

*Required fields are shown with yellow backgrounds and asterisks.*

Page 1 of \*       **SECURITIES AND EXCHANGE COMMISSION**      File No.\* SR -  - \*   
 WASHINGTON, D.C. 20549      Form 19b-4      Amendment No. (req. for Amendments \*)

Filing by National Securities Clearing Corporation  
 Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

<b>Initial *</b>	<b>Amendment *</b>	<b>Withdrawal</b>	<b>Section 19(b)(2) *</b>	<b>Section 19(b)(3)(A) *</b>	<b>Section 19(b)(3)(B) *</b>
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
			Rule		
<b>Pilot</b>	<b>Extension of Time Period for Commission Action *</b>	<b>Date Expires *</b>	<input type="checkbox"/> 19b-4(f)(1)	<input type="checkbox"/> 19b-4(f)(4)	
<input type="checkbox"/>	<input type="checkbox"/>	<input type="text"/>	<input type="checkbox"/> 19b-4(f)(2)	<input type="checkbox"/> 19b-4(f)(5)	
			<input type="checkbox"/> 19b-4(f)(3)	<input type="checkbox"/> 19b-4(f)(6)	

<b>Notice of proposed change pursuant to the Payment, Clearing, and Settlement Act of 2010</b>	<b>Security-Based Swap Submission pursuant to the Securities Exchange Act of 1934</b>
<b>Section 806(e)(1) *</b>	<b>Section 806(e)(2) *</b>
<input checked="" type="checkbox"/>	<input type="checkbox"/>
	<b>Section 3C(b)(2) *</b>
	<input type="checkbox"/>

<b>Exhibit 2 Sent As Paper Document</b>	<b>Exhibit 3 Sent As Paper Document</b>
<input type="checkbox"/>	<input type="checkbox"/>

**Description**

Provide a brief description of the action (limit 250 characters, required when Initial is checked \*).

Enhance the Credit Risk Rating Matrix.

**Contact Information**

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 \*       Last Name \*

Title \*

E-mail \*

Telephone \*       Fax

**Signature**

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      

By      

(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.

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 National Securities Clearing Corporation (“NSCC”) consists of proposed modifications to NSCC’s Rules and Procedures (“Rules”),<sup>1</sup> annexed hereto as Exhibit 5. The proposed rule change would amend the Rules in order to (i) enhance the matrix (hereinafter referred to as the “Credit Risk Rating Matrix” or “CRRM”)<sup>2</sup> developed by NSCC to evaluate the risks posed by certain Members (“CRRM-Rated Members”) to NSCC and its Members from providing services to these CRRM-Rated Members and (ii) make other amendments to the Rules to provide more transparency and clarity regarding NSCC’s current ongoing membership monitoring process.

(b) NSCC expects the proposed rule change to enhance the CRRM to have a direct effect on the application of Procedure XV (Clearing Fund Formula and Other Matters) with respect to Clearing Fund deposits associated with Members’ Net Unsettled Positions in family-issued securities. Specifically, Section I(B)(1) of Procedure XV requires Members who are rated 5, 6 or 7 on the CRRM to make an additional Clearing Fund deposit based on the Members’ long Net Unsettled Positions in family-issued securities. This additional amount is not required of Members that are not currently rated by the CRRM. NSCC believes that because the proposed rule change would enable the CRRM to generate credit ratings for Members that are currently not subject to the CRRM (that is, foreign banks or trust companies), the proposed rule change may have a direct effect on the application of Procedure XV on such Members as this provision of Procedure XV will now become applicable to them. NSCC also expects the proposed rule change to enhance the CRRM to have a direct effect on the application of Procedure XV on Members that are currently rated by the CRRM, as Section I(B)(1) of Procedure XV will now become applicable to them if they are rated 5, 6 or 7 under the enhanced CRRM.

(c) The file numbers for the filings with respect to NSCC’s margining methodology as applied to family-issued securities of Members that are rated 5, 6 or 7 by the CRRM are SR-NSCC-2015-003 and SR-NSCC-2015-803.

## 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 NSCC at a meeting duly called and held on June 14, 2016.

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

<sup>2</sup> The proposed rule changes with respect to the enhancement of the CRRM are reflected in the inclusion of (i) qualitative factors and examples thereof in the proposed new definition for “Credit Risk Rating Matrix” in Rule 1 and (ii) Members that are foreign banks or trust companies that have audited financial data that is publicly available in Section 4(b)(i) of Rule 2B.

**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. NSCC will notify the Commission of any written comments received by NSCC.

**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, among other things, enhance the CRRM to enable it to rate Members that are foreign banks or trust companies and have audited financial data that is publicly available. It would also enhance the CRRM by allowing it to take into account qualitative factors when generating credit ratings for Members. In addition, it would enhance the CRRM by shifting it from a relative scoring approach to an absolute scoring approach.

This rule filing also contains proposed rule changes that are not related to the proposed CRRM enhancements but that provide specificity, clarity and additional transparency to the Rules related to NSCC's current ongoing membership monitoring process.

(i) Background

NSCC occupies an important role in the securities settlement system by interposing itself as a central counterparty between Members that are counterparties to transactions accepted for clearing by NSCC, thereby reducing the risk faced by Members. NSCC uses the CRRM, the Watch List (as defined below) and the enhanced surveillance to manage and monitor default risks of Members on an ongoing basis, as discussed below. The level and frequency of such monitoring for a Member is determined by the Member's risk of default as assessed by NSCC. Members that are deemed by NSCC to pose a heightened risk to NSCC and its Members are subject to closer and more frequent monitoring.

*Existing Credit Risk Rating Matrix*

In 2005, the Securities and Exchange Commission ("Commission") approved a proposed rule change filed by NSCC ("Initial Filing")<sup>3</sup> to establish new criteria for placing certain Members on a list for closer monitoring ("Watch List").

NSCC proposed in the Initial Filing that all U.S. broker-dealers and U.S. banks that were Members would be assigned a rating generated by entering financial data of those Members into an internal risk assessment matrix, *i.e.*, the CRRM. However, the text of the current Rule 2B, Section 4, does not specify which Members are CRRM-Rated Members and whether non-CRRM-Rated Members may be included on the Watch List.

Currently, Members that are U.S. broker-dealers and U.S. banks are assessed against the CRRM and assigned a credit rating based on certain quantitative factors.<sup>4</sup> Unfavorably-rated Members are placed on the Watch List. In addition, NSCC credit risk staff may downgrade a particular Member's credit rating based on various qualitative factors. An example of such qualitative factors might be that the Member in question received a qualified audit opinion on its annual audit. NSCC believes that, in order to protect NSCC and its other Members, it is important that credit risk staff maintain the discretion to downgrade a Member's credit rating on the CRRM and thus subject the Member 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 Members 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 Securities Exchange Act Release No. 51362 (March 11, 2005), 70 FR 13562 (March 21, 2005) (SR-NSCC-2003-11).

<sup>4</sup> Quantitative factors considered by NSCC include (a) for broker dealers, size (*i.e.*, total excess net capital), capital, leverage, liquidity, and profitability and (b) for banks, size, capital, asset quality, earnings, and liquidity.

Over time, the current CRRM has not kept pace with NSCC's evolving membership base and heightened expectations from regulators and stakeholders for robustness of financial models. Specifically, the current CRRM only generates credit ratings for those Members that are U.S. banks or U.S. broker-dealers that file standard reports with their regulators. Although these types of Members currently represent the vast majority (approximately 95%) of Members at NSCC,<sup>5</sup> foreign banks and trust companies are expected to be a growing category of NSCC's membership base in the future, and the proposed enhancements to the CRRM would enable it to assign credit ratings to these entities. 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 NSCC's credit risk staff using financial criteria deemed relevant by NSCC and can be placed on the Watch List if they experience a financial change that presents risk to NSCC. Given the potential increase in the number of Members that are foreign banks or trust companies in the coming years, there is a need to formalize NSCC's credit risk evaluation process of these Members by assigning credit ratings to them in order to better facilitate the comparability of credit risks among Members.<sup>6</sup>

In addition, the current CRRM assigns each Member that is a U.S. bank or U.S. broker-dealer and that files standard reports with its regulator(s) a credit rating based on inputting certain quantitative data relative to the applicable Member into the CRRM. Accordingly, a Member'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 particular Member that such Member'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 Members.

