

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-80597; File No. SR-NSCC-2017-001)

May 4, 2017

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change to Describe the Illiquid Charge that May Be Imposed on Members

On March 13, 2017, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-NSCC-2017-001, pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on March 22, 2017.³ The Commission did not receive any comment letters on the proposed rule change. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

I. Description of the Proposed Rule Change

NSCC proposes to amend its Rules & Procedures (“Rules”)⁴ in order to provide transparency to an existing margin charge (i.e., the “Illiquid Charge”) and to codify NSCC’s current practices with respect to the assessment and collection of the Illiquid

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 80260 (March 16, 2017), 82 FR 14781 (March 22, 2017) (SR-NSCC-2017-001) (“Notice”).

⁴ Available at <http://www.dtcc.com/en/legal/rules-and-procedures>.

Charge, as described below.⁵ Separately, NSCC also proposes to amend Procedure XV of the Rules to define the “Market Maker Domination Charge,” also described below.

A. The Illiquid Charge

NSCC states that it designed the Illiquid Charge to mitigate the market risk that NSCC faces when liquidating securities that lack marketability, based on insufficient access to a trading venue, and may have low and volatile share prices (“Illiquid Securities”),⁶ following a member default.⁷ In such a situation, the liquidation of Illiquid Securities could be difficult or delayed due to a lack of interest in the securities or limitations on the share price of the securities.⁸

NSCC calculates an Illiquid Charge for each net unsettled position in an Illiquid Security (i.e., an “Illiquid Position”) that exceeds applicable volume thresholds. Following is a description of (i) the volume thresholds that must be met in order for the Illiquid Charge to be applied, (ii) the methodology for calculating the Illiquid Charge, and (iii) the exceptions to and application of the Illiquid Charge.

⁵ Specifically, NSCC proposes to amend Rule 1 (Definitions and Descriptions) to add certain defined terms associated with the Illiquid Charge, and amend Procedure XV (Clearing Fund Formula and Other Matters) to clarify the circumstances and manner in which NSCC calculates and imposes the Illiquid Charge.

⁶ More specifically, NSCC proposes to define Illiquid Security to mean a security, other than a family-issued security as defined in Procedure XV of the Rules, that either (i) is not traded on or subject to the rules of a national securities exchange registered under the Act, or (ii) is an OTC Bulletin Board or OTC Link issue.

⁷ Notice, 82 FR at 14781.

⁸ Id.

1. Net Buy Illiquid Positions and Net Sell Illiquid Positions

Depending on whether the Illiquid Position is a net buy or a net sell position, NSCC applies different volume thresholds and calculation methods for establishing the Illiquid Charge. The purpose of this is to address the different risk profiles presented by such net buy and net sell positions.⁹

a. Net Buy Illiquid Positions

The Illiquid Charge only applies to a member's net buy Illiquid Position if the position meets a specific volume threshold. For an NSCC member with a strong credit rating, the net buy Illiquid Position must meet a volume threshold of greater than 100 million shares.¹⁰ For an NSCC member with a weak credit rating, the net buy Illiquid Position must meet a volume threshold of greater than 10 million shares.¹¹ If the volume

⁹ In the event of a Member default, NSCC would complete the liquidation of an Illiquid Position by buying or selling that position into the market. Notice, 82 FR at 14783. According to NSCC, the different risk profiles of net buy positions and net sell positions are based on, in part, the difference in the potential responsiveness of prices change to quantity that may occur when NSCC is liquidating a net buy position in an Illiquid Security, compared to when it is liquidating a net sell position in an Illiquid Security. *Id.*

¹⁰ Credit ratings are established through NSCC's credit risk rating matrix ("CRRM"). *See* Rule 2B, Section 4, *supra* note 4; *see also* Securities Exchange Act Release No. 80381 (April 5, 2017), 82 FR 17475 (April 11, 2017) (SR-NSCC-2017-002) (NSCC proposed rule change to modify the CRRM formula). The CRRM applies a 7-point rating system, with "1" being the strongest rating and "7" being the weakest rating. *Id.* A CRRM credit rating of 1-4 would be a stronger credit rating, while a CRRM credit rating of 5-7 would be a weaker credit rating. *Id.*

¹¹ Members with a stronger CRRM rating would be assessed an Illiquid Charge on a net buy Illiquid Position at a higher volume threshold because NSCC believes these members pose a lower risk of default. Notice, 82 FR at 14783. Meanwhile, members with a weaker CRRM rating present a heightened credit risk to NSCC or have demonstrated a higher risk related to their ability to meet settlement. *Id.*

threshold is met, the net buy position in the Illiquid Securities is considered an Illiquid Position and is subject to the Illiquid Charge.

