HOWREY LLP

170 South Main Street
Suite 400
Salt Lake City, Utah 84101-3636
T 801.533.8383
F 801.531.1486
www.howrey.com

June 1, 2006

VIA EMAIL SUBMISSION

Nancy M. Morris
Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comment Letter Opposing Proposed Rule Change SR-NSCC-2006-03

Dear Ms. Morris:

On behalf of the International Association of Small Broker-Dealers and Advisors (the "IASBDA"), Wilson-Davis & Co., Inc. ("Wilson-Davis") and Alpine Securities Corporation ("Alpine") (collectively, the "Commenting Parties"), we respectfully submit this letter in response to the request for comment in Release No. 34-53671: Notice of Filing of Proposed Rule Changes to Institute a Clearing Fund Premium Based Upon a Member's Clearing Fund Requirement to Excess Regulatory Capital Ratio dated April 18, 2006 (the "Proposed Rule").[1] The Commenting Parties appreciate the opportunity to

[1] The Commenting Parties also request that the National Securities Clearing Corporation (the "NSCC") ***provide specific details*** of how the NSCC currently computes the clearing fund formula set forth in Procedure XV of its Rules and Procedures, including any assumptions relied upon and variables used to arrive at the amount that must be on deposit with the NSCC (the "current deposit requirement"). These details are necessary because: (i) the formula in the Proposed Rule used to calculate the NSCC's proposed clearing fund deposit requirements (the "proposed additional deposit requirement") is a dependent variable (*i.e.*, the amount needed for the current deposit requirement must be computed in order to calculate the proposed additional deposit requirement because the current deposit requirement is part of the formula set forth in the Proposed Rule); accordingly, broker-dealers must have a clear understanding of how the current deposit requirement is computed in order to analyze the impacts of the Proposed Rule; (ii) the Commenting Parties believe the formula (including how to arrive at any variable amounts) used to calculate the current deposit requirement would reveal significant discretionary risk premiums that the NSCC currently charges, thereby calling into doubt any assertion by the NSCC that its interests are not adequately protected by the current deposit requirement; and (iii) the Commenting Parties believe that if they are provided the details of the formula used to calculate the current deposit requirement, they would be able to show that the NSCC's calculations are premised on faulty assumptions and apply variables in an arbitrary manner. In addition, public disclosure of this information will benefit the Commenting Parties and others similarly situated because it improves the degree of certainty as to the amount the NSCC would demand as a deposit, thereby enabling the NSCC's member firms to better manage their businesses. The NSCC should be willing to provide the specific details. First, how it applies its formula to determine the current deposit requirement should not be confidential. Second, the NSCC should support any efforts by its members to better manage their businesses because, in so doing, those members are reducing their risks (and by extension, the risk they pose to the NSCC).

provide this comment letter addressing their concerns and objections to the Proposed Rule.

The IASBDA is an organization created for the purpose of protecting the interests of small and mid-size broker-dealers. Thus, the IASBDA advocates for the implementation of fair rules by those regulatory agencies and organizations with authority over small broker-dealers. In addition to protecting the interests of small broker-dealers, the IASBDA seeks to protect the interests of micro-cap or small business issuers (hereinafter referred to as "small issuers") because, in part, small issuers and small broker-dealers have a mutually dependent relationship.[2] Because the Proposed Rule is adverse to the interests of small broker-dealers as well as small issuers, the IASBDA joins in this comment letter in opposition to the Proposed Rule.

Wilson-Davis and Alpine are two such small broker-dealers that would be negatively affected by the Proposed Rule. Both firms are self clearing and have been so for several decades – Wilson Davis since 1968 and Alpine since 1984. Wilson-Davis and Alpine are also market makers for a number of small issuers' securities that are traded OTC, OTCBB or on Pink Sheets.[3] Wilson-Davis and Alpine believe the Proposed Rule is adverse to small broker-dealers and its practical effect will cause harm to small issuers and investors.

