



## **Fixed Income Clearing Corporation**

### **Mortgage Backed Securities Division (MBSD)**

#### **General Policies Regarding the Insolvency of an MBSD Clearing Member<sup>1</sup>**

##### **1. INTRODUCTION**

In order to help mitigate risk in the marketplace, FICC monitors the financial status of its participants against the requirements of its rules. FICC also attempts to reduce market risk through the establishment of collateral requirements, the collection of margin and the daily marking-to-market of open net settlement positions of its participants. FICC requires that its participants maintain ongoing conformity with each of the admission standards applicable to them. In addition, DTCC's Risk Management unit analyzes financial and regulatory reports and statements submitted by members.

This document describes the steps FICC will generally take if it decides to cease to act for one or more of its Mortgage-Backed Securities Division (MBSD) participants. These steps may change if FICC is instructed to proceed in a different way by, for example, a regulator or a court of appropriate jurisdiction. FICC would confer with its Board and its regulators in this regard.

##### **ACTION STEPS**

Generally speaking, FICC performs certain tasks before, during and after a participant has become insolvent.

###### **1) Declaring a participant insolvent and ceasing-to-act**

FICC declares a participant to be insolvent and proceeds to cease to act for a participant.

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<sup>1</sup> In the event of a conflict between this document and the Rules of the MBSD, the Rules shall govern.

**2) Making the decision to liquidate**

Once a participant has been declared insolvent, FICC must formally make the decision to have the insolvent participant's open positions liquidated by its settlement counterparty.

**3) Notifying all MBSD participants of insolvency**

When FICC determines to cease to act for a participant, it notifies all participants.

**4) Preparing the close-out**

Before an insolvent participant's positions can be closed out, FICC must identify the insolvent participant's Open Commitments in the Comparison and Clearing System.

**5) Closing out final net settlement positions**

Under the MBSD's current rules, the close-out trades are conducted by the contra-side participant. FICC will closely monitor the close-out process, paying particular attention to tracking the profits and/or losses associated with the liquidation. FICC will also liquidate the insolvent participant's Participant Fund.

**6) Post-close-out tasks**

After the insolvent participant's positions have been closed out, FICC still has a number of tasks to complete. These include the calculation of the liquidation results and the allocation of any possible liquidation losses, as well as final reporting.

## **IMPLEMENTING THE STEPS**

### **DECLARING A PARTICIPANT INSOLVENT AND CEASING TO ACT**

#### **Insolvency**

A participant is deemed insolvent by FICC once it has provided written notice to the corporation that it is insolvent. Any transaction processed by FICC until the point of notification will be considered a legitimate trade.

A participant is determined to be insolvent if it has notified FICC that it either:

- cannot perform any of its material contracts, obligations or agreements; or
- determines that it will no longer be able to perform any of its material contracts, obligations or agreements

FICC may also determine a participant to be insolvent if the participant becomes subject to a bankruptcy or other similar proceeding as defined in the MBSD Rules, or if one or more of the following parties determine that the participant is insolvent:

- the FICC Board or the Board's Credit and Market Risk Management Committee;

- any Designated Examining Authority or appropriate regulatory agency with jurisdiction over such participant; or
- any Self-Regulatory Organization that such participant belongs to.

Once FICC has declared a participant insolvent, the Corporation will cease-to-act for the insolvent participant.

### **Other causes for ceasing to act**

FICC may decide to cease to act for a participant for reasons other than notification of insolvency by a participant. FICC may decide to cease to act based on the judgment of its Credit and Market Risk Management Committee that adequate cause exists to do so.

In order for FICC to cease to act for a participant, one or more of the following factors must be present:

- 1) The participant has failed to make timely payment of its Cash Settlement obligations or to perform its obligations to other participants.
- 2) FICC has determined that the participant no longer meets all of the membership qualifications.
- 3) FICC has reasonable grounds to believe that the participant has been responsible for any fraudulent or dishonest conduct, or has made a material misstatement or omitted to state a material fact in any statement to any officer or employee of the FICC in connection with any transaction processed or service furnished by FICC.
- 4) The participant has materially violated the Rules, the Procedures or any agreement with FICC.
- 5) FICC has reasonable grounds to believe that the participant is in or is approaching financial difficulty or will otherwise be unable to meet its obligations to FICC or other participants.
- 6) FICC has reasonable grounds to believe that such ceasing to act is necessary for the protection of investors or other participants or to facilitate the orderly and continuous performance of FICC's service.