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

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<sup>5</sup> As of March 16, 2017, there are 155 Members. Of the 155 Members, 11 (or 7%) are U.S. banks, 136 (or 88%) are U.S. broker-dealers and one (or 1%) is a foreign bank or trust company.

<sup>6</sup> CRRM is applied across NSCC and its affiliated clearing agencies, Fixed Income Clearing Corporation ("FICC") and The Depository Trust Company ("DTC"). Specifically, in order to run the CRRM, credit risk staff uses the financial data of the applicable NSCC Members in addition to data of applicable members and participants of FICC and DTC, respectively. In this way, each applicable NSCC Member is rated against other applicable members and participants of FICC and DTC, respectively.

*Proposed Credit Risk Rating Matrix Enhancements*

To improve the coverage and the effectiveness of the current CRRM, NSCC is proposing three enhancements. The first proposed enhancement would expand the scope of CRRM coverage by enabling the CRRM to generate credit ratings for Members 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 Member 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 Member.

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

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks. NSCC 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 membership classes to which the CRRM would apply to include Members that are foreign banks or trust companies and that have audited financial data that is publicly available. The CRRM credit rating of a Member that is a foreign bank or trust company 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 Members, the enhanced CRRM would provide more comprehensive credit risk coverage of NSCC's membership base.

With the proposed enhancement to the CRRM as described above, applicable foreign bank or trust company Members 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 Members 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 Members that are U.S. banks, U.S. brokers-dealers and foreign banks and trust companies, which together represent approximately 96% of the NSCC Members.<sup>8</sup>

*B. Incorporate Qualitative Factors into the CRRM*

In addition, as proposed, the enhanced CRRM would blend qualitative factors with quantitative factors to produce a credit rating for each applicable Member in relation to the

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<sup>7</sup> Currently, these Members are monitored by NSCC credit risk staff that review similar criteria as those reviewed for CRRM-Rated Members, but such review occurs outside of the CRRM process.

<sup>8</sup> As of March 16, 2017, there are 7 Members that would not be rated by the enhanced CRRM, as proposed, because they are central securities depositories, securities exchanges and U.S. trust companies that do not file Call Reports (as defined below).

Member'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 are chosen by NSCC based on the industry best practice as well as research and sensitivity analysis conducted by NSCC. NSCC 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 NSCC 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 Member is or will soon be undergoing financial distress, which may in turn signal a higher default exposure to NSCC and its other Members. 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 Members, 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 Member 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 Member's CRRM-generated credit rating reflect an absolute measure of the Member's default risk and eliminate any potential distortion of a Member's credit rating from the Member'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, NSCC also maintains an enhanced surveillance list (referenced herein and in the proposed rule text as "enhanced surveillance") for membership

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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 Member 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.



monitoring. The enhanced surveillance list is generally used when Members are undergoing drastic and unexpected changes in their financial conditions or operation capabilities and thus are deemed by NSCC to be of the highest risk level and/or warrant additional scrutiny due to NSCC's ongoing concerns about these Members. Accordingly, Members that are subject to enhanced surveillance are reported to NSCC's management committees and are also regularly reviewed by a cross-functional team comprised of senior management of NSCC. More often than not, Members that are subject to enhanced surveillance are also on the Watch List. The group of Members 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 NSCC that triggers increased monitoring of a Member above the monitoring that occurs when a Member is on the Watch List.

A Member 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 NSCC deems such placement as necessary to protect NSCC and its Members. In contrast, a Member would be subject to enhanced surveillance only when close monitoring of the Member is deemed necessary to protect NSCC and its Members.

The Watch List and enhanced surveillance tools are not mutually exclusive; they may complement each other under certain circumstances. A key distinction between the Watch List and enhanced surveillance is that being placed on the Watch List may result in Required Deposit<sup>11</sup> related consequences under the Rules, whereas enhanced surveillance does not.<sup>12</sup> For example, a Member that is in a precarious situation could be placed on the Watch List and be subject to enhanced surveillance; however, because the Watch List status could increase a Member's Required Deposit, when NSCC has preliminary concerns about a Member, to avoid potential increase to a Member's Required Deposit, NSCC may opt not to place the Member on the Watch List until it is certain that such concerns would not be alleviated in the short-term. Instead, in such a situation, NSCC might first subject the Member to enhanced surveillance in order to closely monitor the Member's situation without affecting the Member's Required Deposit. If the Member's situation improves, then it will no longer be subject to enhanced surveillance. If the situation of the Member worsens, the Member may then be placed on the Watch List as deemed necessary by NSCC.

(ii) Detailed Description of the Proposed Rule Changes Related to the Proposed CRRM Enhancements

In connection with the proposed enhancements to the CRRM, NSCC proposes to amend the Rules to (1) incorporate qualitative factors into CRRM and (2) add Members that are foreign

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<sup>11</sup> See Rule 4 (Section 1). The "Required Deposit" is the amount that each Member is required to deposit in NSCC's Clearing Fund. Rules, supra note 1.

<sup>12</sup> NSCC expects to provide additional clarity to Members regarding the Watch List and its impact on Required Deposit in a subsequent proposed rule change to be filed with the Commission in 2017.

banks or trust companies to the categories of Members that would be assigned credit ratings by NSCC using the CRRM.

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

NSCC is proposing to include qualitative factors, such as management quality, market position/environment, and capital and liquidity risk management in the proposed new definition for “Credit Risk Rating Matrix” in Rule 1 because, as proposed, the enhanced CRRM would blend both qualitative factors and quantitative factors to produce a credit rating for each applicable Member.

*B. Proposed Changes to Section 4(b)(i) of Rule 2B (Ongoing Membership Requirements and Monitoring)*

NSCC is proposing to expand the membership types to which the CRRM would apply to include Members that are foreign banks or trust companies and that have audited financial data that is publicly available by amending Section 4 of Rule 2B.

The enhanced CRRM would assign credit ratings for each Member that is a foreign bank or trust company based on its publicly available audited financial data. The credit rating would be based on an 18-point scale, which is then mapped to the 7-point rating system currently in use today, with “1” being the strongest credit rating and “7” being the weakest credit rating.

(iii) Other Proposed Rule Changes

This rule filing also contains proposed rule changes that are unrelated to the proposed enhancement of the CRRM. These proposed rule changes would provide specificity, clarity and additional transparency to the Rules with respect to NSCC’s current ongoing membership monitoring process, as described below.

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

NSCC is proposing to 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 Members as specified in Section 4 of Rule 2B. The definition would state that the CRRM is developed by NSCC to evaluate the credit risk such Members pose to NSCC and its Members and is based on factors determined to be relevant by NSCC from time to time, which factors are designed to collectively reflect the financial and operational condition of a Member. The proposed definition would state that, in addition to the proposed qualitative factors described above, these factors include quantitative factors, such as capital, assets, earnings and liquidity.

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 Members whose credit ratings derived from the CRRM are 5, 6 or 7, as well as Members and Limited Members that, based on NSCC’s consideration of relevant factors, including those set forth in Section 4(d) of Rule 2B (described below), are deemed by NSCC to pose a heightened risk to NSCC and its Members.

