Cheryl T. Lambert
Managing Director
Risk Management
TEL. (212) 855-3600
FAX (212) 855-4936

DTCC
The Depository Trust & Clearing Corporation
55 Water Street
New York, NY 10041-0099
Clambert@dtcc.com

July 28, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: **File No. SR-NSCC-2006-03 and SR-FICC-2006-03**
Securities and Exchange Commission ("SEC" or the "Commission") Release No. 34-53671 (April 18, 2006)

Dear Ms. Morris:

National Securities Clearing Corporation ("NSCC") and Fixed Income Clearing Corporation ("FICC") appreciate the opportunity to respond to the adverse comment letters submitted by Schonfeld Securities LLC ("Schonfeld")[1], HOWREY LLP ("Howrey", representing Wilson-Davis & Co., Inc.("Wilson-Davis"), Alpine Securities Corporation ("Alpine") and the International Association of Small Broker-Dealers and Advisers ("IASBDA"))[2], Man Securities Inc. ("Man")[3], LaBranche Financial Services, Inc. ("LaBranche")[4], and the IASBDA[5], with respect to the above captioned rule filings (collectively, the "Filings"). Schonfeld, Wilson-Davis, Alpine and LaBranche are full-service Members of NSCC. Man is a Netting Member of FICC's Government Securities Division (the "GSD"), and a Member of NSCC. Each of these firms is a registered broker-dealer. The IASBDA appears to be a recently organized trade association, whose stated mission is to focus on the "disproportionate regulatory burdens on the small business community that is discouraging investment in small businesses".[6]

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[1] E-mail from Jim Nardone to rule-comments@sec.gov, dated May 5, 2006.
[2] Letter from Greggory A. Teeter to Nancy M. Morris, dated June 1, 2006.
[3] Letter from Richard Gill and Donald Galante to Nancy M. Morris, dated May 15, 2006.
[4] Letter from L. Thomas Patterson and Kathleen M. Toner, Esq. to Michael Milone, dated May 18, 2006.
[5] E-mail from Peter Chepucavage, Esq. to rule-comments @sec.gov, dated May 19, 2006.
[6] See www.plexusconsulting.com.

Since the Filings are substantially the same, and the commenters raise a number of similar objections, NSCC and FICC collectively respond to their comments as set forth below.[7]

Background

The Filings seek to impose a clearing fund premium on NSCC's and FICC's GSD members based upon the ratio (the "Ratio") of the member's clearing fund requirement to its capital (as measured, with respect to broker-dealers, by their excess net capital and, with respect to banks, by their equity capital) (for ease of reference, collectively referred to in this letter as "EC"). NSCC and FICC believe that the degree to which a member's clearing fund requirement compares to its EC is an important indicator of the potential risk that the member presents to the clearing corporation (and thereby it's other members). Determining a member's risk profile by reference to the size of its calculated clearing fund requirement is appropriate, given that the greater the potential exposure NSCC and FICC have with respect to guaranteed open transactions, the greater the member's required deposit should be. Similarly, a member's EC (the ratio's denominator) is a reasonable indicium of the member's creditworthiness. So when a firm presents transactions for clearance and settlement through the clearing agency in an amount that its risk profile indicates is not supported by its EC, the firm is in essence relying on the clearing corporation's other participants to support its business: should that firm fail, it would fall to the clearing corporation to close out the failing firm's open positions, assuming the risk of loss in doing so. Should the failing member's clearing fund deposit be *insufficient* to cover any such loss, then that loss would be borne by the clearing agency's *other members*, from their collective clearing fund deposits, and as loss allocations, allocated and assessed in accordance with NSCC's and FICC's respective rules.[8]

The proposed premium will be determined by multiplying the amount by which a member's Clearing Fund requirement (determined prior to the imposition of the proposed premium) exceeds its EC, by the member's Ratio, expressed as a percent. When the ratio exceeds 1.0, the premium would be imposed. The formula thus allows the premium to increase or decrease in proportion to changes in the ratio, resulting in a charge measured in proportion to the risk presented.