In addition, the Illiquid Charge only applies to net buy Illiquid Positions in Illiquid Securities that have a share price below \$0.01. If a transaction in any security, including an Illiquid Security, with a share price below \$0.01 is entered into NSCC's Continuous Net Settlement system or Balance Order Accounting Operation,¹² NSCC rounds up the price of the security to \$0.01. Therefore, when a member holds a buy position in a sub-penny security, NSCC records the position's value at a higher price than the actual per share price of the position. The difference may reduce the member's required fund deposit,¹³ particularly for a large quantity of buy positions in a sub-penny security.

To address this risk, NSCC states that it calculates the Illiquid Charge for net buy Illiquid Positions by multiplying the aggregate quantity of shares in such positions by \$0.01.¹⁴ NSCC assesses and collects the resulting amounts as the Illiquid Charge component of affected members' required fund deposit.¹⁵

¹² NSCC processed guaranteed trades through the Continuous Net Settlement system if the underlying security is freely transferable. NSCC processed guaranteed trades through the Balance Order Accounting Operation when the underlying security is subject to a restriction such as Reg. S or Reg. 144A. See Rule 1, supra note 4

¹³ The required fund deposit is a mutualized deposit made by a member to NSCC to be used in the event of a member default. See Rule 4, Section 1, supra note 4

¹⁴ Notice, 82 FR at 14783.

¹⁵ Id.

b. Net Sell Illiquid Positions

The Illiquid Charge only applies to a member's net sell Illiquid Position if the position meets a specific volume threshold. To determine the volume threshold, NSCC first offsets the quantity of shares in the member's net sell Illiquid Position against the number of shares of the same Illiquid Security held by the member at The Depository Trust Company ("DTC inventory offset").¹⁶ Next, NSCC determines the applicable volume threshold for the net sell Illiquid Position based on (i) the percentage of the average daily volume ("ADV")¹⁷ of the underlying Illiquid Securities, (ii) the member's credit rating, and, in some cases, (iii) the member's excess net capital ("ENC"). More specifically, for an NSCC member with a strong credit rating (i.e., a CRRM rating of 1-4), the net sell Illiquid Position must meet a volume threshold of 1 million shares, when the net sell Illiquid Position is greater than or equal to 25 percent of the ADV. For an NSCC member with a weak credit rating (i.e., a CRRM rating of 5-7), the net sell Illiquid Position must meet a volume threshold of 500,000 shares, when the net sell Illiquid Position is greater than or equal to 25 percent of the ADV and the member's ENC is greater than \$10 million. However, the net sell Illiquid Position need only meet a volume threshold of 100,000 shares, if an NSCC member has a weak credit rating (i.e., a CRRM rating of 5-7), and the net sell Illiquid Position is greater than or equal to 25 percent of the ADV, and the member's ENC is less than or equal to \$10 million. A member may

¹⁶ DTC is a central depository where NSCC-traded securities are held. The DTC inventory offset does not apply to members with the weakest CRRM rating (i.e., a 7). See Rule 2B, Section 4, supra note 4; Notice, 82 FR at 14783.

¹⁷ NSCC states that "ADV" is the average daily volume over the most recent twenty business days as determined by NSCC. Notice, 82 FR at 14783.

not meet the applicable volume thresholds after applying the DTC inventory offset, and, therefore, would not be subject to the Illiquid Charge.

If the applicable volume threshold is met, the net sell Illiquid Position is subject to the Illiquid Charge. To calculate the Illiquid Charge for net sell Illiquid Positions, NSCC considers the Current Market Price¹⁸ of the subject Illiquid Security and the quantity of shares in such position compared to the ADV of that Illiquid Security:

- (A) If the Illiquid Position has a Current Market Price equal to or less than \$1.00, NSCC calculates the Illiquid Charge as the product of the aggregate quantity of shares in the Illiquid Position and either (i) the highest market price of the Illiquid Security during the preceding 20 trading days (“One Month High Price”),¹⁹ or (ii) the Current Market Price of the Illiquid Security multiplied by a factor between 2 and 10, depending on the market price.²⁰
- (B) If the Illiquid Position has a Current Market Price that is greater than \$1.00, NSCC calculates the Illiquid Charge as the product of the aggregate quantity of shares in the Illiquid Position and either (i) the One Month

¹⁸ The term “Current Market Price” is defined in Rule 1 and is generally the most recent closing price of the security. Supra note 4.

