IDTA

March 29, 2018

SUBMITTED VIA E-MAIL

Eduardo A. Aleman
Assistant Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. SR-FICC-2018-001; Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to the Required Fund Deposit Calculation in the Government Securities Division Rulebook

Dear Mr. Aleman:

The Independent Dealer and Trader Association ("IDTA" or "Association")[1] submits this letter in response to your request for comment on the Fixed Income Clearing Corporation's ("FICC") filing with the Securities and Exchange Commission ("SEC") of the proposed rule change SR-FICC-2018-001 (the "Proposed Rule Change") to amend the FICC Government Securities Division ("GSD") Rulebook (the "GSD Rules") to make changes to GSD's method of calculating GSD members' ("Members") margin, referred to in the GSD Rules as the Required Fund Deposit ("RFD") amount.[2]

The IDTA supports the FICC's efforts to ensure the financial strength, resiliency, and continuity of the organization during times of market stress. The IDTA, however, believes the Proposed Rule Change will exacerbate existing flaws in the RFD methodology, and will have a disproportionately negative effect on smaller institutions, particularly those that are not Bank Netting Members or large Dealer Netting Members affiliated with a bank holding company (collectively referred to herein as "Bank Members"). Such disproportionality places competitive

[1] The IDTA is a new trade association formed to create a forum for independent dealers and traders to discuss and consider the impact of market operational issues on their industry sector and to advocate for constructive solutions that promote the liquidity and efficiency of capital markets. As of the date of this letter, the IDTA is composed of ten organizations registered as broker-dealers or futures commission merchants (or affiliates of such organizations) that are not affiliated with a bank holding company. A list of current IDTA membership is attached as Appendix I.

[2] Securities Exchange Act Release No. 82876 (Mar. 14, 2018), 83 Fed. Reg. 12229 (March 20, 2018) ("Request for Comment"), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-03-20/pdf/2018-05565.pdf. The FICC also filed a nearly identical advance notice SR-FICC-2018-801 ("Advance Notice") on January 12, 2018. Securities Exchange Act Release No. 82779 (Feb. 26, 2018), 83 Fed. Reg. 9055 (Mar. 2, 2018), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-03-02/pdf/2018-04236.pdf. This letter responds to both the Proposed Rule Change and the Advance Notice, collectively referred to herein as the "Filings."

and financial burdens on non-Bank Members that have a higher cost of funds and access to fewer pools of liquidity than those available to Bank Members. It also is possible that these burdens could result in adversely affecting the diversity of liquidity across fixed income markets during those times when both market participants and regulators want this diversity.

This letter focuses on the FICC's specific proposals that the IDTA feels are most burdensome to non-Bank Members, including:

- The inadequate time Members were given to analyze the proposed changes, and lack of calculation methodology tools available to them;
- The arbitrary three-day liquidation period that will apply to all Members;
- The distorted look-back period that will be used in calculating Members' margin;
- The discriminatory impact of the Excess Capital Premium on Dealer Netting Members; and
- The flawed MBS Blackout Period Exposure Adjustment proposal.

The IDTA highlights the flaws it sees in the Proposed Rule Change's methodology and implementation, and recommends a number of adjustments to fix these shortcomings. The Association looks forward to working with the FICC to implement the recommended solutions further detailed below.

I. FICC Filing Rationale And IDTA's Overarching Concerns

The Proposed Rule Change states: the "FICC is proposing to amend its calculation of GSD's VaR Charge because during the fourth quarter of 2016, FICC's current methodology for calculating the VaR Charge did not respond effectively to the market volatility that existed at that time. As a result, the VaR Charge did not achieve backtesting coverage at a 99% confidence level and therefore yielded backtesting deficiencies beyond FICC's risk tolerance."[3] The FICC also is proposing a backtesting charge "designed to mitigate exposures to GSD caused by settlement risks that may not be adequately captured by GSD's Required Fund Deposit."[4]

For purposes of evaluating the Proposed Rule Change, the SEC must determine that the FICC's backtesting practices are appropriate and based on accurate components.[5] Moreover, the SEC's standards for clearing agencies require the FICC to ensure that its backtesting practices are appropriate for determining the adequacy of the covered clearing agency's margin resources.[6]

[3] Securities Exchange Act Release No. 82588 (January 26, 2018), 83 Fed. Reg. 4687, 4689 (Feb. 1, 2018) (SR-FICC-2018-001) ("Notice"), *available at* https://www.gpo.gov/fdsys/pkg/FR-2018-02-01/pdf/2018-01949.pdf.

[4] *Id.*

[5] 17 C.F.R. 240.17Ad-22(e)(6)(vi).

[6] *See, e.g.*, 17 C.F.R. 240.17Ad-22(e)(6)(vi) (requiring a covered clearing agency to establish procedures to cover "its credit exposures to its participants by establishing a risk-based margin system" that is "monitored by management on an ongoing basis and is regularly reviewed, tested, and verified").

The IDTA is concerned that, in an effort to eliminate backtesting deficiencies, the FICC has recalibrated the methodology and components of the RFD calculation resulting in an imprecise measure of risk and unwarranted burden on competition. The IDTA believes that the FICC approached the change in methodology to achieve its backtesting goal on the RFD in total, as opposed to tackling the problem at the individual Member level. Addressing this issue at the Member level would better manage the clearing agency's exposures to individual Members and attribute the collection of margin to those creating the failures in coverage from a backtesting perspective.

The Proposed Rule Change results in a material increase to the RFD for some Members, not only due to sensitivities value-at-risk ("SVaR"), but also due to the compounding effect the new SVaR has on other components of the RFD. The IDTA believes the increase in RFD disproportionately targets non-Bank Members on a percentage basis. Recent disclosure from the FICC supports this belief. In its rebuttal letter to comment letters submitted by Amherst Pierpont Securities LLC and Ronin Capital, LLC, the FICC illustrates that the statistical impact of the Proposed Rule Change on the RFD resulted in 40% of Netting Members having a net reduction to RFD (without disclosure of how large the reductions are), and 31% of Netting Members having between no RFD impact to a 10% RFD impact.[7] The results, therefore, imply that the remaining 29% of Netting Members saw an increase of over 10% to the RFD. Coincidently, after consolidating affiliated entities who are GSD Netting Members, 29% of the GSD Membership is made up of Dealer Netting Members who are not affiliated with bank holding companies.[8] These results suggest that the Proposed Rule Change will have a disproportionate impact on non-Bank Members.