A. Reasons for the Commenting Parties opposition to the Proposed Rule.

The Proposed Rule should not be adopted because (1) it would have a disproportionately negative impact on small to mid-size broker-dealers, (2) it imposes unnecessary burdens on small broker-dealers, particularly because the NSCC already possesses the tools necessary to adequately protect its interest,[4] and (3) it would have an anticompetitive effect given that many smaller firms will be unable to meet the additional capital deposit requirements and would be forced to cease operations, thereby reducing investors' options and impeding many small issuers' abilities to raise capital.

---

2 Small issuers often rely on small broker-dealers to assist them with capital formation and to provide liquidity for their securities. In return, the business provided by small issuers to small broker-dealers is often critical to a small broker-dealer's success.

3 We understand that the securities the NSCC presumes are risky are those traded OTC, OTCBB or on Pink Sheets and for issuers whose securities trade in lower dollar amounts (*e.g.*, less than $5).

4 In fact, the formula currently used to determine a broker-dealer's current deposit requirement affords the NSCC almost ***unfettered discretion*** on the amount of a deposit it can seek to protect its interest. Although the current deposit requirement is based on an inextricable formula as applied, Procedure XV is abundantly clear that the NSCC can unilaterally determine what amount it will require a clearing firm to deposit. For example, the NSCC can determine that its wants to require an additional deposit for "special charges" when it considers those charges appropriate. *See* NSCC Rules and Procedures, Procedure XV at 230-31.

First, the Commenting Parties oppose the Proposed Rule because, ***as applied***, it would cause a disproportionate burden on small broker-dealers. Although the disparate burden the Proposed Rule would create may not be apparent, that additional burden becomes clear when the NSCC's methodology is examined – both under the current deposit requirement and the deposit that would be required under the Proposed Rule. Included in the NSCC's deposit requirements are risk premiums, which are generally based upon (1) a firm's excess net capital, and (2) the types of securities a firm clears through the NSCC. Whenever a firm does not have what the NSCC deems to be sufficient excess net capital, the NSCC will charge that firm a risk premium that must be included in the amounts on deposit with the NSCC. Additionally, the NSCC charges risk premiums for certain types of equity securities that it deems risky. The types of equity securities that the NSCC deems risky appear to be ***all*** securities that trade OTC, OTCBB, and on Pink Sheets and securities below a certain threshold trading value (*e.g.*, $5). As applied, these risk premiums disproportionately affect small broker-dealers more than their large broker-dealer counterparts because small broker-dealers generally have less excess net capital than the larger broker-dealers and small broker-dealers that self-clear generally provide services to small issuers, which are the types of securities targeted by the NSCC for additional risk premiums. The NSCC's presumptions that a firm's size and the types of securities it clears through the NSCC are accurate indicators of a firm's risk cannot be supported when evaluated against the risk posed by Wilson-Davis and Alpine – and likely many other small broker-dealers. Despite being considered by the NSCC to be risky under both of these assumptions, Wilson-Davis and Alpine have always met their obligations to the NSCC, to their creditors, and to their customers.

Second, the Commenting Parties oppose the premise underlying the Proposed Rule that risk can be accurately managed by targeting a broker-dealers' size and targeting small issuers' securities without considering other components of credit risk. Even if excess net capital is an indicator of a firm's ability to meet its obligations should it fail,[5] the NSCC should not be allowed to use excess net capital in such a way as to replace sound risk management principles. Similarly, the NSCC should not be allowed to target particular types of issuers' securities and deem them risky, thereby increasing the costs to broker-dealers to clear those types of securities, without assessing the actual risk posed by an individual issuer.[6] Wilson-Davis and Alpine are ***not*** risky firms merely because their excess net capital amounts may not be as high as other major clearing firms and they

[5] The NSCC's reasoning is counterintuitive because smaller firms logically should present less exposure than their big-firm counterparts in a situation where one fails. The NSCC has even admitted that "the size of exposure due to the failure of any one of [its small member firms] is relatively small." *See* NSCC Proposed Rule Change, File No. SP-NSCC-97-7 (09/22/1997).

