

Required fields are shown with yellow backgrounds and asterisks.

Page 1 of * 43	SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549 Form 19b-4		File No.* SR - 2017 - * 801	Amendment No. (req. for Amendments *)
Filing by The Depository Trust Company Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934				
Initial * <input checked="" type="checkbox"/>	Amendment * <input type="checkbox"/>	Withdrawal <input type="checkbox"/>	Section 19(b)(2) * <input type="checkbox"/>	Section 19(b)(3)(A) * <input type="checkbox"/>
			Section 19(b)(3)(B) * <input type="checkbox"/>	
			Rule	
Pilot <input type="checkbox"/>	Extension of Time Period for Commission Action * <input type="checkbox"/>	Date Expires * <input type="text"/>	<input type="checkbox"/> 19b-4(f)(1) <input type="checkbox"/> 19b-4(f)(2) <input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(4) <input type="checkbox"/> 19b-4(f)(5) <input type="checkbox"/> 19b-4(f)(6)
Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010			Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934	
Section 806(e)(1) * <input checked="" type="checkbox"/>		Section 806(e)(2) * <input type="checkbox"/>	Section 3C(b)(2) * <input type="checkbox"/>	
Exhibit 2 Sent As Paper Document <input type="checkbox"/>	Exhibit 3 Sent As Paper Document <input type="checkbox"/>			
<b>Description</b>				
Provide a brief description of the action (limit 250 characters, required when Initial is checked *).				
<input type="text" value="Address and update practices and policies with respect to the Credit Risk Rating Matrix."/>				
<b>Contact Information</b>				
Provide the name, telephone number, and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the action.				
First Name *	<input type="text" value="Rosa"/>	Last Name *	<input type="text" value="Chang"/>	
Title *	<input type="text" value="Executive Director and Associate General Counsel"/>			
E-mail *	<input type="text" value="rchang1@dtcc.com"/>			
Telephone *	<input type="text" value="(212) 855-4985"/>	Fax	<input type="text"/>	
<b>Signature</b>				
Pursuant to the requirements of the Securities Exchange Act of 1934,				
has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.				
(Title *)				
Date	<input type="text" value="03/22/2017"/>	<input type="text" value="Managing Director and Deputy General Counsel"/>		
By	<input type="text" value="Lois J. Radisch"/>	<input type="text" value=""/>		
(Name *)				
NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.				
		<input type="button" value="lradisch@dtcc.com"/>		

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFF website.

**Form 19b-4 Information \***

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change \***

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 1A- Notice of Proposed Rule Change, Security-Based Swap Submission, or Advance Notice by Clearing Agencies \***

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change, security-based swap submission, or advance notice being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Exhibit Sent As Paper Document

Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Exhibit Sent As Paper Document

Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

## **1. Text of Advance Notice**

(a) This advance notice of The Depository Trust Company (“DTC”) consists of proposed modifications to DTC’s Rules, By-Laws and Organization Certificate (“Rules”),<sup>1</sup> annexed hereto as Exhibit 5. The proposed rule change would amend Rules 1 and 2 in order to (i) address and update DTC’s practices and policies with respect to the existing matrix (hereinafter referred to as the “Credit Risk Rating Matrix” or “CRRM”), which was, as described in an earlier DTC rule filing,<sup>2</sup> developed by DTC to assign a credit rating to certain Participants (“CRRM-Rated Participants”) by evaluating the risks posed by CRRM-Rated Participants to DTC and its Participants from providing services to these CRRM-Rated Participants and (ii) make other amendments to the Rules to provide more transparency and clarity regarding DTC’s current ongoing membership monitoring process.

(b) Not applicable.

(c) Not applicable.

## **2. Procedures of the Clearing Agency**

The filing of this advance notice with the Commission was approved by the Risk Committee of the Board of Directors of DTC at a meeting duly called and held on June 14, 2016.

## **3. Self-Regulatory Agency’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

Not applicable.

## **4. Self-Regulatory Agency’s Statement on Burden on Competition**

Not applicable.

## **5. Self-Regulatory Agency’s Statement on Comments on the Advance Notice Received from Members, Participants, or Others**

Written comments relating to this proposal have not been solicited or received. DTC will notify the Commission of any written comments received by DTC.

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<sup>1</sup> Capitalized terms not defined herein are defined in the Rules, available at [www.dtcc.com/~media/Files/Downloads/legal/rules/dtc\\_rules.pdf](http://www.dtcc.com/~media/Files/Downloads/legal/rules/dtc_rules.pdf).

<sup>2</sup> See Securities Exchange Act Release No. 53655 (April 14, 2006), 71 FR 20428 (April 20, 2006) (SR-DTC-2006-03) (order of the Securities and Exchange Commission (“Commission”) approving a proposed rule change (“2006 Rule Change”) of DTC to amend the criteria used by DTC to place Participants on surveillance status, including, but not limited to DTC’s application of the CRRM and the placement of lower rated CRRM-Rated Participants on an internal list in order to be monitored more closely (“Watch List”).

**6. Extension of Time Period for Commission Action**

Not applicable.

**7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)**

(a) Not applicable.

(b) Not applicable.

(c) Not applicable.

(d) Not applicable.

**8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission**

Not applicable.

**9. Security-Based Swap Submissions Filed Pursuant to Section 3C of the Exchange Act**

Not applicable.

**10. Advance Notice Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act**

*Nature of the Proposed Change*

The proposed rule change would amend Rules 1 and 2 in order to (i) address and update DTC's practices and policies with respect to the CRRM and (ii) provide more transparency and clarity regarding DTC's current membership monitoring process. In this regard, the proposed rule change would (i) add proposed definitions for the terms "Credit Risk Rating Matrix" and "Watch List" to Rule 1 (Definitions), as discussed below and (ii) amend Rule 2 (Participants and Pledges) to (A) clarify a provision in Section 1 relating to the types of information a Participant must provide to DTC upon DTC's request for the Participant to demonstrate its satisfactory financial condition and operational capability, including its risk management practices with respect to services of DTC utilized by the Participant for another Person and (B) add a new Section 10 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of the CRRM and proposed enhancements to the CRRM, as further discussed below.

(i) Background

DTC occupies an important role in the securities settlement system by, among other things, providing services for the settlement of book-entry transfer and pledge of interests in eligible deposited securities and net funds settlement, in connection with which Participants may incur net funds settlement obligations to DTC. DTC uses the CRRM, the Watch List and the

enhanced surveillance to manage and monitor default risks of Participants on an ongoing basis, as discussed below. The level and frequency of such monitoring for a Participant is determined by the Participant's risk of default as assessed by DTC. Participants that are deemed by DTC to pose a heightened risk to DTC and its Participants are subject to closer and more frequent monitoring.

*Existing Credit Risk Rating Matrix*

Pursuant to the 2006 Rule Change, all Participants that are either U.S. broker-dealers or U.S. banks are assigned a rating generated solely based on quantitative factors by entering financial data of those Participants into an internally generated credit rating matrix, i.e., the CRRM.<sup>3</sup> All other types of Participants are monitored by credit risk staff using financial criteria deemed relevant by DTC but would not be assigned a rating by the CRRM.<sup>4</sup>

The 2006 Rule Change explained that credit risk staff could downgrade a particular Participant's credit rating based on various qualitative factors. An example of such qualitative factors might be that the Participant in question received a qualified audit opinion on its annual audit. DTC noted in the 2006 Rule Change that in order to protect DTC and its other Participants, it was important that credit risk staff maintain the discretion to downgrade a Participant's credit rating on the CRRM and thus subject the Participant to closer monitoring.

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks – and generates credit ratings for the relevant Participants based on a 7-point rating system, with “1” being the strongest credit rating and “7” being the weakest credit rating.

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<sup>3</sup> See 2006 Rule Change, SR-DTC-2006-03, 71 FR 20428, which explained that the ratings assigned by the CRRM were generated using financial data extracted from standard regulatory reports of U.S. broker-dealers and banks. A small number of U.S. banks which submitted standard regulatory reports were not assigned a rating because they did not take deposits or make loans, and therefore the regulatory reports of these banks did not contain information on asset quality and/or liquidity, which was a data component used in the CRRM. *Id.* However, the 2006 Rule Change provided DTC with discretion to continue to “evaluate the matrix methodology and its effectiveness and make such changes as it deems prudent and practicable within such time frames as it determines to be appropriate.” *Id.* DTC has continued to evaluate the CRRM and has determined that the CRRM is the most effective method available to it to evaluate the default risk presented by any U.S. bank that submits regulatory reports, including a bank whose reports exclude certain data components as mentioned above. Accordingly, DTC applies the CRRM to assign ratings to any U.S. bank that submits regulatory reports, including those that were not covered by the CRRM in 2006, as reflected in the proposed rule change.