For example, six members of the IDTA who submitted data saw, on average, an 85% increase under the proposed methodology as of the close of business requirement for the most recent month end, when comparing to the existing versus proposed FICC RFD.[9] The IDTA urges the FICC to disclose the full statistical distribution of the impact on Netting Members for both net increases and decreases to RFD. Before approving the Proposed Rule Change, the SEC should independently determine if the changes have an unfairly discriminatory impact on certain Members (particularly non-Bank Members who have access to fewer pools of liquidity and higher costs of funds than Bank Members), resulting in an unnecessary burden on competition.

In reviewing the Proposed Rule Change, it is important to consider that the existing calculation already includes the Margin Proxy, which was added by the FICC to aid in

[7] *See* Letter from Timothy J. Cuddihy, Managing Director, The Depository Trust & Clearing Corporation ("DTCC") to Robert W. Errett, Deputy Secretary, Securities and Exchange Commission at 3 (March 19, 2018) ("FICC Rebuttal Letter"), *available at* https://www.sec.gov/comments/sr-ficc-2018-001/ficc2018001-3287446-162045.pdf.

[8] Member data compiled using FICC GSD Member Directory as of March 19, 2018. *See FICC-GOV Member Directories,* DTCC (Mar. 19, 2018), http://www.dtcc.com/client-center/ficc-gov-directories. There were 84 Netting Member accounts after consolidating affiliated entities (e.g. Citibank, NA and Citigroup Global Markets). Twenty-four (29%) of these accounts belonged to Dealer Netting Members not affiliated with a bank holding company.

[9] The SEC has access to detailed information on the individual impact to FICC Members. The IDTA is willing to discuss this data with the SEC upon request.

maintaining its backtesting goal at the 99% confidence level.[10] Therefore, any delay designed to create a more carefully calibrated margin model would not pose systemic risk and would allow more time to ensure the RFD components, calculations, and risk offsets are properly adjusted to meet the mandates of a covered clearing agency.

II. SEC Standard Of Review

When a self-regulatory organization proposes changes to its rules, the SEC "shall approve" the changes only "if it finds that such proposed rule change is consistent with" provisions of the Exchange Act ("Act").[11] In turn, a clearing agency's rules are consistent with the Act only if "the Commission determines that" they meet certain specified requirements.[12]

First, the Act requires that a clearing agency's rules "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Act.[13] Second, the Act requires that a clearing agency's rules be "designed . . ., in general, to protect investors and the public interest."[14] Third, the same subsection requires that rules not be "designed to permit unfair discrimination . . . among participants in the use of the clearing agency."[15] Fourth, the Act requires that a self-regulatory organization "comply with . . . its own rules."[16]

This standard was recently reviewed by the U.S. Court of Appeals for the D.C. Circuit in *Susquehanna International Group, LLP v. Securities and Exchange Commission*.[17] The IDTA believes the SEC will be unable to meet these requirements should it accept the Proposed Rule Change as it was submitted, and suggests the SEC work with the FICC and its Members to address the concerns described herein.

III. The FICC Should Further Discuss The Impacts Of Its Rule Changes With Its Members Before They Are Approved

The RFD is a complex calculation that warrants adequate testing and transparent discussion between the FICC and its Netting Members. The FICC usually provides Members with sufficient time to adapt to new margins and change business practices or models, if needed. For example, the Margin Proxy was launched in April 2017 to provide the FICC, its Members, and their regulators with the confidence of a forthcoming fair and prudent margin system. The

[10] The proposed SVaR model, which will become the basis for margin calculations, presents new challenges in its complexity and failure to align with industry conventions. As discussed in Part III, the FICC should further discuss this impact with its Members before implementing the change.

[11] 15 U.S.C. § 78s(b)(2)(C)(i); *see id.* § 78s(b)(2)(C)(ii).

[12] *Id.* § 78q-1(b)(3).

[13] *Id.* § 78q-1(b)(3)(I).

[14] *Id.* § 78q-1(b)(3)(F).

[15] 15 U.S.C. § 78q-1(b)(3)(F). Section 17A(b)(3)(D) of the Act further requires that a clearing agency's rules "provide for the equitable allocation of reasonable dues, fees, and other charges among its participants." 15 U.S.C. § 78q-1(b)(3)(D).

[16] 15 U.S.C. § 78s(g)(1).

[17] 866 F.3d 442 (D.C. Cir. 2017).

FICC gave its Members a year to adapt to this change. On the other hand, the FICC gave its members less than one month to review the Filings – i.e., from December 19, 2017 (when detailed test data became available to Members) to January 12, 2018 (when the Filings were filed with the SEC).[18] This short turnaround, compounded with the holiday season and year-end review, did not provide FICC Members adequate time to review the proposed changes.

Furthermore, while the FICC performed member outreach prior to January 12, 2018,[19] discussion on the proposed changes and opportunities to provide feedback were inadequate. It was only *after* the FICC submitted its Filings to the SEC did the implications of the proposed rule changes become clear. Under Rule 17Ad-22(e)(23)(i) and (ii), the FICC has to "publicly disclos[e] all relevant rules and material procedures, including key aspects of its default rules and procedures," and provide "sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency."[20] The inadequate opportunities to review and evaluate the rule changes suggest that the FICC has not met its requirements under the Rule.

FICC Members are currently provided limited tools to evaluate the impacts they face in the RFD for their current or prospective portfolios. Detailed risk information must be specifically requested by Members and there is no methodology in place to prospectively determine the impact of an addition or deletion to a portfolio. Members, therefore, cannot identify and evaluate the risks and other costs, such as margin, required under Rule 17Ad-22(e)(23)(i) and (ii). Having the proper tools and information to analyze and manage the risk from the proposed RFD is of the utmost importance to Members. Not only are there significant costs to Members from the loss of use and the cost of funds as a result of increased margin, but RFD contributed to the FICC is subject to loss allocation and is therefore at risk to a Member default.

