National Securities Clearing Corporation / Industry Working Group

Trade Clearance Input Concept Paper

August, 2014

DTCC

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I. Executive Summary

The National Securities Clearing Corporation (NSCC) has been working with a group of industry participants (referred to as the Industry Working Group or “IWG) to develop ways to further manage risk in the clearance and settlement process. This paper describes some of the issues addressed by this group, and provides a preliminary outline of concepts that the IWG has developed.

NSCC’s trade capture system receives and validates transactions from market centers, then prepares them for netting and settlement. In recent years, NSCC consolidated four separate legacy applications into a single engine, called Universal Trade Capture (UTC). UTC has streamlined and standardized the equity clearance process, allowing the industry to better reconcile clearance transactions and manage their risk exposure. Since UTC’s launch, NSCC and industry participants have considered methods to further manage risk in the post-trade process. In 2013, NSCC established the IWG to discuss ways to address the possible risks that may be related to trade submission practices.

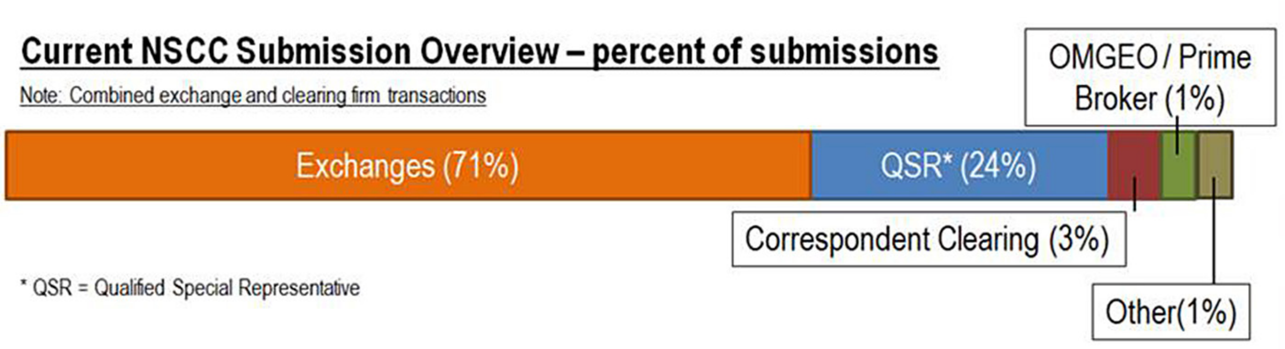
A key conclusion is that counterparty risk may be reduced if transactions are submitted to NSCC in real-time. Effective in February 2014, NSCC’s rules now require that all locked in trades be submitted to NSCC in real-time, without pre-netting or batching trades. As a result, equity trade capture transmissions from exchanges and qualified special representatives (QSRs) must be sent to NSCC immediately following execution. Currently, over 95% of clearance submissions are received in real-time, primarily from exchanges and alternative trading systems, such as dark pools. Only a small portion of transactions are still submitted to NSCC at the end of the day through NSCC’s Correspondent Clearing service.

The IWG’s primary focus is the improved risk management capabilities enabled with real-time trade processing. In addition, the group expressed the need to establish common clearance submission standards and practices across the industry, which will create efficiencies and will ensure that all market participants that submit trades to NSCC do so within the same standards and practices. Finally, proposed structure changes to trade submission practices are expected to set the stage for the implementation of future industry improvements in trade clearance. Industry review meetings have given direction to a new clearance submission structure, and their preliminary proposals are outlined in the following pages.

II. Current Trade Submission Structure

As required by NSCC’s rules, currently, all exchanges submit real-time clearance records to NSCC. This requirement facilitates efficient risk management for NSCC and for clearing firms, and enables same-day bookkeeping and reconciliation.

Under the current structure, clearing firms may submit transactions directly to NSCC using two vehicles. First, NSCC’s rules require that QSR submissions be sent to NSCC immediately upon transaction execution by firms that operate automated execution systems, in real-time. Second, Correspondent Clearing submissions allow for the post-execution position movement between clearing firms. While NSCC clients are encouraged to submit Correspondent Clearing submissions to NSCC as soon as possible following execution, today these position movements may be sent to NSCC either in real-time, intraday, or at the end of the day. Both QSR and Correspondent Clearing transactions are validated within NSCC’s UTC system to ensure that the submitter is authorized to lock in the counterparty.



