

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-94998; File No. SR-NSCC-2022-801)

May 27, 2022

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of No Objection to Advance Notice to Introduce Central Clearing for Securities Financing Transaction Clearing Service

I. INTRODUCTION

On March 28, 2022, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2022-801 (“Advance Notice”), pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”)¹ and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (“Exchange Act”).² The Advance Notice was published for comment in the Federal Register on April 19, 2022.³ The Commission has received comments regarding the proposal.⁴ This publication serves as notice of no objection to the Advance Notice.

¹ 12 U.S.C. 5465(e)(1).

² 17 CFR 240.19b-4(n)(1)(i).

³ Securities Exchange Act Release No. 94695 (April 12, 2022), 87 Fed. Reg. 23328 (April 19, 2022) (SR-NSCC-2022-801) (“Notice of Filing”). NSCC also filed related proposed rule change with the Commission pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder, seeking approval of proposed changes to their rules necessary to implement the Advance Notice. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. The proposed rule change was published in the Federal Register on April 19, 2022. Securities Exchange Act Release No. 94694 (April 12, 2022), 87 Fed. Reg. 23372 (April 19, 2022) (SR-NSCC-2022-003).

⁴ Comments are available at <https://www.sec.gov/comments/sr-nsc-2022-801/srnsc2022801.htm>.

II. DESCRIPTION OF THE PROPOSED RULE CHANGE

A. Overview of Proposal

NSCC proposes to expand its central counterparty (“CCP”) services to include securities financing transactions (“SFTs”), also referred to generally as securities lending.⁵ SFTs are transactions in which a securities lender loans securities to a securities borrower, for a fee. The borrowers typically use the borrowed securities to cover short sales or fails to deliver that may result from either short or long sales.⁶ A lender typically lends securities to generate income through the fees that it charges.

As a CCP, NSCC would interpose itself between the securities lender and borrower and become the counterparty to each entity. NSCC would then be obligated to complete the transaction, that is, to return loaned securities to the lender and collateral to the borrower, even if a lender or borrower in an SFT fails to satisfy its obligations, thereby assuming the risk of each entity’s failure to perform to each other.

Specifically, NSCC would novate and guarantee SFTs that involve eligible securities, meaning equity securities (including ETFs) cleared at NSCC with a particular per share price, initially set at \$5 or greater. The service would be limited to overnight SFTs (i.e., with a one business day term), with the ability for the parties to extend an expiring SFT into a new transaction.

⁵ The Options Clearing Corporation (“OCC”) operates a stock loan program as a CCP. NSCC’s new service is similar to OCC’s service with one key difference: unlike OCC’s service, which only covers transactions between OCC’s direct members (i.e., broker to broker), NSCC’s new service would allow indirect participation by buy-side clients. See Section II.B.(2).

⁶ A short sale is any sale of securities that a seller does not own or has borrowed. See 17 CFR 242.200(a).

The SFT service would be available to existing NSCC members.⁷ In addition, NSCC would create two new membership categories that would be able to submit SFTs for central clearing: Sponsoring Members that would sponsor institutional clients into NSCC and act as a principal to SFTs with their clients, and Agent Clearing Members that submit SFTs on behalf of institutional customers strictly as an agent. These two new types of membership would allow the proposed service to meet the existing market practices for SFTs, where different types of entities employ different trading strategies and relationships to accommodate their regulatory and other requirements.

Consistent with its risk management for all other transactions in equity securities, NSCC would collect margin from the lender and borrower for novated SFTs to address the credit risk arising from such transactions. NSCC would also identify potential liquidity exposures if an SFT member were to default and address that potential need in its risk management.

According to NSCC, the proposed SFT clearing service would provide several benefits for market participants, including increased balance sheet netting benefits, capital efficiency opportunities, and mitigation of fire sale risk.⁸ With respect to balance sheet netting benefits and capital efficiency opportunities, NSCC states that the SFT clearing service may allow participants to net down payables and receivables related to the SFTs on their balance sheets because such payables and receivables have one

⁷ Capitalized terms not defined herein are defined in the NSCC Rules & Procedures (“Rules”), available at http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf.

⁸ See Notice of Filing, supra note 3, at 23329-30.

counterparty, NSCC. In turn, NSCC states that because of the capital requirements arising under Basel III rules that favor a netted balance sheet,⁹ market participants may reduce the amount of capital they are required to hold under the applicable leverage requirements.¹⁰

In addition, NSCC believes that the proposal would reduce the potential for market disruption from fire sales for a number of reasons.¹¹ First, NSCC believes that it would be able to better manage default scenarios by conducting a centralized and orderly liquidation of the defaulter's SFT positions.¹² NSCC represents that a centralized and orderly liquidation would result in substantially less price depreciation and market disruption compared to the multiple independent non-defaulting parties racing against one another to liquidate the positions. Second, NSCC would be able to liquidate the defaulter's net positions instead of gross positions, meaning that a position that needs to be liquidated would be smaller in size and a market disruption can be minimized. Third, by guaranteeing SFTs through central clearing, NSCC believes that it would be able to provide confidence to market participants in a stressed market scenario, thereby lessening any inclination to rush to unwind transactions.¹³

⁹ See 12 CFR § 217.10(c)(4)(ii)(E)-(F).

