

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-65899; File No. SR-FICC-2008-01)

December 6, 2011

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Allow the Mortgage-Backed Securities Division to Provide Guaranteed Settlement and Central Counterparty Services

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, notice is hereby given that on March 12, 2008, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”), and on November 21, 2011, amended the proposed rule change as described in Items I, II, and III below, which Items have been prepared primarily by FICC. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule changes consist of modifications to the rules of FICC’s MBSD to allow MBSD to provide guaranteed settlement and central counterparty (“CCP”) services.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

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

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) The purpose of this rule filing is to introduce CCP and guaranteed settlement services for the MBSB. Establishment of these processes for the MBSB has necessitated the drafting of a new MBSB rulebook. Therefore, the existing MBSB clearing rulebook will be replaced, in its entirety, by a new rulebook.<sup>3</sup> Certain provisions in the current MBSB rules which reflect processes that will continue upon the introduction of the CCP services have been retained in the proposed MBSB rulebook, where applicable. In order to promote uniformity between FICC's two Divisions and to create transparency for common members, the new MBSB rulebook follows the structure of the Government Securities Division (the "GSD") rulebook. In addition, where possible and/or applicable, the new MBSB provisions mirror the equivalent GSD provisions. It should be noted that under the current MBSB Clearing Rules, member firms are referred to as "Participants." In the new MBSB CCP rulebook, which is proposed by this filing, member firms shall be referred to as "Clearing Members."

I. OVERVIEW

With the introduction of CCP services and guaranteed settlement for transactions submitted to the MBSB, FICC will provide a trade guarantee for all existing types of trades upon comparison of trade details submitted by members.<sup>4</sup> Additionally, a new pool netting system

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<sup>3</sup> The MBSB's Electronic Pool Notification Service rulebook will remain unchanged.

<sup>4</sup> Currently, the MBSB recognizes two types of trades. Those are "to be announced" ("TBA") trades and specified pool trades ("SPTs"). TBA trades may proceed through the Settlement Balance Order engine for netting or may settle on a trade-for-trade basis. A TBA is a contract for the purchase or sale of agency mortgage-backed securities to be delivered at a future agreed-upon date; however, the actual pool identities or the number of pools that will be delivered to fulfill the trade obligation or terms of the contract are unknown at the time of the trade. The difference between TBAs and SPTs is that for an SPT all required pool data, including the pool number to be delivered on settlement date, are agreed upon by Clearing Members at the time of execution.

will perform a daily net of pool allocations for those TBA trades that according to the MBSD rules and procedures are eligible for pool netting.<sup>5</sup> It should be noted that not all guaranteed trades will be included in the pool netting system. A determination of which trades are included will be determined by netting percentages. FICC will become CCP to those obligations, and settlement will occur versus FICC. For all other obligations, settlement will occur outside of FICC, with original settlement counterparties.

A. Current Processing

At no time during the current MBSD processing does FICC guarantee settlement, or act as a CCP for submitted transactions. Under the current MBSD processing model, the majority of the trading activity submitted to the MBSD for processing, is submitted as Settlement Balance Order Destined (“SBOD”). SBOD trades are eligible for comparison, risk management services and the TBA Netting cycle. Firms can submit TBA trades as Trade-For-Trade (“TFTD”) transactions, which are TBA trades that are eligible for comparison and risk management services but ineligible for the TBA Netting cycle. SPTs are not considered TBAs because the actual pool number is part of the trade terms; SPTs are eligible for comparison and risk management services but ineligible for the TBA Netting cycle.

Each of the transactions mentioned above is compared by FICC’s RTTM™ system. Settlement obligations for SPTs and TBA TFTD transactions are generally established when a report indicating the trade as compared is made available by the MBSD to the Participants on both sides of the transaction.<sup>6</sup> Settlement obligations for TBA SBOD transactions are not

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<sup>5</sup> SPTs are not eligible for pool netting under this proposal.

<sup>6</sup> Participants use FICC’s Interactive Submission Method, Multiple Batch Submission Method or Single Batch Submission Method to submit trade data to the MBSD. Contemporaneous with

established in this way. Instead, SBOD transactions proceed to the MBSD's settlement balance order ("SBO") engine for TBA netting. The TBA Netting process establishes the settlement obligations for the SBOD transactions.

The SBO netting system produces settlement obligations between MBSD Participants. Once Participants' settlement obligations are established, Participants use FICC's electronic pool notification service (the "EPN Service") to inform each other with respect to the specific pools that will be delivered for settlement purposes. Thereafter, members transmit notifications of settlement to FICC when they have ultimately settled their obligations with applicable counterparties.

#### B. Proposed Processing - Overview

Under the proposed MBSD rules, each Clearing Member will be required to submit to the MBSD for processing transactions with other Clearing Members in all securities that are netting-eligible according to MBSD rules and procedures. Certain MBSD processes will continue to operate as they do today. Specifically, eligible transactions will continue to be submitted to the RTTM™ system for matching purposes.<sup>7</sup> FICC will provide output of the trade as compared,

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successful comparison of the trade data in FICC's RTTM system, FICC generates output indicating that such trade data is compared, is uncomparing and/or has been deleted. FICC makes available to the Participants, the RTTM Compare Report, which establishes the settlement obligation for TBA TTFD transactions and for SPTs between the counterparties since these trades do not enter the TBA netting process.

<sup>7</sup> Trade data submitted to the MBSD must include such identifying information as the MBSD may require and must be submitted in the form and manner and in accordance with the time schedules prescribed by the MBSD rules or otherwise set forth by FICC from time to time. The symbol corresponding to the name of a Clearing Member that is printed, stamped or written on any form, document or other item issued by the Clearing Member pursuant to Rule 5 Section 2 shall be deemed to have been adopted by the Clearing Member as its signature and shall be valid and binding upon the Clearing Member in all respects as though it had manually affixed its signature to such form document or other item.

uncompared and/or deleted. The SBO netting process for TBA trades will also continue to generate settlement obligations between Clearing Members. However, the MBSD will now provide a trade guarantee at the point of comparison of all submitted transactions (i.e., SBOD trades, TFTD trades, SPT trades and Option Contracts (collectively, “MBSD Eligible Trades”) will be guaranteed by the MBSD), as is currently done in the GSD. The timing of comparison of MBSD Eligible Trades is the point at which the MBSD will make available to the Clearing Members on both sides of the transaction an output indicating that such trade data has been compared. In the event of a member default, FICC will settle the guaranteed trade.

The MBSD proposes to introduce “pool comparison” and “pool netting,” and interpose itself as settlement counterparty to certain settlement obligations. Specifically, after the netting of TBA trades occurs through the SBO engine, settlement obligations will be issued between members and members will allocate pools for settlement via the EPN Service (just as is done today). Additionally, however, members will be required to submit pool details for those netted TBA Settlement obligations via the RTTM™ system for pool comparison and for consideration for pool netting. Pools allocated to obligations associated with Settlement Balance Order Non-Original Counterparty trades, Settlement Balance Order Original Counterparty trades and with TFTD trades will be eligible for pool netting which establishes settlement obligations.<sup>8</sup>

Compared pools will be evaluated for eligibility for pool netting. The MBSD’s system will determine which pools will receive maximum benefit from pool netting by considering such factors as trading velocity and projected netting factor. It is important to note that not every compared pool will proceed to the pool netting system.

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<sup>8</sup> SPTs will not be considered an eligible transaction type for pool netting at this time.

