SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73388; File No. SR-FICC-2014-801)

October 17, 2014

Self-Regulatory Organizations; The Fixed Income Clearing Corporation; Notice of No Objection to Advance Notice Filing, as Amended by Amendment No. 1, Concerning the Government Security Division's Inclusion of GCF Repo® Positions in Its Intraday Participant Clearing Fund Requirement Calculation, and Its Hourly Internal Surveillance Cycles

On January 10, 2014, The Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") advance notice SR-FICC-2014-801 ("Advance Notice") pursuant to Section 806(e)(1)(A) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act" or "Title VIII")[1] and Rule 19b-4(n)(1)(i) of the Securities Exchange Act of 1934 ("Act").[2] The Advance Notice was published for comment in the Federal Register on February 10, 2014.[3] On March 10, 2014, the Commission staff sent FICC a letter, pursuant to Section 806(e)(1)(D)[4] and Commission authorization, requesting

1 12 U.S.C. 5465(e)(1)(A). The Financial Stability Oversight Council designated FICC a systemically important financial market utility on July 18, 2012. *See* Financial Stability Oversight Council 2012 Annual Report, Appendix A, http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf. Therefore, FICC is required to comply with Title VIII of the Payment, Clearing and Settlement Supervision Act.

2 17 CFR 240.19b-4(n)(1)(i).

3 Securities Exchange Act Release No. 71469 (Feb. 4, 2014), 79 FR 7722 (Feb. 10, 2014) (SR-FICC-2014-801).

4 12 U.S.C. 5465(e)(1)(D).

additional information regarding this advance notice.[5] FICC filed an amendment to the Advance Notice on August 11, 2014, which was published for comment in the Federal Register on September, 26, 2014.[6] The Commission received no comments on the Advance Notice. This publication serves as a notice of no objection to the changes proposed in the Advance Notice.

I. Description of the Advance Notice

The Advance Notice concerns a proposal by FICC's Government Securities Division ("GSD") to include GCF Repo®[7] positions in its intraday (i.e., noon) participant Clearing Fund requirement calculation ("CFR"), and its hourly internal surveillance cycles. FICC intends for this enhancement to align GSD's risk management calculations and monitoring with the changes that have been implemented to the tri-party infrastructure by the Tri-Party Repo Infrastructure Reform Task Force ("Task Force")[8] specifically, with respect to locking up of GCF Repo® collateral until 3:30 p.m. (ET)

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5 The Commission received a response to this request for additional information August 19, 2014, at which time a 60 day review period for the Advance Notice began pursuant to Section 806(e)(1)(G). 12 U.S.C. 5465(e)(1)(G)

6 Securities Exchange Act Release No. 73187 (September 23), 79 FR 58007 (September 26, 2014) (SR-FICC-2014-801).

7 The GCF Repo® service enables dealers to trade general collateral repos, based on rate, term, and underlying product, throughout the day without requiring intra-day, trade-for-trade settlement on a Deliver-versus-Payment ("DVP") basis. The service fosters a highly liquid market for securities financing.

8 The Task Force was formed in September 2009 under the auspices of the Payments Risk Committee, a private-sector body sponsored by the Federal Reserve Bank of New York. The Task Force's goal is to enhance the repo market's ability to navigate stressed market conditions by implementing changes that help better safeguard the market. FICC has worked in close collaboration with the Task Force on its reform initiatives.

rather than 7:30 a.m. (ET). The Advance Notice also provides FICC the ability to account for an altered intraday risk profile of members as a result of a member's substitution of cash for securities that were used as collateral for a GCF Repo® position the prior day ("Cash Substitution") or a clearing bank unwind of the cash lending side of the transaction for an inter-bank GCF Repo ® transaction at 7:30 a.m. (ET) ("Early Unwind") by implementing an Early Unwind Intraday Charge ("EUIC") where appropriate.

