear provisions in this regard would enable SFT Members to better identify the point at which settlement is final with respect to their SFTs. As such, NSCC believes the proposed changes to establish the SFT Clearing Service are consistent with Rule 17Ad-22(e)(8) under the Act.<sup>151</sup>

#### Making Other Amendments and Clarifications

Section 17A(b)(3)(F) of the Act requires, in part, that the Rules be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>152</sup> NSCC believes that the proposed changes to make other amendments and clarifications to the Rules would allow NSCC to help promote prompt and accurate clearance and settlement of securities transactions. This is because the proposed amendments and clarifications to the Rules are conforming and technical changes that would ensure consistency in the Rules and that the Rules remain clear and accurate. Having clear and accurate Rules would help Members to better understand their rights and obligations regarding NSCC's clearance and settlement services. NSCC believes that when Members better understand their rights and obligations regarding NSCC's clearance and settlement services, they can act in accordance with the Rules. NSCC believes that better enabling

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> 17 CFR 240.17Ad-22(e)(7).

<sup>143</sup> *Supra* note 27.

<sup>144</sup> *See* proposed Rule 56, Section 14(b)(ix).

<sup>145</sup> *Id.*

<sup>146</sup> 17 CFR 240.17Ad-22(e)(7).

<sup>147</sup> *Supra* note 39.

<sup>148</sup> 17 CFR 240.17Ad-22(e)(7).

<sup>149</sup> 17 CFR 240.17Ad-22(e)(8).

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> 15 U.S.C. 78q-1(b)(3)(F).

Members to comply with the Rules would promote the prompt and accurate clearance and settlement of securities transactions by NSCC. As such, NSCC believes the proposed changes to make other amendments and clarifications are consistent with Section 17A(b)(3)(F) of the Act.<sup>153</sup>

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

NSCC believes that the proposed rule change to establish the SFT Clearing Service and the additional membership categories in connection therewith would promote competition by increasing the types of entities that may participate in NSCC and therefore permit more market participants to utilize NSCC's services.

At the same time, the proposed rule change may impose a burden on competition by limiting participation in the proposed SFT Clearing Service to institutions that are eligible to participate in the service. The proposed rule change may also impose a burden on competition by (i) calculating Required Fund Deposits for Sponsoring Members and Agent Clearing Members on a gross basis with no offsets for netting of positions between different Sponsored Members or different Customers, as applicable, and (ii) imposing an additional charge with respect to any Non-Returned SFT that is calculated based on the relevant SFT Member's Credit Risk Rating Matrix rating. However, NSCC believes any burden on competition that may result from the proposed rule change would not be significant and would be necessary and appropriate in furtherance of the purposes of the Act,<sup>154</sup> for the reasons described below.

Although the proposal would limit full participation in the proposed SFT Clearing Service to Members, and such limitation may impact institutional firm clients that are unable to satisfy such eligibility requirements by excluding them from being able to directly submit their equity securities financing activity in SFT eligible securities to NSCC for novation (and avail themselves of the commensurate benefits described above in Item II(A)1(i)—Background), NSCC believes that any related burden on competition would be necessary and appropriate in furtherance of the purposes of the Act. This is because such eligibility requirements are designed to allow NSCC to prudently manage the risks associated with SFT Members' participation in the proposed SFT Clearing Service by ensuring that

SFT Members are able to satisfy their obligations to NSCC. In addition, although the proposal would limit the scope of entities eligible to be Sponsored Members to those institutions that are able to satisfy the eligibility criteria discussed above, NSCC does not believe such limit would materially impact market participants that are unable to satisfy such eligibility requirements because such market participants would be able to have their equity securities financing activity in SFT eligible securities submitted to NSCC for novation through an Agent Clearing Member. Moreover, any burden on competition would be necessary and appropriate in furtherance of the purposes of the Act because the eligibility requirements applicable to Sponsored Members are designed to ensure the financial sophistication of Sponsored Members and to prudently manage the risk associated with Sponsored Members' participation in NSCC. Additionally, although the proposal would limit the scope of entities able to submit equity securities financing activity in SFT eligible securities to NSCC on behalf of others to entities that are able to satisfy the eligibility criteria for Sponsoring Members and Agent Clearing Members, as specified in proposed Rules 2C and 2D (*i.e.*, be an existing Member and, if the Member applicant is a Registered Broker-Dealer, having to satisfy certain minimum financial threshold amounts), and such limitation may impact institutions that are unable to satisfy such eligibility requirements by excluding them from being able to submit transactions on behalf of others (and avail themselves of the commensurate benefits described above in Item II(A)1(i)—Background), NSCC believes that any related burden on competition would be necessary and appropriate in furtherance of the purposes of the Act. This is because such eligibility requirements are designed to allow NSCC to prudently manage the risks associated with Sponsoring Members' and Agent Clearing Members' participation in the proposed SFT Clearing Service by ensuring that such institutions have the operational capability and sufficient financial ability to meet all of their anticipated obligations to NSCC. Furthermore, NSCC believes any related burden on competition would not be significant because, as described above in Item II(A)1(vii)—Impact of the Proposed SFT Clearing Service on Various Persons, participation in the proposed SFT Clearing Service would be entirely voluntary and would not

restrict the ability of firms to enter into bilateral securities financing transactions outside of NSCC.