By way of background, the proposed premium grew out of the wind-down of Refco Securities LLC ("Refco"), formerly a registered broker-dealer and member of NSCC, The Depository Trust Company, and both Divisions of FICC, that took place from mid-October through December, 2005. On October 12, 2005 (the day that Refco's parent company filed for bankruptcy protection), the potential risk to the overall settlement process for various securities markets posed by a Refco failure was significant: indicated by the fact that its open positions pending settlement across NSCC and FICC

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[7] NSCC and FICC are both wholly-owned subsidiaries of The Depository Trust & Clearing Corporation ("DTCC").

[8] See, *eg*, NSCC Rule 4, sections 3-5 and FICC's GSD Rule 4, section 8.

totaled well over $200 billion. At that time, and as reported in the press, Refco was highly leveraged; both its regulatory and excess capital were substantially less than its clearing fund requirements.

Then, as currently, FICC's GSD imposed a collateral premium of 25% on a member whose ratio of clearing fund to EC was greater than 1. The Refco experience showed, however, that a 25% premium was not sufficient to encourage member firms to maintain reasonable capital levels, given the amount of risk their business brings to the clearing corporations. The proposed premium is designed to remedy just that situation, and prevent firms from leveraging up their business to a potentially infinite level through the clearing agencies, without adequate capital.

As it happened, Refco determined to wind-down its activities, and DTCC helped manage the wind-down of the pending positions at the clearing agencies with the cooperation of Refco management. With the wind-down process now complete, however, NSCC and FICC, with the approval and support of their respective user-representative Boards, seek to impose the proposed collateral premium to protect the clearing agencies and their members and minimize the systemic risk that a Refco-type situation presents.

Rebuttal of Specific Points

1. The proposed rule would disproportionately impact smaller firms.

The commenters argue that the proposed rule would disproportionately impact smaller firms:

- "The additional deposit requirements as indicated in said rule actually can create an [sic] cash issue for a smaller to medium size firm and could result in inability to satisfy their obligations thereby..." (Schonfeld).

- "[T]he Commenting Parties oppose the Proposed Rule because, as applied, it would cause a disproportionate burden on small broker-dealers..." (Howrey).[9]

[9] The Howrey letter goes on to argue that the disproportionate impact on smaller broker-dealers arises from the application of NSCC's clearing fund formula, given the types of securities that its clients, Alpine and Wilson-Davis (and, presumably other small broker-dealers) clear through NSCC, and because it is more likely that the smaller broker-dealers make markets for microcap issuers. Granted, NSCC's Clearing Fund formula, as set forth in Procedure XV of its Rules & Procedures, (i) does include specific charges for transactions in illiquid securities that break certain parameters (*i.e.* "special charges"), (ii) applies a fixed haircut (rather than a formula-driven volatility charge) on bulletin board and pink sheet securities, as there is not sufficient historical price data for these types of securities to accurately calculate a volatility charge, and (iii) applies a charge for market-maker domination to cover the additional risk of liquidating a dominant position should the market-maker fail. These components are applied to all members. Howrey concludes: "the NSCC's presumptions that a firm's size and the type of securities it clears through the NSCC are accurate indicators of a firm's risk cannot be supported...." It is difficult what to make of this argument, particularly when these types of risk mitigants represent standard risk management practices in the financial services industry, and have been approved by the Commission as

- "We believe that a disproportionate share of the burden of this Proposal and the risk and potentially catastrophic premium requirements fall on the lower capitalized Members and as a result the proposal is anticompetitive." (Man).