(i) Historical Background

Prior to the changes implemented by the Task Force, the underlying collateral pertaining to the GCF Repo® positions was locked up each afternoon (approximately 4:30 p.m. (ET)) and unwound at the beginning of the next business day (approximately 7:30 a.m. (ET)). Thus, the GCF Repo® positions were included in the end of day ("EOD") CFR calculations but not included in FICC's noon intraday CFR calculations. Because the GCF Repo® positions were not included in FICC's noon intraday CFR calculation, the noon calculation could result in an under-margined condition relative to the same EOD[9] CFR. Thus, FICC imposed a "higher-of" standard on GCF Repo® participants, whereby their noon intraday CFR was the higher of the actual noon intraday CFR calculation or its prior EOD CFR calculation.[10]

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9 As used herein "prior EOD" refers to the end of day cycle immediately preceding the current noon intraday cycle and "same EOD" refers to the cycle immediately subsequent to the current noon intraday cycle.

10 For example, in the extreme case where a participant's portfolio was comprised entirely of GCF Repo® positions, at each EOD margining cycle FICC could calculate a substantial margin requirement which had to be met by 9:30 a.m. (ET)

With the advent of the Task Force's reform, which resulted in moving the unwind from 7:30 a.m. (ET) to 3:30 p.m. (ET), details on the underlying collateral pertaining to GCF Repo® positions are now received from the clearing banks on an hourly basis and can be incorporated into the noon intraday CFR calculation. Substitutions of underlying collateral are now permitted between 8:30 a.m. (ET) and 3:30 p.m. (ET).[11]

(ii) Proposed Change

Because GCF Repo® collateral remains locked-up until 3:30 p.m. (ET), FICC proposed incorporating the underlying collateral pertaining to GCF Repo® positions in its noon intraday participant CFR calculation, and its hourly internal surveillance cycles.[12] This enhancement is intended to align FICC's risk management calculations

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the next morning. But at each intraday margining cycle, FICC would calculate a negligible margin requirement (because GCF Repo® positions were not included at intraday). This would allow the participant to withdraw substantially all its margin collateral before the same EOD. In this case, if the participant defaulted overnight, FICC would hold almost no margin collateral from the participant while having the exposure of liquidating losses on a substantial GCF Repo® portfolio. To prevent this potential under-margin condition, FICC imposed the "higher of" standard.

11 A key aspect of the GCF Repo® service is to give the repo side (cash borrower) the ability to retrieve its securities during the business day and deliver those securities to meet a delivery obligation. As a result, GCF Repo® was unwound in the morning. With the Tri-Party Reform's change in the unwind from 7:30 a.m. (ET) to 3:30 p.m. (ET), participants now have access to their securities during the day via collateral substitutions.

12 In the ordinary course of business, the "higher of" standard will not apply. However, this standard will remain available in the event that one or both clearing banks do not provide intraday underlying collateral pertaining to the GCF Repo® position data because such clearing bank, as applicable, is unable to provide the data.

and monitoring with the changes that have been implemented to the tri-party infrastructure by the Task Force.

In certain instances, Cash Substitutions, for repo and reverse repo positions and the Early Unwind of interbank allocations for reverse repo positions, could result in higher cash balances in the underlying collateral pertaining to GCF Repo® positions at noon intraday than the same EOD, and could present a potential under-margin condition because cash collateral is not margined but the cash likely will be replaced by securities in the next GCF Repo® allocation of collateral. The under-margin condition will exist overnight because the VaR on the GCF Repo® collateral in the same EOD cycle will not be calculated until after Fedwire is closed, thus precluding members from satisfying margin deficits until the morning of the next business day.

As a result, FICC amended its proposal[13] to include the EUIC to account for the altered intraday risk profile created by Cash Substitutions and Early Unwinds.[14] In order to determine whether an EUIC should be applied, FICC will take the following steps:

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13 See Securities Exchange Act Release No. 73187 (September 23), 79 FR 58007 (September 26, 2014) (SR-FICC-2014-801).