Although the proposal would require the Sponsoring Member Required Fund Deposits and Agent Clearing Member Required Fund Deposits to be calculated on a gross basis with no offsets for netting of positions across different Sponsored Members or different Customers, as applicable, and such requirement may limit the ability of certain Members to participate as a Sponsoring Member and/or an Agent Clearing Member in the proposed SFT Clearing Service, NSCC believes that any related burden on competition would be necessary and appropriate in furtherance of the purposes of the Act. This is because such requirement is designed to allow NSCC to prudently manage the risks associated with these Members' participation in the proposed SFT Clearing Service by ensuring that NSCC's volatility-based Clearing Fund deposit requirements represent the sum of each individual institutional firm's activity. Furthermore, NSCC believes any related burden on competition would not be significant because, as described above in Item II(A)1(vii)—Impact of the Proposed SFT Clearing Service on Various Persons, participation in the proposed SFT Clearing Service would be entirely voluntary and would not restrict the ability of firms to enter into bilateral securities financing transactions outside of NSCC.

Although the proposal would impose an additional charge with respect to any Non-Returned SFT that is calculated based on the relevant SFT Member's Credit Risk Rating Matrix rating and such requirement may limit the ability of certain Members to participate in the proposed SFT Clearing Service, NSCC believes that any related burden on competition would be necessary and appropriate in furtherance of the purposes of the Act. This is because such requirement is designed to allow NSCC to prudently manage increased risks associated with Non-Returned SFTs. As described above, to the extent that the Final Settlement of an SFT is scheduled on a particular date but does not occur, whether directly or through a pair off in accordance with Section 8 of proposed Rule 56 (as discussed above), that could potentially be a result of a "squeeze" or other market dislocation whereby NSCC may face increased market risk in the event of the default of either the Transferor or the Transferee. The proposed requirement would help to ensure that NSCC's Clearing Fund deposit requirements take into account increased market risk

<sup>153</sup> *Id.*

<sup>154</sup> 15 U.S.C. 78q-1(b)(3)(I).

that NSCC may face in connection with Non-Returned SFTs. Furthermore, NSCC believes any related burden on competition would not be significant because, as described above in Item II(A)1(vii)—Impact of the Proposed SFT Clearing Service on Various Persons, participation in the proposed SFT Clearing Service would be entirely voluntary and would not restrict the ability of firms to enter into bilateral securities financing transactions outside of NSCC.

NSCC does not believe the proposal to make technical and conforming changes would impact competition. These changes are being proposed to ensure consistency in the Rules. They would not change NSCC's current practices or affect Members' rights and obligations. As such, NSCC believes the proposal to make technical and conforming 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*

NSCC reviewed the proposed rule change with various Members and market participants (*e.g.*, agent lenders, brokers, matching service providers, and books and records service providers) in order to benefit from their expertise and industry knowledge. Written comments relating to this proposed rule change have not been received from Members or any other person. If any written comments are received, they will be publicly filed as an Exhibit 2 to this filing, as required by Form 19b-4 and the General Instructions thereto.

Persons submitting comments are cautioned that, according to Section IV (Solicitation of Comments) of the Exhibit 1A in the General Instructions to Form 19b-4, the Commission does not edit personal identifying information from comment submissions. Commenters should submit only information that they wish to make available publicly, including their name, email address, and any other identifying information.

All prospective commenters should follow the Commission's instructions on how to submit comments, available at <https://www.sec.gov/regulatory-actions/how-to-submit-comments>. General questions regarding the rule filing process or logistical questions regarding this filing should be directed to the Main Office of the Commission's Division of Trading and Markets at [tradingandmarkets@sec.gov](mailto:tradingandmarkets@sec.gov) or 202-551-5777.

NSCC reserves the right not to respond to any comments received.

**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.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

**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:

*Electronic Comments*

- Use the Commission's internet comment form (<https://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2022-003 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-NSCC-2022-003. This file number should be included on the subject line if email 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 (<https://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 NSCC and on DTCC's website (<https://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-NSCC-2022-003 and should be submitted on or before May 10, 2022.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>155</sup>

**J. Matthew DeLesDernier**,  
Assistant Secretary.

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<sup>155</sup> 17 CFR 200.30-3(a)(12).