*B. Proposed Changes to Rule 2B (Ongoing Membership Requirements and Monitoring)*

Section 2B of Rule 2B

NSCC is proposing to amend Section 2B of Rule 2B to state that NSCC may review the financial responsibility and operational capability of each Member and may otherwise require additional reporting from the Member regarding its financial or operational condition that may (1) include information regarding the businesses and operations of the Member and its risk management practices with respect to NSCC's services utilized by the Member for another Person and (2) result in the Member being placed on the Watch List and/or being subject to enhanced surveillance as determined by NSCC.

Members are direct participants of NSCC. However, there are firms that rely on the services provided by Members in order to have their activity cleared and settled through NSCC's facilities (the "indirect participants"). These indirect participants pose certain risks to NSCC that need to be identified and monitored as part of NSCC's ongoing member due diligence process. In order for NSCC to understand (1) the material dependencies between Members and the indirect participants that rely on the Members for the clearance and settlement of the indirect participants' transactions, (2) significant Member-indirect participant relationships and (3) the various risk controls and mitigants that these Members employ to manage their risks with respect to such relationships, NSCC may request information from Members regarding the Members' businesses and operations as well as their risk management practices with respect to services of NSCC utilized by the Members for indirect participants. The information provided by Members would then be taken into consideration by NSCC when determining whether a Member may need to be placed on the Watch List, be subject to enhanced surveillance or both.

Section 4 of NSCC Rule 2B

NSCC is proposing to amend Section 4 of Rule 2B in order to (1) specify the membership types that are currently subject to NSCC's ongoing monitoring and review, (2) clarify which U.S. broker-dealers and U.S. banks will be assigned a credit rating by NSCC in accordance with the CRRM, (3) provide that NSCC may manually downgrade a CRRM-Rated Member's credit rating in certain instances, (4) provide that NSCC may place non-CRRM-Rated Members and certain Limited Members on the Watch List and/or subject them to enhanced surveillance, if necessary, (5) describe some of the factors that could be taken into consideration by NSCC when downgrading a Member's or Limited Member's credit rating, placing a Member or Limited Member on the Watch List and/or subjecting a Member or Limited Member to enhanced surveillance, (6) allow NSCC to collect additional deposits to the Clearing Fund and to retain deposits in excess of the Required Deposit from Members or Limited Members that are on the Watch List and (7) provide for enhanced monitoring of Members or Limited Members that are on the Watch List and/or are subject to enhanced surveillance.

In connection with the forgoing, NSCC proposes to delete the current first paragraph in Section 4 of NSCC Rule 2B and add the following:

1. Section 4(a), specifying that NSCC currently monitors and reviews all Members and certain Limited Members on an ongoing and periodic basis, which may include monitoring news and market developments relating to these Members and Limited Members and conducting reviews of financial reports and other public information of these Members and Limited Members.

2. Section 4(b)(i), clarifying that (1) Members that are (A) U.S. banks or trust companies that file the Consolidated Report of Condition and Income (“Call Report”) or (B) U.S. broker-dealers that file the Financial and Operational Combined Uniform Single Report (“FOCUS Report”) or the equivalent with their regulators, would be assigned a credit rating by NSCC in accordance with the CRRM and (2) each CRRM-Rated Member’s credit rating would be reassessed upon receipt of additional information from the Member.

3. Section 4(b)(ii), providing that, because the factors used as part of the CRRM may not identify all risks that a Member may pose to NSCC, NSCC may, in addition to other actions permitted by the Rules, downgrade the Member’s credit rating derived from the CRRM if NSCC believes the CRRM-generated rating is insufficiently conservative or if it deems such downgrade as necessary to protect NSCC and its Members. Depending on the credit rating of the Member, a downgrade may result in the Member being placed on the Watch List and/or being subject to enhanced surveillance based on relevant factors.

4. Section 4(c), specifying that, other than CRRM-Rated Members, NSCC may place Members and Limited Members that are monitored and reviewed by NSCC on the Watch List and/or subject them to enhanced surveillance even though they are not being assigned credit ratings by NSCC in accordance with the CRRM.

5. Section 4(d), describing some of the factors that could be taken into consideration by NSCC when downgrading a Member’s credit rating, placing a Member or Limited Member on the Watch List and/or subjecting a Member or Limited Member to enhanced surveillance. These factors include but are not limited to (i) news reports and/or regulatory observations that raise reasonable concerns relating to the Member or Limited Member, (ii) reasonable concerns around the Member’s or Limited Member’s liquidity arrangements, (iii) material changes to the Member’s or Limited Member’s organizational structure, (iv) reasonable concerns of NSCC about the Member’s or Limited Member’s financial stability due to particular facts and circumstances, such as material litigation or other legal and/or regulatory risks, (v) failure of the Member or Limited Member to demonstrate satisfactory financial condition or operational capability or if NSCC has a reasonable concern regarding the Member’s or Limited Member’s ability to maintain applicable membership standards and (vi) failure of the Member or Limited Member to provide information required by NSCC to assess risk exposures posed by the Member’s or Limited Member’s activity.

6. Section 4(e), allowing NSCC to (1) require a Member or Limited Member that has been placed on the Watch List to make and maintain additional deposits to the Clearing Fund

and (2) withhold any deposit in excess of the Required Deposit of a Member or Limited Member that has been placed on the Watch List as provided in Section 9 of Rule 4.

7. Section 4(f), providing that NSCC would, in addition to other actions permitted by the Rules, conduct a more thorough monitoring of the financial condition and/or operational capability of, and require more frequent financial disclosures from, not only those Members and Limited Members that are placed on the Watch List but also Members and Limited Members subject to enhanced surveillance, including examples of how the monitoring could be conducted and the types of disclosures that may be required. In addition, Members and Limited Members that are subject to enhanced surveillance would be reported to NSCC's management committees and regularly reviewed by a cross-functional team comprised of senior management of NSCC.

In addition to the proposed changes described above, NSCC is proposing to make technical corrections to the second paragraph of Section 4 of Rule 2B to (1) renumber the paragraph as Section 4(g), (2) update an internal cross reference and (3) clarify that the references in the paragraph to Members under surveillance are referring to Members on the Watch List.

*C. Proposed Changes to Rule 4 (Clearing Fund)*

NSCC is proposing to amend Section 9 of Rule 4 to clarify that NSCC may, in its discretion, withhold all or part of any excess Clearing Fund deposit of Members that are on the Watch List.

*D. Proposed Changes to Procedure XV (Clearing Fund Formula and Other Matters)*

NSCC is proposing to amend Section I(B)(1) of Procedure XV to clarify that Members or Limited Members that are placed on the Watch List would be required to make additional Clearing Fund deposits, as determined by NSCC.

In addition, NSCC is proposing to make the following technical corrections to Section I(B)(1) of Procedure XV, (i) renumber the final three paragraphs as Section I(B)(2) and title the new subsection "Family Issued Securities" to reflect the different subject matter of the new subsection, (ii) capitalize references to the Credit Risk Rating Matrix to reflect the proposed addition of the defined term to Rule 1 and (iii) make other grammatical corrections to the new Section I(B)(2).

Finally, NSCC is proposing to amend Section II(C) of Procedure XV to clarify that, although NSCC would not request additional Clearing Fund deposits from Members unless they exceed a predetermined threshold, such floor would not apply to Members or Limited Members that are on the Watch List.

*E. Additional Proposed Changes to Rule 1 (Definitions and Descriptions) and Procedure XV (Clearing Fund Formula and Other Matters)*

NSCC is proposing to amend the definition of “Illiquid Position” in Rule 1 as well as Procedure XV Sections I(A)(1) and I(A)(2), each as proposed in connection with a separate proposed rule change filed with the Commission but not yet approved.<sup>13</sup> Specifically, the proposed amendments would replace and conform references to “credit risk matrix” with “Credit Risk Rating Matrix” in the proposed definition of “Illiquid Position” in Rule 1 as well as Procedure XV Sections I(A)(1) and I(A)(2).