¹⁰ The Basel III capital and leverage requirements, as implemented by the U.S. banking regulators, mandate banks and depository institutions to hold certain amounts of capital. See generally, e.g., 12 CFR Part 3; 12 CFR Part 217; 12 CFR Part 252, Subpart Q; 12 CFR Part 324.

¹¹ See Notice of Filing, supra note 3, at 23329.

¹² Id.

¹³ See Notice of Filing, supra note 3, at 23329-30.

B. Securities Financing Transaction Clearing Service

NSCC proposes to introduce central clearing for SFTs by establishing rules governing (1) key aspects of the SFTs; (2) SFT participant categories; and (3) SFT risk management, as elaborated below.

(1) Key Aspects of the SFTs

Overnight SFTs. The proposed SFT clearing service would apply to transactions with a one business day term (i.e., overnight SFTs) in eligible equity securities. NSCC represents that the proposal applies to overnight SFTs, as opposed to open SFTs, to offer balance sheet netting and capital efficiency opportunities, which require a scheduled settlement date.¹⁴ However, a lender and a borrower would have an option to extend an expiring SFT by rolling it, or a portion thereof, into a new, linked SFT. Accordingly, an expiring SFT would be eligible for renewal every day.

Operational Issues. SFTs would be required to be submitted to NSCC on a locked-in basis and matched between the lender and the borrower.¹⁵ NSCC would receive underlying SFT securities from a lender, send them to a borrower, receive cash collateral equal to no less than 100% of the market value of the securities from the borrower, and send it to the lender.¹⁶

¹⁴ See Notice of Filing, supra note 3, at 23330-31.

¹⁵ Specifically, the transaction data for an SFT must be submitted by an entity that the parties have selected, which could be either a member or a third-party vendor. The SFT members would select which approved submitter to use, and NSCC would have to approve any entity serving as an approved submitter.

¹⁶ To address regulatory and investment guideline requirements applicable to certain institutional firms (e.g., Section 17(f) of the Investment Company Act of 1940 and Rule 17f-2 thereunder), a participant would be permitted to transfer an

When an SFT settles, in general, NSCC would essentially reverse the transaction of the prior day by receiving the underlying SFT securities from the borrower and returning them to the lender, and receiving the cash collateral from the lender and returning it to the borrower. NSCC would also pass through daily interest,¹⁷ as applicable. If the parties decide to extend into a linked SFT, instead of transferring the underlying securities and collateral, NSCC would transfer the daily interest and calculate and pass through a mark-to-market payment on the underlying securities, effectively putting the parties in a position of closing the settling SFT and starting a new SFT.

Eligible Equity Securities. As an initial matter, NSCC would provide the proposed SFT service for securities that are eligible to be processed through NSCC's Continuous Net Settlement ("CNS") System,¹⁸ and have a per share price of \$5 or more.¹⁹

additional cash haircut above 100% (e.g., 102%) to such institutional firms as part of this initial settlement of the SFT.

¹⁷ NSCC refers to this daily interest as a "Rate Payment."

¹⁸ NSCC processes clearance and settlement of equity securities using the CNS System. Securities are CNS-eligible if they are eligible for book-entry transfer on the books of DTC, not subject to certain transfer restrictions, and not subject to certain corporate actions. NSCC, Disclosure Framework for Covered Clearing Agencies and Financial Market Infrastructures (December 2021), https://www.dtcc.com/-/media/Files/Downloads/legal/policy-and-compliance/NSCC_Disclosure_Framework.pdf. ("NSCC Disclosure").

NSCC would maintain a list of the securities that may underlie an SFT that NSCC will accept. Such list would not be a rule but a separate document maintained by NSCC and available to members, consistent with NSCC's practice for equity securities. See Notice of Filing, *supra* note 3, at 23331; Rule 3 (Lists to be Maintained) of the Rules, *supra* note 8.

¹⁹ Notice of Filing, *supra* note 3, at 23331. NSCC selected \$5 as the per share price minimum for underlying equity securities because \$5 is a common share price minimum adopted in brokerage margin eligibility schedules. NSCC may modify

If the price of the underlying securities of a novated SFT falls below the threshold price established by NSCC, that SFT would continue to be novated to NSCC, but the margin required for such SFT would be 100% of the market value of such underlying securities until the per share price of the underlying securities equals or exceeds the threshold price.

Recall, Buy-In, and Accelerated Settlement. Consistent with the existing bilateral market, NSCC proposes to introduce recall, buy-in, and accelerated settlement features in its proposed SFT clearing service. Under the proposal, a lender would have a right to recall an existing SFT and stop the SFT from being extended.