¹⁹ The “One Month High Price” means the highest of all NSCC observed market prices over the most recent 20 trading day period for purposes of the Illiquid Charge. Notice, 82 FR at 14783

²⁰ Generally, the factor applied would be 10 where the market price is less than \$0.10; the factor applied would be 5 where the market price is between \$0.10 and \$0.20; the factor applied would be 2 where the market price is between \$0.20 and \$1.00. Where the market price is greater than \$1.00, a \$0.50 price increment is applied. Id.

High Price, or (ii) the Current Market Price of the Illiquid Security rounded up to the next \$0.50 increment.

In determining whether to use the One Month High Price or the Current Market Price of the Illiquid Security to calculate the Illiquid Charge, NSCC compares the percentage of the ADV to the share quantity in the Illiquid Position. If the quantity of shares in the Illiquid Position is less than 100 percent of the ADV, but greater than or equal to 25 percent of the ADV, then the calculation uses the lesser of the One Month High Price or the Current Market Price of the Illiquid Securities (rounded up to the next \$0.50 increment, if applicable). If the quantity of shares in the Illiquid Position is greater than or equal to 100 percent of the ADV, then the calculation uses the greater of the One Month High Price or the Current Market Price of the Illiquid Security (rounded up to the next \$0.50 increment, if applicable).

Furthermore, depending on the result of the calculation described above, the Illiquid Charge would remain subject to a minimum price per share, which would not be less than \$0.01. Therefore, when calculating the Illiquid Charge, the One Month High Price or the Current Market Price of the Illiquid Security is substituted by the minimum price per share if the One Month High Price or the Current Market Price, as applicable, is below the minimum price per share.

2. Exceptions and Exclusions from the Illiquid Charge

NSCC states that, in order to avoid duplicate margin charges, it does not apply the Illiquid Charge when a greater Market Maker Domination Charge (“MMDC”) charge is

also applicable to the same Illiquid Positions.²¹ The MMDC applies to a position in a security that is greater than 40 percent of the overall unsettled long position in that security, if such position is held by the Market Maker in that security.²²

Similarly, NSCC proposes to exclude family-issued securities from the definition of “Illiquid Security.”²³ NSCC believes that family-issued securities have a different risk profile than other illiquid securities that is better addressed through a separate margin charge.

B. The Market Maker Domination Charge Change

Separate from the proposed changes related to the Illiquid Charge, NSCC would amend the Rules to define the term “Market Maker Domination Charge” in Procedure XV, Section I(A)(1)(d) of the Rules and use the defined term in Section I(A)(2)(c) of the Rules. NSCC believes that this change would improve clarity and create ease of reference in the Rules.²⁴

²¹ Notice, 82 FR at 14784.

²² For purposes of calculating the MMDC, the overall unsettled long position is calculated as the sum of each member’s net long position. Application and calculation of the MMDC is described in Procedure XV of the Rules, Sections I(A)(1)(d) and I(A)(2)(c). Supra note 4.

²³ NSCC defines family-issued securities as securities that were issued by either that member or by an affiliate of that member. Procedure XV, Section I(B)(1), supra note 4.

²⁴ Supra note 4.

II. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act²⁵ directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. The Commission believes the proposal is consistent with Act, specifically Section 17A(b)(3)(F) of the Act and Rules 17Ad-22(e)(1), (e)(4)(i), and (e)(6)(v)²⁶ under the Act, as discussed below.

A. Consistency with Section 17A(b)(3)(F)

Section 17A(b)(3)(F) of the Act, requires, in part, that NSCC's Rules be designed to assure the safeguarding of securities and funds that are within the custody or control of the clearing agency and to promote the prompt and accurate clearance and settlement of securities transactions.²⁷ As described above, the Illiquid Charge could help protect NSCC from potential losses in the event that a member defaults. Specifically, the Illiquid Charge is calculated and collected to help mitigate the potential costs associated with NSCC's potential difficulties or delays in liquidating Illiquid Securities, due to the illiquid nature of such securities, following a member default. By enabling NSCC to better assess and collect required fund deposits in consideration of members' Illiquid Positions, the Commission believes that the proposed changes related to the Illiquid Charge would help promote the safeguarding of securities and funds that are within

²⁵ 15 U.S.C. 78s(b)(2)(C).