Implementation Timeframe

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

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

The proposed rule changes would mitigate counterparty credit risk for NSCC by allowing NSCC to more accurately monitor the creditworthiness and risk profile of its Members. 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 NSCC’s ability to monitor the credit risk of its Members and are expected to lessen the frequency of manual overrides. The enhanced CRRM would also expand the coverage of NSCC’s membership by providing credit ratings for Members that are foreign banks or trust companies, which are not covered under the existing CRRM.

By mitigating counterparty credit risk for NSCC as described above, the enhanced CRRM would also mitigate risk for Members because lowering the risk profile for NSCC would in turn lower the risk exposure that Members may have with respect to NSCC in its role as a central counterparty.

Management of Identified Risks

The proposed rule changes are designed to mitigate counterparty credit risk for NSCC and to provide greater clarity and transparency to Members regarding the counterparty credit risk management approach used by NSCC.

The enhanced CRRM would improve NSCC’s ability to monitor the probability of default for Members 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.

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<sup>13</sup> See Securities Exchange Act Release No. 80260 (March 16, 2017), 82 FR 14781 (March 22, 2017) (SR-NSCC-2017-001).

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

Members that have been placed on the Watch List may also be required to maintain a higher deposit to the Clearing Fund, which would help offset potential risks to NSCC and its Members arising from activity submitted by these Members.

The enhanced CRRM would also expand the coverage of NSCC's membership 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 NSCC to employ its risk-based approach to identify those higher risk Members 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 NSCC to identify those Members that could present credit risk to NSCC, which then would allow NSCC to better manage the potential risks from these Members.

*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>14</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>15</sup>

By enhancing the CRRM to enable it to assign credit ratings to Members 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 Members, which would improve NSCC'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 Member's credit rating, the proposed change would enable NSCC to take into account relevant qualitative factors in an automated and more effective manner when monitoring

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<sup>14</sup> 12 U.S.C. 5464(b)

<sup>15</sup> Id.

the credit risks presented by the Members, which would improve NSCC'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 Member's credit rating, the proposed rule change would enable NSCC to generate credit ratings for Members that are more reflective of the Members' default risk, which would improve NSCC'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>16</sup> Rule 17Ad-22(e)(3)(i) will require NSCC 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 NSCC, which includes...systems designed to identify, measure, monitor and manage the range of risks that arise in or are borne by NSCC.<sup>17</sup> The proposed enhancements to the CRRM have been designed to assist NSCC in identifying, measuring, monitoring and managing the credit risks to NSCC posed by its Members. The proposed enhancements to the CRRM accomplish this by (i) expanding the CRRM's applicability to a wider group of Members to include Members 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 Members and (iii) enabling the CRRM to generate credit ratings for Members that are more reflective of the Members' default risk by shifting to an absolute scoring approach, all of which would improve NSCC's membership monitoring process overall. Therefore, NSCC believes the proposed enhancements to the CRRM would assist NSCC in identifying, measuring, monitoring and managing risks that arise in or are born by NSCC, consistent with the requirements of Rule 17Ad-22(e)(3)(i).

The proposed rule change to Section 2B of Rule 2B with respect to the scope of information that may be requested by NSCC from its Members has been designed to be consistent with Rule 17Ad-22(e)(19) under the Act, which was recently adopted by the Commission.<sup>18</sup> Rule 17Ad-22(e)(19) will require NSCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage the

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<sup>16</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). FICC 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>17</sup> Id.

<sup>18</sup> 17 CFR 240.17Ad-22(e)(19). Id.



material risk to NSCC arising from arrangements in which firms that are indirect participants in NSCC rely on the services provided by Members to access NSCC's payment, clearing, or settlement facilities.<sup>19</sup> By expressly reflecting in the Rules what is already NSCC's current practice associated with its request for additional reporting of a Member's financial or operational conditions to state that such request may include information regarding the businesses and operations of the Member, as well as its risk management practices with respect to services of NSCC utilized by the Member for another Person, this proposed rule change would help enable NSCC to have rule provisions that are reasonably designed to identify, monitor and manage the material risks to NSCC 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.

Exhibit 4 – Not applicable.

Exhibit 5 – Proposed changes to the Rules.

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<sup>19</sup>

Id.

**EXHIBIT 1A**

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

[DATE]

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Advance Notice to Enhance 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, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) the advance notice SR-NSCC-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, NSCC filed this Advance Notice as a proposed rule change (SR-NSCC-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 NSCC's Rules and Procedures ("Rules").<sup>4</sup> The proposed rule change would amend the Rules in order to (i) enhance the matrix (hereinafter referred to as the "Credit Risk Rating Matrix" or "CRRM")<sup>5</sup> developed by NSCC to evaluate the risks posed by certain Members ("CRRM-Rated Members") to NSCC and its Members from providing services to these CRRM-Rated Members and (ii) make other amendments to the Rules to provide more transparency and clarity regarding NSCC'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.

(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.

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

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

<sup>5</sup> The proposed rule changes with respect to the enhancement of the CRRM are reflected in the inclusion of (i) qualitative factors and examples thereof in the proposed new definition for "Credit Risk Rating Matrix" in Rule 1 and (ii) Members that are foreign banks or trust companies that have audited financial data that is publicly available in Section 4(b)(i) of Rule 2B.

(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, among other things, enhance the CRRM to enable it to rate Members that are foreign banks or trust companies and have audited financial data that is publicly available. It would also enhance the CRRM by allowing it to take into account qualitative factors when generating credit ratings for Members. In addition, it would enhance the CRRM by shifting it from a relative scoring approach to an absolute scoring approach.

This rule filing also contains proposed rule changes that are not related to the proposed CRRM enhancements but that provide specificity, clarity and additional transparency to the Rules related to NSCC's current ongoing membership monitoring process.

(i) Background

NSCC occupies an important role in the securities settlement system by interposing itself as a central counterparty between Members that are counterparties to transactions accepted for clearing by NSCC, thereby reducing the risk faced by Members. NSCC uses the CRRM, the Watch List (as defined below) and the enhanced surveillance to manage and monitor default risks of Members on an ongoing basis, as discussed below. The level and frequency of such monitoring for a Member is determined by the Member's risk of default as assessed by NSCC. Members that are deemed by NSCC to pose a heightened risk to NSCC and its Members are subject to closer and more frequent monitoring.

*Existing Credit Risk Rating Matrix*

In 2005, the Commission approved a proposed rule change filed by NSCC (“Initial Filing”)<sup>6</sup> to establish new criteria for placing certain Members on a list for closer monitoring (“Watch List”).

NSCC proposed in the Initial Filing that all U.S. broker-dealers and U.S. banks that were Members would be assigned a rating generated by entering financial data of those Members into an internal risk assessment matrix, *i.e.*, the CRRM. However, the text of the current Rule 2B, Section 4, does not specify which Members are CRRM-Rated Members and whether non-CRRM-Rated Members may be included on the Watch List.

Currently, Members that are U.S. broker-dealers and U.S. banks are assessed against the CRRM and assigned a credit rating based on certain quantitative factors.<sup>7</sup> Unfavorably-rated Members are placed on the Watch List. In addition, NSCC credit risk staff may downgrade a particular Member’s credit rating based on various qualitative factors. An example of such qualitative factors might be that the Member in question received a qualified audit opinion on its annual audit. NSCC believes that, in order to protect NSCC and its other Members, it is important that credit risk staff maintain the discretion to downgrade a Member’s credit rating on the CRRM and thus subject the Member 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

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<sup>6</sup> See Securities Exchange Act Release No. 51362 (March 11, 2005), 70 FR 13562 (March 21, 2005) (SR-NSCC-2003-11).

<sup>7</sup> Quantitative factors considered by NSCC include (a) for broker dealers, size (*i.e.*, total excess net capital), capital, leverage, liquidity, and profitability and (b) for banks, size, capital, asset quality, earnings, and liquidity.