Upon FICC's issuance of pool netting results to members, those pools that are eligible for netting will be novated, i.e., settlement obligations between the Clearing Members will be replaced with obligations to settle with FICC. Certain outstanding obligations will still require the Notification of Settlement ("NOS") process. These will include (1) SPTs, because they are not eligible for pool netting; (2) transactions for which Clearing Members chose not to submit allocation information into pool netting<sup>9</sup>; and (3) certain transactions with an incomplete master file on a pool record or number. When a pool is matched, in order for it to be considered for pool netting, FICC must have the required pool information on its Security Masterfile. This data for example would include the pool itself, factor information and data to map it back to a TBA.<sup>10</sup> With respect to any obligations that fail to settle, these obligations will not be re-netted, as they are in the GSD.<sup>11</sup>

## II. PROPOSED MBSD RULEBOOK

As noted above, the current MBSD rulebook will be replaced in its entirety by a new proposed rulebook. Set forth below is an overview of the significant substantive and structural changes to the rules.

### A. Definitions

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<sup>9</sup> For example, if a Clearing Member has a trade that was matched with stipulations, the Clearing Member would not submit it for pool netting. Pool netting creates delivery obligations based off the net position of Members without regard to the original counterparty relationship. With a trade matched with stipulations, the buyer/seller will want to ensure receipt/delivery is maintained between themselves to ensure the stipulated terms are adhered to.

<sup>10</sup> For example, if FICC has not received current month factor on the pool number.

<sup>11</sup> The MBSD will retain the discretion to re-net fails or to conduct pair-offs if it believes that such actions are necessary to protect itself and its Clearing Members due to market conditions or events.

The MBSD rules will have a revised Rule 1, “Definitions,” which will include terminology applicable to new MBSD processing and procedures. For example, terms relevant to pool netting have been included (such as “pool deliver obligation” and “pool receive obligation”). Where practical and/or applicable, the MBSD rulebook uses terms from the current GSD rules, in order to harmonize language between the Divisions.

## B. Membership

Rule 2, “Members”, Rule 2A, “Initial Membership Requirements,” Rule 3, “Ongoing Membership Requirements,” and Rule 3A, “Cash Settling Bank Members,” will govern membership types, member application requirements and ongoing reporting requirements.

### 1. Initial Membership Requirements

The new MBSD rules will provide for two membership types (as set forth in Rule 2): Clearing Members and Cash Settling Bank Members. Those entities qualifying for clearing membership will be guaranteed service members of the MBSD – trades submitted by these Members will be guaranteed at the point of comparison, and eligible, as applicable, for pool comparison, netting and settlement. Categories of clearing membership will include: (i) registered brokers or dealers; (ii) other registered clearing agencies; (iii) registered investment companies; (iv) banks<sup>12</sup>; (v) government securities issuers/government sponsored enterprises; (vi) insurance companies;<sup>13</sup> and (vii) unregistered investment pools.<sup>14</sup> In addition, the MBSD will have the discretion to make its services available to other entity types which it deems

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<sup>12</sup> The term “Banks” shall include Federal Savings Associations.

<sup>13</sup> The MBSD does not currently have any insurance company Clearing Members. Financial and other membership requirements for this category will be established in a future rule filing.

<sup>14</sup> Currently there are two members who do not fit the listed membership types. As a result, these entities will be grandfathered in and subject to ongoing membership requirements.

appropriate subject to the approval of the Commission. Membership requirements for Cash Settling Bank Members are set forth in Rule 3A, “Cash Settling Bank Members”. These requirements remain unchanged from the current MBSD rulebook and they mirror the requirements of the GSD-equivalent members, known as funds-only settling banks.

With respect to initial membership requirements as set forth in Rule 2A, “Initial Membership Requirements,” the MBSD has mirrored the current requirements for the GSD netting membership, where there is an existing membership type in the GSD rules. The two membership categories where there are no GSD equivalents are the unregistered investment pools (the “UIPs”) and the registered investment companies. In addition to standard requirements regarding financial and operational responsibility applicable to all Clearing Members, registered investment companies must be registered under the Investment Company Act of 1940, and have minimum net assets of \$100 million. With respect to the UIPs, membership standards that were adopted for these entities via a 2006 rule filing<sup>15</sup> will be revised in the new MBSD rulebook, in consideration of their new status as guaranteed service members. Revised requirements will be as follows:

- The UIP applicant must have an investment advisor domiciled in the United States.
- The UIP’s investment advisor must be registered with the SEC under the Investment Advisors Act of 1940, the UIP must have (i) \$250 million in net assets, or (ii) have \$100 million in net assets and the UIP’s investment advisor must advise an existing UIP Clearing Member that has assets under management of \$1.5 billion.

Additional requirements for UIPs will appear in Rule 3, “Ongoing Membership Requirements,” discussed further below. As is the case with all MBSD Clearing Member

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<sup>15</sup> See Securities Exchange Release Act Release No. 34-55037 (Jan. 3, 2007), 72 FR 1252 (Jan. 10, 2007) [SR-FICC-2006-10].



applicants, UIPs must meet all applicable financial requirements set forth in the proposed MBSD rules in order to be admitted into membership. The required levels must be maintained as a condition of membership on an ongoing basis.<sup>16</sup> With respect to all MBSD Clearing Member categories, as is currently the case under the MBSD rules, applicants whose financial statements are not prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) will be subject to increased minimum financial requirements.<sup>17</sup>

The MBSD will continue to require non-domestic membership applicants to submit, with their membership application, legal opinions on the laws of the applicants’ home jurisdictions. Updates to such legal opinions will be required from direct foreign members on an annual basis. Any additional legal risk<sup>18</sup> posed by such applicants due to their home country law may result in additional risk mitigation measures, including, for example, the posting of letters of credit as collateral. Members that are U.S. branches or agencies of non-U.S. banks (“U.S. Branches”) will

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<sup>16</sup> Required membership levels must be maintained by all members on an ongoing basis as a condition of membership.

<sup>17</sup> These higher GAAP-based requirements remain unchanged from the current GSD and MBSD rules. Specifically, firms whose financial statements are prepared in accordance with International Financial Reporting Standards, Canadian GAAP or UK GAAP will have a minimum financial requirement that is 1.5 times the U.S. GAAP requirement, firms whose financial statements are prepared in accordance with the GAAP principles of a European Union country other than the United Kingdom will have a minimum financial requirement that is 5 times the U.S. GAAP requirement, and firms whose financial statements are prepared in accordance with any other type of GAAP will have a minimum financial requirement that is 7 times the U.S. GAAP requirement.

<sup>18</sup> “Legal risk” is currently defined in the rules as the risk that, as a result of a law applicable to a Clearing Member’s insolvency or bankruptcy, FICC may be delayed or prohibited from: (i) accessing any portion of the Member’s Clearing Fund, (ii) netting, closing out or liquidating transactions, or setting off obligations, or taking any other action contemplated by the rules regarding clearing fund, cease to act, insolvency of a member or (iii) otherwise exercising its rights pursuant to the rules.

be classified as U.S. members, based particularly on the rationale that such U.S. Branches are regulated by the U.S. and/or state regulators.<sup>19</sup>

## 2. Ongoing Membership Requirements

Pursuant to Rule 3, “Ongoing Membership Requirements,” current provisions applicable to the GSD netting membership under the GSD rules have been carried over to the MBSD rules to apply to certain member types. For example, the GSD currently assesses a premium against any member whose Clearing Fund requirement exceeds its specified regulatory capital figure.<sup>20</sup> The MBSD will also apply this premium to members. Also, bank, broker-dealer and UIP members of the MBSD will be rated. Among other things, financial measures relevant to these types of entities will be assessed. Any member that receives a poor rating may be monitored more closely and/or placed on FICC’s internal watch list.

As set forth in Rule 3, the MBSD will take additional risk management measures with respect to UIP members. Specifically, the “value at risk” (“VaR”) confidence level for UIP members will be set at 99.5%, half a percentage higher than the standard assumption set forth in

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<sup>19</sup> As in the current version of MBSD rule Article III Rule 15 “Special Provisions Applicable to Non-Domestic Participants”, U.S. Branches will not be required to submit annual updates to their foreign legal opinions unless FICC deems it necessary to address legal risk; applicants in this category will, however, continue to be required to submit an initial foreign legal opinion on their home country law with their membership application. *See* Securities Exchange Release Act Release No. 34-62828 (Sep. 2, 2010), 75 FR 54929 (Sep. 9, 2010) [SR-FICC-2010-02].