The National Securities Clearing Corporation ("NSCC"), an affiliate of the FICC, recently launched a calculator that enables its Members to input sample portfolios to determine the margin required.[21] The FICC has discussed plans to launch a similar calculator for its Members. This calculator, along with full disclosure of the methodology used, should be made available to FICC Members before the Proposed Rule Change is approved.[22]

[18] *See* Request for Comment, 83 Fed. Reg. at 12229.

[19] *See* FICC Rebuttal Letter at 5.

[20] 17 C.F.R. 240.17Ad-22(e)(23)(i)-(ii).

[21] The CME Group also has a robust member-facing risk system that provides for a number of tools discussed above.

[22] Since the FICC is the only covered clearing agency that clears U.S. Treasury and agency mortgage-backed securities, there is no competitive threat in disclosing this information. If there appears to be disclosure concerns, non-disclosure agreements could be used to remedy the situation.

IV. Concerns Over Proposed Changes To VaR and Backtesting Calculations

A. The Liquidation Period is Arbitrary.

The SVaR methodology recommended by the FICC assumes a three-day liquidation period for each Member's portfolio.[23] This same, three-day liquidation assumption applies to both Members with several hundred million in FICC eligible securities and Members with several hundred *billion* in eligible securities. In other words, there is no "sensitivity" given to Members with smaller portfolios that bear no default risk to the financial system. It is arbitrary to apply the same liquidation period across all Members because the smaller Members' portfolios can be more easily liquidated or hedged in a shorter period of time with no measurable impact on the market. The SEC should undertake an independent assessment of the FICC's liquidation period assumptions, as applied to both large and small portfolios.[24]

To address the IDTA's concerns, the FICC should link the margin period of risk to the portfolio size of a defaulting Member. For example, utilizing daily volume in the U.S. Treasury ("UST") and Mortgage Backed Securities ("MBS") markets, several tiers can be matched with volume and days to liquidate or hedge. A UST portfolio of $5 billion may have a one-day liquidation or hedge period, while a UST portfolio of $50 billion may have a five-day liquidation or hedge period. The smaller portfolio should have VaR matched to true one-day risk, while the larger portfolio should see some increase (30-50%) that matches the additional risk associated with longer periods to liquidate or hedge a large portfolio (without risking a fire sale).

Tiering Member risk is not new. The Capped Contingency Liquidity Fund ("CCLF") has established tiers to allocate larger contingencies on portfolios that exceed larger liquidity needs on a regular basis.[25] The Sponsored Member program only allows Bank Netting Members with greater than $5 billion in capital to participate. Moreover, the FICC itself originally proposed a Margin Liquidity Adjustment Charge to address liquidation risks of large portfolios. The charge would have been "an add-on charge, calculated based on aggregated gross position by asset class in all portfolios of a Netting Member, when above designated thresholds."[26] It is unclear why the Margin Liquidity Adjustment Charge was abandoned, but such a charge would address the liquidation risks posed from the portfolios maintained by some of the FICC's largest Netting Members.[27]

[23] Notice, 83 Fed. Reg. at 4689.

[24] The FICC disagrees that the three-day liquidation period is arbitrary, and explains that it "believes" the period is "an accurate assumption of the length of time it would take to liquidate or hedge a portfolio . . . ." FICC Rebuttal Letter at 3. The SEC cannot rely on the FICC's beliefs. Rather, the SEC must determine for itself that the liquidation period is appropriate. *See Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442, 446, 449 (D.C. Cir. 2017) (requiring SEC to make an "independent review" involving "reasoned decisionmaking").

[25] *Government Securities Division Rulebook*, FIXED INCOME CLEARING CORPORATION at Rule 1 (defining "liquidity tier" as it relates to the CCLF) ("GSD Rule"), *available at* www.dtcc.com/~/media/Files/Downloads/legal/rules/ficc_gov_rules.pdf.

[26] *GSD Proposed Clearing Fund Changes*, DTCC PowerPoint Presentation to Members at 17 (Aug. 16, 2017) (on file with author).

[27] The FICC did not address why it abandoned the Margin Liquidity Adjustment Charge in its Filings.

The Proposed Rule Change imposes margin policies that create an uncompetitive field for smaller portfolios, discriminating against them in favor of larger ones. The FICC should consider adopting tiers of liquidation periods based on a Member's actual risk, instead of the proposed blanket three-day liquidation period for all Members.

B. The Look-Back Period Distorts Risk.

In the Proposed Rule Change, the FICC proposes an extended 10-year look-back period in calculating Members' margin.[28] The 10-year look-back period, though, is infrequently used in risk calculations, as one- to five-year look-back periods are more typical. A study of 18 large financial institutions by McKinsey & Company found no firms using a 10-year look-back period, and only one firm using a look-back period of five years.[29]

A longer look-back period of five years may enable more stability in the daily margin due to its lengthy period. The longer tenure also is more reasonable when an entire portfolio is measured. The FICC, though, only analyzes in-house GSD assets, and does not include offsetting to-be-announced ("TBAs") or UST Futures.

In addition to the unusual methodology of the 10-year look-back period, the FICC proposes an "additional stress period" of the 2008/2009 financial crisis scenario to the extent an equally or more stressed period does not occur in the 10-year period.[30] The addition of an arbitrary year to be added to the 10-year period is statistically biased and anomalous from industry accepted risk management practices. Permanent inclusion of this volatile period makes the most volatile day permanent in the risk calculations and not sufficiently calibrated to address expected risk. The table in Appendix II shows the distribution of the most volatile days in 10-year and two-year USTs over the past 10 years, which is heavily skewed to the financial crisis. As the FICC recognizes, this practice clearly makes the VaR charge for the overall clearing fund less volatile, not because of the superiority of the model, but because the most volatile days are included in the calculations with no periodic roll off. The unnecessary collection of margin results in harmful costs that disproportionately burden non-Bank Members as compared to larger Bank Members.

The IDTA believes a shorter look-back period without an additional year would still provide the improvement over the current VaR model the FICC desires, and would sufficiently margin Members for the risk of their portfolios without being statistically biased.

[28] Notice, 83 Fed. Reg. at 4691.