Members 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 NSCC’s evolving membership base and heightened expectations from regulators and stakeholders for robustness of financial models. Specifically, the current CRRM only generates credit ratings for those Members that are U.S. banks or U.S. broker-dealers that file standard reports with their regulators. Although these types of Members currently represent the vast majority (approximately 95%) of Members at NSCC,<sup>8</sup> foreign banks and trust companies are expected to be a growing category of NSCC’s membership base in the future, and the proposed enhancements to the CRRM would enable it to assign credit ratings to these entities. 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 NSCC’s credit risk staff using financial criteria deemed relevant by NSCC and can be placed on the Watch List if they experience a financial change that presents risk to NSCC. Given the potential increase in the number of Members that are foreign banks or trust companies in the coming years, there is a need to formalize NSCC’s credit risk evaluation process of these Members by assigning credit ratings to them in order to better facilitate the comparability of credit risks among Members.<sup>9</sup>

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<sup>8</sup> As of March 16, 2017, there are 155 Members. Of the 155 Members, 11 (or 7%) are U.S. banks, 136 (or 88%) are U.S. broker-dealers and one (or 1%) is a foreign bank or trust company.

<sup>9</sup> CRRM is applied across NSCC and its affiliated clearing agencies, Fixed Income Clearing Corporation (“FICC”) and The Depository Trust Company (“DTC”).

In addition, the current CRRM assigns each Member that is a U.S. bank or U.S. broker-dealer and that files standard reports with its regulator(s) a credit rating based on inputting certain quantitative data relative to the applicable Member into the CRRM. Accordingly, a Member'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 particular Member that such Member'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 Members.

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

*Proposed Credit Risk Rating Matrix Enhancements*

To improve the coverage and the effectiveness of the current CRRM, NSCC is proposing three enhancements. The first proposed enhancement would expand the scope of CRRM coverage by enabling the CRRM to generate credit ratings for Members 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

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Specifically, in order to run the CRRM, credit risk staff uses the financial data of the applicable NSCC Members in addition to data of applicable members and participants of FICC and DTC, respectively. In this way, each applicable NSCC Member is rated against other applicable members and participants of FICC and DTC, respectively.

the CRRM and therefore is expected to reduce the need and the frequency of manual overrides of Member 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 Member.

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

The current CRRM is comprised of two credit rating models – one for the U.S. broker-dealers and one for the U.S. banks. NSCC 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 membership classes to which the CRRM would apply to include Members that are foreign banks or trust companies and that have audited financial data that is publicly available. The CRRM credit rating of a Member that is a foreign bank or trust company 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 Members, the enhanced CRRM would provide more comprehensive credit risk coverage of NSCC's membership base.

With the proposed enhancement to the CRRM as described above, applicable foreign bank or trust company Members 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 Members 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 Members that are U.S. banks, U.S. brokers-dealers and foreign banks and trust companies, which together represent approximately 96% of the NSCC Members.<sup>11</sup>

*B. Incorporate Qualitative Factors into the CRRM*

In addition, as proposed, the enhanced CRRM would blend qualitative factors with quantitative factors to produce a credit rating for each applicable Member in relation to the Member'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 are chosen by NSCC based on the industry best practice as well as research and sensitivity analysis conducted by NSCC. NSCC 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 NSCC 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

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<sup>10</sup> Currently, these Members are monitored by NSCC credit risk staff that review similar criteria as those reviewed for CRRM-Rated Members, but such review occurs outside of the CRRM process.

<sup>11</sup> As of March 16, 2017, there are 7 Members that would not be rated by the enhanced CRRM, as proposed, because they are central securities depositories, securities exchanges and U.S. trust companies that do not file Call Reports (as defined below).

qualitative factors may indicate that a Member is or will soon be undergoing financial distress, which may in turn signal a higher default exposure to NSCC and its other Members. 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 Members, 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>

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

As proposed, the enhanced CRRM would use an absolute scoring approach and rank each Member 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 Member's CRRM-generated credit rating reflect an absolute measure of the Member's

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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 Member 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.

default risk and eliminate any potential distortion of a Member's credit rating from the Member'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, NSCC 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 Members are undergoing drastic and unexpected changes in their financial conditions or operation capabilities and thus are deemed by NSCC to be of the highest risk level and/or warrant additional scrutiny due to NSCC's ongoing concerns about these Members. Accordingly, Members that are subject to enhanced surveillance are reported to NSCC's management committees and are also regularly reviewed by a cross-functional team comprised of senior management of NSCC. More often than not, Members that are subject to enhanced surveillance are also on the Watch List. The group of Members 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 NSCC that triggers increased monitoring of a Member above the monitoring that occurs when a Member is on the Watch List.

A Member 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 NSCC deems such placement as necessary to protect NSCC and its Members. In contrast, a Member would be subject to enhanced surveillance only when close monitoring of the Member is deemed necessary to protect NSCC and its Members.

The Watch List and enhanced surveillance tools are not mutually exclusive; they may complement each other under certain circumstances. A key distinction between the Watch List and enhanced surveillance is that being placed on the Watch List may result in Required Deposit<sup>14</sup> related consequences under the Rules, whereas enhanced surveillance does not.<sup>15</sup> For example, a Member that is in a precarious situation could be placed on the Watch List and be subject to enhanced surveillance; however, because the Watch List status could increase a Member's Required Deposit, when NSCC has preliminary concerns about a Member, to avoid potential increase to a Member's Required Deposit, NSCC may opt not to place the Member on the Watch List until it is certain that such concerns would not be alleviated in the short-term. Instead, in such a situation, NSCC might first subject the Member to enhanced surveillance in order to closely monitor the Member's situation without affecting the Member's Required Deposit. If the Member's situation improves, then it will no longer be subject to enhanced surveillance. If the situation of the Member worsens, the Member may then be placed on the Watch List as deemed necessary by NSCC.

(ii) Detailed Description of the Proposed Rule Changes Related to the Proposed CRRM Enhancements

In connection with the proposed enhancements to the CRRM, NSCC proposes to amend the Rules to (1) incorporate qualitative factors into CRRM and (2) add Members

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<sup>14</sup> See Rule 4 (Section 1). The "Required Deposit" is the amount that each Member is required to deposit in NSCC's Clearing Fund. Rules, supra note 4.

<sup>15</sup> NSCC expects to provide additional clarity to Members regarding the Watch List and its impact on Required Deposit in a subsequent proposed rule change to be filed with the Commission in 2017.

that are foreign banks or trust companies to the categories of Members that would be assigned credit ratings by NSCC using the CRRM.

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

NSCC is proposing to include qualitative factors, such as management quality, market position/environment, and capital and liquidity risk management in the proposed new definition for “Credit Risk Rating Matrix” in Rule 1 because, as proposed, the enhanced CRRM would blend both qualitative factors and quantitative factors to produce a credit rating for each applicable Member.

*B. Proposed Changes to Section 4(b)(i) of Rule 2B (Ongoing Membership Requirements and Monitoring)*

NSCC is proposing to expand the membership types to which the CRRM would apply to include Members that are foreign banks or trust companies and that have audited financial data that is publicly available by amending Section 4 of Rule 2B.

The enhanced CRRM would assign credit ratings for each Member that is a foreign bank or trust company based on its publicly available audited financial data. The credit rating would be based on an 18-point scale, which is then mapped to the 7-point rating system currently in use today, with “1” being the strongest credit rating and “7” being the weakest credit rating.

(iii) Other Proposed Rule Changes

This rule filing also contains proposed rule changes that are unrelated to the proposed enhancement of the CRRM. These proposed rule changes would provide specificity, clarity and additional transparency to the Rules with respect to NSCC’s current ongoing membership monitoring process, as described below.

