MEMORANDUM

To: Files

From: Hester Peirce

Re: Proposed Rule: File No. SR-NSCC-2006-04: Notice of Filing of Proposed Rule Change Relating to Trade Submission Requirements and Fees and Pre-Netting

Date: September 19 2006

On September 14, 2006, Donald Donahue and Larry Thompson of the Depository Trust and Clearing Corporation met with Commissioner Paul Atkins and Hester Peirce, counsel to Commissioner Atkins. They discussed issues related to NSCC's proposed rule change. An outline of the discussion is attached.

DTCC

The Depository Trust &
Clearing Corporation

Proposed NSCC Rule Change

File No. SR-NSCC-2006-04 –

- Mandates real-time trade submission for original trade data
- Establishes rules prohibiting all forms of pre-netting
- Introduces rules clarifying the acceptable use of correspondent clearing
- Restructures NSCC's fee schedule for Trade Recording

Purpose of Proposed NSCC Rule Change

- Mandates real-time capture of trade input to support Business Continuity Safe Store at NSCC
- Establishes fair and consistent pricing for all participants and across markets
- Differentiates trade recording and position movement services
- Effectively supports the growing trend toward smaller trades

Focus on "Pre-Netting" Aspects of Filing

- **Practice of "pre-netting" is found today among <u>some</u> OTC trading platforms.**

- **Pre-netting today results in delays – often until end-of-day – in trade reports to NSCC.**

- **These delays today impact NSCC's business continuity posture and intra-day risk monitoring.**

- **Further spread of this practice would dramatically worsen these effects.**

9/11 Crisis in the Fixed Income Markets

- At the time of the 9/11 terrorist attacks, the equity markets had not yet opened, so significant trading had not begun.
- In contrast, in the U.S. Treasury market substantial trading had already occurred by 8:45AM that morning:
  - $500 billion in repos
  - $80 billion in cash market trades

9/11 Crisis in the Fixed Income Markets

- Once the attacks occurred 8 out of 9 inter-dealer brokers (IDBs) lost communication with the clearing corporation.
  - Most IDBs lost voice trades
  - Most IDBs could not submit trades the next day
- The IDBs lost approximately 7,500 trades with market value of $170 billion.
- A comparable loss of data in the equity markets would involve over 1 million trades with a value over $25 billion dollars.

9/11 Crisis in the Fixed Income Markets

- **In response to the loss of data on U.S. Treasury securities trades following the 9/11 attack:**
  - **The standard trade settlement period for these securities had to be lengthened twice, with the longer period remaining in effect for weeks after the attacks.**
  - **The clearing corporation, the IDBs and participants spent months recreating lost trades and reconciling positions and money settlements.**
  - **Notwithstanding these efforts participants still incurred significant financial losses (to an unknown amount) due to trades that could not be reconstructed.**

9/11 - The New BCP Paradigm

- **Consistent with the *Interagency Sound Practices* paper mandate for "core clearance and settlement organizations," DTCC implemented:**
  - **Out-of-region data processing capabilities, supporting remote safe storage of data and two-hour recovery of data processing (and providing capacity to process three times peak volume)**
  - **An out-of-region business center capable of carrying out all key DTCC functions in the event of loss of the primary business center**

- **DTCC invested significant industry resources to implement this strengthened business continuity configuration.**

FICC's Move to Real-Time Trade Input

- Since 9/11 the fixed income markets have embraced real-time trade input.

- FICC now receives most of its trade recording data real-time:
  - Government Debt Securities – 97%
  - Corporate Bonds, Municipal Bonds and Unit Investment Trusts – 97%
  - Mortgage-Backed Securities – 94%

- FICC received SEC approval (June '05) to prohibit pre-netting for GSD trades.

NSCC's Move to Real-Time Trade Input

- NSCC initiated a move to real-time input in 2000, preparing for adoption of a T+1 settlement cycle for equities:
  - NYSE, Amex and Nasdaq currently submit real-time (58% of total trade data)
  - ARCA is testing real-time submission (12% of total trade data)
  - All others – regional exchanges, ECNs, ATS, etc. – submit trades either multi-batch or end-of-day (30% of total trade data)

Business Continuity Risks

- NSCC's remote safe storage of all trade data submitted in real-time helps to support orderly clearance and settlement in the event of a disaster.
- On a typical day over 930,000 trades are reported to NSCC after 5PM. Many of these trades were executed earlier but held back for pre-netting; therefore, the actual number of trades is much higher.
- Reconstructing these trades (analogous to what had to be done in the fixed income markets post 9/11) likely would be impossible.