[29] The other look-back periods were as follows: seven firms used one year, six firms used two years, two firms used three years, and two firms used four years. Amit Mehta *et. al*, *Managing Market Risk: Today and Tomorrow*, MCKINSEY & COMPANY at 4 (May 2012), *available at* https://www.mckinsey.com/~/media/mckinsey/dotcom/client_service/Risk/Working%20papers/Working_Papers_on_Risk_32.ashx.

[30] Notice, 83 Fed. Reg. at 4691.

C. The Backtesting Analysis Must be Modified.

IDTA also is concerned that the impact study performed by the FICC used statistically biased data. For example, the Proposed Rule Change states that the FICC's analysis compared the proposed sensitivity approach to the existing VaR Charge supplemented by the Margin Proxy.[31] Yet, the Margin Proxy was intended to be temporary until the SVaR was in place. A proper analysis, therefore, should utilize the original methodology – without the Margin Proxy – against the proposed SVaR.

Specifically, the FICC should conduct two separate comparisons of the proposed SVaR, both with the original VaR methodology (without the Margin Proxy) and with the existing, current VaR methodology (which includes the Margin Proxy). These comparisons should not only examine overall aggregate increases to the RFD, but also should examine changes in the RFD of each individual Netting Member. If the FICC adjusts its analysis to include this detail, the IDTA believes the results will clearly show that very significant increases in VaR are disproportionately burdening many smaller firms. As discussed above, a sample of six firms in the IDTA showed an increase of approximately 85% in SVaR over current VaR, and increases in SVaR relative to net capital.[32] The changes, at least anecdotally, result in discrimination against a specific set of non-Bank Members.

Significantly, the Proposed Rule Change does not clearly state which data is being presented to the SEC for analysis. It is unclear if each Member's historical returns are being compared individually to each Member's clearing fund requirement, or if both sets of data are being aggregated. Aggregation shows whether the clearing fund as a whole meets the backtesting requirement, but does not show if there is discrimination in the form of over-margining at a Member level. The FICC should allow the SEC and FICC Members to review the data the FICC used in its analysis.

V. Excess Capital Premium Concerns

A. The Excess Capital Premium Definition Requires Refinement.

The Excess Capital Premium ("ECP") is incorrectly defined in the Proposed Rule Change as "the amount that a Netting Member's Required Fund Deposit exceeds its Excess Capital."[33] The FICC should clarify this definition to be consistent with the GSD Rulebook and existing practices before any rule changes are adopted.

In the Proposed Rule Change, the new denominator would be Net Capital or "Netting Member Capital" (although the term is not defined in the Proposed Rule Change) as a replacement for Excess Net Capital.[34] There is little mention in the Proposed Rule Change of

[31] Notice, 83 Fed. Reg. at 4702.

[32] *See supra* note 9.

[33] Notice, 83 Fed. Reg. at 4696 ("Proposed Change to the Excess Capital Premium Calculation for Broker Netting Members, Inter-Dealer Broker Netting Members and Dealer Netting Members").

[34] Notice, 83 Fed. Reg. at 4698.

any change in the numerator amending the definition of the term "VaR Charge" other than to establish that: "(1) the Margin Proxy would be utilized as an alternative volatility calculation in the event that the requisite data used to employ the sensitivity approach is unavailable, and (2) a VaR Floor would be utilized as the VaR Charge in the event that the proposed model based approach yields an amount that is lower than the VaR Floor."[35]

The VaR Charge, as defined in the GSD Rules, provides the FICC with significant discretion to amend the components of its VaR Charge.[36] The existing practice includes only the VaR component of the RFD and specifically excludes the Coverage Charge and the Augmented Volatility Adjustment Multiplier ("AVM"), both of which are proposed to be eliminated with the implementation of the SVaR. The FICC states that the AVM was "designed to mitigate the effect of the 1-year look-back period" and the AVM is "no longer necessary given the proposed sensitivity approach would have a longer look back."[37] Regarding the Coverage Charge, the FICC states it was "based on historical portfolio activity . . . to address potential shortfalls in margin charges under the current VaR model" and is proposing to eliminate it because the "sensitivity approach would provide overall better margin coverage."[38]

While the IDTA agrees that elimination of the AVM and Coverage Charge is appropriate if the SVaR is implemented, it contends that the ECP calculation needs to be updated, as well. The SVaR is a significantly larger charge than the existing VaR measure and encompasses factors that the FICC has historically deemed inappropriate to include in the ECP. Clarification and justification is needed on the ECP because the potential ECP under a SVaR measure will result in material additional margin for some Members without sufficient explanation in the Proposed Rule Change.

B. The Net Capital Measure Discriminatorily Impacts Dealer Netting Members.

The IDTA believes that the use of Net Capital in the denominator in the ECP rules will result in a discriminatory change that arbitrarily penalizes Dealer Netting Members, since many Members who currently do not have an ECP charge will if the Proposed Rule Change is approved. It also is unclear if using Net Capital was the intended goal or if that was changed when the Proposed Rule Change was filed.[39] Using Net Capital as the Excess Capital figure also will result in discrimination against Dealer Netting Members as compared to Bank Netting Members to determine the ECP. Bank Netting Members' Excess Capital is based on equity without any reduction for positions, while Dealer Netting Members are required to use Net Capital, a measure of net worth after reductions for haircuts on positions.

[35] *Id.*

[36] GSD Rule 1 ("Such volatility calculations shall be made in accordance with any generally accepted portfolio volatility model, including, but not limited to, any margining formula employed by any other clearing agency registered under Section 17A of the Securities Exchange Act of 1934.").

[37] Notice, 83 Fed. Reg. at 4692.

[38] Notice, 83 Fed. Reg. at 4694.

[39] Based on communications with the FICC in the fourth quarter of 2017, IDTA members had been told the new ECP rule would use Tentative Net Capital ("TNC") – Line 8 on FOCUS Computation of Net Capital – as the new denominator, not Net Capital – Line 10.

The IDTA recommends that Dealer Netting Members be able to add back the haircut to Net Capital for all U.S. Government securities that are cleared at the FICC. This would eliminate a large element of the Net Capital penalty and incentivize Members to maintain securities within the FICC. The example in Appendix III illustrates the difference in treatment to a Dealer versus a Bank Netting Member with the same amount of equity capital and same starting GSD VaR buying an additional $100mm U.S. Treasury security. Although likely unintended, the effect of the ECP is a penalty for these types of activities and the imposition of a competitive burden on non-Bank Members.