[6] Failure to assess an individual issuer's liquidity leads the NSCC to charge an arbitrary liquidity risk premium. For example, the NSCC targets small issuers by charging a broker-dealer a liquidity premium to clear securities traded OTC, OTCBB or on Pink Sheets. Yet, ***in many instances***, Wilson-Davis and Alpine were charged a liquidity premium even through the volume of trading in the issuer's securities that caused the "illiquid" premium was in the millions of shares per day. Even in instances when the daily volume of a small issuer's securities exceeded a large cap company's volume, the NSCC still charged a liquidity premium to clear the small issuer's securities but did not require the same to clear the lower-volume, large-cap securities.

make markets for and assist in capital formation for small issuers. The clear import of the Proposed Rule is to impute risks to firms such as Wilson-Davis and Alpine based on unsubstantiated notions of accurate risk measures.

Third, Wilson-Davis and Alpine also oppose the Proposed Rule to the extent it includes the current deposit requirement to arrive at the proposed additional deposit requirement because the NSCC's current practices, as applied, are discriminatory against small to mid-size broker-dealers. Although the rules determining broker-dealers' current deposit requirements ostensibly apply equally to all self-clearing broker-dealers, in practice the risk premiums charged by the NSCC result in significantly higher relative deposits being required of small broker-dealers than are required of larger broker-dealers and clearing firms.[7] Wilson-Davis and Alpine have several examples where the NSCC's rules as applied are discriminatory to small broker-dealers that self-clear. For example, on at least four occasions this year, the NSCC demanded that Wilson-Davis have on deposit an amount greater than its net worth. In another example, Alpine was asked to immediately deposit with the NSCC an amount in excess of $1.5 billion, which was many times in excess of its net worth.[8] Based on discussions with larger self-clearing firms, those same deposit demands have not been made to larger broker-dealers. The Proposed Rule would perpetuate and exacerbate this inequitable conduct.

Fourth, the Commenting Parties oppose the Proposed Rule because the NSCC fails to offer sufficient justification for the rule, therefore, creating a per se unnecessary burden on small broker-dealers. The additional burdens imposed on small broker-dealers are self-evident. Small broker dealers may be required under the Proposed Rule to deposit exorbitant amounts with the NSCC that could result in failures of otherwise viable small broker-dealers. The Proposed Rule also burdens small broker-dealers because it further exacerbates the problem of not being able to forecast their deposit requirements, thereby leaving small broker-dealers with uncertainty by not knowing whether the NSCC's daily deposit demands can be met. Failure to do so would result in a broker-dealer being removed from the NSCC's system, thereby preventing a firm from self- clearing its trades which, using Wilson-Davis and Alpine as examples, would reduce their net incomes by approximately 95% and 90%, respectively.

---

7 Troubled by the NSCC's application of its deposit requirements, Wilson-Davis and Alpine have made several requests to the NSCC that it disclose what assumptions, variables, and other factors the NSCC relies upon to establish the current deposit requirement. The NSCC has been uncooperative in providing those specific details.

8 The request for $1.5 billion, which was reduced at the request of Alpine because even the NSCC recognized the absurdity of that deposit request, raised another issue in how the current clearing fund formula is applied: the deposit the NSCC demanded has on many instances far exceeded the market value of the underlying stocks for which the NSCC sought the deposit. The justification provided by the NSCC to support its deposit requirements is that it is within its discretion to include volatility charges and "special" charges as part of its deposit requirements. Even if true, the NSCC should be limited in how it applies "special" charges by requiring such a charge bear a ***reasonable*** relation to the value of the underlying stock.

Despite the additional burden on broker-dealers that the Proposed Rule would create, the NSCC attempts to justify its actions with its conclusory assertion that the Proposed Rule "allows ... [it] to more effectively manage risk presented by certain [m]embers" and that, "[a]s such, it assures the safeguarding of securities and funds" in its control or for which it is responsible. *See* Proposed Rule § 6. As discussed below, the Commenting Parties believe the current system provides the NSCC the ability to adequately manage its risk. Thus, the securities industry deserves a better explanation of how this helps the NSCC safeguard securities and how the current deposit requirement fails to do that.[9]