<sup>20</sup> By way of example, under the current GSD rules, if a member has a Clearing Fund requirement of \$11.4 million and excess net capital of \$10 million, its “ratio” is 1.14 (or 114 percent), and the applicable collateral premium would be 114 percent of \$1.4 million (which is equal to the amount by which the member’s Clearing Fund requirement exceeds its excess net capital), or \$1,596,000. The current GSD rules provide that FICC has the right to: (i) apply a lesser collateral premium (including no premium) based on specific circumstances (such as a member being subject to an unexpected haircut or capital charge that does not fundamentally change its risk profile), and (ii) return all or a portion of the collateral premium amount if it believes that the member’s risk profile does not require the maintenance of that amount. These rights will be carried over to the proposed MBSD rules.

the procedures of the Corporation (currently set to 99%).<sup>21</sup> As set forth in Rule 2A, UIP members will also be required to achieve a qualitative assessment rating of at least “medium” as part of the initial membership requirement. Qualitative assessments will be based on such factors as management, capital, strategy/risk and profile, valuation procedures and internal risk management controls. Any UIP member rated less than “medium” may be subject to an increased Required Fund Deposits that may be achieved via higher confidence levels and may also become subject to revocation of membership as set forth in Rule 3, Section 6. Also, pursuant to Rule 4, the Clearing Fund requirement of UIPs shall be no less than \$1 million, whereas the current minimum is \$100,000.<sup>22</sup>

#### C. Clearing Fund and Loss Allocation

MBSD Rule 4, “Clearing Fund and Loss Allocation” will set forth requirements with respect to Clearing Fund<sup>23</sup> deposited by Clearing Members.

The MBSD has already standardized the clearing and settlement processes. The objective in offering CCP services is to leverage potential means by which risks can be curbed, efficiency increased, and operational risk within the marketplace can be reduced.

The conversion of the MBSD to a CCP increases the amount of risk for the clearing agency. The purpose of a CCP is to ensure settlement can continue in the face of a member firm failure, and to reduce the risk of loss due to that member failure. A CCP interposes itself as a

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<sup>21</sup> The MBSD rules will provide FICC with the discretion to increase the confidence level if it determines that it is appropriate to do so with respect to a particular Clearing Member or Members generally. As an initial matter, UIPs will begin the service with a confidence level of 99.5%.

<sup>22</sup> The MBSD rules will provide FICC with the discretion to increase the minimum charge if it determines that it is appropriate to do so with respect to a particular member or members generally. As an initial matter, UIPs will begin the service with the higher minimum of \$1 million.

<sup>23</sup> The MBSD is adopting the term “Clearing Fund” to replace “Participants Fund.”

legal counterparty to both sides of a transaction. The CCP assumes the counterparty credit risk of the other Clearing Members which primarily includes (1) the market risk associated with liquidating the defaulted Member's portfolio, and (2) the liquidity risk associated with maintaining sufficient liquid resources to finance the defaulted Member's scheduled settlement obligations.

The MBSD has established a robust risk management framework to manage the credit risks from its Clearing Members and the credit risks involved with its payment, clearing and settlement process.

The MBSD relies on five different controls to manage its counterparty risk: member standards, initial/variation margins, back/stress testing, position/risk monitoring and non-margin collateral. The first set of controls aims to prevent the CCP from dealing with or reducing activity of counterparties that have unacceptably high probabilities of default. As noted above in section B, concurrent with the introduction of CCP services the MBSD will increase its minimum financial standard for clearing membership eligibility to mirror GSD eligibility standards and enhance its risk monitoring for UIPs.

The second line of defense is the margins collected from counterparties in the form of cash and highly liquid government securities in the Clearing Fund. The dual purpose of the Clearing Fund is to provide readily accessible liquidity to facilitate settlement and reduce loss-related costs which may be incurred in the event of a Clearing Member's insolvency or failure to fulfil its contractual obligations to the MBSD. Margins are intended to cover possible losses between the time of default of a counterparty, at which point the CCP would inherit its positions, and the close-out of these positions through selling or hedging. For this purpose, the MBSD marks member portfolios to the market on a daily basis and charges variation margins

accordingly, and establishes initial margins to cover a minimum 99th percentile of expected possible losses that could arise over a 3-day settlement period utilizing a VaR-based approach<sup>24</sup>. In order to enhance the MBSD's risk framework and concurrent with the introduction of CCP services, the MBSD will add two new components - the margin requirement differential and the coverage charge - to the Clearing Fund, as well as additional MBSD mark-to-market items related to the new pool netting services. The MBSD also has the ability to collect charges above the systemically generated Clearing Fund charges when deemed appropriate in order to protect the corporation and its members. If any loss were incurred in the liquidation of a Member that was not covered by the Member's Clearing Fund deposit or amounts available under the cross guaranty arrangement to which FICC is a party, the MBSD would invoke its loss allocation process.

The MBSD uses regular back and stress testing to monitor the sufficiency of collected margin levels vis-a-vis the risk represented by the 99<sup>th</sup> percentile of expected possible losses from member portfolios and to monitor its tail risk exposure that is beyond the 99<sup>th</sup> percentile. If a member portfolio does not pass the back test, additional margin will be collected via the coverage charge. Stress tests are also used to evaluate margin adequacy. The MBSD's framework reflects stress events from the last 10 years as well as special stress events that were not within the past 10 years and takes the form of swap rate shifts and credit spread shocks that reflect market conditions for the instruments that the MBSD clears or holds as collateral. As described in the Clearing Fund section below, the MBSD analyzes and reviews on an intraday basis certain components of the Clearing Fund that are recalculated using updated positions and prices if there is increased exposure in a member's portfolio intraday. In addition, the MBSD

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<sup>24</sup> An index-based haircut methodology will be used for securities with insufficient pricing data.

may at its discretion call for additional collateral on an intraday basis if exposures are in excess of predefined thresholds.

Finally, aside from the risk of loss that could be encountered from a Clearing Member failure, a central counterparty could also face liquidity risk, defined as the risk that the central counterparty has insufficient financial resources to cover a default by a Clearing Member to which it has the largest exposure. To that end, the MBSD maintains sufficient resources to meet its observed liquidity risk. The Clearing Fund would be the primary source to fulfil the liquidity need incurred if MBSD had to complete settlement on behalf of the defaulting Clearing Member. Other conventional funding tools such as loans secured via the MBSD clearing banks and/or tri-party repo transactions would also be used to fulfil the liquidity need, but if those were unavailable or insufficient, the MBSD would invoke the “Capped Contingency Liquidity Facility,” described in section G below to provide additional financing in the event of a member default.

Tail risk is one of the risks the MBSD has to manage. The MBSD addresses this through a continuous process of (1) reviewing margining methodologies with stakeholders; (2) analysis and monitoring of margin/collateral requirements; (3) actively reviewing and timely/appropriate action on market conditions and credit events; (4) reviews of back/stress tests, and (5) identifying, assessing and managing risks associated with the products and services provided by the MBSD and FICC.

#### 1. Clearing Fund

The underlying Clearing Fund methodology is designed primarily to account for market risks associated with a Clearing Member’s unsettled portfolio. The Clearing Fund model is back tested on a monthly basis and periodically validated by outside experts. Additional charges and

premiums may be considered to address additional risks (i.e., credit, reputation, legal, etc.) or non-compliance with MBSD rules. The Clearing Fund is calculated every business day for each MBSD Clearing Member.

