9

DTCC

Larry E. Thompson
General Counsel

August 18, 2006

Tel: 212 855 3240
Fax: 212 855 3215
lthompson@dtcc.com

The Depository Trust & Clearing Corporation
55 Water Street
New York, NY 10041-0099

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

RECEIVED
AUG 2 3 2006
OFFICE OF THE SECRETARY

Re: **File No. SR-NSCC-2006-04**
Securities and Exchange Commission ("SEC" or the "Commission")
SEC Release No. 34-53742 (April 28, 2006)

Dear Ms. Morris:

National Securities Clearing Corporation ("NSCC") appreciates the opportunity to respond to the adverse comment letters submitted by GETCO, LLC ("GETCO")[1], Wedbush Morgan Securities, Inc. ("Wedbush")[2], Knight Capital Group, Inc. ("Knight")[3], UBS Securities LLC ("UBS")[4], Automated Trading Desk, LLC ("ATD")[5], Tradebot Systems, Inc. ("Tradebot")[6], BB&T Asset Management ("BB&T")[7], and BNY Brokerage Inc. ("BNY")[8] with respect to NSCC's rule filing SR-NSCC-2006-04 (the "Filing"), in which NSCC is proposing to modify its trade submission practices to require that all locked-in trade data submitted to NSCC for trade recording be submitted on a real-time basis, and to prohibit "pre-netting" practices that preclude real-time trade submission. The Filing also establishes a new fee model for equity trade recording and clearance services.

Of the commenters, only Wedbush, UBS and BNY are Members of NSCC. GETCO, Knight, ATD and Tradebot are broker-dealers who are not NSCC Members, but rather clear their business through NSCC Member clearing firms (Knight clearing through Merrill Lynch, ATD clearing through BNY, and GETCO and Tradebot clearing through Wedbush) and BB&T is an investment manager. Since the commenters raise a number of similar objections, NSCC responds to their collective comments as set forth below.

I. Executive Summary

[1] Letter from Stephen Schuler to Mr. Johnathan G. Katz, dated May 9, 2006.
[2] Letter from R. James Richards to Mr. Jonathan G. Katz, dated May 25, 2006.
[3] Letter from Leonard J. Amoruso to Ms. Nancy M. Morris, dated May 30, 2006.
[4] Letter from Matthew Price to the Chairman and Commissioners of the SEC, dated May 30, 2006.
[5] Letter from Steve Swanson to Ms. Nancy M. Morris, dated May 30, 2006.
[6] Letter from Robert Alumbaugh to Ms. Nancy M. Morris, dated June 5, 2006.
[7] Letter from Keith F. Karlawish to Ms. Nancy M. Morris, dated June 6, 2006.
[8] Letter from Barclay M. Frey to the Chairman and Commissioners of the SEC, dated June 9, 2006.

NSCC's Filing would modify NSCC's Rules & Procedures to require that all locked-in trade data submitted to NSCC for trade recording be submitted on a real-time basis. Consistent with this requirement, the Filing also seeks to eliminate "pre-netting" practices that preclude real-time trade submission, and establish a new fee model for equity trade recording and netting services.

NSCC believes that, contrary to the assertions of the commenters, the Commission may reasonably determine that the adoption of the proposals covered in the Filing would

(i) significantly reduce the operational and systemic risk that results from trade data not being submitted real-time, especially from firms that delay trade submission so as to pre-net their trade data to reduce clearance fees, and
(ii) not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

NSCC is user-owned and governed; it operates on a not-for-profit basis, retaining only those revenues necessary for operations, development, or as otherwise determined by its user-representative Board. Its fees are set at a level designed to cover estimated costs, and excess revenues are returned to participants in the form of discounts or rebates. The proposals encompassed in the Filing were reviewed and approved by NSCC's Board, through its Operations and Planning Committee. As a user-owned industry utility, it is absolutely appropriate for the Board to determine how to address perceived operational and systemic risks, and how to allocate the costs of its services, so long as fees are reasonable and allocated among NSCC participants fairly and equitably. The proposed fees more than meet that standard.

All of the comments essentially boil down to the following complaint: Those firms who currently pre-net (whether through trade compression, summarization, or otherwise) [9] and who have objected to the Filing will generally pay higher fees under the new structure than they do currently. Thus, in these commentators' view, this renders the proposal by definition "anti-competitive". However, enabling participants to persist in this practice permits them to continue to evade paying their fair share of NSCC's costs, thus rendering NSCC's fee schedule, as currently applied, inequitable to those firms for whom trades are submitted real-time without any pre-netting. Ultimately, if the Filing is not approved, then the pre-netting practices it seeks to prohibit will in all likelihood become significantly more widespread. This will not only exacerbate the operational and systemic risks which the Filing seeks to address, it will also eliminate any supposed competitive advantage currently enjoyed by those firms who complain that the proposals are anti-competitive. It will also make it effectively impossible for the industry ever to move to a shortened securities settlement cycle, since it would lock in

[9] Summarization is the practice of combining like-sided trades by executing/correspondent broker, and compression is the practice of combining like-sided trades by clearing broker. While NSCC is not aware that firms are actually netting opposite-side trades prior to their submission to NSCC, the proposal seeks to prohibit all forms of "pre-netting" for trades ultimately submitted to NSCC for clearance and settlement.

place a practice of delaying input to the clearing corporation until late in the trading day.