Once a lender issues a recall notice, a borrower would be required to satisfy its final settlement obligations by the recall date, which would be the second business day following NSCC's receipt of such notice. If the borrower fails to satisfy its final settlement obligations by the recall date, the lender could go to the market to conduct a buy-in in a commercially reasonable manner,²⁰ that is, to purchase some or all of securities equivalent to the underlying securities that are the subject to the SFT and charge the borrower for the cost of this purchase or to elect to be deemed to have purchased such securities.²¹ Similar to a lender's recall right, a borrower would have a

the eligible equity securities' minimum share price and would announce any such change via notice to its members. See id.

²⁰ After a buy-in, the lender would give written notice to NSCC of its costs to purchase the relevant SFT securities or the buy-in costs. NSCC would then transfer the costs from the borrower to the lender, and the SFT would be closed.

²¹ NSCC states that the requirement that a party exercising buy-in rights do so in a "commercially reasonable manner" is the current industry standard, as reflected in the Master Securities Loan Agreement published by Securities Industry and Financial Markets Association. See Notice of Filing, supra note 3, at 23332-33;

right to accelerate the scheduled final settlement of an SFT that has been novated to NSCC. NSCC states that this right is required to ensure that certain borrowers would be able to satisfy their regulatory requirements.²²

(2) SFT Participant Categories

The proposed SFT clearing service would be available for SFTs entered into between two current NSCC members. In addition, NSCC proposes new categories of membership that are designed to accommodate current bilateral SFT arrangements.²³

First, the Sponsoring Member/Sponsored Member categories would accommodate principal-style trades, in which a Sponsoring Member acting as principal for its own account completes a Sponsored Member's trades using its own inventory. Typically, in these types of arrangements, a Sponsoring Member can earn a profit from the bid-ask spread differences between its Sponsored Member trades and any offsetting trades.

Second, the Agent Clearing Member category would accommodate transactions by firms who typically conduct trades on an agent basis for their institutional clients. An Agent Clearing Member would arrange a transaction on behalf of an institutional client and charge fees for the services (rather than taking spreads).²⁴ Such client firms may, as part of their business models and agreed-upon investment guidelines, only permit agented

Section 13.1 of the Master Securities Loan Agreement published by Securities Industry and Financial Markets Association.

²² Specifically, NSCC states that borrowers may have the need to accelerate settlement of securities lending transactions if they lose a "permitted purpose" for such loans under Regulation T. See 12 CFR 220.1-220.12.

²³ See Notice of Filing, supra note 3, at 23330.

²⁴ See Notice of Filing, supra note 3, at 23337.

transactions, making the Agent Clearing Member a better fit.

According to NSCC, the costs of clearing that may be passed through to the institutional clients, whether as Sponsored Members or as clients to the Agent Clearing Members (“Customers”), by its intermediary would be largely equivalent.²⁵ However, one key difference between Sponsored Members and Customers would be that Sponsored Members would have a contractual relationship with NSCC while the Agent Clearing Member’s Customers would not. NSCC states that, from the perspective of an institutional firm client, whether to become a Sponsored Member or Customer to an Agent Clearing Member may be determined based on who the client’s current clearing intermediaries are and the nature of the client’s commercial arrangement with its intermediaries.²⁶ NSCC states that giving a choice to institutions to become a Sponsored Member or Customer should facilitate additional central clearing of SFTs.²⁷

Sponsoring Members. All NSCC members would be eligible to apply to become Sponsoring Members, so long as they meet the specified requirements.²⁸ For operational

²⁵ See Notice of Filing, supra note 3, at 23338.

²⁶ See id.

²⁷ See Notice of Filing, supra note 3, at 23330.

²⁸ 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 certain financial requirements. 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, for example, for a new member that has yet to demonstrate a track record of financial responsibility and operational capability. Moreover, after becoming a Sponsoring Member, it would be obligated to notify NSCC if it is no longer compliant with the relevant standards and qualifications. NSCC would have a right to review the financial responsibility and operational capability of Sponsoring Members.

and administrative purposes, NSCC would interact solely with the Sponsoring Member as the agent of its Sponsored Members, and the Sponsoring Member would be responsible for posting the required margin on Sponsored Member transactions and for covering any default loss allocated to Sponsored Members.²⁹

Sponsoring Members would unconditionally guarantee to NSCC the payment and performance of their Sponsored Members' 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 proposal, the Sponsoring Member would be required to satisfy those settlement obligations on behalf of a Sponsored Member if the Sponsored Member defaults and fails to perform its settlement obligations. Moreover, Sponsoring Members would be subject to an activity limit based on the perceived volatility of its portfolio as compared to its capital.³⁰

Sponsored Members. Sponsored Members would be required to be either a qualified institutional buyer³¹ or a legal entity that satisfies the financial requirements

²⁹ NSCC aggregates all members' margin together with certain other deposits required under NSCC's Rules as its clearing fund. NSCC would be able to access the clearing fund should a defaulted member's own margin be insufficient to satisfy losses to NSCC caused by the liquidation of that member's portfolio. See Rule 4 (Clearing Fund) and Procedure XV (Clearing Fund Formula and Other Matters) of the Rules, supra note 8.