Fifth, the Commenting Parties oppose the Proposed Rule because of its impact on capital formation. Smaller issuers and emerging companies, whose stocks often trade on the OTC, OTCBB, and on Pink Sheets, rely on brokerage firms such as Wilson-Davis and Alpine to assist the issuer with capital formation. For example, small issuers benefit from Wilson-Davis' and Alpine's abilities to offer these types of securities to investors who want to invest in small issuers and emerging companies. Further, small issuers benefit from Wilson-Davis' and Alpine's ability to maintain liquidity in many smaller issuers' equity securities through their market making activities. Moreover, small issuers often depend on firms such as Wilson-Davis and Alpine because (1) small broker-dealers will provide services to small issuers that large broker-dealer often will not, (2) small broker-dealers often can provide these services at better prices, especially considering (3) that small broker-dealers often have a particular acumen for assisting small issuers and experience in doing so – in part because the larger broker-dealers have pushed this business down to small to mid-size broker-dealers.

Before it should be allowed to impose such a burden on small broker-dealers, the NSCC should be required to provide evidence that objectively supports any purported reasons it now offers for requesting approval of the Proposed Rule. For example, what support does the NSCC have that the additional capital requirements in the Proposed Rule are needed? What support does the NSCC have to substantiate its contention that excess net capital is an accurate measurement of risk? Did the NSCC consider other methods to more effectively manage risk? Has the NSCC considered the impact that reducing the number of clearing firms would have on its risk? Has the NSCC considered the negative impact that the Proposed Rule would have on small broker-dealers? What support does the NSCC have that the Proposed Rule would ***not be*** an unnecessary burden on competition? Finally, has the NSCC considered whether it can adequately assess a firm's risk based on factors other than size and types of securities?

It is unlikely that the NSCC will provide the requested support because that would likely reveal that the current deposit requirement and the proposed additional deposit

---

[9] The Commenting Parties reject the idea that the Proposed Rule would allow the NSCC to more effectively manage risks because, rather than managing risk, the Proposed Rule uses the proposed additional deposit requirements as a prophylactic measure against and from every self-clearing broker-dealer below a certain excess net capital level.

requirement are, consistent with the NSCC's past practices,[10] arbitrary rules and therefore are an unnecessary burden on small broker-dealers. When an entity such as the NSCC has a monopoly granted it by law,[11] it is axiomatic that such an entity not abuse its discretion by imposing undue burdens on those that must comply with its rules. The United States Securities and Exchange Commission (the "SEC" or "Commission") cannot countenance this abuse of the NSCC's rulemaking authority.

B. Factors the Commission should consider when analyzing whether to adopt the Proposed Rule.

The Commission should only approve a proposed rule change of a self-regulatory organization ("SRO") when it finds that the proposed rule is consistent with the requirements of Title 15 and all other rules and regulations applicable to such organization. 15 U.S.C.A. § 78s(b)(2) (1996). Under Section 17A, a condition for approval of the Proposed Rule is that the rule must "not impose any burden on competition ***not necessary*** or appropriate in furtherance of the purposes of this chapter." 15 U.S.C.A. 78q-1(a)(3)(I) (1996) (emphasis added). In addition to assessing the Proposed Rule's burden on competition, the Commission must also consider the impact created by its adoption given that the NSCC's rules must be "designed . . . to protect investors and the public interest." 15 U.S.C.A. 78q-1(a)(3)(F) (1996). In analyzing whether the Proposed Rule is designed to protect the public interest, the Commission should factor in "whether the [proposed] action will promote efficiency, competition, and capital formation." 15 U.S.C.A. 78c(f) (1996). When an SRO's proposed rule does not on balance promote efficiency, competition and capital formation, the Commission should reject the proposed rule because it would be inconsistent with the SRO's requirement that its rules protect the public interest. If a proposed rule does not promote competition, that rule would be a per se burden on competition and therefore should be rejected by the Commission. The Commission should also reject the Proposed Rule because the deposit amounts requested by the NSCC are arbitrary. Moreover, the Proposed Rule would fail the Regulatory Flexibility Act (the "RFA") analysis because of its unjustified negative effect on small broker-dealers.