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

NSCC is proposing to 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 Members as specified in Section 4 of Rule 2B. The definition would state that the CRRM is developed by NSCC to evaluate the credit risk such Members pose to NSCC and its Members and is based on factors determined to be relevant by NSCC from time to time, which factors are designed to collectively reflect the financial and operational condition of a Member. The proposed definition would state that, in addition to the proposed qualitative factors described above, these factors include quantitative factors, such as capital, assets, earnings and liquidity.

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 Members whose credit ratings derived from the CRRM are 5, 6 or 7, as well as Members and Limited Members that, based on NSCC’s consideration of relevant factors, including those set forth in Section 4(d) of Rule 2B (described below), are deemed by NSCC to pose a heightened risk to NSCC and its Members.

B. *Proposed Changes to Rule 2B (Ongoing Membership Requirements and Monitoring)*

Section 2B of Rule 2B

NSCC is proposing to amend Section 2B of Rule 2B to state that NSCC may review the financial responsibility and operational capability of each Member and may otherwise require additional reporting from the Member regarding its financial or

operational condition that may (1) include information regarding the businesses and operations of the Member and its risk management practices with respect to NSCC's services utilized by the Member for another Person and (2) result in the Member being placed on the Watch List and/or being subject to enhanced surveillance as determined by NSCC.

Members are direct participants of NSCC. However, there are firms that rely on the services provided by Members in order to have their activity cleared and settled through NSCC's facilities (the "indirect participants"). These indirect participants pose certain risks to NSCC that need to be identified and monitored as part of NSCC's ongoing member due diligence process. In order for NSCC to understand (1) the material dependencies between Members and the indirect participants that rely on the Members for the clearance and settlement of the indirect participants' transactions, (2) significant Member-indirect participant relationships and (3) the various risk controls and mitigants that these Members employ to manage their risks with respect to such relationships, NSCC may request information from Members regarding the Members' businesses and operations as well as their risk management practices with respect to services of NSCC utilized by the Members for indirect participants. The information provided by Members would then be taken into consideration by NSCC when determining whether a Member may need to be placed on the Watch List, be subject to enhanced surveillance or both.

Section 4 of NSCC Rule 2B

NSCC is proposing to amend Section 4 of Rule 2B in order to (1) specify the membership types that are currently subject to NSCC's ongoing monitoring and review, (2) clarify which U.S. broker-dealers and U.S. banks will be assigned a credit rating by

NSCC in accordance with the CRRM, (3) provide that NSCC may manually downgrade a CRRM-Rated Member's credit rating in certain instances, (4) provide that NSCC may place non-CRRM-Rated Members and certain Limited Members on the Watch List and/or subject them to enhanced surveillance, if necessary, (5) describe some of the factors that could be taken into consideration by NSCC when downgrading a Member's or Limited Member's credit rating, placing a Member or Limited Member on the Watch List and/or subjecting a Member or Limited Member to enhanced surveillance, (6) allow NSCC to collect additional deposits to the Clearing Fund and to retain deposits in excess of the Required Deposit from Members or Limited Members that are on the Watch List and (7) provide for enhanced monitoring of Members or Limited Members that are on the Watch List and/or are subject to enhanced surveillance.

In connection with the forgoing, NSCC proposes to delete the current first paragraph in Section 4 of NSCC Rule 2B and add the following:

1. Section 4(a), specifying that NSCC currently monitors and reviews all Members and certain Limited Members on an ongoing and periodic basis, which may include monitoring news and market developments relating to these Members and Limited Members and conducting reviews of financial reports and other public information of these Members and Limited Members.

2. Section 4(b)(i), clarifying that (1) Members that are (A) U.S. banks or trust companies that file the Consolidated Report of Condition and Income ("Call Report") or (B) U.S. broker-dealers that file the Financial and Operational Combined Uniform Single Report ("FOCUS Report") or the equivalent with their regulators, would be assigned a credit rating by NSCC in accordance with the CRRM and (2) each CRRM-



Rated Member's credit rating would be reassessed upon receipt of additional information from the Member.

3. Section 4(b)(ii), providing that, because the factors used as part of the CRRM may not identify all risks that a Member may pose to NSCC, NSCC may, in addition to other actions permitted by the Rules, downgrade the Member's credit rating derived from the CRRM if NSCC believes the CRRM-generated rating is insufficiently conservative or if it deems such downgrade as necessary to protect NSCC and its Members. Depending on the credit rating of the Member, a downgrade may result in the Member being placed on the Watch List and/or being subject to enhanced surveillance based on relevant factors.

4. Section 4(c), specifying that, other than CRRM-Rated Members, NSCC may place Members and Limited Members that are monitored and reviewed by NSCC on the Watch List and/or subject them to enhanced surveillance even though they are not being assigned credit ratings by NSCC in accordance with the CRRM.

5. Section 4(d), describing some of the factors that could be taken into consideration by NSCC when downgrading a Member's credit rating, placing a Member or Limited Member on the Watch List and/or subjecting a Member or Limited Member to enhanced surveillance. These factors include but are not limited to (i) news reports and/or regulatory observations that raise reasonable concerns relating to the Member or Limited Member, (ii) reasonable concerns around the Member's or Limited Member's liquidity arrangements, (iii) material changes to the Member's or Limited Member's organizational structure, (iv) reasonable concerns of NSCC about the Member's or Limited Member's financial stability due to particular facts and circumstances, such as

material litigation or other legal and/or regulatory risks, (v) failure of the Member or Limited Member to demonstrate satisfactory financial condition or operational capability or if NSCC has a reasonable concern regarding the Member's or Limited Member's ability to maintain applicable membership standards and (vi) failure of the Member or Limited Member to provide information required by NSCC to assess risk exposures posed by the Member's or Limited Member's activity.

6. Section 4(e), allowing NSCC to (1) require a Member or Limited Member that has been placed on the Watch List to make and maintain additional deposits to the Clearing Fund and (2) withhold any deposit in excess of the Required Deposit of a Member or Limited Member that has been placed on the Watch List as provided in Section 9 of Rule 4.

7. Section 4(f), providing that NSCC would, in addition to other actions permitted by the Rules, conduct a more thorough monitoring of the financial condition and/or operational capability of, and require more frequent financial disclosures from, not only those Members and Limited Members that are placed on the Watch List but also Members and Limited Members subject to enhanced surveillance, including examples of how the monitoring could be conducted and the types of disclosures that may be required. In addition, Members and Limited Members that are subject to enhanced surveillance would be reported to NSCC's management committees and regularly reviewed by a cross-functional team comprised of senior management of NSCC.

In addition to the proposed changes described above, NSCC is proposing to make technical corrections to the second paragraph of Section 4 of Rule 2B to (1) renumber the paragraph as Section 4(g), (2) update an internal cross reference and (3) clarify that the

references in the paragraph to Members under surveillance are referring to Members on the Watch List.

*C. Proposed Changes to Rule 4 (Clearing Fund)*

NSCC is proposing to amend Section 9 of Rule 4 to clarify that NSCC may, in its discretion, withhold all or part of any excess Clearing Fund deposit of Members that are on the Watch List.

*D. Proposed Changes to Procedure XV (Clearing Fund Formula and Other Matters)*

NSCC is proposing to amend Section I(B)(1) of Procedure XV to clarify that Members or Limited Members that are placed on the Watch List would be required to make additional Clearing Fund deposits, as determined by NSCC.

In addition, NSCC is proposing to make the following technical corrections to Section I(B)(1) of Procedure XV, (i) renumber the final three paragraphs as Section I(B)(2) and title the new subsection “Family Issued Securities” to reflect the different subject matter of the new subsection, (ii) capitalize references to the Credit Risk Rating Matrix to reflect the proposed addition of the defined term to Rule 1 and (iii) make other grammatical corrections to the new Section I(B)(2).