³⁰ Specifically, if the sum of the margin charges applied by NSCC to capture the risks related to market price movement applicable to its Sponsored Member sub-accounts and its other accounts at NSCC exceeds its required net assets or equity capital, the Sponsoring Member would not be permitted to submit new Sponsored Member transactions, unless otherwise determined by NSCC.

³¹ The term qualified institutional buyer is defined by Rule 144A under the Securities Act of 1933, as amended. See 17 CFR 230.144A.

necessary to be a qualified institutional buyer. Sponsored Members would enter into an agreement with NSCC whereby Sponsored Members would agree to terms and conditions NSCC identifies as necessary in order to protect NSCC and its members. Sponsored Members would not be full-service NSCC members, but instead would be limited members which rely on the Sponsoring Members to access NSCC's services.

A Sponsored Member would only be eligible to submit transactions in which its respective Sponsoring Member is the counterparty (i.e., "done with" transactions). However, a Sponsored Member can be sponsored by more than one Sponsoring Member, should it wish to continue to transact with different entities.

Agent Clearing Members. Agent Clearing Members would serve as agent and credit intermediary for its institutional clients. Agent-style trading is the manner in which such agent lenders are typically approved to transact in securities lending transactions on behalf of their Customers. All NSCC members would be eligible to apply to become Agent Clearing Members in NSCC, so long as they meet the specified requirements.

In addition, Agent Clearing Members would be subject to similar responsibilities as Sponsoring Members. Specifically, an Agent Clearing Member would be responsible for posting to NSCC the required margin for its Customers' activity and covering any default loss allocable to its Customers. Agent Clearing Member transactions would be subject to the same activity limit applicable to Sponsored Member transactions.

An 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.³² Unlike Sponsored Members, Customers would not have any direct relationship with NSCC and would not need to apply to become a member or enter into an agreement with NSCC. Moreover, the Agent Clearing Members would be able to submit transactions with a counterparty other than the Agent Clearing Member, resulting in transactions “done away” from the Agent Clearing Member.

(3) Risk Management

Under the proposal, NSCC would centrally manage risks associated with SFTs in a manner consistent with other transactions in equity securities that NSCC clears.

Calculation of Margin. NSCC would require all SFT members to provide margin with respect to their SFT activity, subject to a \$250,000 minimum amount. NSCC is proposing to calculate an SFT member’s required margin by applying the methodology used to determine margin for transactions in equity securities. Specifically, the determination would include certain risk-based margin components³³ that are currently applicable to NSCC’s equity securities transactions.

³² Like a Sponsoring Member, an Agent Clearing Member would be obligated to notify NSCC if it is no longer in compliance with the relevant standards and qualifications. NSCC would have a right to review Agent Clearing Members’ financial and operational capability.

³³ Specifically, it would include the volatility charge, mark-to-market charge, special charge, margin required differential component charge, coverage component charge, and margin liquidity adjustment (“MLA”) charge set forth in NSCC’s Rules, as well as charges for non-returned SFTs, which is similar to the charges that NSCC for CNS fails under its Rules. A further description of these charges is available in Procedure XV of NSCC’s Rules and in the NSCC Disclosure. For the volatility charge, NSCC would consider the potential future exposure of a given portfolio based on historical price movements and the margin floor, and it would also determine margin to address the risk due to a high concentration level in a single stock (“gap risk”). For the MLA charge, NSCC would consider the risk when a member’s portfolio contains large net unsettled positions in a

NSCC would determine an SFT member's required margin independently of the member's other positions, including its equity securities transaction positions outside of the SFTs. NSCC would not net a member's SFT positions with its other positions to determine margin, except for the margin liquidity adjustment charge component. Because NSCC would aggregate all members' margins together as its clearing fund³⁴ regardless of whether they are for SFTs or CNS transactions, an SFT or CNS member default may impact NSCC's clearing fund as a whole. In other words, a default by an SFT member may impact non-SFT members and vice versa.

NSCC would require that a certain portion of its margin be a combination of cash and eligible securities, i.e., the specific Treasury securities that NSCC accepts as collateral. NSCC would also have the discretion to require an SFT member to post its margin in a higher proportion of cash than would otherwise be required, based on the current market conditions and the SFT member's financial and operational capabilities.

For transactions submitted by Sponsoring Members or Agent Clearing Members, NSCC would require that the Sponsoring Members and Agent Clearing Members establish an account or accounts for the margin collected on behalf of Sponsored Members and Customers, respectively. This account would be separate from the Sponsoring Member or Agent Clearing Member's proprietary account. NSCC would determine the required margin for transactions for each Sponsored Member and Customer on a gross basis, that is, separately without netting. The margin obligated for a

particular group of securities with a similar risk profile or in a particular asset type, which could pose particular liquidation risk in the event of a default.

³⁴ See supra note 31.

Sponsoring Member or Agent Clearing Member would be the sum of the individual margin amounts determined for each Sponsored Member and Customer to ensure that the total margin amount represents the sum of each individual institutional client's activity.