C. Commenting Parties' Arguments against the Proposed Rule.

The Proposed Rule should be rejected because it creates an *unnecessary* burden given that the NSCC's current rules provide it the tools it needs to adequately manage its risk. The Proposed Rule should also be rejected because it is not designed to protect the public interest in that it does not promote efficiency, competition, and capital

---

[10] *See, e.g.,* NSCC Proposed Rule Change: File No. SR-NSCC-97-7 (09/22/1997) (arbitrarily increasing capital requirement to what the NSCC considered to be a "meaningful level," which had no relation to the size of the firm). Any capital requirement that is an absolute value across all broker-dealers does not take into account a firm's size and is therefore a per se arbitrary decision.

[11] Pursuant to Section 17A of the Securities Exchange Act of 1934 (the "Exchange Act"), the Commission was directed to establish a national system for clearance and settlement of securities transactions. *See* 15 U.S.C.A. § 78q-1. The NSCC was created pursuant to this authority.

formation. To the contrary, the Proposed Rule will have an anticompetitive effect by harming smaller broker-dealers and, as a direct result, the investing community. Finally, the Proposed Rule should be rejected because the deposit amounts is seeks to impose are arbitrarily determined and would significantly impact small firms in contravention to the RFA.

1. The Proposed Rule would create an unnecessary burden on smaller broker-dealers because the NSCC's current rules allow it to adequately manage its risk.

The Proposed rule is unnecessary because the NSCC already has the ability to adequately manage its risks.[12] The NSCC can manage its risk through the premiums it charges – which are subjectively determined – in order to calculate the current deposit requirement. Furthermore, the NSCC has the failsafe of being able to require members on "Surveillance Status" to deposit any amount that it determines.[13] *See* NSCC Procedure XV, I.B. *Additional Clearing Fund Formula for Member on Surveillance Status.*

In addition to charging premiums to firms under surveillance, the NSCC charges risk premiums to its member clearing firms. For example, the NSCC charges a premium if a member firm trades in bulletin board or pink sheet stocks.[14] The premiums it charges include those for volatility and illiquidity. The NSCC even has the ability to charge a "special charge" premium whenever the NSCC deems appropriate.

In addition to its risk premiums, the NSCC admits it has other tools to better manage risk.[15] Even assuming that ***all*** of its risk management measures fail to detect an

---

12 Although the current system provides the NSCC adequate risk management tools, the NSCC seeks to completely ameliorate any and all of its risk by transferring that risk on all self-clearing firms under a certain level of excess net capital.

13 The Commenting Parties also want to know what factors the NSCC uses to determine when a firm is on surveillance status. Further, if a firm should be placed on surveillance status, under what circumstances a firm may be removed from surveillance status. This information is important because when, and if, the Proposed Rule is rejected by the Commission, the NSCC could subvert the Commission's denial of the Proposed Rule by the expedient of placing a firm on surveillance status and charging excessive and burdensome deposit amounts, the result of which could also force many small broker-dealers out of business.

14 These premiums appear to target small issuers, thereby having a disproportionately negative effect on smaller broker-dealers. Another issue that the Commenting Parties would like to bring to the attention of the Commission is that the NSCC applies premiums to these types of securities (*i.e.*, small issuers) in an arbitrary manner. For example, the NSCC charges these types of securities with illiquidity premiums even though many of these stocks are very liquid, particularly those in which Wilson-Davis and Alpine make a market. Similarly, it appears that the NSCC charges volatility premiums based on an issuer's size, not the volatility of its stock price.

15 *See, e.g., Clearance and Settlement*, at http://www.nscc.com/clearandset.html (last reviewed May 15, 2006) (the "NSCC guarantees and settles transactions between market professionals . . . in a manner that reduces risk;" the NSCC's guarantee that a trade will be completed once it enters the NSCC system

insolvent firm, the NSCC has admitted that "the size of the exposure due to the failure of any one of [the small member firms] is relatively small." *See* NSCC Proposed Rule Change, File No. SP-NSCC-97-7 (09/22/1997). Accordingly, because the NSCC can effectively manage its risk, and because smaller broker-dealers pose less risk due to failure, the Proposed Rule should be rejected given the unnecessary burdens it imposes on small broker-dealers.