Finally, NSCC is proposing to amend Section II(C) of Procedure XV to clarify that, although NSCC would not request additional Clearing Fund deposits from Members unless they exceed a predetermined threshold, such floor would not apply to Members or Limited Members that are on the Watch List.

*E. Additional Proposed Changes to Rule 1 (Definitions and Descriptions) and Procedure XV (Clearing Fund Formula and Other Matters)*

NSCC is proposing to amend the definition of “Illiquid Position” in Rule 1 as well as Procedure XV Sections I(A)(1) and I(A)(2), each as proposed in connection with a separate proposed rule change filed with the Commission but not yet approved.<sup>16</sup> Specifically, the proposed amendments would replace and conform references to “credit risk matrix” with “Credit Risk Rating Matrix” in the proposed definition of “Illiquid Position” in Rule 1 as well as Procedure XV Sections I(A)(1) and I(A)(2).

Implementation Timeframe

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

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

The proposed rule changes would mitigate counterparty credit risk for NSCC by allowing NSCC to more accurately monitor the creditworthiness and risk profile of its Members. 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 NSCC’s ability to monitor the credit risk of its Members and are expected to lessen the frequency of manual overrides. The enhanced CRRM would also expand the coverage of NSCC’s membership by providing credit ratings for Members that are foreign banks or trust companies, which are not covered under the existing CRRM.

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<sup>16</sup> See Securities Exchange Act Release No. 80260 (March 16, 2017), 82 FR 14781 (March 22, 2017) (SR-NSCC-2017-001).

By mitigating counterparty credit risk for NSCC as described above, the enhanced CRRM would also mitigate risk for Members because lowering the risk profile for NSCC would in turn lower the risk exposure that Members may have with respect to NSCC in its role as a central counterparty.

*Management of Identified Risks*

The proposed rule changes are designed to mitigate counterparty credit risk for NSCC and to provide greater clarity and transparency to Members regarding the counterparty credit risk management approach used by NSCC.

The enhanced CRRM would improve NSCC's ability to monitor the probability of default for Members 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.

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

Members that have been placed on the Watch List may also be required to maintain a higher deposit to the Clearing Fund, which would help offset potential risks to NSCC and its Members arising from activity submitted by these Members.

The enhanced CRRM would also expand the coverage of NSCC's membership 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 NSCC to employ its risk-based approach to identify those higher risk Members 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 NSCC to identify those Members that could present credit risk to NSCC, which then would allow NSCC to better manage the potential risks from these Members.

*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 Clearing Supervision Act.<sup>17</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>18</sup>

By enhancing the CRRM to enable it to assign credit ratings to Members 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 Members, which would improve NSCC's membership monitoring process and

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<sup>17</sup> 12 U.S.C. 5464(b)

<sup>18</sup> Id.

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 Member's credit rating, the proposed change would enable NSCC to take into account relevant qualitative factors in an automated and more effective manner when monitoring the credit risks presented by the Members, which would improve NSCC'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 Member's credit rating, the proposed rule change would enable NSCC to generate credit ratings for Members that are more reflective of the Members' default risk, which would improve NSCC'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>19</sup> Rule 17Ad-22(e)(3)(i) will require NSCC 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 NSCC, which

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<sup>19</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). FICC 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.

includes...systems designed to identify, measure, monitor and manage the range of risks that arise in or are borne by NSCC.<sup>20</sup> The proposed enhancements to the CRRM have been designed to assist NSCC in identifying, measuring, monitoring and managing the credit risks to NSCC posed by its Members. The proposed enhancements to the CRRM accomplish this by (i) expanding the CRRM's applicability to a wider group of Members to include Members 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 Members and (iii) enabling the CRRM to generate credit ratings for Members that are more reflective of the Members' default risk by shifting to an absolute scoring approach, all of which would improve NSCC's membership monitoring process overall. Therefore, NSCC believes the proposed enhancements to the CRRM would assist NSCC in identifying, measuring, monitoring and managing risks that arise in or are born by NSCC, consistent with the requirements of Rule 17Ad-22(e)(3)(i).

The proposed rule change to Section 2B of Rule 2B with respect to the scope of information that may be requested by NSCC from its Members has been designed to be consistent with Rule 17Ad-22(e)(19) under the Act, which was recently adopted by the Commission.<sup>21</sup> Rule 17Ad-22(e)(19) will require NSCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to identify, monitor, and manage the material risk to NSCC arising from arrangements in which firms that are indirect participants in NSCC rely on the services provided by Members to access

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<sup>20</sup> Id.

<sup>21</sup> 17 CFR 240.17Ad-22(e)(19). Id.



NSCC's payment, clearing, or settlement facilities.<sup>22</sup> By expressly reflecting in the Rules what is already NSCC's current practice associated with its request for additional reporting of a Member's financial or operational conditions to state that such request may include information regarding the businesses and operations of the Member, as well as its risk management practices with respect to services of NSCC utilized by the Member for another Person, this proposed rule change would help enable NSCC to have rule provisions that are reasonably designed to identify, monitor and manage the material risks to NSCC 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

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<sup>22</sup>

Id.

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-NSCC-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-NSCC-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 NSCC 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-NSCC-2017-801 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

By the Commission.

Secretary



NATIONAL  
SECURITIES  
CLEARING  
CORPORATION

RULES & PROCEDURES

TEXT OF PROPOSED RULE CHANGE

indicates proposed added language

indicates proposed deleted language

indicates proposed language added in connection with a separate proposal that has not yet been approved (SR-NSCC-2017-001, filed on March 14, 2017)

indicates proposed additions to language that was added in connection with a separate proposal that has not yet been approved (SR-NSCC-2017-001, filed on March 14, 2017)

indicates proposed deletions to language that was added in connection with a separate proposal that has not yet been approved (SR-NSCC-2017-001, filed on March 14, 2017)

## RULE 1. DEFINITIONS AND DESCRIPTIONS

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 Members specified in Section 4 of Rule 2B. The matrix is developed by the Corporation to evaluate the credit risk such Members pose to the Corporation and its Members 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 Member. 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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### **Illiquid Position**

**The term “Illiquid Position” means a Net Unsettled Position in an Illiquid Security that exceeds applicable volume thresholds. For net buy positions in an Illiquid Security, the volume thresholds shall be no greater than 100 million shares and based on the Member’s rating on the eCredit rRisk Rating mMatrix. For net sell positions in an Illiquid Security, the volume threshold shall be no greater than 1 million shares on an absolute value basis, and based on both the Member’s excess net capital and the Member’s rating on the eCredit rRisk Rating mMatrix.**

**In determining if the volume threshold is met with respect to a net sell position in Illiquid Securities, the Corporation shall apply an offset against shares of Illiquid Securities in the Member’s inventory at DTC to the quantity of shares in a Member’s Illiquid Position. Such offset shall not be applied to (1) net buy positions in Illiquid Securities, or (2) Members that have the weakest rating on the eCredit rRisk Rating mMatrix.**

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**Watch List**

**The term “Watch List” means, at any time and from time to time, the list of Members whose credit ratings derived from the Credit Risk Rating Matrix are 5, 6 or 7, as well as Members and Limited Members that, based on the Corporation’s consideration of relevant factors, including those set forth in Section 4(d) of Rule 2B, are deemed by the Corporation to pose a heightened risk to the Corporation and its Members.**

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RULE 2B. ONGOING MEMBERSHIP REQUIREMENTS AND MONITORING

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SEC. 2. DATA TO BE FILED WITH THE CORPORATION

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B. Notification of Changes in Condition

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(e) Failure to notify the Corporation under this Section may be deemed to be a violation of the Corporation's Rules and therefore may be subject to sanctions. **In addition, the Corporation may review the financial responsibility and operational capability of the Member to the extent provided in these Rules and Procedures and otherwise require from the Member additional reporting of its financial or operational condition at such intervals and in such detail as the Corporation shall determine, including, but not limited to, such information as the Corporation may request regarding the businesses and operations of the Member and its risk management practices with respect to services of the Corporation utilized by the Member for another Person or Persons, and shall make a determination as to whether such Member should be placed on the Watch List and/or be subject to enhanced surveillance by the Corporation consistent with the provisions of Section 4 of Rule 2B.**