Default Management. NSCC's proposed rules would specify the procedures that it would use to centrally manage the default of that member,³⁵ including liquidating the underlying securities and meeting the final settlement obligations. If there is an SFT member default, NSCC would continue paying to and receiving from a non-defaulting SFT member the difference in market value of the underlying securities with respect to the novated SFTs until final settlement. By continuing to process the difference in market value, NSCC would maintain the non-defaulting SFT member in largely the same position as if the defaulting SFT member has not defaulted.

In addition, in the event an SFT member defaults, NSCC would have all the rights and obligations of the defaulting party, whether it was the lender or borrower in relation to such default-related SFTs. For example, if a borrower defaults, NSCC would assume all the rights of a lender and the defaulting borrower, and be able to issue a recall notice and conduct a buy-in in a commercially reasonable manner.³⁶ On the other hand, if a

³⁵ NSCC would be able to take actions listed above when NSCC "ceases to act" for an SFT member. The factors NSCC would consider in making the decision to cease to act include the member's suspension from any regulatory organization, failure to make a payment to NSCC, or other financial issues. See Rules 46 (Restrictions on Access to Service) and 18 (Procedures for When the Corporation Ceases to Act) of the Rules, supra note 8.

³⁶ The proposal would specify that in the case of a default-related SFT, the commercial reasonableness of a buy-in shall be determined by NSCC based on whether such buy-in would create a disorderly market in the relevant SFT security, consistent with the applicable market standard. See supra note 23.

lender defaults, NSCC would be able to deliver a recall notice to a borrower to stop the final settlement date of a default-related SFT from being further delayed.

To the extent that an SFT default generates a loss larger than the resources that the defaulter has provided to NSCC, i.e., its margin and the proceeds from its liquidated portfolio, NSCC's loss allocation rule would apply to all members including Sponsoring Members and Agent Clearing Members.³⁷

Liquidity Risk. The proposal also describes how NSCC manages potential liquidity exposures arising from clearing SFT transactions. Currently, NSCC is required to hold sufficient liquidity resources to cover the largest settlement obligation stemming from the cleared CNS positions, assuming a member default. Under the proposal, NSCC's liquidity exposures would also include settlement obligation arising from SFT positions. Specifically, the liquidity obligations relating to SFT would include the daily market to market of the underlying securities as well as any final cash settlement obligation owed by the defaulting member.

To account for a potentially higher liquidity need as a result of the SFT expansion, NSCC is planning to utilize its current suite of qualifying liquidity resources, including the supplemental liquidity deposit. NSCC may collect supplemental liquidity deposits from members whose default would pose the largest liquidity exposure to NSCC.³⁸ Accordingly, such deposits may be used to address any heightened liquidity

³⁷ Specifically, under NSCC's loss allocation rule, NSCC would use its own capital (referred to as the "Corporate Contribution") and then allocate losses to members pro rata via rounds of cash calls. See Rule 4 (Clearing Fund) of the Rules, supra note 8.

³⁸ See Rule 4A (Supplemental Liquidity Deposits) of the Rules, supra note 8.

exposures stemming from clearing SFTs because the deposits, by design, act to cover the difference between a member's peak liquidity need and NSCC's liquidity resources.

III. DISCUSSION AND NOTICE OF NO OBJECTION

Although the Clearing Supervision Act does not specify a standard of review for an Advance Notice, the stated purpose of the Clearing Supervision Act is instructive: to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for SIFMUs and strengthening the liquidity of SIFMUs.³⁹ Section 805(a)(2) of the Clearing Supervision Act authorizes the Commission to prescribe regulations containing risk management standards for the payment, clearing, and settlement activities of designated clearing entities engaged in designated activities for which the Commission is the supervisory agency.⁴⁰ Section 805(b) of the Clearing Supervision Act provides the following objectives and principles for the Commission's risk management standards prescribed under Section 805(a):⁴¹

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

Section 805(c) provides, in addition, that the Commission's risk management

³⁹ See 12 U.S.C. 5461(b).

⁴⁰ 12 U.S.C. 5464(a)(2).

⁴¹ 12 U.S.C. 5464(b).

standards may address such areas as risk management and default policies and procedures, among other areas.⁴²

The Commission has adopted risk management standards under Section 805(a)(2) of the Clearing Supervision Act and Section 17A of the Exchange Act.⁴³ These rules require, among other things, each covered clearing agency to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for its operations and risk management practices on an ongoing basis.⁴⁴ As such, it is appropriate for the Commission to review advance notices against the Clearing Agency Rules and the objectives and principles of these risk management standards as described in Section 805(b) of the Clearing Supervision Act.⁴⁵ As discussed below, the Commission believes the proposal in the Advance Notice is consistent with the objectives and principles described in Section 805(b) of the Clearing Supervision Act,⁴⁶ and in the Clearing Agency Rules, in particular Rules 17Ad-22(e)(6), (e)(7), (e)(18), (e)(19), and (e)(21).⁴⁷

⁴² 12 U.S.C. 5464(c).

⁴³ 17 CFR 240.17Ad-22. NSCC is a “covered clearing agency” as defined in Rule 17Ad-22(a)(5).