<sup>4</sup> In the 2006 Rule Change, DTC noted that these Participants would be monitored by credit risk staff by reviewing similar criteria as those reviewed for Participants included on the matrix but such review would occur outside of the matrix process. *Id.*

Over time, the current CRRM has not kept pace with DTC's evolving Participant membership base and heightened expectations from regulators and stakeholders for robustness of financial models. Specifically, the current CRRM only generates credit ratings for those Participants that are U.S. banks or U.S. broker-dealers that file standard reports with their regulators, which currently comprise 80% of Participants; foreign banks and trust companies currently account for 5% of Participants.<sup>5</sup> The number of Participants that are foreign banks or trust companies increased from 12 in 2012 to 13 in 2017, and is expected to continue to grow over the coming years. Foreign banks and trust companies are typically large global financial institutions that have complex businesses and conduct a high volume of activities. Although foreign banks and trust companies are not currently rated by the CRRM, they are monitored by DTC's credit risk staff using financial criteria deemed relevant by DTC and can be placed on the Watch List if they experience a financial change that presents risk to DTC. Given the increase in the number of foreign bank Participants in recent years, there is a need to formalize DTC's credit risk evaluation process of the foreign bank or trust company Participants by assigning credit ratings to them in order to better facilitate the comparability of credit risks among Participants.<sup>6</sup>

As mentioned above, a Participant's credit rating is currently based solely upon quantitative factors. It is only after the CRRM has generated a credit rating with respect to a Participant that such Participant's credit rating may be downgraded manually by credit risk staff, after taking into consideration relevant qualitative factors. The inability of the current CRRM to take into account qualitative factors requires frequent and manual overrides by credit risk staff, which may result in inconsistent and/or incomplete credit ratings for Participants.

Furthermore, the current CRRM uses a relative scoring approach and relies on peer grouping of Participants to calculate the credit rating of a Participant. This approach is not ideal because a Participant's credit rating can be affected by changes in its peer group even if the Participant's financial condition is unchanged.

#### *Proposed Credit Risk Rating Matrix Enhancements*

To improve the coverage and the effectiveness of the current CRRM, DTC is proposing three enhancements to the CRRM. The first proposed enhancement would expand the scope of CRRM coverage by enabling the CRRM to generate credit ratings for Participants that are foreign banks or trust companies and that have audited financial data that is publicly available. The second proposed enhancement would incorporate qualitative factors into the CRRM and

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<sup>5</sup> As of March 16, 2017, there are 251 Participants, of which 50 (or 20%) are U.S. banks, 151 (or 60%) are U.S. broker-dealers and 13 (or 5%) are foreign banks or trust companies.

<sup>6</sup> DTC noted in the 2006 Rule Change that the CRRM is applied across DTC and its affiliated clearing agencies, NSCC and FICC. Specifically, in order to run the CRRM, credit risk staff uses the financial data of the applicable DTC Participants in addition to data of applicable members of NSCC and FICC. In this way, each applicable DTC Participant is rated against other applicable members of NSCC and FICC. See 2006 Rule Change, SR-DTC-2006-03, 71 FR 20428.



therefore is expected to reduce the need and the frequency of manual overrides of Participant credit ratings. The third enhancement would replace the relative scoring approach currently used by CRRM with a statistical approach to estimate the absolute probability of default of each Participant.

*A. Enable the CRRM to Generate Credit Ratings for Foreign Bank or Trust Company Participants*

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks. DTC is proposing to enhance the CRRM by adding an additional credit rating model for the foreign banks and trust companies. The additional model would expand the scope of Participants to which the CRRM would apply to include foreign banks and trust companies that have audited financial data that is publicly available. The CRRM credit rating of a foreign bank or trust company that is a Participant would be based on quantitative factors, including size, capital, leverage, liquidity, profitability and growth, and qualitative factors, including market position and sustainability, information reporting and compliance, management quality, capital management and business/product diversity. By enabling the CRRM to generate credit ratings for these Participants, the enhanced CRRM would provide more comprehensive credit risk coverage of DTC's membership base.

With the proposed enhancement to the CRRM as described above, applicable foreign bank or trust company Participants would be included in the CRRM process and be evaluated more effectively and efficiently because financial data with respect to these foreign bank or trust company Participants could be extracted from data sources in an automated form.<sup>7</sup>

After the proposed enhancement, CRRM would be able to generate credit ratings on an ongoing basis for all Participants that are U.S. banks, U.S. brokers-dealers and foreign banks and trust companies, which together represent approximately 85% of Participants.<sup>8</sup>

*B. Incorporate Qualitative Factors into the CRRM*

In addition, as proposed, the enhanced CRRM would blend both qualitative factors and quantitative factors to produce a credit rating for each applicable Participant in relation to the Participant's credit risk. For U.S. and foreign banks and trust companies, the enhanced CRRM would use a 70/30 weighted split between quantitative and qualitative factors to generate credit ratings. For U.S. broker-dealers, the weight split between quantitative and qualitative factors would be 60/40. These weight splits have been chosen by DTC based on the industry best

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<sup>7</sup> In the 2006 Rule Change, DTC noted that these Participants would be monitored by credit risk staff by reviewing similar criteria as those reviewed for Participants included on the CRRM, but such review would occur outside of the CRRM process. *Id.*

<sup>8</sup> As of March 16, 2017, there are 37 Participants that would not be rated by the enhanced CRRM, as proposed, because they are central securities depositories, securities exchanges, government sponsored entities, central counterparties, central banks and U.S. trust companies that do not file Call Reports (as defined below).

practice as well as research and sensitivity analysis conducted by DTC. DTC would review and adjust the weight splits as well as the quantitative and qualitative factors, as needed, based on recalibration of the CRRM to be conducted by DTC approximately every three to five years.

Although there are advantages to measuring credit risk quantitatively, quantitative evaluation models alone are incapable of fully capturing all credit risks. Certain qualitative factors may indicate that a Participant is or will soon be undergoing financial distress, which may in turn signal a higher default exposure to DTC and its other Participants. As such, a key enhancement being proposed to the CRRM is the incorporation of relevant qualitative factors into each of the three credit rating models mentioned above. By including qualitative factors in the three credit rating models, the enhanced CRRM would capture risks that would otherwise not be accounted for with quantitative factors alone.<sup>9</sup> Adding qualitative factors to the CRRM would not only enable it to generate more consistent and comprehensive credit ratings for applicable Participants, but it would also help reduce the need and frequency of manual credit rating overrides by the credit risk staff because overrides would likely only be required under more limited circumstances.<sup>10</sup>

### *C. Shifting From Relative Scoring to Absolute Scoring*

As proposed, the enhanced CRRM would use an absolute scoring approach and rank each Participant based on its individual probability of default rather than the relative scoring approach that is currently in use. This proposed change is designed to have a Participant's CRRM-generated credit rating reflect an absolute measure of the Participant's default risk and eliminate any potential distortion of a Participant's credit rating from the Participant's peer group that may occur under the relative scoring approach used in the existing CRRM.

### *D. Watch List and Enhanced Surveillance*

In addition to the Watch List, DTC also maintains an enhanced surveillance list (referenced herein and in the proposed rule text as "enhanced surveillance") for membership monitoring. The enhanced surveillance list is generally used when Participants are undergoing drastic and unexpected changes in their financial conditions or operation capabilities and thus are deemed by DTC to be of the highest risk level and/or warrant additional scrutiny due to DTC's ongoing concerns about these Participants. Accordingly, Participants that are subject to

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<sup>9</sup> The initial set of qualitative factors that would be incorporated into the CRRM includes (a) for U.S. broker dealers, market position and sustainability, management quality, capital management, liquidity management, geographic diversification, business/product diversity and access to funding, (b) for U.S. banks, environment, compliance/litigation, management quality, liquidity management and parental demands and (c) for foreign banks and trust companies, market position and sustainability, information reporting and compliance, management quality, capital management and business/product diversity.

<sup>10</sup> Once a Participant is assigned a credit rating, if circumstances warrant, credit risk staff would still have the ability to override the CRRM-issued credit rating by manually downgrading such rating as they do today. To ensure a conservative approach, the CRRM-issued credit ratings cannot be manually upgraded.



enhanced surveillance are reported to DTC's management committees and are also regularly reviewed by a cross-functional team comprised of senior management of DTC. More often than not, Participants that are subject to enhanced surveillance are also on the Watch List. The group of Participants that is subject to enhanced surveillance is generally much smaller than the group on the Watch List. The enhanced surveillance list is an internal tool for DTC that triggers increased monitoring of a Participant above the monitoring that occurs when a Participant is on the Watch List.