²⁶ 15 U.S.C. 78q-1(b)(3)(F); 17 CFR 240.17Ad-22(e)(1); 17 CFR 240.17Ad-22(e)(4)(i); 17 CFR 240.17Ad-22(e)(6).

²⁷ 15 U.S.C. 78q-1(b)(3)(F).

NSCC’s custody or control, consistent with the requirements of Section 17(b)(3)(F) of the Act.²⁸

The Commission also finds that the proposed rule change pertaining to the Market Maker Domination Charge is consistent with Section 17A(b)(3)(F) of the Act.²⁹ As described above, NSCC proposes to add to its Rules a definition of the Market Maker Domination Charge. This change could make the Rules more clear for members that rely on them, enabling members to more easily and promptly rely on the Rules, which help support NSCC’s prompt and accurate clearance and settlement of securities transactions made by members. Therefore, the Commission believes that the proposed rule change related to the Market Maker Domination Charge is consistent with Section 17A(b)(3)(F) of the Act.³⁰

B. Consistency with Rule 17Ad-22(e)(1)

Rule 17Ad-22(e)(1) under the Act requires, in part, a clearing agency to “establish, implement, maintain and enforce written policies and procedures reasonably designed to . . . [p]rovide for a well-founded, clear, transparent and enforceable legal basis for each aspect of its activities.”³¹ As described above, NSCC proposes to define the term “Market Maker Domination Charge” Procedure XV, Section I(A)(1)(d) of the

²⁸ Id.

²⁹ Id.

³⁰ Id.

³¹ 17 CFR 240.17Ad-22(e)(1).

Rules.³² The Commission believes that this proposed change could make the Rules more clear and transparent for members that rely on them, consistent with Rule 17Ad-22(e)(1).

C. Consistency with Rule 17Ad-22(e)(4)(i)

Rule 17Ad-22(e)(4)(i) under the Act requires a clearing agency to establish, implement, maintain and enforce written policies and procedures reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to members and those exposures arising from its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each member fully with a high degree of confidence.³³ As described above, the Illiquid Charge is calculated and imposed based on the amount and nature of Illiquid Securities in each member's portfolio, and in consideration of the members' credit rating. In doing so, the Illiquid Charge is designed to help obtain sufficient financial resources to help cover the credit exposures, with a high degree of confidence, presented by members that maintain Illiquid Positions. Therefore, the Commission believes that the proposed changes related to the Illiquid Charge are consistent with Rule 17Ad-22(e)(4)(i) under the Act.³⁴

D. Consistency with Rule 17Ad-22(e)(6)(v)

Rule 17Ad-22(e)(6)(v) under the Act requires, in part, NSCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to cover its credit exposures to its members by establishing a risk-based margin system that,

³² Supra note 4.

³³ 17 CFR 240.17Ad-22(e)(4)(i).

³⁴ Id.

at a minimum, uses an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products.³⁵ As described above, the Illiquid Charge is a component of the required fund deposits that NSCC calculates and collects using a risk-based margin methodology that is designed to help maintain the coverage of NSCC's credit exposures to its members at a confidence level of at least 99 percent. The Illiquid Charge is calculated to address the unique risk characteristics presented by Illiquid Securities, specifically their lack of marketability and their low and volatile share prices, and in consideration of the credit rating of the member holding the Illiquid Position. Therefore, the Commission believes that the proposed changes related to the Illiquid Charge are consistent with Rule 17Ad-22(e)(6)(v) under the Act.³⁶

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act, in particular the requirements of Section 17A of the Act³⁷ and the rules and regulations thereunder.

³⁵ 17 CFR 240.17Ad-22(e)(6)(v).

³⁶ Id.

³⁷ 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule change SR-NSCC-2017-001 be, and hereby is, APPROVED.³⁸

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.³⁹

Eduardo A. Aleman
Assistant Secretary

³⁸ In approving the proposed rule change, the Commission considered the proposals' impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³⁹ 17 CFR 200.30-3(a)(12).