⁴⁴ 17 CFR 240.17Ad-22.

⁴⁵ The issues raised by the commenters that are outside the scope of this Advance Notice are generally not addressed here because they are not relevant to the Commission’s decision. The standard of review for the proposal is whether the proposal is consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act and Rule 17Ad-22(e) under the Exchange Act.

⁴⁶ 12 U.S.C. 5464(b).

⁴⁷ 17 CFR 240.17Ad-22(e)(6), (e)(7), (e)(18), (e)(19), and (e)(21).

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

(1) Reducing Systemic Risks and Supporting the Stability of the Broader Financial System

The Commission believes that NSCC's proposal to introduce the central clearing of SFTs is consistent with the objectives of reducing systemic risk and supporting the stability of the broader financial system.

As described above in Section II.A., through central clearing, NSCC would be able to reduce each SFT member's counterparty credit risk by becoming a counterparty to all SFTs. Central clearing would also help reduce risk because unlike bilateral transactions involving multiple counterparties, a market participant would be able to transact with one counterparty, subject to uniform and transparent risk management practices and centralized default management, minimizing the risk of potential fire sales. In addition, central clearing would provide netting efficiencies by allowing SFT members to offset cash payables and receivables, which in turn, would allow SFT members to reduce their required collateral amount and create capital efficiencies.

For these reasons, the Commission believes that the proposal should help decrease the operational, credit, and liquidity risk of SFTs relative to those made outside of central clearing through risk management, novation, trade guarantee, and netting. Accordingly, the Commission believes that, through the new SFT clearing service, the proposal would help reduce systemic risks and support the stability of the broader financial system,

consistent with Section 805(b) of the Act.⁴⁸

(2) Promoting Robust Risk Management and Safety and Soundness

The Commission believes that NSCC's proposal is consistent with the objectives of promoting robust risk management and promoting safety and soundness at NSCC.

As described in Section II.B.(3), NSCC proposes to manage the risks associated with the new SFT central clearing service in a manner consistent with its risk management of other equity securities transactions and provide a centralized method to manage any defaults. First, NSCC would manage its credit risk with respect to SFTs by requiring minimum margin deposits and applying specific aspects of its margin methodology to determine the appropriate margin to cover the risks posed by the SFTs, as well as by applying an additive margin component designed to address any high concentration risk posed by cleared SFTs. When calculating margin, NSCC would not net SFT members' SFT positions with other CNS position, and NSCC also would not net across Sponsored Member accounts or Customer accounts, thereby collecting greater amounts of margin and improving overall resilience of NSCC. NSCC also would specify that a certain portion of margin be in cash and eligible Treasury clearing fund securities to protect against market risk of the collateral. Further, as described in Section II.B.(2), NSCC would apply activity limits to ensure that SFT members' financial resources are sufficient to meet their margin requirements.

Second, as described in Section II.B.(3), NSCC would include an SFT member's potential liquidity exposures as part of NSCC's potential liquidity need. This means that,

⁴⁸ 12 U.S.C. 5464(b).

if a member's SFT activity were to drive NSCC's potential liquidity need, that member would have to provide supplemental liquidity under NSCC's existing rules, to ensure that NSCC would maintain adequate resources to satisfy liquidity needs arising from its SFT settlement obligations.

Third, the proposal would provide a procedure to address SFT member defaults to allow NSCC to take timely action to contain losses and continue to meet its obligations. Specifically, NSCC would have a right to close out a defaulting member's positions, assume the rights of the non-defaulting party in relation to such default-related SFTs, and apply its loss allocation procedure if the defaulting member's resources are insufficient to cover a loss. The loss allocation procedure would provide an orderly application of funds to absorb any loss.⁴⁹ Taken together, these procedures should minimize the likelihood that losses arising out of an SFT member default would exceed NSCC's prefunded resources and threaten the safety and soundness of NSCC's ongoing operations.

For the foregoing reasons, the Commission believes that the proposal would promote robust risk management and safety and soundness at NSCC,⁵⁰ consistent with

⁴⁹ See supra note 39.

⁵⁰ A large number of commenters expressed concerns that the proposal is designed to exclusively benefit large institutions by obscuring and facilitating negligent risky behavior, and the proposal would hamper a fair and transparent market. See, e.g., Letters from Zachary Williams and from Rob Sanders, dated April 19, 2022. The commenters' concerns generally rely on the premise that SFTs are designed to promote short sales and potentially naked short sales that such commenters believe should be illegal. See, e.g., Letters from Adam and from Bennett Zhang, dated April 19, 2022. Any SFTs that would be cleared as part of the proposed service are transactions that occur bilaterally today, and the proposal does not impact Commission rules applicable to short sales. Because this Advance Notice is not addressing short sales, and is designed to reduce risks associated with bilateral SFTs, the Commission believes that the commenters'

Section 805(b) of the Act.⁵¹

B. Consistency with Rule 17Ad-22(e)(6)(i)

Rule 17Ad-22(e)(6)(i) under the Exchange Act requires that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its participants by establishing a risk-based margin system that, at a minimum, considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.⁵²