Clearing Fund requirements will be calculated in accordance with the VaR model. The Clearing Fund components will consist of the VaR charge,<sup>25</sup> the coverage charge, the margin requirement differential charge and the deterministic components charge (which will include the mark-to-market charges, cash obligation items and accrued principal and interest). The VaR methodology will utilize the prior 252 days of historical information for cash positions, including prices, spreads, and market variables to simulate the market environments in the forthcoming three days. Projected portfolio losses are then calculated assuming these simulated environments actually will be realized. The coverage charge is an additional charge to bring the Clearing Member's coverage to a targeted confidence level. The margin requirement differential considers intra-day portfolio variations and estimates the potential increased risk intra-day and the risk that the next margin call will not be satisfied. The deterministic risk component combines the mark-to-market of the portfolio, gain or loss for the difference between the original contract value and the internally generated netting price derived from the TBA netting process, principal and interest adjustments on failed positions, and other miscellaneous cash items. The deterministic risk component can result in an increase or decrease to a member's total clearing fund requirement.

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<sup>25</sup> The definition of "VaR Charge" (which is referred to as "VaR Component" in the current rules) is being amended to remove the reference to the application of "minimum amounts" to such VaR Charge. The MBSD is currently applying a minimum 5-basis point charge which will not be applicable when the MBSD CCP becomes a CCP because of the addition of the other components to the overall Clearing Fund calculation. Minimum Clearing Fund deposit amounts per Rule 4 remain applicable.

Requirements as to acceptable forms of collateral will remain unchanged in the new MBSD rulebook.

In order to further mitigate risk, and as part of FICC's efforts to enhance its intraday monitoring capabilities, FICC has determined to expand its intraday monitoring<sup>26</sup> to recalculate the mark-to-market elements of the deterministic risk component. This component of the risk calculations will be updated at least hourly using intraday pricing and position feeds for FICC members and compared against the amounts that were previously collected in the Clearing Fund. If the exposures increase above certain defined thresholds Risk Management staff will be alerted to consider additional intraday margin calls, outside of the formal Clearing Fund collection process. The proposed rule change provides that such calls would need to be satisfied by the affected members within one hour of FICC's notice. The initial thresholds will be based on changes to a Clearing Member's position size, composition and price changes on the constituent securities. Qualitative factors including, but not limited to, Watch List status and internal rating will also be considered in the application of intraday mark-to-market.

## 2. Other Changes – Clearing Fund

### *Use of Payments and Deposits*

FICC is proposing to revise Rule 4 “Clearing Fund and Loss Allocation”, Section 5 “Use of Payments” to include additional disclosure relating to the Corporation's use of a Clearing Member's deposits and payments for temporary financing needs. The proposed revisions also clarify that whenever the Clearing Fund is charged for any reason, other than to satisfy a clearing

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<sup>26</sup> This proposal is different from the intra-day margining that was approved by the Commission to implement the single-pot margining with New York Portfolio Clearing, LLC (“NYPC”). *See* Securities Exchange Act Release No. 63986 (Feb. 28, 2011), 76 FR 12144 (Mar. 4, 2011). In the FICC-NYPC rule filing, established second scheduled calls were approved. In the present proposal, FICC is seeking the authority to require additional margin outside of the formal calls.



loss attributable to a Clearing Member solely from that Clearing Member's Clearing Fund deposit, the Corporation will provide the reasons therefore to each Clearing Member. This would apply when the Clearing Fund is charged, meaning the Corporation has applied the Clearing Fund for more than 30 days and is allocating the amount as a loss or for other loss allocation purposes.

### 3. Loss Allocation

In this CCP proposal, FICC is also introducing a new loss allocation methodology for the MBSD. If a defaulting Clearing Member's Clearing Fund and any amounts of the Defaulting Member available under a cross-guaranty agreement are not sufficient to cover losses incurred in the liquidation of the defaulting Clearing Member's positions (the "Remaining Losses"), the MBSD's loss allocation methodology will be invoked. Under this proposed loss allocation methodology, Remaining Losses will first be allocated to the retained earnings of FICC attributable to the MBSD, in the amount of up to 25 percent of the retained earnings or such higher amount as may be approved by the Board of Directors of FICC. If a loss still remains, MBSD Clearing Members are placed into one of two tiers for loss allocation purposes: Tier One members are subject to loss mutualization, whereas Tier Two members are not subject to loss mutualization.<sup>27</sup> FICC will divide the Remaining Losses between the Tier One members and Tier Two members. The division of Remaining Losses is based on the amount each solvent Clearing Member would have lost or gained if it had closed out its original outstanding trades

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<sup>27</sup> Tier Two members are those that are legally prohibited from participating in loss mutualization. Currently, only investment companies registered under the Investment Company Act of 1940, as amended, qualify as Tier Two members.

with the defaulting Clearing Member on a bilateral basis.<sup>28</sup> FICC then will determine the relevant share of each Tier One member's bilateral losses (members with a bilateral liquidation profit are ignored) in the total of all members' bilateral losses and sum these shares to determine the Tier One Remaining Loss. Similarly, FICC will determine the relative share of each Tier Two member's bilateral loss in the total of all members' bilateral losses and sum these shares to determine the Tier Two Remaining Loss.

Tier One Remaining Losses will be allocated to Tier One members first by assessing the Required Fund Deposit of each such Member in the amount of up to \$50,000, equally. If a loss remains, Tier One members will be assessed ratably, in accordance with the respective amounts of their Required Fund Deposits, based on the average daily amount of the Clearing Member's Required Fund Deposit over the prior twelve months. Tier Two Remaining Loss will be allocated to Tier Two Clearing Members based on each Tier Two member's original trading activity with the Defaulting Member that resulted in a loss. Tier Two members will only be subject to loss to the extent they originally traded with the Defaulting Member consistent with regulatory requirements applicable to the Tier Two members. FICC shall assess such loss against the Tier Two members ratably based upon their loss as a percentage of the entire amount of the Tier Two Remaining Loss. This ensures that Tier Two members are not subject to loss mutualization. Tier Two counterparties will be liable for losses related to both direct and

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<sup>28</sup> With respect to brokered trades, in the MBSD such trades are done on a "give-up basis," and brokers are thus not considered parties to fully-matched trades. However, for purposes of loss allocation, broker members will be subject to loss allocation for certain partially-matched trades. Brokers are considered Tier One members, and as such will be subject to loss mutualization.

brokered trades<sup>29</sup> including partially-matched trades for which the Tier Two member did not submit a statement to FICC denying the existence of the trade.<sup>30</sup>

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<sup>29</sup> Brokered trades involve a broker intermediary between two dealers. Each dealer and broker must submit the trade details to the MBSD for trade comparison. This means that each dealer submits against the broker and the broker submits against each dealer. A fully matched trade will be achieved when both dealers match against the broker (i.e. all submissions discussed above match). With a fully matched trade, both dealers assume principle status which results in the broker having no settlement obligations with respect to the trade; the broker cannot be subject to any loss with respect to such trade. A partially matched trade results when only one of the two submissions achieves a bilateral match versus the broker. The dealer who has matched with the broker will have a settlement guarantee and is subject to Clearing Fund requirements with respect to such trade. If the unmatched dealer submits a statement to FICC denying the existence of the trade, the broker becomes the other side of the trade which means that the broker is responsible for such trade from a risk management perspective and loss allocation. If the unmatched dealer does not submit a statement to FICC denying the existence of the trade, the dealer becomes responsible for the settlement and risk management and the broker is released from these responsibilities.

<sup>30</sup>To illustrate the proposed MBSD Tier One (“T1”) /Tier 2 (“T2”) loss allocation rules, consider an example where the \$20 million Clearing Fund requirement of an insolvent MBSD member X turns out to be insufficient to cover the \$30 million liquidation loss that the MBSD incurred as a result of closing out all of X’s open positions. If X doesn’t have any excess collateral, MBSD would need to allocate a \$10 million remaining loss.