Despite the provisions stated above, FICC shall not be required to cease-to-act for a participant if directed otherwise by the Securities and Exchange Commission or any court or administrative agency having jurisdiction over FICC.

It should be noted that the decision to cease to act can also be made:

- either with respect to any account or set of aggregated accounts; or
- with respect to a particular transaction or transactions generally; or

- with respect to any system offered or service provided by FICC.

### **Actions following the decision to cease to act**

FICC's decision to cease to act leads to certain actions including:

#### 1. Notifying the participants

When FICC ceases to act for a participant, it will promptly communicate its decision to the affected participant as well as all other participants. The communication will either state that FICC has ceased to act generally for all transactions to which the participant is a party, or it will identify the particular transaction(s) for which FICC has ceased to act. In addition, it will state, as far as appropriate and to the extent that this information is available:

- how pending matters and transactions will be affected; and
- what steps will be taken by FICC in view of its decision.

Furthermore, FICC will promptly furnish any participant for which it has ceased to act with a written statement of the grounds for its decision. The participant will have the right to request an appeal. The request for an appeal, however, will not in any way affect the decision under appeal unless or until the decision itself is reversed or modified in accordance with the MBSD hearings rule.

#### 2. Ceasing to accept data from the affected participant

#### 3. Reporting to the SEC and notifying other relevant parties

### **PREPARING THE CLOSE-OUT**

#### **Preliminary Actions**

- All participants receive notification of MBSD's decision to cease acting for the former participant;
- MBSD liquidates all securities (and draws upon letters of credit, if any) that the former participant has deposited into its Participants Fund.

#### **Identification of Open Commitments**

- MBSD may designate a specific pass during which all contra-sides will be required to affirm or DK all unmatched trades and NOS. Failure to take required action may result in MBSD's determination that the unmatched trade and/or NOS is a valid transaction;

- MBSD is authorized, per MBSD's Rules, to obtain, if necessary, immediate disclosure of the settlement status of any transaction from depository institutions and/or clearing banks;
- MBSD identifies all open TFTD, SBOD, SBOO, SBON and all "in the money" OPTN contracts for the former participant;
- MBSD discloses all fully matched, yet-to-be disclosed, give-up trades to which the former participant is a contra-side;
- MBSD cancels all "out of the money" option (OPTN) contracts involving the former participant;
- MBSD generates the Fail and Forward versions of the Special Open Commitment Report, identifying all open commitments with the former participant;
- MBSD generates the Net-Out Report, detailing open Net-Out obligations as of Settlement Date plus 1, by contra, within a TBA CUSIP;
- All previously cleared SBOO, SBON and TFTD trades are cancelled.

### CLOSING OUT FINAL NET SETTLEMENT POSITIONS

MBSD notifies all contra-sides to liquidate open commitments with the former participant. The liquidation of the former participant's open commitments may occur on a net basis, as determined by MBSD. All open commitments will be disposed of as TBAs regardless of any specification previously agreed upon by the former participant and contra-side. SBON contra-side participants that liquidate SBON trades are covered for losses by the former participant's Participants Fund and, if necessary, assessments against original contra-sides.

Each contra-side is required within a specified time-frame to:

1. Obtain at least three competing bids for the assumption of the open commitment, at each trade's face value. MBSD will not allow claims for variance relating to a former participant's open commitments that have not completed SBO netting or that have a Trade-for-Trade status.
2. Accept or match the best bid received and advise MBSD of the terms of the accepted or matched bid.
3. Advise MBSD of the following information for each bid obtained:
  - The name of the bidding organization and the trader submitting the bid
  - The date and time of the bid;
  - The terms of the bid;
  - Commissions paid;
  - Fail costs incurred;

MBSD will confirm receipt of the above terms.

## **Cancellation of Open Commitments by MBSD**

Once confirmation regarding the accepted or matched bid has been received, MBSD will:

### **If the successful bidder is an MBSD participant:**

Cancel the defaulted open commitment and record the terms of the accepted or matched trade.

-or-

### **If the successful bidder is not an MBSD participant:**

Cancel the defaulted open commitment and record the terms of the accepted or matched trade on an internal ledger.