As described above in Section II.B.(3)(i), NSCC proposes to establish margin requirements to cover its credit exposures to the SFT members. First, NSCC proposes to collect margin from SFT members, including the application of both a minimum margin amount and of NSCC's existing margin system that contains multiple component charges designed to cover various types of risk and meet applicable regulatory requirements.⁵³ Second, NSCC would apply more conservative approaches to the calculation of SFT, as compared to NSCC's existing margin system. For example, unlike the current calculation of the volatility of a member's net unsettled positions, NSCC would apply a more stringent method to address risks associated with issuer-specific events affecting the price of the concentrated security within the SFT portfolio, and risk associated with liquidating a defaulted SFT member's portfolio with a large position by asset class,

concerns related to short sales are outside the scope of the Advance Notice and the Proposed Rule Change.

⁵¹ 12 U.S.C. 5464(b).

⁵² 17 CFR 240.17Ad-22(e)(6)(i).

⁵³ See supra note 35.

relative to market-wide liquidity.⁵⁴ Further, NSCC would not net SFTs against other equity transactions at NSCC when determining margin requirements, to ensure that margins associated with SFTs would not be reduced by other equity transactions outside of the SFTs. Separately, it would collect margin on a gross basis for different Sponsored Members or different Customers, thereby accounting and collecting margin for each individual Sponsored Member and Customer.

Because NSCC applies its risk-based margin methodology, tailored to address SFTs, the Commission believes that the proposal is reasonably designed to cover NSCC's credit exposures from SFT members and consistent with Rules 17Ad-22(e)(6)(i).

C. Consistency with Rule 17Ad-22(e)(7)

Rule 17Ad-22(e)(7)(i) under the Exchange Act requires that NSCC 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, including measuring, monitoring, and managing its settlement and funding flows on an ongoing and timely basis, and its use of intraday liquidity by, at a minimum maintaining sufficient liquid resources at the minimum in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of foreseeable stress scenarios that includes, but is not limited to, the default of the participant family that would generate the largest aggregate payment obligation for the

⁵⁴ See id.

covered clearing agency in extreme but plausible market conditions.⁵⁵

As described above in Section II.B.(3)(ii), when calculating its liquidity need, in addition to liquidity exposures relating to other equity positions, NSCC would include all the differences in market value of the underlying securities owed by a defaulting SFT member in the event an SFT member defaults, as well as all novated open SFT transactions of a defaulting SFT. This determination of the liquidity need is designed to ensure that NSCC would cover any liquidity need associated with its final settlement obligations to non-defaulting SFT members and members. NSCC currently relies on various liquidity resources, all of which would be available in the event of a liquidity shortfall relating to SFTs. The Commission believes that NSCC's existing liquidity risk management framework, including NSCC's ability to collect supplemental liquidity if a member's activity, including its SFT activity, increases NSCC's liquidity need,⁵⁶ would

⁵⁵ 17 CFR 240.17Ad-22(e)(7)(i).

⁵⁶ NSCC is required to have policies and procedures reasonably designed to monitor and manage its liquidity risk by maintaining sufficient liquid resources at the minimum to effect settlement of payment obligations with a high degree of confidence under a wide range of foreseeable stress scenarios that includes, but is not limited to, the default of the participant family that would generate the largest aggregate payment obligation for the covered clearing agency in extreme but plausible market conditions, and by determining that amount and regularly testing the sufficiency of its liquidity resources. 17 CFR 240.17Ad-22(e)(7)(i) and (vi). Pursuant to this regulatory requirement, NSCC's Liquidity Risk Management Framework outlines NSCC's liquidity resources and liquidity risk management practices. See Securities Exchange Act Release No. 82377 (December 21, 2017), 82 Fed. Reg. 61617 (December 28, 2017). One such liquidity resource is NSCC's supplemental liquidity deposit, which is designed to withstand NSCC's fluctuating peak liquidity needs and source adequate liquidity at all times. To do so, NSCC allocates a funding obligation to those members driving peak liquidity needs that surpass NSCC's available liquidity resources through SLDs. See Securities Exchange Act Release No. 71000 (December 5, 2013), 78 Fed. Reg. 75400 (December 11, 2013).

be sufficient to ensure that NSCC would continue to meet its regulatory obligations.

The Commission believes that NSCC's proposal to manage its potential liquidity exposures associated with SFTs by using its established liquidity resources is reasonably designed to manage the liquidity risk that may arise in the SFT central clearing service, and consistent with Rule 17Ad-22(e)(7)(i).⁵⁷

D. Consistency with Rule 17Ad-22(e)(18)

Rule 17Ad-22(e)(18) under the Exchange Act requires that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to establish objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access by direct and, where relevant, indirect participants and other financial market utilities, require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the clearing agency, and monitor compliance with participation requirements on an ongoing basis.⁵⁸

First, the Commission believes that the proposal is reasonably designed to establish objective, risk-based, and publicly-disclosed criteria for SFT members. As described above, all members would be eligible to apply to become Sponsoring Members or Agent Clearing Members subject to such criteria, similar to how NSCC currently provides membership criteria for its members. For example, if a Sponsoring or Agent Clearing Member applicant is a registered broker-dealer, it would be subject to particular financial resource requirements, as specified in the proposed rule. Only a qualified institutional buyer or a legal entity that satisfies the financial requirements necessary to

⁵⁷ 17 CFR 240.17Ad-22(e)(7)(i).