C. Excess Capital Premium Trigger Results in Charges that Discriminate Against Non-Bank Members.

The IDTA is concerned about the implications on Members' liquidity planning from the combination of the proposed SVaR margins, MBS Blackout Adjustment, MBS Basis and Haircut Charges, Excess Capital Premium, CCLF, and unexpected intra-day fail charges. Given the confidence in new sensitivity measures and components being proposed, the FICC should consider modifying the ECP.

The market also has changed dramatically since the original imposition of the ECP. The Financial Industry Regulatory Authority ("FINRA") has become more actively involved in liquidity stress planning and dealer requirements, with frequent reporting required of liquidity sources, leverage, and liquidity plans.[40] The development of increased regulation on liquidity stress management should be taken into consideration. The FICC could leverage these regulatory developments to more effectively quantify and identify the true liquidity risk of its Members and not just the FICC portfolio. If implemented as proposed, the ECP would not be a sound measure of a Member's credit risk. Instead, it would make liquidity stress scenarios for FINRA reporting more difficult to develop, since the ECP compounded with the SVaR would result in requirements dramatically higher and harder to calculate than any scenario currently envisioned or presented.

Rather than an immediate application of the ECP placing an unwarranted drain on liquidity, an ECP over 1 could be used as a trigger for a credit review of the Member. This solution would already be possible under the existing Rule 2A Section 14 of the GSD Rules.[41] This approach also is consistent with the requirements of Rule 17Ad-22(e)(4)(i) and (6)(i)-(v) because it establishes a risk based system to monitor credit exposure and monitor and manage that exposure to Members.[42] The IDTA believes that the diversity of Members' business models,

[40] *See, e.g.*, FINRA Regulatory Notice 18-02 (Jan. 8, 2018), *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-18-02.pdf.

[41] GSD Rule 2A Section 14 (the FICC reserves the "right to (i) collect an amount less than the Excess Capital Premium (including no premium) based on specific circumstances . . . and (ii) return all or a portion of the Excess Capital Premium (or such lesser amount) if it believes that the Netting Member's risk profile does not require the maintenance of that amount").

[42] *See* 17 C.F.R. 240.17Ad-22(e)(4)(i) (requiring a covered agency to establish procedures that effectively "identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by: (i) [m]aintaining sufficient financial resources to cover its credit exposures to each participant fully with a high degree of confidence"); *Id.* at 240.17Ad-22(e)(6) (requiring a covered

offsetting positions at other clearinghouses and liquidity profiles, makes it inappropriate to place a blanket charge without understanding the risks derived from each individual Member. The FICC also should consider eliminating the ECP. This is permitted under FICC rules given the increased FINRA surveillance and increased confidence from the FICC in the new model.[43]

In the Proposed Rule Change, the FICC states that "the proposed change to the Excess Capital Premium calculation would help to ensure that FICC does not unnecessarily increase its calculation and collection of Required Fund Deposit amounts for" Members.[44] Given the issues raised above, the SEC must carefully examine this statement, require additional information from the FICC, and examine the impact the requested rule changes would have to individual Netting Members. The IDTA believes the Proposed Rule Change will result in charges that will bring disproportionate financial harm to IDTA Members and other non-Bank Members. The SEC must ensure that the Proposed Rule Change does not discriminate in its application between Member types and result in an unnecessary burden on competition to Dealer Netting Members who have a higher cost of funds.

VI. MBSD And CME Offset

Due to longstanding practices and situations beyond the control of Members, there has been no margin offset benefit available to Members with offsetting risk positions at the Mortgage Backed Securities Division ("MBSD") with short TBAs and only limited offsets at the CME with short futures positions.[45] The FICC and the CME have access to client portfolio data, which enables them to offset their clearinghouse risk to the Member while the Member must post margin at both clearinghouses. This discourages liquidity in the U.S. Treasury market and is an issue that requires intervention from the SEC. The IDTA urges the SEC to recommend the development of improved cross-margin ability to avoid over-margining.

Due to the inability or lack of incentive to share data with other clearing agencies, the FICC cannot accurately identify outright risk versus basis risk in many instances. Outright risk is clearly much more volatile than basis risk. The FICC also cannot currently distinguish hedged risk from unhedged risk, which results in the over-margining of some of its Netting Members. Moving to the SVaR, extending the look-back period, and adding an additional stressed period compounds the pressure on Netting Members even further. These changes place a burden on all participants, but create a particularly unnecessary burden on competition to non-Bank Members who have higher costs of capital.

clearing agency to establish procedures to cover "its credit exposures to its participants by establishing a risk-based margin system").

[43] Under GSD Rule 4, Section 2(e), the FICC retains the ability to levy additional requirements on Members who pose a unique risk to the FICC and other Members.

[44] Notice, 83 Fed. Reg. at 4699.

[45] Only some CME futures contracts provide cross-margin offsets. This does not include the 10-year or 30-year sectors, and will likely not include the recently announced Secured Overnight Funding Rate ("SOFR") launching May 7, 2018. *See* Joshua Frost, *Introducing the Secured Overnight Financing Rate (SOFR)*, FEDERAL RESERVE BANK OF NEW YORK (Nov. 2, 2017), *available at* https://www.newyorkfed.org/medialibrary/media/newsevents/speeches/2017/Frostpresentation.pdf.

Since both the GSD and MBSD are within the FICC, there is no issue around information sharing of the offset benefit. Without cross-margin ability, Members must post margin to both clearinghouses even though the positions held may offset risk.[46] The ultimate goal, shared by the FICC and its Members, is to have the ability to reduce the required margin at the FICC by offsetting risk positions.

The FICC should promptly submit a rule change to allow Members to have the option to cross-margin their FICC portfolios and address the competitive disparity described above.

VII. MBS Blackout Period Exposure Adjustment

In the Proposed Rule Change, the FICC proposes the MBS Blackout Period Exposure Adjustment ("BPEA") as a new component of the RFD replacing the existing MBS Blackout Period Exposure Charge ("BPEC"). The IDTA believes that serious flaws exist in the current BPEC and proposed BPEA that should be revisited by the FICC with Netting Members. These flaws result in both an inaccurate measurement of risk and excessive margin charges that are harmful to Netting Members, particularly non-Bank Members who have a relative higher cost of funds than other Netting Members.