All of these statements mischaracterize the nature of the premium. It does not target smaller capitalized firms, as it is ratio based and it applies to all members equally. Rather, the proposed premium's application is a function of the trading business a member brings to the clearing agency, not the size of its EC. Essentially, the commenters view clearing agency membership as including the inherent right to transfer to the clearing agency and its other members an unlimited amount of credit risk associated with its trading positions. This is absolutely not the case. The remedy for the concerns raised by the commenters is for a member's capital to be maintained at a level commensurate to the business they are doing and the risk that business presents.[10]

2. The proposed rule would have an anti-competitive effect.

Howrey paints a doomsday scenario whereby it asserts (without any substantiation) that because smaller firms may not have sufficient capital to be able to pay a clearing fund premium, they will therefore go out of business, thereby leaving microcap issuers high and dry with no one to act as their underwriters and market-makers providing liquidity for their issues. This argument is misplaced.

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part of a prudent risk management framework. We would also note that these types of charges (particularly market-maker domination) were added to NSCC's clearing fund formula *as a direct result* of member failures, most notably the failure of Adler, Coleman Clearing Corp. in 1995.

[10] Howrey also argues that NSCC's Clearing Fund calculation is arbitrary and subjective, and seeks specific details as to how the formula set forth in Procedure XV is calculated. As support for the purported "arbitrariness" of the formula, Howrey cites a clearing fund request for $1.5 billion, which they claim was reduced "at the request of Alpine because even the NSCC recognized the absurdity of that deposit request. . ." (Howrey, at p. 4.) This statement is deliberately misleading. The incident Alpine refers to occurred on January 23, 2006, when the system had an incorrect price for a particular CUSIP (the issue had undergone a stock split, but the pre-split price had not been adjusted). As margin requirements are calculated on a straight through processing basis and automatically sent to members overnight, the system generated requirements are reviewed by Risk Management staff upon their arrival early in the morning. Upon review of the requirements that morning, staff identified large charges for a number of firms, and researching the matter determined they were the result of the incorrectly priced security. Thereupon they promptly notified *all* participants affected by the incorrect price, and manually adjusted their deposit requirements accordingly (irrespective of whether Alpine actually called or not).

With respect to the basis on which the formula is calculated, it is formula-based using specific objective criteria that is systemically calculated. So, for example, the special charges component is calculated based upon a number of factors—including average daily volume of the issue, its price, the size of the unsettled position the firm has in the security, and whether that position is long or short. In order for any member to incur such a charge, a number of parameters must first be broken. Risk Management staff has offered, and remains available, to meet with Alpine, Wilson-Davis, and any other member, to discuss the mechanics of the clearing fund formula and the basis, or cause, for particular charges.

We note that while NSCC currently has approximately 221 full service broker-dealer members, and FICC has 61 broker-dealers as members of its GSD, there are over 6000 broker-dealers currently registered with the SEC. Competition among broker-dealers is, and remains, robust, and nothing in the Filings acts as a barrier to entering the brokerage business.

Moreover, nothing in the Securities Exchange Act of 1934, as amended (the "Act") provides broker-dealers with an absolute right to be a direct member of a registered clearing agency. Membership in NSCC and FICC has always been voluntary. Clearing agencies are required to adopt prudent risk management policies and procedures, which include minimum membership standards, ongoing monitoring and review of members, and the collection of clearing fund/margin. Over the years as the securities markets and financial services industry have changed and evolved, so have the clearing agencies' risk management policies and requirements in response to such changes. (The fact that these requirements have so changed does not per se make them arbitrary.)

A member firm that is potentially affected by the proposed collateral premium has a number of options open to it: First, should it wish to remain a member of the relevant clearing agency, it can either retain or raise additional capital relative to the business it proposes to conduct and clear through the clearing agency. Second, if it doesn't deem this a viable approach, it can limit its business that it clears through the clearing agency, so that the risk to which the clearing agency and its members is exposed based upon such business is proportionate to the firm's actual EC. Finally, a broker-dealer always has the choice of seeking another firm through which to clear its business.