⁵⁸ 17 CFR 240.17Ad-22(e)(18).

be a qualified institutional buyer would be eligible to be a Sponsored Member. In addition, an applicant must provide adequate assurances for its financial responsibility and operational capability.

Second, the proposal is reasonably designed to allow direct and indirect participants to access the new SFT central clearing service by establishing new membership categories to allow for such access by particular types of market participants. For example, a participant who cannot or does not want to meet the requirements to become either a member, a Sponsoring Member, or an Agent Clearing Member can participate as a Sponsored Member or as a Customer, the latter of which does not have a direct relationship with NSCC.

Third, the proposal is reasonably designed to allow NSCC to monitor compliance with participation requirements on an ongoing basis. The proposal would require an SFT member to notify NSCC if it is no longer in compliance with applicable requirements to be an SFT member, and allow NSCC to inspect SFT members' financial resources and operational capability on an ongoing basis.

For the foregoing reasons, the Commission believes that the proposal is consistent with Rule 17Ad-22(e)(18).⁵⁹

E. Consistency with Rule 17Ad-22(e)(19)

Rule 17Ad-22(e)(19) under the Exchange Act requires a covered clearing agency to establish, implement, maintain, and enforce written policies and procedures reasonably designed to identify, monitor, and manage the material risks to the covered clearing agency arising from arrangements in which firms that are indirect participants in the

⁵⁹ Id.

covered clearing agency rely on the services provided by direct participants to access the covered clearing agency's payment, clearing, or settlement facilities.⁶⁰

The proposal allows Sponsoring Members to submit Sponsored Members' transactions to NSCC, and Agent Clearing Members to submit its Customers' transactions to NSCC. In both cases, Sponsoring Members and Agent Clearing Members would be ultimately responsible to NSCC for Sponsored Members' and Customers' transactions and liable to satisfy all settlement obligations. Both Sponsoring Members and Agent Clearing Members serve as the processing agent for all the Sponsored Member and Customer transactions responsible for posting margin and satisfying any losses arising from the client transactions. Sponsoring Members and Customers do not have any direct mechanism to submit their own margin or settle transactions directly with NSCC. Moreover, even though Sponsored Members would be principally liable for their own settlement obligations, Sponsoring Members' guaranty requires Sponsoring Members to satisfy settlement obligations on behalf of its Sponsored Members.

By calculating and collecting margins for Sponsored Members' and Customers' transactions and providing certainty that Sponsoring Members and Agent Clearing Members would be responsible for their Sponsored Members' and Customers' transactions, the Commission believes that the proposal is consistent with Rule 17Ad-22(e)(19).⁶¹

F. Consistency with Rule 17Ad-22(e)(21)

Rule 17Ad-22(e)(21) under the Exchange Act requires a covered clearing agency

⁶⁰ 17 CFR 240.17Ad-22(e)(19).

⁶¹ Id.

to establish, implement, maintain, and enforce written policies and procedures reasonably designed to be efficient and effective in meeting the requirements of its participants and the markets it serves, including the clearing agency's clearing and settlement arrangements and the scope of products cleared or settled.⁶²

As described above in Section II.B.(1) and (2), the proposal is designed to reflect the current structure of the bilateral securities lending market, ensuring that relevant features and market participants subject to differing regulatory requirements and existing contractual relationships can be accommodated as part of the service provided by NSCC. For example, the proposal would allow for central clearing of SFTs with a one business day term, in order to provide a scheduled settlement date so that the transaction may be eligible for balance sheet netting benefit as explained in Section II.(B)(1). Second, the proposal would allow accelerated settlement so that certain market participants are able to quickly unwind their SFTs to satisfy applicable regulatory requirements. Third, the proposed membership categories would accommodate principal and agency trading to allow different types of market participants to enter into the new SFT central clearing service, consistent with their business models and applicable regulatory requirements.

⁶² 17 CFR 240.17Ad-22(e)(21).

Accordingly, the Commission believes that the proposal is reasonably designed to be efficient and effective in meeting the requirements of its participants and the market it serves, and consistent with Rule 17Ad-22(e)(21).⁶³

VI. CONCLUSION

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Clearing Supervision Act, that the Commission DOES NOT OBJECT to Advance Notice (SR-NSCC-2022-801) and that NSCC is AUTHORIZED to implement the proposal as of the date of this notice or the date of an order by the Commission approving proposed rule change SR-NSCC-2022-003, whichever is later.

By the Commission.

J. Matthew DeLesDernier,

Assistant Secretary.

⁶³

Id.