A Participant could be placed on the Watch List either based on its credit rating of 5, 6 or 7, which can either be generated by the CRRM or from a manual downgrade, or when DTC deems such placement as necessary to protect DTC and its Participants. In contrast, a Participant would be subject to enhanced surveillance only when close monitoring of the Participant is deemed necessary to protect DTC and its Participants.

(ii) Detailed Description of the Proposed Rule Changes

The 2006 Rule Change, while setting forth the procedures DTC follows with regard to the CRRM and the Watch List, did not incorporate these procedures into the text of the Rules. Pursuant to the proposed rule change, DTC would amend the Rules to incorporate the CRRM with the enhancements proposed above, including (1) the use of both quantitative and qualitative factors in generating credit ratings for CRRM-Rated Participants, (2) the expansion of the scope of CRRM coverage to enable the CRRM to generate credit ratings for Participants that are (a) U.S. banks that file the Consolidated Report of Condition and Income ("Call Report"), (b) U.S. broker-dealers that file the Financial and Operational Combined Uniform Single Report ("FOCUS Report") or the equivalent with their regulators, or (c) foreign banks or trust companies that have audited financial data that is publicly available and (3) that the CRRM would use an absolute scoring approach and rank each Participant based on its individual probability of default (rather than the relative scoring approach that is currently in use). Also, the proposed rule change would define the CRRM and the Watch List and add rule text to provide more transparency and clarity regarding DTC's current ongoing membership monitoring process.

In this regard, the proposed rule change would (i) add proposed definitions for CRRM and Watch List to Rule 1 (Definitions) and (ii) amend Rule 2 (Participants and Pledgees) (A) Section 1 to clarify a provision relating to the types of information a Participant must provide to DTC upon DTC's request for the Participant to demonstrate its satisfactory financial condition and operational capability, including its risk management practices with respect to services of DTC utilized by the Participant for another Person or Persons and (B) to add a new Section 10 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of the CRRM and proposed enhancements to the CRRM, as further discussed below.

A. *Proposed Changes to Rule 1 (Definitions)*

The proposed rule change would amend Rule 1 to add definitions for the CRRM and the Watch List.

The proposed definition of the CRRM would provide that the term “Credit Risk Rating Matrix” means a matrix of credit ratings of Participants as specified in the proposed new Section 10(a) of Rule 2. As proposed, the definition would state that the CRRM is developed by DTC to evaluate the credit risk such Participants pose to DTC and its Participants and is based on factors determined to be relevant by DTC from time to time, which factors are designed to collectively reflect the financial and operational condition of a Participant. The proposed definition would also state that these factors include (i) quantitative factors, such as capital, assets, earnings and liquidity and (ii) qualitative factors, such as management quality, market position/environment and capital and liquidity risk management.

The proposed definition of the Watch List would provide that the term “Watch List” means, at any time and from time to time, the list of Participants whose credit ratings derived from the CRRM are 5, 6 or 7, as well as Participants that, based on DTC’s consideration of relevant factors, including those that would be set forth in the proposed new Section 10 of Rule 2 (described below), are deemed by DTC to pose a heightened risk to DTC and its Participants.

*B. Proposed Changes to Section 1 of Rule 2 (Participants and Pledges)*

Section 1 of Rule 2 provides, among other things, that upon the request of DTC, a Participant shall furnish to DTC information sufficient to demonstrate its satisfactory financial condition and operational capability. The proposed rule change would, by way of example, clarify that the types of information that DTC may require in this regard include, but are not limited to, such information as DTC may request regarding the businesses and operations of the Participant and its risk management practices with respect to services of DTC utilized by the Participant for another Person.

*C. Proposed New Section 10 of Rule 2*

The proposed rule change would add a new Section 10 of Rule 2 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of, and the proposed enhancements to, the CRRM. In this regard, the proposed new Section 10 of Rule 2 would provide that:

- (1) All Participants would be monitored and reviewed by DTC on an ongoing and periodic basis, which may include monitoring of news and market developments and review of financial reports and other public information.
- (2) (i) A Participant that is (A) qualified to be a Participant pursuant to (x) Rule 3, Section 1(d) and files the Call Report (i.e., a U.S. Bank) or (y) Rule 3, Section 1(h)(ii) and files the FOCUS Report or the equivalent with its regulator (i.e., a U.S. broker-dealer) or (B) a foreign bank or trust company qualified to be a Participant pursuant to Section 2 of the Policy Statement on the Admission of Participants and that has audited financial data that is publicly available, would be assigned a credit rating by DTC in accordance with the CRRM. The proposed rule change would also provide that a Participant’s credit rating will be reassessed each time the Participant provides DTC with

requested information pursuant to Section 1 of Rule 2, or as may be otherwise required under the Rules and Procedures<sup>11</sup> (including proposed new Section 10 of Rule 2).

(ii) Because the factors used as part of the CRRM may not identify all risks that a CRRM-Rated Participant may present to DTC, DTC may, in its discretion, override the CRRM-Rated Participant's credit rating derived from the CRRM to downgrade that Participant. In this regard, the proposed rule change would provide that (A) such a downgrading may result in the Participant being placed on the Watch List, and/or it may subject the Participant to enhanced surveillance based on relevant factors, including those described in paragraph (4) below and (B) DTC may also take such additional actions with regard to the Participant as are permitted by the Rules and Procedures.

(3) Participants other than CRRM-Rated Participants would not be assigned a credit rating by the CRRM but may be placed on the Watch List and/or may be subject to enhanced surveillance based on relevant factors, including those described in paragraph (4) below, as DTC deems necessary to protect it and its Participants.

(4) The factors to be considered by DTC as proposed in paragraphs (2)(ii) and (3) above would include, but would not be not limited to, (i) news reports and/or regulatory observations that raise reasonable concerns relating to the Participant, (ii) reasonable concerns around the Participant's liquidity arrangements, (iii) material changes to the Participant's organizational structure, (iv) reasonable concerns of DTC about the Participant's financial stability due to particular facts and circumstances, such as material litigation or other legal and/or regulatory risks, (v) failure of the Participant to demonstrate satisfactory financial condition or operational capability or if DTC has a reasonable concern regarding the Participant's ability to maintain applicable participation standards and (vi) failure of the Participant to provide information required by DTC to assess risk exposure posed by the Participant's activity (including information requested by DTC pursuant to Section 1 of Rule 2).

(5) A Participant being subject to enhanced surveillance or being placed on the Watch List would result in more thorough monitoring of the Participant's financial condition and/or operational capability, which could include, for example, on-site visits or additional due diligence information requests from DTC. In this regard, the proposed rule change would provide that DTC may require a Participant placed on the Watch List and/or subject to enhanced surveillance to make more frequent financial disclosures, including, without limitation, interim and/or pro forma reports. The proposed rule change would also provide that Participants that are subject to enhanced surveillance would also be reported to DTC's management committees and regularly reviewed by a cross-functional team comprised of senior management of DTC. The proposed rule change would further provide that DTC may also take such additional actions with regard to any Participant (including a Participant placed on the Watch List and/or subject to enhanced surveillance) as are permitted by the Rules and Procedures.

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<sup>11</sup> Pursuant to Section 1 of Rule 1, the term "Procedures" means the Procedures, service guides, and regulations of DTC adopted pursuant to Rule 27, as amended from time to time. Rules, supra note 1.

### Implementation Timeframe

Pending Commission approval, DTC expects to implement this proposal promptly. Participants would be advised of the implementation date of this proposal through issuance of a DTC Important Notice.

### Expected Effect on Risks to the Clearing Agency, Its Participants and the Market

The proposed rule changes would mitigate Participant credit risk posed to DTC from Participant activity by allowing DTC to more accurately monitor the creditworthiness and risk profile of its Participants. The enhanced CRRM would provide a more robust credit rating methodology by incorporating qualitative factors and adopting an absolute scoring approach. Both of these enhancements would improve DTC's ability to monitor the credit risk of its Participants and are expected to lessen the frequency of manual overrides. The enhanced CRRM would also expand the coverage Participants by providing credit ratings for Participants that are foreign banks or trust companies, which are not covered under the existing CRRM.

By mitigating credit risk to DTC as described above, the enhanced CRRM would also mitigate risk for Participants because lowering the risk profile for DTC would in turn lower the risk exposure that Participants may have with respect to DTC in its role as a securities settlement system.