All of the commenters conveniently ignore the option of either raising or retaining additional capital in their businesses. They also imply that the last alternative—clearing through others--is neither attractive nor realistic, because it may be more expensive and because clearing firms maintain their own risk management policies which include collecting margin and placing limits on the type of business that can be cleared through them. Essentially Howrey and the IASBDA argue that the clearing agencies should not be able to avail themselves of the same prudent risk mitigants that the clearing firms use. We fail to see the logic of such an argument.[11]

3. A fund similar to that used by SIPC should be used.

Recognizing the validity of the concerns NSCC and FICC seek to address by imposing the premium, LaBranche and Schonfeld argue that in lieu of the proposed premium, the clearing agencies (or perhaps the Federal government), should adopt some sort of

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[11] In fact, most firms' risk management policies include counterparty trading limits. If clearing agencies did not exist, firms would impose more stringent trading limits on their counterparties, or likely would not do business with those they deemed present too great a credit risk. Given that NSCC and FICC do not impose net debit caps, NSCC and FICC believe the premium is a reasonable response.

"general fund, quite similar to a SIPC or FDIC model…"[12] Given that members should be well aware that the clearing agencies maintain a clearing fund comprised of the aggregate deposits of their respective members, we do not understand this comment. The Clearing Fund exists precisely as the means of mutualizing the risk that any given member presents as a result of its business, should it fail and the clearing agency be required to close out and assume the risk of loss on those positions. It is thus unclear whether the commenters want another agency to collect additional fees or a separate fund, or whether these firms are in fact unaware that they themselves are potentially subject to assessment should another member fail, causing losses to the clearing corporation in excess of the defaulting member's clearing fund deposit. In either case, these firms are asking for some entity (be it the Clearing Fund or a new SIPC-type fund) other than themselves to bear the risk of their businesses, by shifting the credit risk from the broker-dealer to NSCC (or FICC, as applicable) and its membership at large.

4. Current risk management tools are adequate to protect NSCC. Current minimum net worth requirements have provided adequate protection to FICC.

Both Man and Howrey contend that the existing tools available to FICC and NSCC - - the net worth requirement at FICC, and the ability to collect additional clearing fund at NSCC for members on surveillance - - are sufficient to address counterparty risk. Man further argues that the proposed premium has no correlation to underlying collateral, but rather appears simply to be a deterrent "to clearing in the FICC".

In response to Man's argument—the clearing agencies believe that the Refco case itself provides the best example of why mere capital requirements are not sufficient protection against counterparty risk, particularly in an environment where trade submission is not linked to capital levels. Moreover, a mere net worth requirement does not in and of itself address the nature of the business that the member presents to the clearing corporation and its other members. The clearing agencies acknowledge that the objective of the proposal *is* to discourage activity that is not adequately supported by a member firm's capital.

With respect to NSCC, Howrey correctly notes that NSCC has the ability to collect additional clearing fund deposits (pursuant to Rule 15) should it deem circumstances warrant. And while we concur that Rule 15 could, perhaps, be used as a basis on which to charge an occasional clearing fund premium to cover the perceived systemic risk sought to be addressed in the proposal, the clearing agencies' management, and its user-representative board, have determined to address the charge systemically and include the premium as a stated additional charge, in an effort to be clear to members about the types of activity and risks they are trying to discourage.

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[12] Schonfeld e-mail.

5. Management's discretion to charge an amount less than the calculated premium is too vague.

NSCC and FICC recognize, as the commenters point out, that there *will* be circumstances where imposing the premium on a member is not necessary, or may result in unintended consequences. It is precisely for these reasons that the proposed rule provides the clearing agencies with the discretion to either forgo collection of the premium, or to collect a lesser amount. Of the commenters, only Man objects to this discretion, suggesting that the proposed rule should contain specific guidelines with respect to who at NSCC and FICC may grant exceptions to the collateral premium requirement, and the criteria, circumstances and procedures for exercising such discretion.