Assume that X has unsettled trades with three Tier One original counterparties (T1A, T1B and T1C) and three Tier Two original counterparties (T2A, T2B and T2C), all executed directly.

Further assume that the bilateral liquidation results of X’s solvent original counterparties are as follows:

T1A: \$5 million; T1B: (\$5 million); T1C: (\$15 million); T2A: (\$20 million); T2B: (\$10 million); T2C: \$15 million; Total: (\$30 million)

Also assume that there are no secondary defaults and no off-the-market trades.

Based on these assumptions, the bilateral Tier One liquidation losses amount to \$20 million (\$5 million attributable to T1B and \$15 million attributable to T1C), while the bilateral Tier Two liquidation losses amount to \$30 million (\$20 million attributable to T2A and \$10 million attributable to T2B). This means that out of a total of \$50 million bilateral liquidation losses, 40% or \$20 million can be attributed to Tier One counterparties and 60% or \$30 million to Tier Two counterparties. As a result, the Tier One remaining loss would be \$4 million (i.e., 40% of the MBSD’s \$10 million overall remaining loss) and the Tier Two remaining loss would be \$6 million (i.e., 60% of the MBSD’s \$10 million overall remaining loss).

#### D. TBA Trade Processing

Rule 5, “Trade Comparison” and Rule 6, “TBA Netting” of the proposed MBSD rulebook mirror current MBSD rules as these processes will remain unchanged from an operational perspective. Members will continue to submit TBA transactions and SPTs to the MBSD through the RTTM™ system to bilaterally match their trade data with trade data submitted by their counterparties. The significant change to the comparison rule is the introduction of FICC’s guarantee. Transactions will be guaranteed for settlement at the point of comparison.<sup>31</sup> SBOD TBA trades will proceed through the TBA/SBO netting process as they do today. After netting, members will use the EPN Service to allocate pools in satisfaction of open TBA obligations (both trade-for-trade and SBO transactions). In addition, members will now be required to submit pool allocation information to the MBSD’s RTTM™ system<sup>32</sup> – pool allocation processing will proceed as described below.

#### E. Pool Allocation Processing

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Given that T2A’s and T2B’s bilateral losses represent 2/3 and 1/3 respectively of the Tier Two Remaining Loss, T2A’s loss allocation will be \$4 million and T2B’s loss allocation will be \$2 million.

The \$4 million Tier One Remaining Loss would first be assessed equally to each Tier One member’s clearing fund, up to an amount of \$50,000 per Tier One member. If a loss still remains, the amount is allocated among Tier One members, pro-rata based on each Tier One member’s average daily level of clearing fund over the prior twelve months (or shorter period if a member did not maintain a clearing fund deposit over the full twelve month period).

Note that the loss allocation results are not impacted by whether the defaulting Clearing Member is a Tier One or a Tier Two member.

<sup>31</sup> While SPTs will be guaranteed at the point of comparison, they will not be eligible for processing through the pool comparison or pool netting systems. All SPTs will settle outside of FICC with original counterparties.

<sup>32</sup> Because Clearing Members will be required to allocate pools via EPN and RTTM™ in order for pool allocations to proceed to pool comparison and netting, all MBSD Clearing Members will be required to be EPN members.

Pool allocation processing refers to the Clearing Member's submission via a RTTM™ message of an allocated pool for matching and pool netting services.

On the allocation date<sup>33</sup>, Clearing Members will also be required to submit pool allocation information (called "Pool Instructs") via the RTTM system for pool comparison (which is a pre-requisite for pool netting). As with EPN allocation, Pool Instructs are to be submitted against all TBA obligations, whether stemming from Trade-for-Trade activity or TBA Netting. As noted previously, allocations are not performed for SPTs and they are not eligible for pool netting services and Clearing Members may choose not to submit Pool Instructs against trades matched with stipulations.<sup>34</sup>

Pool data information on Pool Instructs must be bilaterally compared (i.e., the mandatory comparison pool data submitted by the seller must match the mandatory comparison pool data submitted by the buyer) in order for the Pool Instructs to be eligible for consideration for pool netting. Pool Instructs must further be "assigned" by the MBSD to a valid, open TBA position, meaning that the trade terms submitted on the Pool Instruct must match the trade terms of a TBA CUSIP that has sufficient open position. Only compared and assigned Pool Instructs are evaluated for inclusion in pool netting.

Pool allocation processing will be governed by Rule 7, "Pool Comparison," Rule 8, "Pool Netting," and Rule 9, "Pool Settlement". Once netting eligible pools are defined by the MBSD, each allocation will be netted into a single net position per pool CUSIP. Pool netting results will

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<sup>33</sup> Pool allocation information (also known as "Pool instructs") may be submitted up to the point that Pool Netting is executed.

<sup>34</sup> Trades with stipulations are those where certain trade terms are agreed to at point of match (e.g., one pool per million); under the proposal, Clearing Members will be provided with the option to hold out stipulation allocations from the pool netting process so that they can preserve their ability to obtain the pools that satisfy the stipulations of the trade.

be novated, meaning that open TBA obligations will be terminated and replaced with resultant pool receive, deliver and associated payment obligations which will settle versus FICC as central counterparty.

F. Settlement

1. Settlement with FICC as Counterparty

As stated above, obligations generated by the pool netting system will settle versus FICC – this settlement process will be governed by Rule 9, “Pool Settlement with the Corporation.” Clearing Members will be required to designate a clearing bank for purposes of delivering securities to, and receiving securities from, the MBSD in satisfaction of settlement obligations. All deliveries and receipts of securities in satisfaction of pool deliver obligations and pool receive obligations will be required to be made against simultaneous payment. These securities settlement procedures mirror the current GSD securities settlement rule.<sup>35</sup>

2. Settlement Outside of FICC

For those allocated pools (or pools matched as trade terms on SPT trades) which are not processed through the pool netting system, Clearing Members will be required to settle such transactions bilaterally with applicable settlement counterparties, outside of FICC. Please refer to “Processing Overview” referenced above, for a description of the trades that would be required to settle outside of FICC. It should be noted that such trades remain guaranteed for settlement by FICC; such trades were guaranteed at the time of comparison. Pursuant to Rule 10, “Notification of Settlement”, Clearing Members must continue to submit to FICC Notifications of Settlement (“NOS”). NOS will be required to be received on the applicable clearance date for each transaction. When the MBSD receives NOS from each counterparty to a

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<sup>35</sup> GSD Rule 12, “Securities Settlement.”

transaction, the MBSD will report clearance of the applicable transaction back to each Clearing Member, as is done today. At this point, the MBSD will stop collecting margin on the transaction, and will no longer be responsible for principal and interest payments.

### 3. Cash Settlement

Rule 11, “Cash Settlement with the Corporation” provides that cash settlement processing will continue to be done via the Federal Reserve’s National Settlement Service and through the use of cash settling banks appointed by Clearing Members. Several items have been added to the calculation of each Clearing Member’s cash settlement obligation, including: (a) a “net pool transaction adjustment payment” (to reflect the difference between the pool net price<sup>36</sup> and a settlement price established at the TBA level); (b) principal and interest payment amounts related to fails, and (c) a “clearance difference amount”<sup>37</sup> (to take into account the delivery to FICC of mispriced securities by a member).

#### G. Additional Rule Changes

##### 1. Capped Contingency Liquidity Facility

FICC is proposing to add a provision to the proposed MBSD rules that introduces a “Capped Contingency Liquidity Facility,” which is a procedure designed to ensure that the MBSD has sufficient liquidity resources to cover the largest failure of a family of accounts. This facility will only be invoked if FICC declares a default or a cease to act against a Clearing Member, i.e., a defaulting Clearing Member and FICC does not have the ability to obtain

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<sup>36</sup> “Pool Net Price” is defined in the proposed rules as the uniform price for a pool (expressed in dollars per unit of par value), not including accrued interest, established by the Corporation on each business day, based on current market information for each eligible security.