### Management of Identified Risks

The proposed rule changes are designed to mitigate credit risk for DTC from Participant activity and to provide greater clarity and transparency to DTC's Participants regarding the risk management approach used by DTC in this regard.

The enhanced CRRM would improve DTC's ability to monitor the probability of default for Participants that are rated by the CRRM and is expected to lessen the need and the frequency of manual downgrades due to the anticipated improvement in the accuracy of the credit ratings generated by the enhanced CRRM.

DTC employs a risk-based approach to conducting monitoring and review of its Participants by using the CRRM to identify higher risk Participants. Once identified, DTC would place these Participants on the Watch List, which would result in more frequent review by DTC of these Participants than the other Participants. For Participants that are placed on the Watch List, DTC would conduct more thorough monitoring of these Participants' financial condition and/or operational capability, which could include, for example, on-site visits or additional due diligence information requests.

The enhanced CRRM would also expand the coverage of Participants by providing credit ratings for foreign banks and trust companies, which are not currently rated under the existing CRRM. The addition of these entities would allow DTC to employ its risk-based approach to identify those higher risk Participants for additional monitoring with more efficiency (by reducing the need for manual overrides) and effectiveness (by generating a more comprehensive and accurate credit rating after taking into account both quantitative and qualitative factors and adopting the absolute scoring approach).

Thus, the enhanced CRRM would help DTC to identify those Participants that could present credit risk to DTC, which then would allow DTC to better manage the potential risks from these Participants.

Consistency with the Clearing Supervision Act

The proposed enhancements to the CRRM as described in detail above would be consistent with Section 805(b) 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”).<sup>12</sup> The objectives and principles of Section 805(b) of the Clearing Supervision Act include, among other things, the promotion of robust risk management.<sup>13</sup>

By enhancing the CRRM to enable it to assign credit ratings to Participants that are foreign banks or trust companies and that have audited financial data that is publicly available, the proposed rule change would expand the CRRM’s applicability to a wider group of Participants, which would improve DTC’s membership monitoring process and promote robust risk management, consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

Similarly, by enhancing the CRRM to enable it to incorporate qualitative factors when assigning a Participant’s credit rating, the proposed change would enable DTC to take into account relevant qualitative factors in an automated and more effective manner when monitoring the credit risks presented by the Participants, which would improve DTC’s membership monitoring process overall and promote robust risk management, consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

Likewise, by enhancing the CRRM to shift from a relative scoring approach to an absolute scoring approach when assigning a Participant’s credit rating, the proposed rule change would enable DTC to generate credit ratings for Participants that are more reflective of the Participants’ default risk, which would improve DTC’s membership monitoring process and promote robust risk management, consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

The proposed enhancements to the CRRM are consistent with Rule 17Ad-22(e)(3)(i) under the Securities Exchange Act of 1934, as amended (“Act”), which was recently adopted by the Commission.<sup>14</sup> Rule 17Ad-22(e)(3)(i) will require DTC to establish, implement, maintain

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<sup>12</sup> 12 U.S.C. 5464(b)

<sup>13</sup> Id.

<sup>14</sup> 17 CFR 240.17Ad-22(e)(3)(i). The Commission adopted amendments to Rule 17Ad-22, including the addition of new subsection 17Ad-22(e), on September 28, 2016. See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 FR 70786 (October 13, 2016) (S7-03-14). DTC is a “covered clearing agency” as defined by the new Rule 17Ad-22(a)(5) and must comply with new subsection (e) of Rule 17Ad-22 by April 11, 2017. Id.



and enforce written policies and procedures reasonably designed to maintain a sound risk management framework for comprehensively managing risks that arise in or are born by DTC, which includes...systems designed to identify, measure, monitor and manage the range of risks that arise in or are borne by DTC.<sup>15</sup> The proposed enhancements to the CRRM have been designed to assist DTC in identifying, measuring, monitoring and managing the credit risks to DTC posed by its Participants. The proposed enhancements to the CRRM accomplish this by (i) expanding the CRRM's applicability to a wider group of Participants to include Participants that are foreign banks or trust companies, (ii) enabling the CRRM to take into account relevant qualitative factors in an automated and more effective manner when monitoring the credit risks presented by Participants and (iii) enabling the CRRM to generate credit ratings for Participants that are more reflective of the Participants' default risk by shifting to an absolute scoring approach, all of which would improve DTC's membership monitoring process overall. Therefore, DTC believes the proposed enhancements to the CRRM would assist DTC in identifying, measuring, monitoring and managing risks that arise in or are born by DTC, consistent with the requirements of Rule 17Ad-22(e)(3)(i).

The proposed rule change to Section 1 of Rule 2 with respect to the scope of information that may be requested by DTC from its Participants has been designed to be consistent with Rule 17Ad-22(e)(19) under the Act, which was recently adopted by the Commission.<sup>16</sup> Rule 17Ad-22(e)(19) will require DTC to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage the material risk to DTC arising from arrangements in which firms that are indirect participants in DTC rely on the services provided by Participants to access DTC's payment, clearing, or settlement facilities.<sup>17</sup> By expressly reflecting in the Rules what is already DTC's current practice associated with its request for information sufficient to demonstrate a Participant's satisfactory financial condition and operational capability to state that such request may include information regarding the businesses and operations of the Participant, as well as its risk management practices with respect to services of DTC utilized by the Participant for another Person, this proposed rule change would help enable DTC to have rule provisions that are reasonably designed to identify, monitor and manage the material risks to DTC arising from tiered participation arrangements consistent with Rule 17Ad-22(e)(19).

## **11. Exhibits**

Exhibit 1 – Not applicable.

Exhibit 1A – Notice of advance notice for publication in the Federal Register.

Exhibit 2 – Not applicable.

Exhibit 3 – Not applicable.

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<sup>15</sup> Id.

<sup>16</sup> 17 CFR 240.17Ad-22(e)(19). Id.

<sup>17</sup> Id.



Exhibit 4 – Not applicable.

Exhibit 5 – Proposed changes to the Rules.

**EXHIBIT 1A**

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-[\_\_\_\_\_]; File No. SR- DTC-2017-801)

[DATE]

Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing of Advance Notice to Address and Update Practices and Policies with Respect to the Credit Risk Rating Matrix and Make Other Changes

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”)<sup>1</sup> and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (“Act”),<sup>2</sup> notice is hereby given that on March \_\_, 2017, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) the advance notice SR- DTC-2017-801 (“Advance Notice”) as described in Items I, II and III below, which Items have been prepared by the clearing agency.<sup>3</sup> The Commission is publishing this notice to solicit comments on the Advance Notice from interested persons.

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<sup>1</sup> 12 U.S.C. 5465(e)(1).

<sup>2</sup> 17 CFR 240.19b-4(n)(1)(i).

<sup>3</sup> On March \_\_, 2017, DTC filed this Advance Notice as a proposed rule change (SR- DTC-2017-002) with the Commission pursuant to Section 19(b)(1) of the Act, 15 U.S.C. 78s(b)(1), and Rule 19b-4, 17 CFR 240.19b-4. A copy of the proposed rule change is available at <http://www.dtcc.com/legal/sec-rule-filings.aspx>.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

This Advance Notice consists of proposed modifications to DTC's Rules, By-Laws and Organization Certificate ("Rules").<sup>4</sup> The proposed rule change would amend Rules 1 and 2 in order to (i) address and update DTC's practices and policies with respect to the existing matrix (hereinafter referred to as the "Credit Risk Rating Matrix" or "CRRM"), which was, as described in an earlier DTC rule filing,<sup>5</sup> developed by DTC to assign a credit rating to certain Participants ("CRRM-Rated Participants") by evaluating the risks posed by CRRM-Rated Participants to DTC and its Participants from providing services to these CRRM-Rated Participants and (ii) make other amendments to the Rules to provide more transparency and clarity regarding DTC's current ongoing membership monitoring process.

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, the clearing agency included statements concerning the purpose of and basis for the Advance Notice and discussed any comments it received on the Advance Notice. The text of these statements may be examined at the places specified in Item IV below. The clearing agency has prepared summaries, set forth in sections A and B below, of the most significant aspects of such statements.

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

<sup>5</sup> See Securities Exchange Act Release No. 53655 (April 14, 2006), 71 FR 20428 (April 20, 2006) (SR-DTC-2006-03) (order of the Commission) approving a proposed rule change ("2006 Rule Change") of DTC to amend the criteria used by DTC to place Participants on surveillance status, including, but not limited to DTC's application of the CRRM and the placement of lower rated CRRM-Rated Participants on an internal list in order to be monitored more closely ("Watch List").

(A) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

Written comments relating to this proposal have not been solicited or received.