III. Rationale for Reviewing the Current Clearing Firm Submission Practices

During discussions with the IWG, in which the proposals above were developed, industry participants identified a number of opportunities to further address the risks that may be present in the current clearance submission landscape. In developing the proposed structure, the industry representatives also considered opportunities for standardization of trade submission processes and for creating a platform on which future changes to trade submission processes may be built. These considerations were raised as important decision criteria in developing the proposed structure that is outlined in Section IV, below.

INDUSTRY RISKS

Risk to the Clearing Firm – Today, most correspondent clearing transactions are submitted to NSCC at the end of the trading day. Clearing firms that ultimately receive the transactions may not have the ability to perform sufficient risk management on that trading day. Further, if the firm disagrees with the transaction details it would have no time for recourse before the end of the processing day.

Risk to the Executing Firm – Executing firms hold intraday counterparty risk for any transactions that are not immediately submitted to NSCC. If a clearing firm defaults, or a trading relationship is deleted in real-time through NSCC's trading relationship management system, any subsequent submissions involving the removed counterparty will be rejected.

Risk to NSCC - NSCC bears the ultimate risk when it acts as central counterparty to cleared transactions. If transactions are not submitted in a timely basis, NSCC's risk management calculations may not fully represent each firm's outstanding net obligations. NSCC's ability to appropriately manage risk on the trades that it guarantees and to protect itself, its members, and the wider financial markets is enhanced when transactions are submitted in real-time.

STANDARDIZATION OF TRADE SUBMISSION PRACTICES

Standardization – NSCC created the UTC application to standardize clearance submission processes across the industry. The proposed changes are expected to promote further standardization of industry practices, consistent reconciliation, and, therefore, more effective risk management.

PLATFORM FOR FUTURE CHANGES

Strategic initiatives – Requiring real-time processing capabilities for all trade submissions could facilitate further industry improvements, such as ensuring that real-time data is included in DTCC Limit Monitoring and setting the stage for the industry's proposal to shorten the settlement cycle.

System improvements – A simplified, standardized clearance input process could also facilitate continuous improvements to firms' clearance systems, leading to greater efficiencies.

IV. Proposed Structure

Real-time processing was the most frequently cited market structure improvement opportunity mentioned during industry discussions. As such, NSCC and the IWG have focused on proposals to increase the volume of real-time clearance submissions. The following proposal identifies potential changes to NSCC's current real-time processing requirements, and defines submission mechanisms that could standardize trade submission across NSCC clients. NSCC will continue to seek wider industry feedback in order to further develop these proposals with functionality and design details.

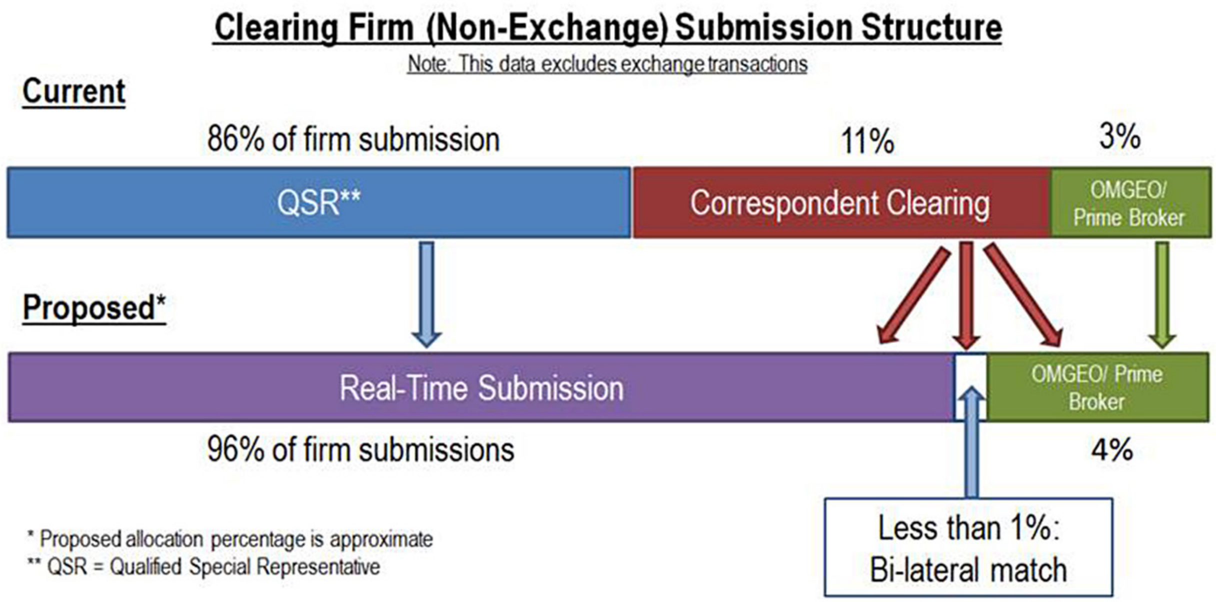
Real-time submissions – The IWG has proposed that NSCC's Rules require real-time submission to NSCC for all transactions in which the submitter knows the counterparty upon execution. Both parties to these transactions are known, obviating the need to delay submission to NSCC. Currently, all exchanges and QSR firms are required to submit real-time, non-pre-netted transactions. The proposal will expand this requirement to transactions currently processed through NSCC's Correspondent Clearing service, in circumstances where the submitter knows the counterparty upon trade execution. It is believed that the risk management benefit associated with real-time submissions greatly outweighs any short-term implementation requirements.