14 If a member is assessed an EUIC that is deemed unnecessary, FICC management will have the discretion to waive such charge.

1. At noon, FICC will compare the prior EOD VaR component of the CFR calculation with the current day's noon intraday VaR component of the CFR calculation.
2. If the current day's noon intraday VaR calculation is equal to or higher than the prior EOD's VaR calculation then GSD will not apply an EUIC. If however, the current day's noon calculation is lower, then FICC will proceed to the step 3 below.
3. FICC will review the GCF Repo® participant's DVP and GCF Repo® portfolio to determine whether the reduction in the noon calculation may be attributable to the GCF Repo® participant's intraday cash substitutions or early unwind of interbank allocations. If so, then FICC will apply the EUIC.
4. At the participant level, the EUIC[15] will be the lesser of (i) the net VaR decrease that may be deemed to be attributable to either Cash Substitutions and/or Early Unwinds of interbank allocations or (ii) the prior EOD VaR minus the noon intraday VaR.[16]

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15 The EUIC will be included in the noon intraday participant CFR, but not the same EOD CFR. This is because the risk associated with cash lockups exists at intraday, that is, at any time before at EOD. At EOD in the normal course of business, GCF Repo® positions consist of 100% eligible non-cash securities. GCF Repo® is used for overnight financing of securities inventory. Absent extraordinary circumstances, participants do not use cash to collateralized overnight cash loans. Cash Substitutions occur at intraday as participants substitute in cash to withdraw securities they need for intraday deliveries.

16 In the event that cash substitutions or early unwind of interbank allocations impacts the CFR, the prior end of day CFR is used as a proxy for the same end of day CFR for the portion of the portfolio that is impacted by such cash substitutions or early unwind of interbank allocations. The EUIC is designed to

The EUIC for Cash Substitutions will apply to both the repo side (cash borrower) and the reverse repo side (cash lender) of the transaction and the EUIC for the Early Unwinds of interbank allocations will apply to the reverse repo side only. The EUIC applies to the reverse repo side because although that side does not initiate the Cash Substitution or the Early Unwind of interbank allocations, these events change the reverse repo participants' risk profile and as a result, their noon intraday CFR could be unduly reduced. The EUIC for the Early Unwind of interbank allocations will only apply to the reverse repo side (cash lender) since it is only the reverse side whose lockup is unwound early. The securities subject to the Early unwind are not returned to the repo side (cash borrower) in connection with the early unwind of interbank allocations. The Early Unwind of interbank allocations is performed on the reverse repo side to ensure that the underlying collateral is available to the repo side at its settlement bank. Cash is returned to the reverse repo side and thus unwound early. There is no automatic unwind (return of securities) to the repo side. If the repo side needs its securities before the 3:30 p.m. (ET) scheduled unwind, it may perform a securities-for-securities substitution or a cash-for-securities substitution (in which case it may be subject to the EUIC).

II. <u>Discussion and Commission Findings</u>

Although the Payment, Clearing and Settlement Supervision Act does not specify a standard of review for an advance notice, the Commission believes its stated purpose is

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prevent the impact of cash substitutions and early unwind of interbank allocations from unduly reducing noon intraday CFR relative to the prior EOD CFR calculation, thus the EUIC will not increase the noon intraday CFR above the prior EOD CFR calculation. (But the noon intraday CFR calculation exclusive of EUIC could be higher than the prior EOD CFR calculation).

instructive.[17] The stated purpose is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically-important financial market utilities ("FMU") and strengthening the liquidity of systemically important FMUs.[18]

Section 805(a)(2) of the Payment, Clearing, and Settlement Supervision Act[19] authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the supervisory agency or the appropriate financial regulator. Section 805(b) of the Payment, Clearing, and Settlement Supervision Act [20] states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and
- support the stability of the broader financial system.

The Commission has adopted risk management standards under Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act[21] ("Clearing Agency

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17 See 12 U.S.C. 5461(b).