A. The Timing of the Blackout Period is an Unnecessary Burden on Competition.

Both the existing BPEC and proposed BPEA are applied to a Member's RFD on Record Date through Factor Date,[47] resulting in the premature and duplicative collection of margin at times when the FICC is already secured. If a Member default were to occur on Record Date, the FICC would become the holder of record and would be entitled to the pay-down. The FICC's true exposure to the MBS Blackout period begins the morning of the first business day. This one-day timing difference is material since Record Date is the end of the month when the costs of funds tend to be at their highest. Because the exposure to the Blackout period is removed in the morning on the Factor Date, the FICC also is incorrectly extending the period through the end of the day on the Factor Date as opposed to removing the adjustment by the intraday RFD.[48] The proposed BPEA results in upwards of a 100% increase for some Netting Members from the existing BPEC, and unnecessarily reduces competition and liquidity by putting pressure on non-Bank Members' abilities to provide financing to the market over month ends, quarter ends, and year end. The IDTA, therefore, recommends further discussion on the Blackout Period to be defined as the first business day of the current month to the morning of the fifth business day.

[46] This also is the case for GSD and CME for UST and futures, and for the Options Clearing Corporation ("OCC") and NSCC for options and equities.

[47] Notice, 83 Fed. Reg. at 4694.

[48] Netting Members are required by the agent bank (and the FICC) to collateralize their GCF deals first thing in the morning on Factor Date after new MBS pool factors are applied.

B. Application of System Wide Pay-Down Rates, Not Member Rates, is Improper.

The IDTA's concerns are compounded because the proposed BPEA is calculated using historical pool factor pay-down rates for all active MBS pools,[49] as opposed to the historical paydown rates for the MBS pools held in the portfolio of each Netting Member. The IDTA believes that applying a system wide pay-down metric, as opposed to continuing to base it on the pool characteristics of the Netting Member's portfolio, is improper and arbitrarily creates "winners" and "losers." It also removes the Members' ability to manage their own risk and liquidity. The FICC agrees that this methodology could result in over/under estimates.[50] IDTA Members have reported increases greater than 20% with the utilization of all active MBS pools compared to their own portfolios.[51] Moreover, by removing the incentive to maintain faster paying MBS outside of the FICC, Netting Members may move this MBS back into the FICC, thus introducing more risk to the FICC and its Netting Members.

C. No Risk Weighting on the MBS Blackout Period Results in Unreasonably High Probability of Loss.

The proposed BPEA assumes 100% probability of GCF Counterparty default across all Netting Members. Such an assumption is not commercially reasonable and the IDTA does not believe a credit risk model would account for such a high probability of loss. A more prudent approach would be for the FICC to apply a credit risk weighting to the BPEA, which would reduce the burden on Netting Members while still protecting the FICC and its Netting Members.

Applying a credit risk measure would not be a new concept. The FICC has internal ranking models for each Netting Member and has the ability to levy additional Clearing Fund requirements based upon the idiosyncratic credit risk of a Member at any point in time. The FICC should utilize recognized credit risk measures and apply default rates to the BPEA, such as those published by Standard and Poor's in Appendix IV.

D. The Existing Charge Methodology Covers Backtesting without Off Market Transfer of Margin.

The proposed BPEA differs from the existing BPEC in that it provides no net increase to the FICC Clearing Fund and results in a RFD transfer between GCF collateral providers (more often non-Bank Members) to cash providers (more often Bank Members).[52] Cash providers in the tri-party and bi-lateral repo market are not customarily afforded a similar transfer of haircut or margin during the MBS Blackout Period. The IDTA believes the existing methodology for the BPEC better protects the FICC and Netting Members by increasing the overall FICC

[49] Notice, 83 Fed. Reg. at 4694 n50.

[50] Notice, 83 Fed. Reg. at 4694.

[51] Data on file with author.

[52] Bank Members with a short-term investment grade credit rating are incentivized to finance their long MBS portfolios in the tri-party market and away from GCF Repo due to lower financing rates.

Clearing Fund deposit by the BPEC component.[53] The FICC states that the Clearing Fund requirement results under the proposed SVaR methodology with and without the BPEA provided better overall coverage during the volatile period following the U.S. presidential election than under the current VaR and Margin Proxy methodology.[54] The proposed BPEA collection, therefore, would be excessive and would not harm the FICC if not approved, and the existing backtesting approach for the BPEC was preserved instead.

VIII. Conclusion

The IDTA believes it would be in the best interest of all Netting Members – and the FICC – if the SEC rejects the Proposed Rule Change and encourages the FICC to work with its Members to revise its proposals. While well-intentioned, the Proposed Rule Change would benefit from more robust data and collaboration with Members to ensure that it is properly calibrated to achieve the mandates of the covered clearing agency rules and goal of backtesting coverage achieving the 99% confidence level. As the concern relating to backtesting deficiencies has, according to the FICC, been cured by implementation of the Margin Proxy, reconsideration of the Proposed Rule Change will not result in systemic harm to the financial system. Reconsideration, moreover, will protect against potentially harmful effects upon competition and liquidity in the market.

The consistent reach for additional margin from Members, even when it may not be statistically warranted or sufficiently calibrated to the risk presented, is of specific concern because of the disproportionate burden on non-Bank Members. Further, the compounding implication of FICC's rules on loss allocation is particularly concerning to IDTA Members.[55] This potential loss allocation reinforces the principle that Members should not be required by the FICC to maintain more than is necessary in the RFD. Any rule changes that increase the margin requirements and the RFD also increase the likelihood that those deposits could be allocated in a loss waterfall.