<sup>37</sup> “Clearance Difference Amount” is defined in the proposed rules as the absolute value of the dollar difference between the settlement value of a pool deliver obligation or a pool receive obligation and the actual value at which such pool deliver obligation or pool receive obligation was settled.

sufficient liquidity through its Clearing Fund cash deposits and its established repurchase agreement arrangements ("CCLF Event"). FICC believes that the Capped Contingency Liquidity Facility provides Clearing Members with finality of settlement and allows firms to prepare for and manage their potential financing requirements in the event of a Member's default. Once a CCLF Event has been declared, FICC will contact Clearing Members that are due to deliver obligations to FICC that are owed to a defaulting Clearing Member. FICC will either cancel the Clearing Member's obligations or instruct the Clearing Member to hold the obligations (or a portion thereof) and await instructions as to when to make these deliveries. With respect to the obligations subject to financing (the "Financing Amount") up to the Clearing Member's defined liquidity contribution cap (the "Defined Capped Liquidity Amount"),<sup>38</sup> FICC as counterparty,

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<sup>38</sup> The "Defined Capped Liquidity Amount" is the maximum amount that a Clearing Member shall be required to fund during a CCLF Event. The Defined Capped Liquidity Amount will be established as follows:

(a) For those Clearing Members that are eligible for and that have established borrowing privileges at the Federal Reserve Discount Window or for those Clearing Members who have an affiliate that is eligible for and has established borrowing privileges at the Federal Reserve Discount Window, FICC will conduct a study every six months, or such other time period as FICC shall determine from time to time as specified in Important Notices to Clearing Members, to determine each Clearing Member's largest liquidity requirement for the applicable time period based on a Clearing Member's sell positions versus other Clearing Members at the family level on a bilateral net basis within a TBA CUSIP. Based on the overall study, FICC will define an adjustable percentage (the initial percentage will be set at 60%), as determined by FICC from time to time, and multiply that percentage amount against the maximum amount to establish each Clearing Member's Defined Capped Liquidity Amount; and

(b) For those Clearing Members that are ineligible for or have not established borrowing privileges at the Federal Reserve Discount Window and for those Clearing Members that do not have an affiliate that is eligible for or has established borrowing privileges at the Federal Reserve Discount Window, FICC will conduct a study every month or such other time period as FICC shall determine from time to time as specified in Important Notices to Clearing Members, to determine each Clearing Member's largest liquidity requirement for the applicable time period based on a Clearing Member's sell positions versus other Clearing Members at the family level on a bilateral net basis within a TBA CUSIP. The Clearing Member's largest liquidity requirement for the past month, adjusted in each case of a CCLF Event to be no greater than the



will enter into repurchase agreements with the Clearing Member equal to the Financing Amount pursuant to the terms of the deemed 1996 SIFMA Master Repurchase Agreement (without referenced annexes). If a liquidity need still exists (the “Remaining Financing Amount”), FICC will inform Clearing Members that are below the Defined Capped Liquidity Amount and also inform Clearing Members that do not have a delivery obligation to defaulting Clearing Member.<sup>39</sup> After these Clearing Members have been notified, FICC will distribute the remaining financing need to such Clearing Members on a pro rata basis and enter into repurchase agreements pursuant to the terms of the deemed 1996 SIFMA Master Repurchase Agreement (without referenced annexes). These transactions would remain open until FICC completes the liquidation of the underlying obligations and a haircut based on market conditions will be applied to the transactions.

Once FICC completes the liquidation of the underlying obligation, FICC will instruct the Clearing Member to deliver the securities back to FICC. FICC will then close the repurchase transaction and deliver the securities to complete settlement on the contractual settlement date of the liquidating trade. Because FICC would be receiving and delivering securities on the same day, FICC would not have a liquidity need resulting from the transaction of a defaulting Clearing Member.

The applicable provisions of Rule 17 outline detailed procedures of the mechanism that will be followed should FICC declare a Capped Contingency Liquidity Facility event.

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actual Pool Delivery Obligation to the defaulting Clearing Member, will represent the Clearing Member's Defined Capped Liquidity Amount. Firms in this category will have a defined non-adjustable percentage amount set to 100%. Clearing Members in this category will not be required to finance any Remaining Financing Amount.

<sup>39</sup> Applicable to those Clearing Members that are eligible for and that have established borrowing privileges at the Federal Reserve Discount Window or to those Clearing Members who have an affiliate that is eligible for and has established borrowing privileges at the Federal Reserve Discount Window.

## 2. Corporation Default

FICC has been approached by some of its dealer Clearing Members who have requested that FICC add provisions to the rules of the MBSD CCP<sup>40</sup> to make explicit the close-out netting of obligations running between FICC and its Clearing Members in the unlikely event that FICC becomes insolvent or defaults in its obligations to its Clearing Members which are included in the proposed rule change. The firms have stated that the proposed rule changes will provide clarity in their application of balance sheet netting to their positions with FICC under U.S. GAAP in accordance with the criteria specified in the Financial Accounting Standards Board's Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39). The firms have stated further that the provisions would allow them to comply with Basel Accord Standards relating to netting. Specifically, firms are able to calculate their capital requirements on the basis of their net credit exposure where they have legally enforceable netting arrangements with their counterparties, which includes a close-out netting provision in the event of the default of the counterparty (in this case, the division of the clearing corporation acting as a central counterparty).

### H. Fails Charge

The Treasury Markets Practices Group (the "TMPG"), a group of market participants active in the Treasury securities market sponsored by the Federal Reserve Bank of New York (the "FRBNY"), has been addressing the persistent settlement fails in Agency debt and mortgage-backed securities transactions that have arisen, in part, due to low interest rates.

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<sup>40</sup> The firms have also requested the filing with respect to the GSD and this change was submitted as a rule filing and approved by the Commission. *See* Securities Exchange Act Release No. 63038 (Oct. 5, 2010), 75 FR 62899 (Oct. 13, 2010) [SR-FICC-2010-04].

To encourage market participants to resolve fails promptly, the TMPG recommends expanding the applicability of the fails charge (which currently applies to Treasury securities transactions) to the Agency debt and MBS markets with the objective of reducing the incidence of delivery failures and supporting liquidity in these markets.

The fails charge will apply to certain trades settled in the MBS, i.e., settlement of pools versus FICC involving failing agency MBS issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae. Pursuant to the TMPG recommendations, a fails charge will not apply to TBA and pool level “round robins.”<sup>41</sup>

The proposed charge will be equal to the greater of (a) 0 percent and (b) 2 percent per annum minus the federal funds target rate. The charge accrues each calendar day a fail is outstanding. The MBS will not impose a fails charge if delivery occurs on either of the two business days following the contractual settlement date. The MBS will not employ a minimum fail charge amount, but, instead, will apply the fails charge to any pool for which delivery has not occurred within the two business day grace period.<sup>42</sup> Each business day, the MBS will provide

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<sup>41</sup> "Round robins" are a circular series of transactions between multiple parties where there is no ultimate long and short position to be settled. For example, if A sells to B and B sells to C and C sells to A, this group of transactions would constitute a "round robin". In a round robin, there is no settlement of securities, but there is satisfaction of money across all interested parties. There can be a fail in a round robin transaction when a deliver obligation arises because the trade submission of certain members of the round robin do not match. The MBS will not apply the fails charge to a round robin if each affected Clearing Member in the round robin provides the MBS with the required information to resolve the trade.