2. The Proposed Rule does not promote the public interest because it will have an anticompetitive effect by harming smaller brokers and, as a direct result, consumers.

Many small broker-dealers would have difficulty meeting the NSCC's proposed additional deposit requirement. If small broker-dealers and clearing firms are unable to meet an NSCC deposit demand, they will no longer be able to clear trades through the NSCC. The NSCC appears unforgiving on this point.[16] If approved, the Proposed Rule would force many small broker-dealers to decide whether to cease operations or wait to receive a deposit demand which cannot be met.

If firms such as Wilson-Davis and Alpine are forced to cease operations because of the proposed additional deposit requirement, investors and small issuers will be negatively affected. Many investors rely on small broker-dealers to handle their investments because of the personal and face-to-face service provided by small broker-dealers. Additionally, many investors rely on small broker-dealers such as Wilson-Davis and Alpine because these firms typically do not have minimum deposit requirements in order to open an account to trade equity securities. The influx of capital from these smaller investors has contributed to capital formation, particularly for small issuers.

Thus, a reduction in small broker-dealers will also negatively effect capital formation. It would be more difficult for small issuers to raise capital given that many larger broker-dealers will not assist small issuers in raising capital (because smaller offerings, of course, do not offer the same financial incentives as larger offerings) or, alternatively, because larger broker-dealers are not equipped to do so cost effectively. Similarly, because firms such as Wilson-Davis and Alpine are often market makers (the purpose of which is to promote liquidity) for small issuers, market efficiency for those small issuers' securities would be negatively affected.

"eliminates risk in the unusual event that a firm becomes insolvent;" "the NSCC's Continuous Net Settlement (CNS) system reduces or nets down the total number of financial obligations requiring settlement, thereby further minimizing market risk").

[16] We know of at least one instance where the NSCC has threatened to remove a broker-dealer from its system if the deposit requirement was late a <u>second</u> time. To provide the Commission with an idea of how heavy handed the NSCC can be, in that instance, the <u>first</u> deposit demand was not timely met ***by hours*** because the bank responsible for transferring the funds to the NSCC experienced technical problems. The broker-dealer submitted a letter to the NSCC from the bank advising it of the same. In response, the NSCC admonished the broker-dealer that should that reoccur the broker-dealer would be removed from the NSCC system.

The Commenting Parties believe that under careful examination the Commission will determine that the Proposed Rule will negatively impact competition because of the rule's effect on investors and capital formation. Neither the brokerage community nor the investing community will benefit from the passage of the Proposed Rule and it should therefore be rejected.

3. The Commission should reject the Proposed Rule because it is an arbitrary and capricious exercise of the authority granted it by the Commission.

The Proposed Rule should be rejected under the arbitrary and capricious standard because the NSCC fails to offer any support for this measure. *See* 15 U.S.C.A. § 706 (a reviewing court should set aside agency action found to be arbitrary, capricious, or an abuse of discretion); *Higgins v. SEC*, 866 F.2d 47, 49 (2d Cir. 1989) (the Commission's approval of the NYSE's rule change should be reviewed for arbitrariness, capriciousness, and abuse of discretion). Nowhere in the Proposed Rule does the NSCC explain how the ratio of the clearing fund requirement to a member's excess regulatory capital was determined, why it is needed, or how it will allow the "NSCC to more effectively manage risk presented by certain members." *See* Proposed Rule Change, SEC Release No. 34-53671, File No. SR-NSCC-2006-03, p.5. Rather, the NSCC makes the blanket assertion that this ratio is an accurate measurement of risk without providing details. *Id.*

Another reason that the Proposed Rule must fail is because of its reliance on arbitrary amounts used to calculate the current deposit requirement as part of the equation used to calculate the proposed additional deposit requirement. The arbitrariness of the underlying numbers (*i.e.*, the current deposit requirement) makes calculations based on those numbers also arbitrary.