In the Proposed Rule Change, the FICC discusses potential burdens on competition as a result of the proposed changes to the calculation, and argues that the changes could both burden and promote competition at different points in time.[56] The FICC admits that a burden on competition exists when the change to RFD calculations "produces relatively greater increases in Required Fund Deposits for Netting Members that have lower operating margins or higher costs

[53] Currently, the BPEC is only applied to GCF Counterparties lending MBS collateral that have two or more backtesting deficiencies during the Blackout Period, and whose overall 12-month trailing backtesting coverage falls below the 99% coverage target. To avoid future backtesting deficiencies, the charge could be applied to all MBS portfolios during the Blackout Period instead of waiting for a deficiency that would be expected for any Member with a significant MBS portfolio. The FICC should evaluate the size of the MBS portfolio monthly to ensure the charge is based upon current portfolio size and is, therefore, sufficient for backtesting coverage.

[54] Notice, 83 Fed. Reg. at 4691 n34.

[55] GSD Rule 4 Section 7(d) (Loss Allocation) provides that: "If there is any Remaining Loss attributable to Tier One Netting Members after application of paragraph (c) above, it shall be allocated among Tier One FICC Members, ratably, in accordance with the amount of each Tier One Netting Member's respective Required Fund Deposit and based on the average daily level of such deposit over the prior twelve months."

[56] Notice, 83 Fed. Reg. at 4701 ("Clearing Agency's Statement on Burden on Competition").

of capital than other Netting Members."[57] Based on the limited time data available, the IDTA believes that the proposed changes would disproportionately result in greater increases in RFD for non-Bank Members and consequently will impose an unnecessary burden on competition.

Considering the FICC has the data in detail to the Member level, the FICC should have evaluated the data and determined whether there would, in fact, be a burden on competition. The IDTA believes the FICC is incorrect when it claims that "no particular category of Netting Member is expected to experience materially greater increases or decreases than other Netting Members . . . ."[58] The FICC should provide the past five years of data comparison between the SVaR and the current VaR with and without Margin Proxy broken down by Member type and size to its Members and the SEC, so that no ambiguity exists regarding the impact on Members. Absent such data, it would be inappropriate to conclude that the FICC proposal is not designed to permit unfair discrimination among participants and does not impose an unnecessary burden on competition. Moreover, requiring the FICC to revise its proposal and base its request upon more robust analysis will ensure that FICC's rules are designed to protect investors and the public interest.

The IDTA recommends the SEC reject the FICC proposal in its current form because it places unnecessary and disproportionate burdens on non-Bank Members, has the effect of being discriminatory, and places a significant burden on the ability of these Members to be competitive in the marketplace. As discussed, the IDTA's primary areas of concern include:

- The inadequate time period given to analyze the proposed changes, and the lack of an adoption period, methodology, and tools (such as a margin calculator), are inconsistent with Rule 17Ad-22(23)(ii).

- A departure from industry standard practices, including the proposed 10-year plus additional stress period look-back period, and three-day liquidation period for all Members despite portfolio size. These methods are unfairly discriminatory towards Members with smaller portfolios and a higher cost of funds, and are inconsistent with Section 17A(b)(3)(I).

- A compounding effect of the SVaR factors introduced to the ECP without explanation, and the resulting discriminatory impact of the Bank and Dealer Netting Member ECP calculations, against what is required in Section 17A(b)(3)(F) & (I).

- The excessive margin required in connection with the BPEA not collected (and returned) at the times warranted by the risk exposure, not estimated based on the Members' actual portfolio, and not risk weighted, resulting in a transfer of funds from collateral providers to cash providers that does not exist in the bilateral or tri-party repo markets. These actions have an unfairly discriminatory impact and an unnecessary burden on competition inconsistent with Section 17A(b)(3)(F).

[57] *Id.*

[58] *Id.*

- Material increases of margin for many non-Bank Members without the ability of a Member to offsets its MBSD portfolio or portfolio at other clearinghouses with offsetting risk. This unfairly discriminates against these Members against requirements in Section 17A(b)(3)(I).

- The backtesting methodology presented to the SEC and lack of transparency in this data for the SEC to perform its own, sound evaluation on different Member types.

The IDTA thanks the SEC for considering the Association's comments. Should you have any questions, please contact me at [redacted] or [redacted]

Sincerely,

James Tabacchi
Chairman
Independent Dealer and Trader Association

Appendix I: IDTA Membership

As of March 29, 2018

Aardvark Securities, LLC

Bethesda Securities, LLC

Buckler Securities, LLC

Curvature Securities LLC

ED&F Man Capital Markets Inc.

J.V.B. Financial Group, LLC

Mirae Asset Securities (USA), Inc.

Ronin Capital, LLC

Rosenthal Collins Group, LLC

South Street Securities LLC

Appendix II: Most Volatile Days in 10-Year Lookback

Most Volatile 100 Days Distributed by Year

Year	US Generic Govt 10 Yr Yield		US Generic Govt 2 Yr Yield	
2007	5		26	
2008	33		64	
2009	22	55	3	67
2010	16		1	
2011	13		0	
2012	2		0	
2013	5		0	
2014	0		0	
2015	2		3	
2016	2		2	
2017	0		0	
2018	0		1	
	100		100	