The discretion to reduce or eliminate the collateral premium requirement will be exercised by those officers of NSCC and FICC who, at the relevant time, are in the best position to assess (i) the risk presented by the particular member to the clearing agency, other members and the system, and (ii) whether there exist any facts or circumstances that merit action to modify the requirement. It would be contrary to the principle and purpose of discretion to require that NSCC and FICC adopt, in advance of the event, detailed criteria, circumstances and procedures for exercising such discretion—particularly given that these situations are likely to be very fact and circumstances driven. In this connection, it should also be noted that the discretion that NSCC and FICC may exercise under the proposed rule is discretion to reduce or eliminate -- and not discretion to increase -- the formula-generated collateral premium. As a result, such discretion can only ameliorate the financial impact of the proposed rule on members. This kind of discretion is not something that should have to be narrowly circumscribed for the protection of members -- and it certainly is not the kind of discretion that should be objectionable to Man.

Nevertheless, in an effort to address appropriate concerns that we understand members have, the clearing agencies have determined the following:

First, the proposals will be amended to clarify the following general calculation principles:

- With respect to FICC GSD Members, the premium will be calculated without reference to the alternative minimum look back provisions of the GSD clearing fund formula's Receive/Deliver and Repo Volatility components. Thus the Average Post Offset Margin Amount ("POMA") and the Average Repo POMA (as defined in FICC's procedures) will not be used. Excluding these provisions will oftentimes provide relief to members whose current portfolios yield lower clearing fund requirements than their look back would suggest.[13]

[13] FICC expects to eventually move to a Value-at-Risk model in order to calculate base clearing fund requirements. VaR does not utilize alternative minimum look back calculations.

- With respect to NSCC Members, in calculating the premium NSCC will not take into account either (i) market-maker domination charges, or (ii) special charges, that are imposed on a member as part of its base requirement. This is because we recognize that these types of charges provide an additional reserve in the base requirement against the risk of those positions that trigger the charges.

In addition, NSCC and FICC have identified the following guidelines or circumstances (which are intended to be illustrative, but not limited) where management has agreed that the imposition of the proposed premium is not warranted:

- With respect to NSCC, the premium will not be imposed where the premium results from base clearing fund charges imposed on municipal securities trades settling in CNS, where the member has offsetting compared trades settling on a trade-for-trade basis though DTC.

- With respect to both clearing agencies, management will look to see whether the premium results from an unusual or non-recurring circumstance, such as the late submission of trade data for trade recording or comparison that would reduce the margined position. In such circumstances management believes it would not be appropriate to assess the premium.

These guiding principles will be incorporated in the Filings and in internal procedures used by DTCC Risk Management. However, NSCC and FICC do not believe that it is practical or appropriate to enumerate at this time specific criteria for applying their discretion beyond these broad indicators. Nor do we agree, as expressed by Man, that the "ability to grant exceptions based on subjective judgments in undefined circumstances will undermine [the confidence of members in the margin process] and therefore the stability of the system". NSCC and FICC are user-owned and operated industry utilities with a long and unblemished history of exercising discretion responsibly and impartially for the good of individual members and the protection of their collective business. Rather than undermine confidence in the margin process, the ability of NSCC and FICC to use discretion in appropriate circumstances to avoid any unintended consequences of the general rule is something that promotes confidence in the margin process -- and that the outcome of the process will reflect a realistic balancing of the needs of the clearing agency and the interests of individual members.

Conclusion

As the foregoing discussion has set forth, the issues presented in the Filings are of great importance to NSCC and FICC, the securities markets they serve, and their respective members. NSCC and FICC respectfully request that the Commission approve the Filings (upon their amendment as discussed above), as we believe that they satisfy all of the factors that the SEC must consider in approving a clearing agency rule filing.

Should you have any questions, please do not hesitate to call me at (212) 855-3600, or Larry E. Thompson, DTCC General Counsel, at (212) 855-3240.

Very truly yours,

Cheryl Lambert

cc: Jerry Carpenter, Securities and Exchange Commission
Jim Nardone, Schonfeld Securities, LLC
Greggory A. Teeter, Howrey LLP
Richard Gill and Donald Galante, Man Securities Inc.
L. Thomas Patterson and Kathleen M. Toner, Esq., LaBranche Financial Services, Inc.
Peter Chepucavage, IASBDA