Batch submissions – A small number of transaction types are position movements, generally defined as riskless clearance obligation movements between two clearing firms within the same family to facilitate special purposes. Today, these transactions are submitted through NSCC's Correspondent Clearing service and are not required to be submitted in real-time. These transactions are proposed to be processed through a bi-lateral matching vehicle and then sent to UTC for clearance processing. Bi-lateral matching would be available for transactions between affiliate firms within the same operating family. Even with respect to these transactions that are not submitted in real-time, firms would be expected to submit to the central counterparty as quickly as possible.

Institutional allocations – Just as is required under the current applicable rules, allocations to institutional customers must not be submitted using NSCC's broker dealer services (QSR and Correspondent Clearing). The IWG proposes that this current requirement not be changed, and any such transactions currently submitted via NSCC's broker dealer services must be submitted through normal institutional trade matching vehicles, regardless of the implementation of this proposal. Institutional transactions currently submitted through NSCC's broker dealer services are a violation of NSCC's Rules and Procedures, subjecting the submitting firm to disciplinary action, and would continue to be considered a violation of NSCC's Rules under the proposed structure. The industry has also expressed interest in developing a proposal to expedite the affirmation process. It is estimated that 53% of transactions are affirmed on trade date and 88% are affirmed by trade date plus 1 or "T+1." This proposal continues to be under discussion.

REAL-TIME SUBMISSION OVERVIEW

- Today, all exchange submissions are submitted to NSCC in real-time.
- Most clearing firm submissions are submitted to NSCC in real-time, with the following breakdown:



NSCC TRADING RELATIONSHIP MANAGEMENT SYSTEM

In 2011, as part of the implementation of UTC, NSCC created an automated system for firms to establish and maintain QSR and Correspondent Clearing trading relationships[1]. Information provided by NSCC clients in the Trading Relationship Management System is used in the UTC validation process. Currently only 10% of QSR and Correspondent Clearing trading relationships have enabled executing broker (MPID) level validation. The Industry Working Group has proposed that NSCC amend its rules in order to require this executing broker information to be provided by any members that create QSR and Correspondent Clearing relationships. This proposal would reduce risk at clearing firms through enhanced validation and control on their customer relationships.

The Trading Relationship Management System (TRMS) has added much needed efficiency to the management and processing of the clearing agreements. As intended, it has added the ability to streamline the establishment and maintenance of the agreement in a real time environment. This allows firms to agree to transact on behalf of a customer and enable the clearing of the customer's business almost immediately. Acceptance of the agreement is accomplished through a bi-lateral agreement and acknowledgement via the TRMS. In contrast, the termination of an agreement is accomplished by a unilateral transaction with no systemic advance notice required. Either party to the agreement can individually decide to terminate the agreement and accomplish it in real-time via the TRMS. The IWG has asked NSCC and the industry to evaluate the current termination practices.

[1] See NSCC Important Notice A#7145, P&S# 6715, dated January 19, 2011 (available on www.dtcc.com).

V. Impact of Proposed Structure on Fees

As required by the Exchange Act, NSCC's rules must provide for the equitable allocation of reasonable dues, fees, and other charges among its participants[2]. Therefore, and in compliance with its regulatory requirements, NSCC will analyze the impact of any proposed rule changes on the fees charged for related services, and may consider modifying its fee structure to minimize the resulting cost impact, where permitted. For example, in 2014 NSCC recalibrated its clearance activity fee structure prior to the implementation of the real-time QSR trade submission requirement by decreasing the units (per transaction) share of overall clearance fees, and lowering the impact of transaction count increases. Industry participants can expect a similar review to coincide with the implementation of any proposals.

PLEASE CONTACT

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[2] 5 U.S.C. 78q-1(b)(3)(D).

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