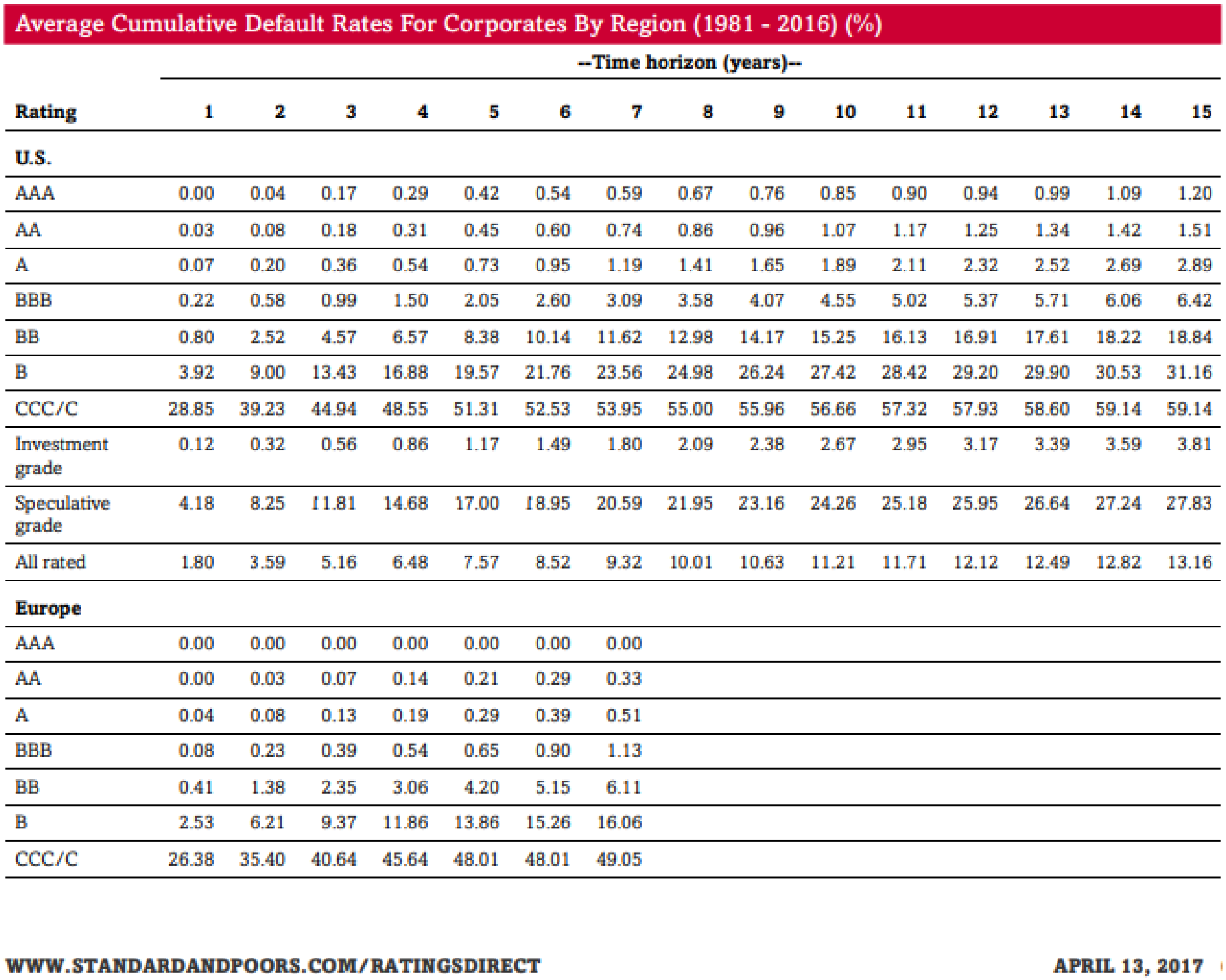
Source: Bloomberg.

Appendix III: ECP Application Between Netting Member Types

	Bank Netting Member	**Dealer Netting Member**
Starting GSD VaR	100	100
Equity	**110**	110
Less Non-Allowable Assets, Non-Marketable Securities, Deficits on Financing Trades. Etc.	N/A	5
Less Securities Haircuts	N/A	5
Net Capital	N/A	**100**
Additional Haircut on 10yr Treasury	N/A	4.5
Net Capital	N/A	95.5
Est. Additional VaR on 10yr Treasury	2.1	2.1
GSD VaR	102.1	102.1
Excess Capital Ratio	0.93	1.07
	ECR = VaR/Equity	ECR = VaR/Net Capital
Excess Capital Premium	0	7.06
Total Additional GSD Margin for 10yr Treasury	**2.1**	**9.16**

Appendix IV: Corporate Default Rates

The below table shows the lowest rated companies having a 28.85% rate of default over a one-year period, as opposed to 100% default as suggested by the proposed BPEA.



Average Cumulative Default Rates For Corporates By Region (1981 - 2016) (%)

	--Time horizon (years)--														
Rating	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
U.S.															
AAA	0.00	0.04	0.17	0.29	0.42	0.54	0.59	0.67	0.76	0.85	0.90	0.94	0.99	1.09	1.20
AA	0.03	0.08	0.18	0.31	0.45	0.60	0.74	0.86	0.96	1.07	1.17	1.25	1.34	1.42	1.51
A	0.07	0.20	0.36	0.54	0.73	0.95	1.19	1.41	1.65	1.89	2.11	2.32	2.52	2.69	2.89
BBB	0.22	0.58	0.99	1.50	2.05	2.60	3.09	3.58	4.07	4.55	5.02	5.37	5.71	6.06	6.42
BB	0.80	2.52	4.57	6.57	8.38	10.14	11.62	12.98	14.17	15.25	16.13	16.91	17.61	18.22	18.84
B	3.92	9.00	13.43	16.88	19.57	21.76	23.56	24.98	26.24	27.42	28.42	29.20	29.90	30.53	31.16
CCC/C	28.85	39.23	44.94	48.55	51.31	52.53	53.95	55.00	55.96	56.66	57.32	57.93	58.60	59.14	59.14
Investment grade	0.12	0.32	0.56	0.86	1.17	1.49	1.80	2.09	2.38	2.67	2.95	3.17	3.39	3.59	3.81
Speculative grade	4.18	8.25	11.81	14.68	17.00	18.95	20.59	21.95	23.16	24.26	25.18	25.95	26.64	27.24	27.83
All rated	1.80	3.59	5.16	6.48	7.57	8.52	9.32	10.01	10.63	11.21	11.71	12.12	12.49	12.82	13.16
Europe															
AAA	0.00	0.00	0.00	0.00	0.00	0.00	0.00								
AA	0.00	0.03	0.07	0.14	0.21	0.29	0.33								
A	0.04	0.08	0.13	0.19	0.29	0.39	0.51								
BBB	0.08	0.23	0.39	0.54	0.65	0.90	1.13								
BB	0.41	1.38	2.35	3.06	4.20	5.15	6.11								
B	2.53	6.21	9.37	11.86	13.86	15.26	16.06								
CCC/C	26.38	35.40	40.64	45.64	48.01	48.01	49.05								

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Source: *2016 Annual Global Corporate Default Study and Rating Transitions*, STANDARD & POOR'S at 62 (April 13, 2017), *available at* https://www.spratings.com/documents/20184/774196/2016+Annual+Global+Corporate+Default+Study+And+Rating+Transitions.pdf/2ddcf9dd-3b82-4151-9dab-8e3fc70a7035.