<sup>42</sup> Fails charges are calculated between legal entities that are counterparties to one another in an MBS transaction. Because the MBS is acting as a counterparty in multiple transactions, the MBS may owe a net credit to one counterparty which is financed by the net debits owed to the MBS by multiple counterparties (some of which may be below the minimum \$500 threshold identified in the TMPG recommendations.) To ensure that the MBS will be in a position to deliver the net credits it owes, the MBS is proposing to its Clearing Members that it will not employ a minimum fails charge for either debits or credits. Current Participants were informed

reports reflecting fail charge amounts to Clearing Members and will generate a consolidated monthly report at month end. Failing parties with a net debit (i.e., the fails charge amounts such party owes exceed the fails charge amounts it is owed) will be required to pay such net amount in respect of those pools that have settled the previous month and which are reflected in the previous month's consolidated month end report by the Class "B" payable date (as established by SIFMA guidelines) of the month following settlement in conjunction with other cash movements. The fails charge funds received by the MBSD then will be used to pay Clearing Members with fail net credits.

The MBSD will implement a rate change procedure so that if fails accrue at one rate and the rate changes, the fail will keep the original accrual and new fails calculations will be subject to the new rate. When there is a substitution of the underlying pool, the fails charge will be calculated pursuant to the above formula, using (in the formula) the Fed funds target rate for each day of the substitution period beginning on the contractual settlement date.

In the event that the MBSD is the failing party because (i) the MBSD received agency MBS issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae too near the close of Fedwire for redelivery or for any other reason or (ii) MBSD received a substitution of a pool deliver obligation of agency MBS issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae too near the specified time in the SIFMA 48-hour rule for same day redelivery of securities or for any other reason, the fails charge will be distributed pro-rata to the Clearing Members based upon usage of the MBSD's services.

The MBSD will not guaranty fails charge proceeds in the event of a default (i.e., if a defaulting Clearing Member does not pay its fail charge, Clearing Members due to receive fails

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of this deviation from the TMPG recommendations via Important Notice (MBS 119.11) and have not objected.

charge proceeds will have those proceeds reduced pro-rata by the defaulting Clearing Member's unpaid amount).

Example 1: A delivery is contracted to occur on settlement date (S), a Tuesday, but does not occur until the second business day following contractual settlement, Thursday (S+2). The Clearing Member would not be subject to a fails charge because delivery occurs within the two business days following the contractual settlement date.

Example 2: A delivery is contracted to occur on settlement date (S), a Tuesday, but does not occur until the third business day following contractual settlement, Friday (S+3). The Clearing Member would be subject to a three-day fails charge.

Example 3: A delivery is contracted to occur on settlement date (S), a Wednesday, but does not occur until the third business day following contractual settlement, Monday (S+3). The Clearing Member would be subject to a five-day fails charge, as the charge accrues on each calendar day in the fail period.

Example 4: A delivery is contracted to occur on settlement date (S), May 10th, but does not occur until the month following the contractual settlement date; it settles on June 8th. The Clearing Member will not be subject to collection of the fails charge in June (the month following the contractual settlement date) because delivery did not occur in May. The participant will be subject to the collection of the fails charge in July (on the Class "B" payable date) because delivery occurred in June. The charge will be recalculated for 29 days.

The implementation of a fails charge trading practice in the mortgage-backed securities market requires that the current MBSD rules be amended to add a new rule (i.e., Rule 12—Fails Charge). This new rule specifies the charges levied on any Clearing Member who does not

satisfy a delivery obligation of securities issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae and outlines the exceptions to this rule, including a two-day grace period.

*Revocation of Charges*

The proposed rule changes provide that FICC's Board of Directors (or appropriate Committee thereof) will retain the right to revoke application of the charges if industry events or practices warrant such revocation.

*Timing of Implementation*

Only as it applies to the proposed fails charge, FICC is proposing that such fails charges will apply to transactions in agency debentures and agency MBS entered into on or after the later of the approval of this rule proposal or February 1, 2012, as well as to transactions that were entered into, but remain unsettled as of the later of the approval of this rule proposal or February 1, 2012. For transactions entered into prior to, and unsettled as of, the later of the approval of this rule proposal or February 1, 2012, the fails charge will begin accruing on the latest of the approval of this rule proposal, February 1, 2012, or the contractual settlement date.

I. Suspension of Rules in Emergency Circumstances

Rule 33, "Suspension of Rules in Emergency Circumstances" in the proposed MBSD rules has been revised from the equivalent rule in the current MBSD rulebook to specify that (1) in the title of the Rule, that the rule applies to emergency circumstances, (2) an emergency shall exist in the judgement of the FICC Board or Officer, which causes the Board or the Officer, as applicable, to believe that an extension, waiver or suspension of the MBSD rules is necessary for the Corporation to continue to facilitate the prompt and accurate clearance and settlement of securities transactions, (3) the Corporation shall notify the Commission of such extension,

waiver or suspension of the MBSD rules within 2 hours of such determination,<sup>43</sup> (4) the written report of such extension shall include the nature of the emergency, along with the other requirements listed in the current rules and (5) such written report shall be submitted to the Commission no later than three (3) calendar days after the implementation of the extension, waiver or suspension of the MBSD rules.

J. Ceasing to Act, Wind-Down Members and Insolvency

Rule 14, “Restrictions on Access to Services”, Rule 15, “Wind Down of a Member,” Rule 16, “Insolvency of a Member,” and Rule 17, “Procedures for When the Corporation Ceases to Act,” mirror the current GSD rules, but have been conformed to apply to the specifics of MBSD processing as applicable. For example, upon the MBSD ceasing to act for a Clearing Member, Members will be required to submit immediate NOS so that the MBSD has all necessary settlement information with respect to a defaulting Member to effect a close-out of such Member. In addition, the MBSD will have the right, with respect to specified pool trades, to substitute alternate pools as necessary.<sup>44</sup>

K. Other<sup>45</sup>

a. It should be noted that certain current MBSD rules will not be included in the proposed MBSD rules. These are as follows:

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<sup>43</sup> But no later than one (1) hour before the close of the Federal Reserve Banks’ Fedwire Funds Service if such determination relates to the extension of time for settlement and is made on a settlement day.

<sup>44</sup> As is the case under Rule 4, “Clearing Fund and Loss Allocation”, in the event of a close out of a defaulting Member, broker members will be responsible for partially-matched trades for which FICC has received a statement denying the existence of the trade.

<sup>45</sup> It should be noted that DTCC has an Audit Committee and such Committee would not be dismantled without prior notification to the Commission.

- With respect to Article III (Participants), in the current MBSD rules: Rule 1, “Requirements Applicable to Participants and Limited Purpose Participants”; Section 5, “Supplemental Agreement of Participants and Limited Purpose Participants”; and Section 14 “Special Provisions Applicable to Partnerships” are not included in the proposed MBSD rules because each of these rules is no longer necessary. Proposed Rule 2A serves to harmonize the attached proposed MBSD rules with the GSD rules on this subject. Rule 1, “Requirements Applicable to Participants and Limited Purpose Participants” Section 15 “Special Provisions Applicable to Non-Domestic Participants” is not included in the proposed MBSD rules because as with the GSD, the MBSD will be using the Netting Agreement for foreign members and not the master agreement format. Proposed Rule 2A, “Initial Membership Requirements”, Section 5, “Member Agreement” covers the provisions of the membership agreement generally and thereby serves to harmonize the proposed MBSD rules with the GSD rules with respect to this subject.
- Rule 3, “Corporation Declines to Act for a Participant or Limited Purpose Participant” Section 2 “Other Grounds for Ceasing to Act for a Participant or Limited Purpose” is not included in the proposed MBSD rules because it is being replaced by proposed MBSD Rule 14 “Restrictions on Access to Services” and Rule 16 “Insolvency of a Member” which cover the same matters and harmonize these provisions with those in the GSD rules.
- In an effort to harmonize with the GSD rules, Rule 3, “Corporation Declines to Act for a Participant or Limited Purpose Participant” Section 3 is not reflected in the proposed MBSD Rules. We do not believe it is necessary to state the current MBSD



concept in the proposed MBSD rules because it would apply regardless of whether it is stated in the rules. Rule 3, “Corporation Declines to Act for a Participant or Limited Purpose Participant” Sections 5(a) “Disposition of Open Commitments” is not included in the proposed MBSD rules because FICC does not accept Letters of Credit as a permissible form of Clearing Fund collateral as a routine matter; however, FICC reserves the right to accept this type of collateral, if needed. In addition, the current MBSD rule addresses the liquidation of other types of collateral posted by the defaulting Member. Under the proposed MBSD rule, close out processes, in general, are covered by Rule 17, which has been drafted to be harmonized with the equivalent GSD Rule to the extent possible. Section 5(c) of the current MBSD Rule 3 in Article III has not been carried into the proposed rulebook because these current provisions speak to non-defaulting Members engaging in the close-out of the defaulting Member’s positions, which will be undertaken by the MBSD as CCP under the proposed rules.

