SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–69470; File No. SR–FICC–2013–02]

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change To Include Options on Interest Rate Futures Contracts With Maturities Not Longer Than Two Years In The One-Pot Cross-Margining Program Between the Government Securities Division and New York Portfolio Clearing, LLC

April 29, 2013.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on April 15, 2013, the Fixed Income Clearing Corporation (''FICC'') filed with the Securities and Exchange Commission (''Commission'') 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 from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change would allow FICC to include options on interest rate futures contracts with maturities not longer than two years in the one-pot cross-margining program between FICC's Government Securities Division (''GSD'') and New York Portfolio Clearing, LLC (''NYPC'').[3]

II. Clearing Agency'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 these statements.[4]

(A) Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(i) The purpose of the proposed rule change is to include options on interest rate futures contracts with maturities not longer than two years in the one-pot cross-margining program between the GSD and NYPC.

Background on NYPC and the FICC–NYPC One-Pot Cross-Margining Program

NYPC is registered with the Commodity Futures Trading Commission (''CFTC'') as a derivatives clearing organization (''DCO'') pursuant to Section 5b of the Commodity Exchange Act and Part 39 of the CFTC regulations. NYPC launched operations on March 21, 2011, and currently clears U.S. dollar-denominated interest rate futures contracts. It plans to add options on interest rate futures to its set of products.

Pursuant to FICC Rule Filing 2010–09,[5] FICC offers ''single pot'' cross margining of certain positions cleared at NYPC and the GSD. This arrangement is reflected in a cross-margining agreement (''FICC–NYPC Cross-Margining Agreement'') between FICC and NYPC, which is a part of the GSD's rules. Specifically, certain GSD members may opt to combine within a single margin portfolio their positions at the GSD and their positions (or those of certain permitted affiliates) cleared at NYPC. Joint GSD–NYPC members or GSD members and their permitted affiliates who wish to participate in the one-pot program must execute the requisite cross-margining participant agreements, which are exhibits to the FICC–NYPC Cross-Margining Agreement.[6]

As noted in FICC Rule Filing 2010–09, FICC is responsible for performing the margin calculations in its capacity as the ''Administrator'' under the terms of the FICC–NYPC Cross-Margining Agreement. Specifically, FICC determines the combined FICC Clearing Fund and NYPC Original Margin [7] requirement for each cross-margining participant. The FICC–NYPC one-pot margin requirement for each participant is then allocated between FICC and NYPC in proportion to each clearing organization's respective ''stand-alone'' margin requirements—in other words, an amount reflecting the ratio of what each clearing organization would have required from that member if it were not participating in the cross-margining program (referred to as the ''Constituent Margin Ratio'' in the FICC–NYPC Cross-Margining Agreement). The FICC–NYPC Cross-Margining Agreement provides that either FICC or NYPC may, at any time, require additional margin to be deposited by a participant (above what is calculated under the FICC–NYPC Cross-Margining Agreement) based upon the financial condition of the participant, unusual market conditions or other special circumstances. The standards that FICC proposed in Rule Filing 2010–09 to use for these purposes are the standards contained within the GSD's rules currently, so that notwithstanding the calculation of a participant's Clearing Fund requirement pursuant to the FICC–NYPC Cross-Margining Agreement, FICC still retains the rights contained within the GSD's rules to require an additional Clearing Fund deposit under the circumstances specified in the GSD's rules. For example, the GSD's rules currently provide that, if a Dealer Netting Member [8] falls below its minimum financial requirement, it shall be required to make an additional Clearing Fund deposit equal to the greater of (i) $1 million or (ii) 25 percent of its Required Fund Deposit.[9] In the event of the insolvency or default of a member that participates in the one-pot cross-margining arrangement, the positions in such member's FICC–NYPC one-pot portfolio (including, where applicable, the positions of its permitted margin affiliate at NYPC) will be liquidated by FICC and NYPC as a single portfolio, and the liquidation proceeds will be applied to the defaulting member's obligations to FICC and NYPC in accordance with the provisions of the FICC–NYPC Cross-Margining Agreement. The FICC–NYPC Cross-Margining Agreement provides for the sharing of losses by FICC and NYPC in the event that the one-pot portfolio margin deposits of a defaulting participant are not sufficient to cover the losses resulting from the liquidation of that participant's trades and positions, which is covered in detail in FICC Rule Filing 2010–09, and is reflected in the terms of the FICC–NYPC Cross-Margining Agreement.

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] NYPC is jointly owned by NYSE Euronext and The Depository Trust & Clearing Corporation.

[4] The Commission has modified the text of the summaries prepared by FICC.

[5] The Commission approved this rule filing on February 28, 2011. *See* Exchange Act Release No. 34–63986 (February 28, 2011); 76 FR 12144–02 (March 4, 2011) (SR–FICC–2010–09).

[6] GSD members and NYPC members are also permitted to cross margin in the single pot the activity of their market professional customers. *See* Exchange Act Release No. 34–66989 (May 15, 2012); 77 FR 30032–02 (May 21, 2012) (SR–FICC–2012–03).

[7] Original Margin is the NYPC equivalent of the Clearing Fund.