DTC will notify the Commission of any written comments received by DTC.

(B) Advance Notice Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

Nature of the Proposed Change

The proposed rule change would amend Rules 1 and 2 in order to (i) address and update DTC's practices and policies with respect to the CRRM and (ii) provide more transparency and clarity regarding DTC's current membership monitoring process. In this regard, the proposed rule change would (i) add proposed definitions for the terms "Credit Risk Rating Matrix" and "Watch List" to Rule 1 (Definitions), as discussed below and (ii) amend Rule 2 (Participants and Pledgees) to (A) clarify a provision in Section 1 relating to the types of information a Participant must provide to DTC upon DTC's request for the Participant to demonstrate its satisfactory financial condition and operational capability, including its risk management practices with respect to services of DTC utilized by the Participant for another Person and (B) add a new Section 10 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of the CRRM and proposed enhancements to the CRRM, as further discussed below.

(i) Background

DTC occupies an important role in the securities settlement system by, among other things, providing services for the settlement of book-entry transfer and pledge of interests in eligible deposited securities and net funds settlement, in connection with

which Participants may incur net funds settlement obligations to DTC. DTC uses the CRRM, the Watch List and the enhanced surveillance to manage and monitor default risks of Participants on an ongoing basis, as discussed below. The level and frequency of such monitoring for a Participant is determined by the Participant's risk of default as assessed by DTC. Participants that are deemed by DTC to pose a heightened risk to DTC and its Participants are subject to closer and more frequent monitoring.

*Existing Credit Risk Rating Matrix*

Pursuant to the 2006 Rule Change, all Participants that are either U.S. broker-dealers or U.S. banks are assigned a rating generated solely based on quantitative factors by entering financial data of those Participants into an internally generated credit rating matrix, i.e., the CRRM.<sup>6</sup> All other types of Participants are monitored by credit risk staff using financial criteria deemed relevant by DTC but would not be assigned a rating by the CRRM.<sup>7</sup>

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<sup>6</sup> See 2006 Rule Change, SR-DTC-2006-03, 71 FR 20428, which explained that the ratings assigned by the CRRM were generated using financial data extracted from standard regulatory reports of U.S. broker-dealers and banks. A small number of U.S. banks which submitted standard regulatory reports were not assigned a rating because they did not take deposits or make loans, and therefore the regulatory reports of these banks did not contain information on asset quality and/or liquidity, which was a data component used in the CRRM. *Id.* However, the 2006 Rule Change provided DTC with discretion to continue to “evaluate the matrix methodology and its effectiveness and make such changes as it deems prudent and practicable within such time frames as it determines to be appropriate.” *Id.* DTC has continued to evaluate the CRRM and has determined that the CRRM is the most effective method available to it to evaluate the default risk presented by any U.S. bank that submits regulatory reports, including a bank whose reports exclude certain data components as mentioned above. Accordingly, DTC applies the CRRM to assign ratings to any U.S. bank that submits regulatory reports, including those that were not covered by the CRRM in 2006, as reflected in the proposed rule change.

<sup>7</sup> In the 2006 Rule Change, DTC noted that these Participants would be monitored by credit risk staff by reviewing similar criteria as those reviewed for Participants

The 2006 Rule Change explained that credit risk staff could downgrade a particular Participant's credit rating based on various qualitative factors. An example of such qualitative factors might be that the Participant in question received a qualified audit opinion on its annual audit. DTC noted in the 2006 Rule Change that in order to protect DTC and its other Participants, it was important that credit risk staff maintain the discretion to downgrade a Participant's credit rating on the CRRM and thus subject the Participant to closer monitoring.

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks – and generates credit ratings for the relevant Participants based on a 7-point rating system, with “1” being the strongest credit rating and “7” being the weakest credit rating.

Over time, the current CRRM has not kept pace with DTC's evolving Participant membership base and heightened expectations from regulators and stakeholders for robustness of financial models. Specifically, the current CRRM only generates credit ratings for those Participants that are U.S. banks or U.S. broker-dealers that file standard reports with their regulators, which currently comprise 80% of Participants; foreign banks and trust companies currently account for 5% of Participants.<sup>8</sup> The number of Participants that are foreign banks or trust companies increased from 12 in 2012 to 13 in 2017, and is expected to continue to grow over the coming years. Foreign banks and trust companies are typically large global financial institutions that have complex businesses

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included on the matrix but such review would occur outside of the matrix process.  
Id.

<sup>8</sup> As of March 16, 2017, there are 251 Participants, of which 50 (or 20%) are U.S. banks, 151 (or 60%) are U.S. broker-dealers and 13 (or 5%) are foreign banks or trust companies.



and conduct a high volume of activities. Although foreign banks and trust companies are not currently rated by the CRRM, they are monitored by DTC's credit risk staff using financial criteria deemed relevant by DTC and can be placed on the Watch List if they experience a financial change that presents risk to DTC. Given the increase in the number of foreign bank Participants in recent years, there is a need to formalize DTC's credit risk evaluation process of the foreign bank or trust company Participants by assigning credit ratings to them in order to better facilitate the comparability of credit risks among Participants.<sup>9</sup>

As mentioned above, a Participant's credit rating is currently based solely upon quantitative factors. It is only after the CRRM has generated a credit rating with respect to a Participant that such Participant's credit rating may be downgraded manually by credit risk staff, after taking into consideration relevant qualitative factors. The inability of the current CRRM to take into account qualitative factors requires frequent and manual overrides by credit risk staff, which may result in inconsistent and/or incomplete credit ratings for Participants.

Furthermore, the current CRRM uses a relative scoring approach and relies on peer grouping of Participants to calculate the credit rating of a Participant. This approach is not ideal because a Participant's credit rating can be affected by changes in its peer group even if the Participant's financial condition is unchanged.

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<sup>9</sup> DTC noted in the 2006 Rule Change that the CRRM is applied across DTC and its affiliated clearing agencies, NSCC and FICC. Specifically, in order to run the CRRM, credit risk staff uses the financial data of the applicable DTC Participants in addition to data of applicable members of NSCC and FICC. In this way, each applicable DTC Participant is rated against other applicable members of NSCC and FICC. See 2006 Rule Change, SR-DTC-2006-03, 71 FR 20428.

*Proposed Credit Risk Rating Matrix Enhancements*

To improve the coverage and the effectiveness of the current CRRM, DTC is proposing three enhancements to the CRRM. The first proposed enhancement would expand the scope of CRRM coverage by enabling the CRRM to generate credit ratings for Participants that are foreign banks or trust companies and that have audited financial data that is publicly available. The second proposed enhancement would incorporate qualitative factors into the CRRM and therefore is expected to reduce the need and the frequency of manual overrides of Participant credit ratings. The third enhancement would replace the relative scoring approach currently used by CRRM with a statistical approach to estimate the absolute probability of default of each Participant.

A. *Enable the CRRM to Generate Credit Ratings for Foreign Bank or Trust Company Participants*

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks. DTC is proposing to enhance the CRRM by adding an additional credit rating model for the foreign banks and trust companies. The additional model would expand the scope of Participants to which the CRRM would apply to include foreign banks and trust companies that have audited financial data that is publicly available. The CRRM credit rating of a foreign bank or trust company that is a Participant would be based on quantitative factors, including size, capital, leverage, liquidity, profitability and growth, and qualitative factors, including market position and sustainability, information reporting and compliance, management quality, capital management and business/product diversity. By enabling the CRRM to generate credit ratings for these Participants, the enhanced CRRM would provide more comprehensive credit risk coverage of DTC's membership base.

With the proposed enhancement to the CRRM as described above, applicable foreign bank or trust company Participants would be included in the CRRM process and be evaluated more effectively and efficiently because financial data with respect to these foreign bank or trust company Participants could be extracted from data sources in an automated form.<sup>10</sup>

After the proposed enhancement, CRRM would be able to generate credit ratings on an ongoing basis for all Participants that are U.S. banks, U.S. brokers-dealers and foreign banks and trust companies, which together represent approximately 85% of Participants.<sup>11</sup>

*B. Incorporate Qualitative Factors into the CRRM*

In addition, as proposed, the enhanced CRRM would blend both qualitative factors and quantitative factors to produce a credit rating for each applicable Participant in relation to the Participant's credit risk. For U.S. and foreign banks and trust companies, the enhanced CRRM would use a 70/30 weighted split between quantitative and qualitative factors to generate credit ratings. For U.S. broker-dealers, the weight split between quantitative and qualitative factors would be 60/40. These weight splits have been chosen by DTC based on the industry best practice as well as research and sensitivity analysis conducted by DTC. DTC would review and adjust the weight splits

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<sup>10</sup> In the 2006 Rule Change, DTC noted that these Participants would be monitored by credit risk staff by reviewing similar criteria as those reviewed for Participants included on the CRRM, but such review would occur outside of the CRRM process. Id.