- Under the section titled “Schedule of Charges Broker Account Group” in the appendix to the proposed MBSD rules, FICC no longer provides hardcopy output from microfiche. As a result, the reference to this charge is being removed.

b. The following rules do not appear in the current MBSD rules and have been added to the proposed MBSD rules in connection with this filing:

- Rule 3, Section 6 “General Continuance Standard” of the proposed MBSD rules includes additional language which states that FICC may require that increased or modified Required Fund Deposits be deposited by the Clearing Member on the same Business Day on which the FICC requests additional assurances from such Member.

FICC has always interpreted that the current rules permit such action, however, this additional language makes it explicit.

- Rule 5, “Trade Comparison” Section 1 “General” and Section 3 “Trade Submission Communication Methods” includes disclosure relating to the means by which data may be entered and submitted to the Corporation. Section 10 “Modification of Trade Data” of this rule allows the Corporation to unilaterally modify trade data submitted by Clearing Members if the Corporation becomes aware of any changes to the transaction which invalidates the original terms upon which it was submitted or compared and Rule 12 “Obligations” of this Section discusses the point at which trade data becomes a settlement obligation.
- With respect to the computation of cash balances under Rule 11, “Cash Settlement”, FICC has included a new process with respect to fail tracking. Fail tracking is an automated process that takes place when the actual settlement date of a transaction is beyond the contract date. An adjustment is made when one or more beneficiary dates fall between the contract date and the settlement date. The adjustment results in the payment of funds from the message originator to the message receiver through the Federal Reserve’s National Settlement Service (“NSS”). This eliminates a cumbersome manual process for tracking and clearing adjustments from securities transaction counter-parties and it impacts all Fed-eligible mortgage-backed securities, including Freddie Mac, Fannie Mae and Ginnie Mae.
- With respect to Rule 26, “Financial Reports and Internal Accounting Control Reports”, Section 1 “Financial Reports” has been revised to state that the Corporation will (1) prepare its financial statements in accordance with Generally Accepted

Accounting Principles, (2) make unaudited financial statements for the fourth quarter available to its Clearing Members within 60 days following the close the Corporation's calendar year, and (3) provide a certain level of minimum disclosures in its quarterly financial statements. This rule has also been revised to include Section 2 "Internal Accounting Control Reports", which requires the Corporation to make internal accounting control reports available to its Clearing Members.

- The proposed MBSD rules also introduce pool netting fees. Below is a description of each fee:
  1. Matched Pool Instruct ("PID") (per side): When a pool instruct is matched resulting from either an instruct or an affirmation (with or without pending status) a matched fee is charged to both sides.
  2. Customer Delivery Request ("CDR") Pool Instruct Fee: When a pool instruct in a matched status is included in the net (vs. FICC) a CDR fee is charged at the instruct PID level to the Clearing Member that submitted the CDR.
  3. Cancel of Matched Pool Instruct: This fee is assessed to the Clearing Member submitting a unilateral cancel on a matched pool instruct.
  4. Pool Obligation: This fee is charged to the net long and short Clearing Member when a Pool Obligation ("POID") is created vs. FICC.
  5. Post Net Subs: Charged to the Clearing Member that submits a substitution (the net seller) on a POID vs. FICC.
  6. Clearance of Pool vs. FICC: Fee associated with clearing a POID vs. FICC.

7. Financing Charges (Financing costs are the costs of carrying positions overnight): For each other Clearing Member, a pass-through charge calculated on a percentage of the total of all such costs incurred by the Corporation, allocated by agency product.

c. The provisions listed below are in the current GSD rules and have been further revised in the proposed MBSD rules in an effort to harmonize the two rulebooks:

- Rule 3 Section 12 (Excess Capital Premium)
- Rule 5 Section 10 (Modification of Trade Data by the Corporation)
- Rule 14 (Restrictions on Access to Services)
- Rule 15 (Wind-Down of a Member)
- Rule 16 (Insolvency of a Member)
- Rule 17 (Procedures For When the Corporation Ceases to Act)
- Rule 17A (Corporation Default)
- Rule 18 (Charges for Services Rendered)
- Rule 19 (Bills Rendered)
- Rule 20 (Admission to Premises of the Corporation, Powers of Attorney, etc.)
- Rule 21 (Forms)
- Rule 22 (Release of Clearing Data)
- Rule 26 (Financial Reports and Internal Accounting Control Reports)
- Rule 27 (Rule Changes)
- Rule 28 (Hearing Procedures)
- Rule 29 (Governing Law and Captions)
- Rule 30 (Limitations of Liability)
- Rule 31 (General Provisions)
- Rule 32 (Cross-Guaranty Agreements)
- Rule 33 (Suspension of Rules in Emergency Circumstances)
- Rule 34 (Action by the Corporation)
- Rule 35 (Notices)
- Rule 36 (Interpretation of Terms)
- Rule 37 (Interpretation of Rules)
- Rule 38 (Disciplinary Proceedings)
- Rule 39 (DTCC Shareholders Agreement)

- Rule 23 (Lists to be Maintained)
- Rule 24 (Signatures)
- Rule 25 (Insurance)

(b) By establishing guaranteed settlement and CCP services for the MBSD, FICC is promoting efficiencies in the mortgage-backed securities marketplace, and for its membership. The MBSD guarantee of settlement upon comparison of submitted trades will reduce risks associated with defaults among counterparties. The introduction of pool comparison, netting, and settlement services will reduce, for MBSD Clearing Members, the number of pool settlements and the associated risks and costs. In addition, providing CCP services will protect Clearing Members from undue risks by allowing FICC to “step in” as settlement counterparty on eligible trades. The proposed changes are therefore consistent with the Securities and Exchange Act of 1934 and the rules and regulations promulgated there under, in that they will further the abilities of FICC to support the prompt and accurate clearance and settlement of securities transactions.

B. Self-Regulatory Organization's Statement on Burden on Competition.

FICC does not believe that the proposed rule change will have any impact, or impose any burden, on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others.

Written comments relating to the proposed change have not yet been solicited or received. FICC will notify the Commission of any written comments received by FICC.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will: (a) by order approve or disapprove such proposed rule change or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the 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-FICC-2008-01 on the subject line.

#### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FICC-2008-01. 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 proposed rule change that are filed with the Commission, and all written communications

relating to the proposed rule change 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 such filing also will be available for inspection and copying at the principal office of FICC and on FICC's website at

[http://dtcc.com/downloads/legal/rule\\_filings/2008/ficc/2008-01\\_Amendment\\_No\\_1.pdf](http://dtcc.com/downloads/legal/rule_filings/2008/ficc/2008-01_Amendment_No_1.pdf). 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 File Number SR-FICC-2008-01 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>46</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>46</sup> 17 CFR 200.30-3(a)(12).