[8] The GSD's rules define the term ''Dealer Netting Member'' as ''a Registered Government Securities Dealer that is admitted to membership in the Netting System pursuant to these Rules, and whose membership in the Netting System has not been terminated . . .'' GSD Rulebook, Rule 2A, Section 2.

[9] The GSD's rules define the term ''Required Fund Deposit'' as ''the amount a Netting Member is required to deposit to the Clearing Fund.'' GSD Rulebook, Rule 1.

The addition of options on interest rate futures to the one-pot cross-margining arrangement does not require any changes to the terms of the FICC–NYPC Cross-Margining Agreement. FICC will continue to act as the Administrator for purposes of margin calculations. The sharing of loss provisions in the FICC–NYPC Cross-Margining Agreement that would apply in the event of a participant's default will remain unchanged under this proposal.

Proposal To Include Options on Interest Rate Futures in the One-Pot Cross-Margining Arrangement

FICC proposes to add options on interest rate futures contracts with maturities not longer than two years to the one-pot cross-margining arrangement. NYPC will act as the DCO for such products.

Options on interest rate futures are a long-standing, standardized product traded and cleared by futures exchanges [10] around the globe, including the Chicago Mercantile Exchange (''CME'').[11] The key risks associated with adding options on interest rate futures to the one-pot cross-margining arrangement relate to the ability of FICC and NYPC to properly model, test and monitor the risks that options on interest rate futures present to the clearing organizations. Consistent with FICC's quantitative policy for new initiatives, any new models or enhancements are subject to external review before they are utilized. The options proposal has followed this protocol, and the team of external reviewers has tested the models and validated their methodology.

In the case of options on interest rate futures that are physically deliverable, the addition of options on interest rate futures to the one-pot cross-margining arrangement will not alter the manner in which physical deliveries occur. Upon exercise or assignment of an option, the resulting futures position will be treated as a traded futures contract, with the same delivery obligations if the resulting futures position is not closed out prior to delivery. In general, delivery of U.S. Treasury futures can be submitted to FICC by NYPC on a locked-in basis and processed in accordance with FICC's rules (when these are submitted to FICC, they are no longer futures contracts but rather are in the form of buy-sells eligible for processing at the GSD).

FICC will submit a separate rule filing to the Commission for the inclusion in the single pot of longer-dated interest rate options products. FICC will also conduct appropriate testing and analysis of the options model and, consistent with FICC's quantitative policy for new initiatives, submit the model for external review.

Risk Considerations Regarding the Proposal To Include Options on Interest Rate Futures in the One-Pot Cross-Margining Arrangement

The methodology for managing risk for options on interest rate futures to be included in the one-pot cross-margining arrangement has three pillars: (i) Value-at-Risk (''VaR'') with historical simulation, (ii) the Barone-Adesi & Whaley (''BAW'') approximation, and (iii) the Stochastic Alpha, Beta, Rho (''SABR'') Volatility Model.

The historical-simulation-based VaR model proposed for options on interest rate futures to be included in the one-pot cross-margining arrangement is the same model utilized in the current one-pot cross-margining arrangement between NYPC and the GSD described in FICC Rule Filing 2010–09. The backbone of this VaR model—namely, the three-day/one-day liquidation period assumption for cash and derivatives positions, respectively; the 99th percentile confidence level; and the one-year look-back period and the use of a linear interpolation/front-weighting mechanism to arrive at the 99 percent threshold from simulated profits and losses—will remain the same when options on interest rate futures are added to FICC–NYPC one-pot portfolios.

The BAW approximation is the pricing function that FICC and NYPC will use to estimate analytically the value of options on interest rate futures within the Black-Scholes-Merton framework. The SABR volatility model will be used to estimate volatility curves for various options series.

As stated above, a three-day liquidation period is assumed for cash positions cleared by FICC, whereas a one-day liquidation period is assumed for futures positions cleared by NYPC. Options on interest rate futures in the one-pot cross-margining arrangement will also be subject to a one-day liquidation requirement due to the similar liquidity of these products compared to futures. This is also consistent with CFTC requirements. In addition, each cross-margining participant's FICC–NYPC one-pot margin requirement is subject to a daily back test, and a ''coverage component'' is applied and charged to the participant in the event the daily back test reflects insufficient coverage. Options on interest rate futures in the one-pot cross-margining arrangement will be subject to this daily testing.

The one-pot FICC–NYPC VaR model will account for the non-linear risk posed by the addition of options on interest rate futures to the one-pot cross-margining arrangement by performing full revaluation of such options using BAW and SABR. As options on interest rate futures can exhibit magnified exposure in extreme market conditions, FICC is proposing to employ the additional tools described below:

1. Minimum Margin Charge for Portfolios Including Options

Similar to the practice that FICC's Mortgage-Backed Securities Division uses to address potential mark-to-market offset of margin requirements, FICC and NYPC are proposing to apply a floor margin charge of five basis points of the gross market value of positions in options on interest rate futures to the unadjusted Required Fund Deposit of GSD Netting Members with one-pot portfolios that include options on interest rate futures. Therefore, for GSD Netting Members with one-pot portfolios that include options on interest rate futures, their minimum Required Fund Deposit will be the greater of: (i) The current minimum Required Fund Deposit as prescribed in GSD Rule 4, Section 2; or (ii) the proposed floor margin charge.