<sup>11</sup> As of March 16, 2017, there are 37 Participants that would not be rated by the enhanced CRRM, as proposed, because they are central securities depositories, securities exchanges, government sponsored entities, central counterparties, central banks and U.S. trust companies that do not file Call Reports (as defined below).

as well as the quantitative and qualitative factors, as needed, based on recalibration of the CRRM to be conducted by DTC approximately every three to five years.

Although there are advantages to measuring credit risk quantitatively, quantitative evaluation models alone are incapable of fully capturing all credit risks. Certain qualitative factors may indicate that a Participant is or will soon be undergoing financial distress, which may in turn signal a higher default exposure to DTC and its other Participants. As such, a key enhancement being proposed to the CRRM is the incorporation of relevant qualitative factors into each of the three credit rating models mentioned above. By including qualitative factors in the three credit rating models, the enhanced CRRM would capture risks that would otherwise not be accounted for with quantitative factors alone.<sup>12</sup> Adding qualitative factors to the CRRM would not only enable it to generate more consistent and comprehensive credit ratings for applicable Participants, but it would also help reduce the need and frequency of manual credit rating overrides by the credit risk staff because overrides would likely only be required under more limited circumstances.<sup>13</sup>

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<sup>12</sup> The initial set of qualitative factors that would be incorporated into the CRRM includes (a) for U.S. broker dealers, market position and sustainability, management quality, capital management, liquidity management, geographic diversification, business/product diversity and access to funding, (b) for U.S. banks, environment, compliance/litigation, management quality, liquidity management and parental demands and (c) for foreign banks and trust companies, market position and sustainability, information reporting and compliance, management quality, capital management and business/product diversity.

<sup>13</sup> Once a Participant is assigned a credit rating, if circumstances warrant, credit risk staff would still have the ability to override the CRRM-issued credit rating by manually downgrading such rating as they do today. To ensure a conservative approach, the CRRM-issued credit ratings cannot be manually upgraded.

*C. Shifting From Relative Scoring to Absolute Scoring*

As proposed, the enhanced CRRM would use an absolute scoring approach and rank each Participant based on its individual probability of default rather than the relative scoring approach that is currently in use. This proposed change is designed to have a Participant's CRRM-generated credit rating reflect an absolute measure of the Participant's default risk and eliminate any potential distortion of a Participant's credit rating from the Participant's peer group that may occur under the relative scoring approach used in the existing CRRM.

*D. Watch List and Enhanced Surveillance*

In addition to the Watch List, DTC also maintains an enhanced surveillance list (referenced herein and in the proposed rule text as "enhanced surveillance") for membership monitoring. The enhanced surveillance list is generally used when Participants are undergoing drastic and unexpected changes in their financial conditions or operation capabilities and thus are deemed by DTC to be of the highest risk level and/or warrant additional scrutiny due to DTC's ongoing concerns about these Participants. Accordingly, Participants that are subject to enhanced surveillance are reported to DTC's management committees and are also regularly reviewed by a cross-functional team comprised of senior management of DTC. More often than not, Participants that are subject to enhanced surveillance are also on the Watch List. The group of Participants that is subject to enhanced surveillance is generally much smaller than the group on the Watch List. The enhanced surveillance list is an internal tool for DTC that triggers increased monitoring of a Participant above the monitoring that occurs when a Participant is on the Watch List.

A Participant could be placed on the Watch List either based on its credit rating of 5, 6 or 7, which can either be generated by the CRRM or from a manual downgrade, or when DTC deems such placement as necessary to protect DTC and its Participants. In contrast, a Participant would be subject to enhanced surveillance only when close monitoring of the Participant is deemed necessary to protect DTC and its Participants.

(ii) Detailed Description of the Proposed Rule Changes

The 2006 Rule Change, while setting forth the procedures DTC follows with regard to the CRRM and the Watch List, did not incorporate these procedures into the text of the Rules. Pursuant to the proposed rule change, DTC would amend the Rules to incorporate the CRRM with the enhancements proposed above, including (1) the use of both quantitative and qualitative factors in generating credit ratings for CRRM-Rated Participants, (2) the expansion of the scope of CRRM coverage to enable the CRRM to generate credit ratings for Participants that are (a) U.S. banks that file the Consolidated Report of Condition and Income (“Call Report”), (b) U.S. broker-dealers that file the Financial and Operational Combined Uniform Single Report (“FOCUS Report”) or the equivalent with their regulators, or (c) foreign banks or trust companies that have audited financial data that is publicly available and (3) that the CRRM would use an absolute scoring approach and rank each Participant based on its individual probability of default (rather than the relative scoring approach that is currently in use). Also, the proposed rule change would define the CRRM and the Watch List and add rule text to provide more transparency and clarity regarding DTC’s current ongoing membership monitoring process.



In this regard, the proposed rule change would (i) add proposed definitions for CRRM and Watch List to Rule 1 (Definitions) and (ii) amend Rule 2 (Participants and Pledges) (A) Section 1 to clarify a provision relating to the types of information a Participant must provide to DTC upon DTC's request for the Participant to demonstrate its satisfactory financial condition and operational capability, including its risk management practices with respect to services of DTC utilized by the Participant for another Person or Persons and (B) to add a new Section 10 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of the CRRM and proposed enhancements to the CRRM, as further discussed below.

*A. Proposed Changes to Rule 1 (Definitions)*

The proposed rule change would amend Rule 1 to add definitions for the CRRM and the Watch List.

The proposed definition of the CRRM would provide that the term "Credit Risk Rating Matrix" means a matrix of credit ratings of Participants as specified in the proposed new Section 10(a) of Rule 2. As proposed, the definition would state that the CRRM is developed by DTC to evaluate the credit risk such Participants pose to DTC and its Participants and is based on factors determined to be relevant by DTC from time to time, which factors are designed to collectively reflect the financial and operational condition of a Participant. The proposed definition would also state that these factors include (i) quantitative factors, such as capital, assets, earnings and liquidity and (ii) qualitative factors, such as management quality, market position/environment and capital and liquidity risk management.

The proposed definition of the Watch List would provide that the term “Watch List” means, at any time and from time to time, the list of Participants whose credit ratings derived from the CRRM are 5, 6 or 7, as well as Participants that, based on DTC’s consideration of relevant factors, including those that would be set forth in the proposed new Section 10 of Rule 2 (described below), are deemed by DTC to pose a heightened risk to DTC and its Participants.

*B. Proposed Changes to Section 1 of Rule 2 (Participants and Pledges)*

Section 1 of Rule 2 provides, among other things, that upon the request of DTC, a Participant shall furnish to DTC information sufficient to demonstrate its satisfactory financial condition and operational capability. The proposed rule change would, by way of example, clarify that the types of information that DTC may require in this regard include, but are not limited to, such information as DTC may request regarding the businesses and operations of the Participant and its risk management practices with respect to services of DTC utilized by the Participant for another Person.

*C. Proposed New Section 10 of Rule 2*

The proposed rule change would add a new Section 10 of Rule 2 to include provisions relating to the monitoring, surveillance and review of Participants, including, but not limited to, the application of, and the proposed enhancements to, the CRRM. In this regard, the proposed new Section 10 of Rule 2 would provide that:

(1) All Participants would be monitored and reviewed by DTC on an ongoing and periodic basis, which may include monitoring of news and market developments and review of financial reports and other public information.

(2) (i) A Participant that is (A) qualified to be a Participant pursuant to (x) Rule 3, Section 1(d) and files the Call Report (i.e., a U.S. Bank) or (y) Rule 3, Section 1(h)(ii) and files the FOCUS Report or the equivalent with its regulator (i.e., a U.S. broker-dealer) or (B) a foreign bank or trust company qualified to be a Participant pursuant to Section 2 of the Policy Statement on the Admission of Participants and that has audited financial data that is publicly available, would be assigned a credit rating by DTC in accordance with the CRRM. The proposed rule change would also provide that a Participant's credit rating will be reassessed each time the Participant provides DTC with requested information pursuant to Section 1 of Rule 2, or as may be otherwise required under the Rules and Procedures<sup>14</sup> (including proposed new Section 10 of Rule 2).