## POST CLOSE-OUT TASKS

### **Determination of Aggregate Profits or Losses**

Upon disposition of all of the former participant's open commitments, MBSD determines the aggregate profits and losses incurred by each contra-side in the following manner:

- MBSD calculates the net profit or loss between the defaulted trade terms and the associated accepted or matched bid;
- MBSD aggregates net losses incurred by the contra-side participants from terms submitted;
- MBSD aggregates net losses incurred within original contra-sides and SBO non-original contra-sides;
- MBSD aggregates net profits realized by original contra-sides and SBO non-original contra-sides.

### **Disposition of Net Profits and Claims for Losses**

#### **Claims for Net Profits**

Participants are required to make payment to MBSD for net profits realized as a result of accepting or matching the best bid. Net profits realized by all contra-sides are payable in the following manner:

- MBSD notifies all contra-sides of the amount claimed;

- Upon receipt of the claim, all contra-sides immediately make payment to MBSD via Federal Funds wire transfer.

Payments made to MBSD are credited to the Participants Fund of the former participant and are available to satisfy claims for losses.

### **Claims Against the Former Participant by MBSD**

MBSD is required to charge the Participants Fund of the former participant for unpaid obligations of the former participant including, but not limited to:

- Unpaid SBOMD payables;
- Unpaid Cash Adjustment payables;

### **Claims Against the Former Participant by SBO Non-Original (SBON) Contra-Sides**

Once MBSD has reviewed information received from SBO non-original (SBON) contra-sides, it calculates the net difference between the aggregate amount of the losses and the value of the former participant's Participants Fund and:

- Satisfies all losses in full if the Participants Fund is greater than or equal to the aggregate losses incurred by the SBON contra-sides by disbursing the former participant's Participants Fund.
- Satisfies all SBON contra-sides in full, if the Participants Fund is less than the aggregate amount of all losses incurred by the SBON contra-sides by charging original contra-sides the amount necessary when combined with the Participants Fund to satisfy losses in full. The original contra-sides will be charged on a pro-rata basis in each TBA CUSIP in which a SBON contra-side incurred a net loss.

### **Claims Against the Former Participant by Original Contra-Sides Relating to Previously Margined Transactions**

After the satisfaction of claims submitted by SBON contra-sides, MBSD, from information submitted by original contra-sides, shall determine the net difference if any, between the aggregate amount of original contra-side claims relating to previously margined transactions and the remaining value of the former participant's Participants Fund.

If the value of the Participants Fund is greater than or equal to the aggregate amount of losses incurred by the original contra-sides relating to previously margined transactions, MBSD satisfies all losses in full.

If the value of the Participants Fund is less than the aggregate amount of all losses incurred by original contra-sides relating to previously margined transactions, MBSD satisfies original contra-sides claims by determining each original contra-side pro rata share (entitlements) to the former participant's Participants Fund. Pro rata share (entitlements) are determined by comparing each original contra-side's loss to the aggregate value of all original contra-side losses relating to previously margined transactions. MBSD then makes the appropriate payment to the original contra-sides.

### **Claims Against the Former Participant by Original Contra-Sides Relating to New Unmargined Transactions**

After the satisfaction of claims submitted by original contra-sides relating to previously margined transactions, MBSD, from information submitted by original contra-sides, shall determine the net difference if any, between the aggregate amount of original contra-side claims relating to new unmargined transactions and the remaining value of the former participant's Participants Fund.

If the value of the Participants Fund is greater than or equal to the aggregate amount of losses incurred by the original contra-sides relating to new unmargined transactions, MBSD satisfies all losses in full.

If the value of the Participants Fund is less than the aggregate amount of all losses incurred by original contra-sides relating to new unmargined transactions, MBSD satisfies original contra-sides claims by determining each original contra-side pro-rata share (entitlements) to the former participant's Participants Fund. Pro-rata share (entitlements) are determined by comparing each original contra-side's loss to the aggregate value of all original contra-side losses relating to new unmargined transactions. MBSD then makes the appropriate payment to the original contra-sides.

### **Interest Losses and Due Bill Claims**

If applicable, MBSD will advise participants of the timeframe to submit interest losses and due bill claims.

### **Cash Adjustments**

Claims may be allowed for Cash Adjustments relating to a former participant's open commitments that have completed SBO (netting) process if such claims are reasonable as determined solely by MBSD.

**Amounts from Limited Cross-Guaranty Agreements**

Amounts, if any, received by MBSD from a Cross-Guaranty Party under the Limited Cross-Guaranty Agreement shall be applied to unpaid obligations of the former participant to MBSD and to reduce assessments against and losses of original contra-sides.

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For additional information, please contact your Relationship Manager.