Under the formula used to calculate the current deposit requirement, the NSCC has seemingly unfettered discretion to require whatever deposits it deems appropriate.[17] The lack of explanation or clarification on how the current deposit requirement is calculated reveals a pattern of arbitrary amounts being imposed on clearing firms. These arbitrary amounts are then added together to calculate the current deposit requirement. To determine the proposed additional deposit amount, the Proposed Rule would add another arbitrary amount on top of that amount by dividing the current deposit requirement by the firms excess net capital (clearing fund requirement / excess net capital, which will result in an artificially high multiple if the current deposit requirement is inflated), and then multiplying that number by the excess net capital. ***Any ratio*** that uses the current deposit requirement as part of its formula is arbitrary and capricious

---

[17] *See, e.g., NSCC Rules and Procedures*, Rule 15 (providing the NSCC with the discretion to require additional amounts above the required clearing fund deposit "as the [NSCC] may at any time or from time to time deem necessary or advisable"); *NSCC Rules and Procedures*, Procedure XV, I.(A) (providing that the NSCC may impose a "special charge" in view of price fluctuations in or volatility or lack of liquidity of any security "based on such factors as the [NSCC] determines to be appropriate").

because of the arbitrariness used to calculate the current deposit requirement (*i.e.*, bad in = bad out).

The NSCC cannot show that the Proposed Rule is based on reason or fact as opposed to preference and convenience. Therefore, the Commission should not adopt the Proposed Rule.

4. The Commission should evaluate and reject the Proposed Rule because it has too negative of an impact on markets, broker-dealers, and consumers and too little support offered by the NSCC.

The Commission should consider the Proposed Rule in the context of the RFA, which applies to "agency" actions. *See* 5 U.S.C.A. §§ 603(a), 604(a). The RFA specifies that when a federal agency proposes to issue a covered rule, the agency must issue an initial and a final regulatory flexibility analysis, unless the agency determines that "the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities." *See* 5 U.S.C.A. §§ 603, 604, 605(b). Under that analysis, the Commission must assess the economic impacts of the proposed rule, the number of small entities the proposed rule will apply to, and regulatory alternatives that could reduce or eliminate unnecessary economic impacts. *See* 5 U.S.C.A. §§ 603, 604. The Commenting Parties believe that application of the RFA analysis would further support the reasons the Proposed Rule should be rejected.

In applying the RFA analysis, the Commission should consider the following:

i. The NSCC fails to offer a sufficient justification for the proposed rule change. The only objective that the NSCC has offered for the proposed rule is to allow the NSCC "to more effectively manage risk presented by certain members." *See* Proposed Rule Change, SEC Release No. 34-53671, File No. SR-NSCC-2006-03, p.5. But, the NSCC has failed to show how this formula works to effectively manage risk, or even that the formulas used to calculate the proposed additional deposit requirement is an accurate measurement of risk.

ii. The NSCC offers no explanation about how its current ability to manage risk is insufficient.

iii. We expect that the Proposed Rule will affect a significant number of small firms, whether directly if the broker-dealer self-clears or indirectly resulting from a broker-dealer's inability to utilize a clearing firm most congruent with that broker-dealer's needs.

iv. The Proposed Rule will create a significant economic burden on many small broker-dealers by increasing their clearing fund deposit requirements, often to amounts exceeding their net worth, which could result in failures of otherwise viable brokerage firms.

v. If the Commission were inclined to consider adopting the Proposed Rule, it should then also consider (a) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (b) the clarification, consolidation, or simplification of the deposit requirements for small entities; (c) the use of performance rather than design standards; and (d) an exemption from coverage of the Rule, or any part thereof, for small entities. *See, e.g.,* 5 U.S.C.A. § 603(c).

D. Conclusion.

For the reasons set forth in this comment letter, we respectfully request that the Commission not adopt the Proposed Rule. The NSCC makes no effort to support the need for the Proposed Rule despite (i) the unnecessary burden the Proposed Rule places on small broker-dealers, and (ii) the anticompetitive effect created as a result of the detrimental effect this rule would have on many small broker-dealers' abilities to continue their businesses, thereby negatively effecting capital formation and smaller investors.

Sincerely,

Greggory A. Teeter

cc: David A. Greenwood
Meghan H. Vernetti
Rod N. Andreason