(ii) Because the factors used as part of the CRRM may not identify all risks that a CRRM-Rated Participant may present to DTC, DTC may, in its discretion, override the CRRM-Rated Participant's credit rating derived from the CRRM to downgrade that Participant. In this regard, the proposed rule change would provide that (A) such a downgrading may result in the Participant being placed on the Watch List, and/or it may subject the Participant to enhanced surveillance based on relevant factors, including those described in paragraph (4) below and (B) DTC may also take such additional actions with regard to the Participant as are permitted by the Rules and Procedures.

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<sup>14</sup> Pursuant to Section 1 of Rule 1, the term "Procedures" means the Procedures, service guides, and regulations of DTC adopted pursuant to Rule 27, as amended from time to time. Rules, supra note 4.

(3) Participants other than CRRM-Rated Participants would not be assigned a credit rating by the CRRM but may be placed on the Watch List and/or may be subject to enhanced surveillance based on relevant factors, including those described in paragraph (4) below, as DTC deems necessary to protect it and its Participants.

(4) The factors to be considered by DTC as proposed in paragraphs (2)(ii) and (3) above would include, but would not be not limited to, (i) news reports and/or regulatory observations that raise reasonable concerns relating to the Participant, (ii) reasonable concerns around the Participant's liquidity arrangements, (iii) material changes to the Participant's organizational structure, (iv) reasonable concerns of DTC about the Participant's financial stability due to particular facts and circumstances, such as material litigation or other legal and/or regulatory risks, (v) failure of the Participant to demonstrate satisfactory financial condition or operational capability or if DTC has a reasonable concern regarding the Participant's ability to maintain applicable participation standards and (vi) failure of the Participant to provide information required by DTC to assess risk exposure posed by the Participant's activity (including information requested by DTC pursuant to Section 1 of Rule 2).

(5) A Participant being subject to enhanced surveillance or being placed on the Watch List would result in more thorough monitoring of the Participant's financial condition and/or operational capability, which could include, for example, on-site visits or additional due diligence information requests from DTC. In this regard, the proposed rule change would provide that DTC may require a Participant placed on the Watch List and/or subject to enhanced surveillance to make more frequent financial disclosures, including, without limitation, interim and/or pro forma reports. The proposed rule

change would also provide that Participants that are subject to enhanced surveillance would also be reported to DTC's management committees and regularly reviewed by a cross-functional team comprised of senior management of DTC. The proposed rule change would further provide that DTC may also take such additional actions with regard to any Participant (including a Participant placed on the Watch List and/or subject to enhanced surveillance) as are permitted by the Rules and Procedures.

#### Implementation Timeframe

Pending Commission approval, DTC expects to implement this proposal promptly. Participants would be advised of the implementation date of this proposal through issuance of a DTC Important Notice.

#### *Expected Effect on Risks to the Clearing Agency, Its Participants and the Market*

The proposed rule changes would mitigate Participant credit risk posed to DTC from Participant activity by allowing DTC to more accurately monitor the creditworthiness and risk profile of its Participants. The enhanced CRRM would provide a more robust credit rating methodology by incorporating qualitative factors and adopting an absolute scoring approach. Both of these enhancements would improve DTC's ability to monitor the credit risk of its Participants and are expected to lessen the frequency of manual overrides. The enhanced CRRM would also expand the coverage Participants by providing credit ratings for Participants that are foreign banks or trust companies, which are not covered under the existing CRRM.

By mitigating credit risk to DTC as described above, the enhanced CRRM would also mitigate risk for Participants because lowering the risk profile for DTC would in turn

lower the risk exposure that Participants may have with respect to DTC in its role as a securities settlement system.

*Management of Identified Risks*

The proposed rule changes are designed to mitigate credit risk for DTC from Participant activity and to provide greater clarity and transparency to DTC's Participants regarding the risk management approach used by DTC in this regard.

The enhanced CRRM would improve DTC's ability to monitor the probability of default for Participants that are rated by the CRRM and is expected to lessen the need and the frequency of manual downgrades due to the anticipated improvement in the accuracy of the credit ratings generated by the enhanced CRRM.

DTC employs a risk-based approach to conducting monitoring and review of its Participants by using the CRRM to identify higher risk Participants. Once identified, DTC would place these Participants on the Watch List, which would result in more frequent review by DTC of these Participants than the other Participants. For Participants that are placed on the Watch List, DTC would conduct more thorough monitoring of these Participants' financial condition and/or operational capability, which could include, for example, on-site visits or additional due diligence information requests.

The enhanced CRRM would also expand the coverage of Participants by providing credit ratings for foreign banks and trust companies, which are not currently rated under the existing CRRM. The addition of these entities would allow DTC to employ its risk-based approach to identify those higher risk Participants for additional monitoring with more efficiency (by reducing the need for manual overrides) and effectiveness (by generating a more comprehensive and accurate credit rating after taking

into account both quantitative and qualitative factors and adopting the absolute scoring approach).

Thus, the enhanced CRRM would help DTC to identify those Participants that could present credit risk to DTC, which then would allow DTC to better manage the potential risks from these Participants.

*Consistency with the Clearing Supervision Act*

The proposed enhancements to the CRRM as described in detail above would be consistent with Section 805(b) of the Clearing Supervision Act.<sup>15</sup> The objectives and principles of Section 805(b) of the Clearing Supervision Act include, among other things, the promotion of robust risk management.<sup>16</sup>

By enhancing the CRRM to enable it to assign credit ratings to Participants that are foreign banks or trust companies and that have audited financial data that is publicly available, the proposed rule change would expand the CRRM's applicability to a wider group of Participants, which would improve DTC's membership monitoring process and promote robust risk management, consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

Similarly, by enhancing the CRRM to enable it to incorporate qualitative factors when assigning a Participant's credit rating, the proposed change would enable DTC to take into account relevant qualitative factors in an automated and more effective manner when monitoring the credit risks presented by the Participants, which would improve DTC's membership monitoring process overall and promote robust risk management,

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<sup>15</sup> 12 U.S.C. 5464(b)

<sup>16</sup> Id.

consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

Likewise, by enhancing the CRRM to shift from a relative scoring approach to an absolute scoring approach when assigning a Participant's credit rating, the proposed rule change would enable DTC to generate credit ratings for Participants that are more reflective of the Participants' default risk, which would improve DTC's membership monitoring process and promote robust risk management, consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

The proposed enhancements to the CRRM are consistent with Rule 17Ad-22(e)(3)(i) under the Act, which was recently adopted by the Commission.<sup>17</sup> Rule 17Ad-22(e)(3)(i) will require DTC to establish, implement, maintain and enforce written policies and procedures reasonably designed to maintain a sound risk management framework for comprehensively managing risks that arise in or are born by DTC, which includes...systems designed to identify, measure, monitor and manage the range of risks that arise in or are borne by DTC.<sup>18</sup> The proposed enhancements to the CRRM have been designed to assist DTC in identifying, measuring, monitoring and managing the credit risks to DTC posed by its Participants. The proposed enhancements to the CRRM accomplish this by (i) expanding the CRRM's applicability to a wider group of Participants to include Participants that are foreign banks or trust companies, (ii) enabling

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<sup>17</sup> 17 CFR 240.17Ad-22(e)(3)(i). The Commission adopted amendments to Rule 17Ad-22, including the addition of new subsection 17Ad-22(e), on September 28, 2016. See Securities Exchange Act Release No. 78961 (September 28, 2016), 81 FR 70786 (October 13, 2016) (S7-03-14). DTC is a "covered clearing agency" as defined by the new Rule 17Ad-22(a)(5) and must comply with new subsection (e) of Rule 17Ad-22 by April 11, 2017. Id.

<sup>18</sup> Id.



the CRRM to take into account relevant qualitative factors in an automated and more effective manner when monitoring the credit risks presented by Participants and (iii) enabling the CRRM to generate credit ratings for Participants that are more reflective of the Participants' default risk by shifting to an absolute scoring approach, all of which would improve DTC's membership monitoring process overall. Therefore, DTC believes the proposed enhancements to the CRRM would assist DTC in identifying, measuring, monitoring and managing risks that arise in or are born by DTC, consistent with the requirements of Rule 17Ad-22(e)(3)(i).

The proposed rule change to Section 1 of Rule 2 with respect to the scope of information that may be requested by DTC from its Participants has been designed to be consistent with Rule 17Ad-22(e)(19) under the Act, which was recently adopted by the Commission.<sup>19</sup> Rule 17Ad-22(e)(19) will require DTC to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage the material risk to DTC arising from arrangements in which firms that are indirect participants in DTC rely on the services provided by Participants to access DTC's payment, clearing, or settlement facilities.<sup>20</sup> By expressly reflecting in the Rules what is already DTC's current practice associated with its request for information sufficient to demonstrate a Participant's satisfactory financial condition and operational capability to state that such request may include information regarding the businesses and operations of the Participant, as well as its risk management practices with respect to services of DTC utilized by the Participant for another Person, this proposed rule change

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<sup>19</sup> 17 CFR 240.17Ad-22(e)(19). Id.