2. Short Option Minimum Charge

To address the risk associated with short positions in deep out-of-the-money (''OTM'') options, FICC and NYPC propose to introduce a short option minimum (''SOM'') for options on interest rate futures in the one-pot cross-margining arrangement. The SOM will apply only to options on interest rate futures with a settlement price of ''cabinet.'' [12] These options demonstrate minimum price volatility in normal market conditions, but may potentially become volatile when market conditions change dramatically. In light of the losses that such options may cause, an

[10] Exchanges that list options on interest rate futures include the following: (i) CME (US); (ii) CBOT (a subsidiary of CME); (iii) BM&F (Brazil); (iv) NYSE LIFFE (UK); (v) Eurex (Germany); (vi) ASX (Australia); (vii) Montreal Exchange (Canada); (viii) SGX (Singapore); and (ix) TFX (Japan).

[11] Options on interest rate futures are currently included in the ''two-pot'' cross-margining arrangement between FICC and the CME. The cross-margining agreement between FICC and the CME is incorporated in the GSD's Rules and may be found on the DTCC Web site, *www.dtcc.com*.

[12] The minimum price increment for futures or options on futures is normally referred to as a ''tick.'' For options on futures whose value is less than one tick, trading and settlement in the options are allowed at a price that is less than a tick. This latter price is known as ''cabinet.''

SOM charge will be applied to any short position in these options.

3. Out-of-the-Money Options Surcharge

FICC and NYPC also propose to impose a surcharge on all OTM options positions in the one-pot cross-margining arrangement in order to address any potential biases in the BAW options pricing model described above. The amount of the surcharge will be determined by the moneyness of the options position.

4. Options Stress Testing

In addition to the regular stress testing practices utilized by FICC and NYPC, monthly hypothetical implied volatility stress tests of FICC–NYPC one-pot portfolios, including options on interest rate futures, will be conducted in order to analyze specifically the non-linear tail risks associated with options products.

Proposed Rule Changes

FICC's proposal to add options on interest rate futures to the one-pot cross-margining arrangement requires that Rule 4, Section 2 of the GSD's rulebook be changed to include a reference to the proposed minimum margin charge discussed above. Technical clarifications to certain GSD rules are also required in order to make it clear that options on interest rate futures will be included in the arrangement. Specifically, FICC is proposing to make technical clarifications to the following: (i) The definitions of ''CFTC-Recognized Clearing Organization'' and ''Eligible Positions'' set forth in Rule 1; (ii) Section 5a of GSD Rule 13, and (iii) subsection (b) of GSD Rule 29. As noted above, no changes are required to be made to the FICC–NYPC Cross-Margining Agreement itself.

(ii) FICC believes that the proposed rule change is consistent with the Act and the rules and regulations promulgated thereunder because it may further the available offsets among positions held at FICC and NYPC, thereby allowing a more efficient use of member collateral and promoting additional efficiencies in the marketplace. FICC believes the proposed rule change is therefore consistent with the Act and the rules and regulations promulgated thereunder because it supports the prompt and accurate clearance and settlement of securities transactions. FICC further believes that, as it will implement this proposed rule change using the enhanced risk-management measures discussed above, the proposed rule change will also be consistent with the Act because it will assure the safeguarding of the securities and funds in FICC's custody and control.

(B) Clearing Agency's Statement on Burden on Competition

FICC does not believe that the proposed rule change will have any negative impact, or impose any burden, on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(C) Clearing Agency's Statement on Comments on the Proposed Rule Change Received From Participants, Members, or Others

Written comments relating to the proposed rule 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 up to 90 days (i) as the Commission may designate 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.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.[13] The clearing agency shall post notice on its Web site of proposed changes that are implemented.

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 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 email to *rule-comments@sec.gov.* Please include File No. SR–FICC–2013–02 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 No. SR–FICC–2013–02. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method of submission. The Commission will post all comments on the Commission's Internet Web site (*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 Web site 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 filings also will be available for inspection and copying at the principal office of FICC and on FICC's Web site at *http://dtcc.com/downloads/legal/rule_filings/2013/ficc/SR_FICC_2013_02.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 No. SR–FICC–2013–02 and should be submitted on or before May 24, 2013.

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.[14]

Kevin M. O'Neill,

Deputy Secretary.

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[13] FICC also filed the proposals contained in this proposed rule change as an advance notice pursuant to Section 806(e)(1) of the Clearing Supervision Act and Rule 19b–4(n)(1)(i) thereunder. 12 U.S.C. 5465(e)(1); 17 CFR 240.19b-4(n)(1)(i). Proposed rule changes filed under the Clearing Supervision Act may be implemented either: at the time the Commission notifies the clearing agency that it does not object to the proposed rule change and authorizes its implementation, or, if the Commission does not object to the proposed rule change, within 60 days of the later of (i) the date that the advance notice was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. *See* 12 U.S.C. 5465(e)(1)(G).

[14] 17 CFR 200.30–3(a)(12).