18 Id.

19 12 U.S.C. 5464(a)(2).

20 12 U.S.C. 5464(b).

21 12 U.S.C. 5464(a)(2).

Standards").[22] The Clearing Agency Standards became effective on January 2, 2013 and require registered clearing agencies that perform central counterparty ("CCP") services to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.[23] As such, it is appropriate for the Commission to review advance notices against these Clearing Agency Standards and the objectives and principles of these risk management standards as described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.[24]

Because it was based on the previous pre-reform unwinding process described above, FICC's intraday risk calculation does not currently capture the GCF Repo® positions on an intraday basis. The change to incorporate the underlying collateral pertaining to the GCF Repo® positions in its noon intraday participant CFR calculation, and its hourly internal surveillance cycles, should improve FICC's risk management by providing a more accurate and timely view of member positions and their corresponding

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22 Rule 17Ad-22, 17 CFR 240.17Ad-22. Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11).

23 The Clearing Agency Standards are substantially similar to the risk management standards established by the Board of Governors of the Federal Reserve System ("Federal Reserve") governing the operations of designated DFMUs that are not clearing entities and financial institutions engaged in designated activities for which the Commission or the Commodity Futures Trading Commission is the Supervisory Agency. See Financial Market Utilities, 77 FR 45907 (August 2, 2012).

24 12 U.S.C. 5464(b).

exposures and may help ensure that FICC collects sufficient clearing fund deposits to safeguard itself in the event of a member default. Further, incorporating GCF Repo® positions into intraday participant CFR calculations and hourly surveillance cycles may better reflect the actual risk in its members' portfolios. Moreover, the inclusion of the EUIC may allow FICC to use more accurate position information in its margin calculations and mitigate the effects of Cash Substitutions and Early Unwinds that occur during the intraday period.

The Commission believes that including GCF Repo® positions in FICC's intraday participant clearing fund calculations and hourly internal surveillance meets the objectives and principles for the risk management standards prescribed under Section 805(a). The inclusion of GCF® Repo positions may provide FICC with a more accurate view of members' intraday exposures and more accurate risk profiles. Additionally, the EUIC allows FICC to account for risks posed by intraday VaR fluctuations that are caused by Cash Substitutions and Early Unwinds and may allow FICC to better manage intraday risk. Thus, the proposal promotes robust risk management and safety and soundness of FICC's risk management systems, reduces systemic risk, and supports the stability of the broader financial system.[25]

The proposed change is also consistent with Rule 17Ad-22[26] of the Clearing Agency Standards which establishes the minimum requirements regarding how registered clearing agencies must maintain effective risk management procedures and controls.

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[25] 12 U.S.C. 5464(b).

[26] 17 CFR 240.17Ad-22.

Specifically, Rule 17Ad-22(b)(1) requires a clearing agency that performs CCP services to establish, implement, maintain and enforce written policies reasonably designed to measure its credit exposures at least daily and to limit exposures to potential losses from defaults by participants under normal market conditions so that the operations of the clearing agency should not be disrupt and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.[27] Rule 17Ad-22(b)(2) requires FICC to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin requirements.[28] To these ends, the change may provide FICC with a more accurate measurement of daily credit exposure using a risk-based model and is designed to address exposures that may occur from intraday activity. In sum, FICC's more accurate and timely calculations around and monitoring of GCF Repo® activity may better enable FICC to respond in the event that a member defaults.

[27] 17 CFR 240.17Ad-22(b)(1).

[28] 17 CFR 240.17Ad-22(b)(2).

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,[29] that the Commission DOES NOT OBJECT to advance notice proposal (SR-FICC2014-801) and that FICC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving a proposed rule change that reflects rule changes that are consistent with this advance notice proposal (SR-FICC-2014-01), whichever is later.

By the Commission.

Kevin O'Neill
Deputy Secretary

29 12 U.S.C. 5465(e)(1)(I).