<sup>20</sup> Id.

would help enable DTC to have rule provisions that are reasonably designed to identify, monitor and manage the material risks to DTC arising from tiered participation arrangements consistent with Rule 17Ad-22(e)(19).

III. Date of Effectiveness of the Advance Notice, and Timing for Commission Action

The proposed change may be implemented if the Commission does not object to the proposed change within 60 days of the later of (i) the date that the proposed change was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

The Commission may extend the period for review by an additional 60 days if the proposed change raises novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. A proposed change may be implemented in less than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

The clearing agency shall post notice on its website of proposed changes that are implemented.

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the Advance Notice is consistent with the Clearing Supervision Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR- DTC-2017-801 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

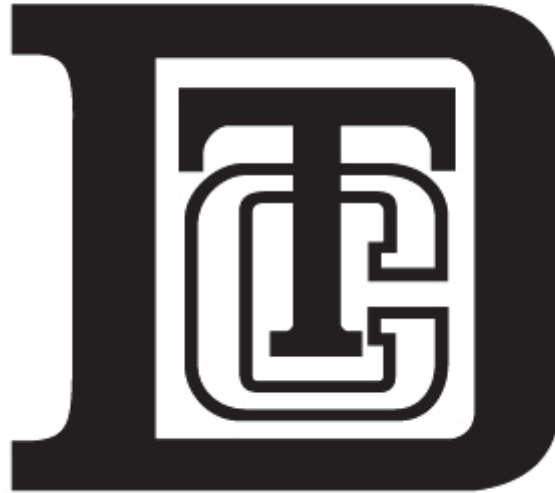
All submissions should refer to File Number SR- DTC-2017-801. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the Advance Notice that are filed with the Commission, and all written communications relating to the Advance Notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC

20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of DTC and on DTCC's website (<http://dtcc.com/legal/sec-rule-filings.aspx>). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR- DTC-2017-801 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Secretary

**Bold and underlined text** indicates proposed added language



**RULES**

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**BY-LAWS**

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**ORGANIZATION CERTIFICATE**

**THE DEPOSITORY TRUST COMPANY**

## RULE 1

### DEFINITIONS; GOVERNING LAW

*Section 1.* Unless the context requires otherwise, the terms defined in this Rule shall, for all purposes of these Rules, have the meanings herein specified:

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#### Credit Risk Rating Matrix

The term “Credit Risk Rating Matrix” means a matrix of credit ratings of Participants specified in Section 10(a) of Rule 2. The matrix is developed by the Corporation to evaluate the credit risk such Participants pose to the Corporation and its Participants and is based on factors determined to be relevant by the Corporation from time to time, which factors are designed to collectively reflect the financial and operational condition of a Participant. These factors include (i) quantitative factors, such as capital, assets, earnings, and liquidity, and (ii) qualitative factors, such as management quality, market position/environment, and capital and liquidity risk management.

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#### Watch List

The term “Watch List” means, at any time and from time to time, the list of Participants whose credit ratings derived from the Credit Risk Rating Matrix are 5, 6 or 7, as well as Participants that, based on the Corporation’s consideration of relevant factors, including those set forth in Section 10 of Rule 2, are deemed by the Corporation to pose a heightened risk to the Corporation and its Participants.

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## RULE 2

### PARTICIPANTS AND PLEDGEEES

#### *Section 1.*

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The Corporation may at any time cease either temporarily or definitively to make its services available to a Participant in accordance with these Rules and the Participant shall, upon receipt of notice thereof given by the Corporation as provided in these Rules cease to be a Participant; provided, however, that if the Corporation notifies a Participant that it has ceased to act for it only with respect to a particular transaction or transactions, the Participant shall continue to be a Participant. A Participant may terminate its business with the Corporation by notifying the Corporation as provided in Sections 7 or 8 of Rule 4 or, if for a reason other than those specified in said Sections 7 and 8, by notifying the Corporation thereof; the Participant shall, upon receipt of such notice by the Corporation, cease to be a Participant. In the event that a Participant shall cease to be a Participant, the Corporation shall thereupon cease to make its services available to the Participant, except that the Corporation may perform services on behalf of the Participant or its successor in interest necessary to terminate the business of the Participant or its successor with the Corporation, and the Participant or its successor shall pay to the Corporation the fees and charges provided by these Rules with respect to services performed by the Corporation subsequent to the time when the Participant ceases to be a Participant. The Corporation shall immediately notify the SEC if it temporarily or definitively ceases to make its services available to a Participant in accordance with these Rules.

Upon the request of the Corporation, a Participant shall furnish to the Corporation information sufficient to demonstrate its satisfactory financial condition and operational capability, **including, but not limited to, such information as the Corporation may request regarding the businesses and operations of the Participant and its risk management practices with respect to services of the Corporation utilized by the Participant for another Person or Persons**; provided, however, that the furnishing of any such financial or operational information to the Corporation shall be subject to any applicable laws or rules and regulations of regulatory bodies having jurisdiction over the Participant which relate to the confidentiality of records.

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#### **Section 10.**

**(a) All Participants will be monitored and reviewed by the Corporation on an ongoing and periodic basis, which may include monitoring of news and market developments and review of financial reports and other public information.**

**(b) (i) A Participant that is (A) qualified to be a Participant pursuant to (x) Rule 3, Section 1(d) and files the Consolidated Report of Condition**



and Income (“Call Report”) or (y) Rule 3, Section 1(h)(ii) and files the Financial and Operational Combined Uniform Single Report (“FOCUS Report”) or the equivalent with its regulator or (B) a non-U.S. bank or trust company qualified to be a Participant pursuant to the Policy Statement on the Admission of Participants, Section 2, and that has audited financial data that is publicly available, will be assigned a credit rating by the Corporation in accordance with the Credit Risk Rating Matrix. Such Participant’s credit rating will be reassessed each time the Participant provides the Corporation with requested information pursuant to Section 1 of Rule 2, or as may be otherwise required under the Rules and Procedures (including this Rule 2, Section 10).

(ii) Because the factors used as part of the Credit Risk Rating Matrix may not identify all risks that a Participant specified in paragraph (b)(i) of this Section 10 may present to the Corporation, the Corporation may, in its discretion, override such Participant’s credit rating derived from the Credit Risk Rating Matrix to downgrade the Participant. This downgrading may result in the Participant being placed on the Watch List, and/or it may subject the Participant to enhanced surveillance based on relevant factors, including those set forth in paragraph (d) below. The Corporation may also take such additional actions with regard to the Participant as are permitted by the Rules and Procedures.

(c) Participants other than those specified in paragraph (b)(i) of this Section 10 will not be assigned a credit rating by the Credit Risk Rating Matrix but may be placed on the Watch List and/or may be subject to enhanced surveillance based on relevant factors, including those set forth in paragraph (d) below, as the Corporation deems necessary to protect the Corporation and its Participants.

(d) The factors to be considered by the Corporation under paragraphs (b)(ii) and (c) of this Section 10 include, but are not limited to, (i) news reports and/or regulatory observations that raise reasonable concerns relating to the Participant, (ii) reasonable concerns around the Participant’s liquidity arrangements, (iii) material changes to the Participant’s organizational structure, (iv) reasonable concerns of the Corporation about the Participant’s financial stability due to particular facts and circumstances, such as material litigation or other legal and/or regulatory risks, (v) failure of the Participant to demonstrate satisfactory financial condition or operational capability or if the Corporation has a reasonable concern regarding the Participant’s ability to maintain applicable participation standards and (vi) failure of the Participant to provide information required by the Corporation to assess risk exposure posed by the Participant’s activity (including information requested by the Corporation pursuant to Section 1 of this Rule 2).

(e) A Participant being subject to enhanced surveillance or being placed on the Watch List shall result in more thorough monitoring of the Participant’s financial

**condition and/or operational capability, which could include, for example, on-site visits or additional due diligence information requests from the Corporation. In addition, the Corporation may require a Participant placed on the Watch List and/or subject to enhanced surveillance to make more frequent financial disclosures, including, without limitation, interim and/or pro forma reports. Participants that are subject to enhanced surveillance are also reported to the Corporation's management committees and regularly reviewed by a cross-functional team comprised of senior management of the Corporation. The Corporation may also take such additional actions with regard to any Participant (including a Participant placed on the Watch List and/or subject to enhanced surveillance) as are permitted by the Rules and Procedures.**