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SEC. 4. ONGOING MONITORING (~~SURVEILLANCE STATUS~~)

~~Based upon criteria as established by the Corporation from time to time (e.g. the "credit risk matrix"), a Member whose financial and/or operational condition has been determined to be such that it may increase, or potentially increase, operational and/or financial risk to the Corporation and/or its participants, may be placed on the corporation's "watch list".~~

**(a) All Members and certain Limited Members 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 Member that is (A) a U.S. bank or trust company that files the Consolidated Report of Condition and Income ("Call Report"), (B) a U.S. broker-dealer that files the Financial and Operational Combined Uniform Single Report ("FOCUS Report") or the equivalent with its regulator or (C) a non-U.S. bank or trust company 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 Member's credit rating will be reassessed each time the Member provides the Corporation with requested information pursuant to Section 2B(e) of Rule 2B, or as may be otherwise required under the Rules and Procedures (including this Rule 2B, Section 4).

(ii) Because the factors used as part of the Credit Risk Rating Matrix may not identify all risks that a Member specified in paragraph (b)(i) of this Section 4 may present to the Corporation, the Corporation may, in its discretion, override such Member's credit rating derived from the Credit Risk Rating Matrix to downgrade the Member. This downgrading may result in the Member being placed on the Watch List, and/or it may subject the Member 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 Member as are permitted by the Rules and Procedures.

(c) Members other than those specified in paragraph (b)(i) of this Section 4 and Limited Members that are monitored and reviewed by the Corporation pursuant to paragraph (a) of this Section 4 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 Members.

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



**(e) The Corporation may require a Member or Limited Member that has been placed on the Watch List to make and maintain a deposit to the Clearing Fund over and above the amount determined in accordance with Procedure XV (which additional deposit shall constitute a portion of the Member's or Limited Member's Required Deposit), or such higher amount as the Board may deem necessary for the protection of the Corporation or other Members, which higher amount may include, but is not limited to, additional payments or deposits in any form to offset potential risk to the Corporation and its Members arising from activity submitted by such Member or Limited Member. The Corporation may also retain any deposit in excess of the Required Deposit of a Member or Limited Member that has been placed on the Watch List as provided in Section 9 of Rule 4.**

**(f) ~~Members included on the watch list are subject to closer monitoring by the Corporation, and the~~ A Member or Limited Member being subject to enhanced surveillance or being placed on the Watch List shall result in a more thorough monitoring of the Member's or Limited Member'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 Member or Limited Member 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. Members and Limited Members 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 such any Member or Limited Member (including a Member or Limited Member placed on the Watch List and/or subject to enhanced surveillance) as are permitted within by these Rules and Procedures.**

**(g) Unless the context otherwise requires, the parent bank holding company of a Member that has been admitted to membership in accordance with section 1.B.2.(a)(ii) of Addendum B, and any material banking subsidiary of such parent bank holding company, shall, for the purpose of applying ~~the surveillance status rule~~ this Section 4, be treated as if it were also a Member, so that the Member, the parent bank holding company and any affiliated material banking subsidiary shall be required individually to meet the standards for a Member not on the Watch List under surveillance, if the Member is not to be placed on the Watch List surveillance status.**

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#### RULE 4. CLEARING FUND

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SEC. 9. The Corporation shall determine with such frequency as it shall, from time to time to specify, whether the amount deposited by each Member, Mutual Fund/Insurance Services Member, Insurance Carrier/Retirement Services Member or Fund Member to the Clearing Fund may be in excess of such participant's Required Deposit. On any day that the Corporation has determined and provided notification that the Clearing Fund deposit of a participant exceeds its Required Deposit, then upon such participant's request, provided in such form and within such timeframe as determined by the Corporation from time to time, the Corporation shall cause to be returned to the participant cash on deposit (in excess of the minimum amount of cash required to be maintained in the Clearing Fund) and/or Eligible Clearing Fund Securities (valued at their collateral value on the day of such withdrawal) securing such participant's open account indebtedness in an aggregate amount equal to such excess or such lesser amount as the Member, Mutual Fund/Insurance Services Member, Insurance Carrier/Retirement Services Member or Fund Member may request; provided, however, that such excess shall not be returned (a) until any amount which is required to be charged against the participant's Required Deposit is paid by the participant to the Corporation and/or (b) if the Corporation determines that the participant's current month's use of one or more services is materially different than the previous month's use of such service(s) upon which such excess deposit is based. Notwithstanding the foregoing, the Corporation may, in its discretion, determine to withhold all or part of any excess deposit of a participant if such participant **has been placed on the Watch List**~~is subject to surveillance~~ pursuant to these Rules.

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PROCEDURE XV. CLEARING FUND FORMULA AND OTHER MATTERS<sup>1</sup>

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I.(A) Clearing Fund Formula for Members

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(1) For CNS Transactions

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**The Corporation shall apply the greater of the Illiquid Charge or the Market Maker Domination Charge if it determines that the Illiquid Position is subject to both charges. Members that are not rated by the eCredit rRisk Rating mMatrix are not subject to the Illiquid Charge.**

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(2) For Balance Order Transactions

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**The Corporation shall apply the greater of the Illiquid Charge or the Market Maker Domination Charge if it determines that the Illiquid Position is subject to both charges. Members that are not rated by the eCredit rRisk Rating mMatrix are not subject to the Illiquid Charge.**

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I.(B) Additional Clearing Fund Formula

(1) Additional Deposits for Members on **the Watch List Surveillance**

Any Member **or Limited Member** who is placed on **the Watch List surveillance status** shall be required to make such additional Clearing Fund deposits as determined by the Corporation on the same day as requested by the Corporation within such timeframe as required by the Corporation from time to time.

**(2) Family-Issued Securities**

The Corporation shall require Members who are rated 5, 6, or 7 on the **eCredit rRisk Rating mMatrix** to contribute to the Clearing Fund an amount determined by multiplying the absolute value of any long Net Unsettled Positions in

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<sup>1</sup> All calculations shall be performed daily or, if the Corporation deems it appropriate, on a more frequent basis.

classes of “family-issued securities” (defined as securities that were issued by either that Member or by an affiliate of that Member) by a percentage designated by the Corporation; such percentage, to be no less than 40% and up to 100%, ~~would~~ **shall** be determined, from time to time, in the sole discretion of the Corporation, within the parameters described as follows, based on the Member’s rating on the **eCredit rRisk Rating mMatrix** and on the type of family-issued securities submitted to the Corporation.

Fixed income securities that are family-issued securities ~~would~~ **shall** be charged a haircut rate of no less than 80% for firms that are rated 6 or 7 on the **eCredit rRisk Rating mMatrix**, and no less than 40% for firms that are rated 5 on the **eCredit rRisk Rating mMatrix**; and equity securities that are family-issued securities ~~would initially~~ **shall** be charged a haircut rate of 100% for firms that are rated 6 or 7 on the **eCredit rRisk Rating mMatrix**, and no less than 50% for firms that are rated 5 on the **eCredit rRisk Rating mMatrix**.

The Corporation shall exclude long Net Unsettled Positions in such family-issued securities of Members who are rated 5, 6, or 7 on the **eCredit rRisk Rating mMatrix** from the calculations describe in Subsections I.(A)(1)(a)(i) and (ii) and I.(A)(2)(a)(i) and (ii).

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II. Minimum Clearing Fund and Additional Deposit Requirements

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- (C) Additional Clearing Fund deposits shall not be requested unless they exceed such threshold as determined by the Corporation from time to time; **provided that the affected Member or Limited Member is not on the Watch List.**

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