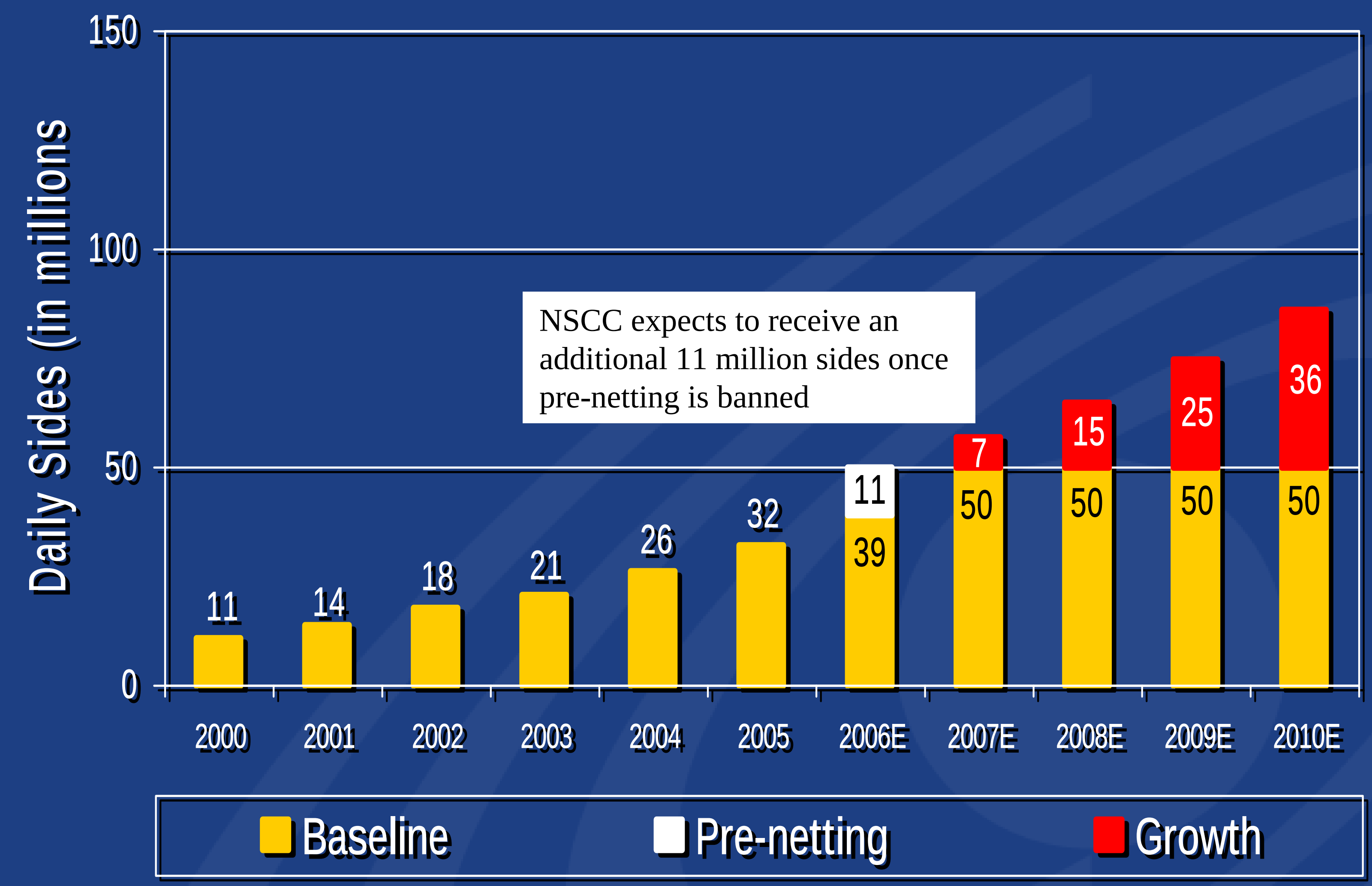
Additional Reasons for Eliminating Pre-Netting Practices

- **Pre-netting masks intraday trading patterns that expose NSCC to unknown risks.**

- **Participants who support the industry's business continuity needs by submitting in real-time and not pre-netting pay higher fees for the same service and may suffer a competitive disadvantage.**
  - **The cost savings of pre-netting is becoming a competitive tool for certain OTC trading platforms.**

- **Shortening the settlement cycle or adopting an earlier trade guaranty will become difficult – if not impossible – if pre-netting and the associated delays in trade reporting are deemed permissible.**

Projected Growth in NSCC Average Trade Sides



New vs. Existing Fee Schedule

	New Fee Model	2006 Current Rates	3rd Party Clearing Fees
NSCC Clearing Fees	Approximately $.009 to $.01 per trade side	Approximately $.016 to $.017 per trade side	Unknown

- NSCC provides annual rebates and reduces fees based on usage

Benefits of New Fee Structure

- New fee structure shifts from a trade-based model to trade-value-based model:
  - Fee structure reflects value of the netting and guaranty services
  - Fee structure limits growth rate of NSCC's revenues since fees are no longer based solely on transaction count
- Change in fee structure is revenue-neutral to NSCC:
  - Anticipates 30% growth in trade sides offset by comparable decline in fees

Clearing Fees External to NSCC

- The clearing and service bureau businesses are vibrant and competitive:
  - Approximately 25 clearing firms
  - Approximately 10 service bureaus
- Clearing firms and service bureaus use various fee structures:
  - Annual flat fee
  - Charge per CUSIP (security)
  - Charge per ticket
- Clearing firms and service bureaus will adjust their fee structures or lose business to competitors.

Summary

- The rule change improves the safety and soundness of the U.S. capital markets by safeguarding the industry's extensive investments in business continuity capabilities (and actually somewhat increases the benefits realized).
- Competition would continue to flourish in the U.S. capital markets.
- NSCC's fee structure will more fairly allocate its costs among participants.
- Obstacles to further improvements in clearance and settlement would be eliminated.