II. Background

The Filing would modify NSCC's Procedure II (Trade Comparison and Recording Service) to require that all locked-in trades submitted for trade recording by self-regulatory organizations (exchanges and marketplaces) and Qualified Special Representatives ("QSRs") be submitted on a real-time basis. In this context, the term "real-time" means the submission of such data on a trade-by-trade basis promptly after trade execution, in any format and by any communication method acceptable to NSCC. Consistent with this requirement, the proposal also seeks to eliminate pre-netting practices that preclude real-time trade submission.

The purpose of this requirement is to reduce systemic and operational risk, particularly business continuity risk: Requiring real-time submission of locked-in trade data reduces operational risk and promotes business continuity by promoting redundant safe storage of transaction data at the clearing agency level. Without real-time submission, should an event occur after trade execution that disrupts trade input (the so-called "9/11 risk"), trade data could be significantly delayed in submission or even lost completely.

The experience of the Government Securities Clearing Corporation (the predecessor to the Fixed Income Clearing Corporation ("FICC"), NSCC's affiliate clearing agency for the government and mortgage-backed securities markets) following the events of 9/11 illustrates the importance of this requirement: While the equity markets had not yet opened by the time the World Trade Center was attacked, substantial trading in the government securities markets had already occurred, including approximately $500 billion in government repos, and $80 billion of transactions in the cash markets. Following the attacks, 8 out of 9 inter-dealer brokers lost communications with GSCC, and could not submit data on trades that had already been executed; since the offices of several of the major inter-dealer brokers were destroyed in the collapse of the Trade Center, the brokers' data on thousands of these trades were lost completely.

To facilitate an orderly settlement process and mitigate the potential for enormous systemic risk associated with thousands of unmatched trades, GSCC initiated a massive reconciliation effort covering over 2,000 broker trades valued at over $70 billion, based on the presumption that the dealer counterparty submissions received by GSCC were accurate. Even so, GSCC and its participants spent months reconciling positions and money settlements, and the final amount of participant losses remains unknown.

Since that time, the marketplace for governments, mortgage-backed securities and municipal securities has embraced real-time trade input, providing trade data to the clearing agencies for trade comparison on a real-time basis.[10] The great majority of

[10] In June of 2005, the Commission approved FICC's proposal (in SR-FICC 2004-15) to prohibit pre-netting practices for FICC's Government Securities Division trades. Securities Exchange Act Release No. 34-51908 (June 22, 2005), 70 FR 37450 (June 29, 2005).

corporate bond transactions are also submitted in real-time, and by year end we expect that all corporate bond transactions will be submitted in this manner. With respect to equity securities, in 2000 NSCC embarked on a program with the relevant marketplaces to voluntarily move them to real-time trade submission. The NYSE, American Stock Exchange and Nasdaq Stock Market currently submit their trade data[12] real-time. As of May 2006, this accounts for approximately 58% of the equity trade data. In addition, Archipelago Exchange is currently testing real-time submission of trade data, which would account for approximately another 12% of the equity trades. The remaining markets – the regional exchanges and QSRs (submitting on behalf of automated execution systems) – currently submit their trades either on a multi-batch basis, or at the end of the day. Collectively these trades represent approximately 30% of the total daily equity trades submitted.[13]

In 2006 on an average day, NSCC receives over 15.5 million transaction sides in batch format, and typically over 930,000 transactions are received after 5 p.m. Many of these transactions are pre-netted (that is, trades may be summarized or compressed prior to their submission to NSCC) and thus the actual number of trades is much higher. Should a significant market disruption event occur prior to NSCC receiving this trade data, it would likely be impossible for NSCC to reconstruct this volume of trades as was done in the fixed income market on a much more limited basis after 9/11. Moreover, the same concern arises if a marketplace or QSR sustains a significant operational disruption, particularly where a correspondent firm is compressing trade data with respect to its trading partners before providing that data to its clearing firm. If either entity suffers an operational disruption, the clearing firm would not have the data with respect to those compressed trades. NSCC's safe storage of real-time trade data helps assure the orderly clearance and settlement of trades should any such event occur.

To support the safe storage of data, and consistent with the business continuity practices mandated by the Commission in the Intraagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System[14] (the "Sound Practices Paper"), DTCC, on behalf of its subsidiaries and at significant cost, implemented:

- a multi-data-center complex with two data centers within a 50-mile region in the Northeast, and additional data processing capabilities out of region;

---

[12] Trade data received from these marketplaces, as well as from Qualified Special Representatives ("QSRs"), is sent to NSCC on a "locked-in" basis, with the trade details already compared. NSCC receives the data and records the trades, reporting the results to its Members as contracts.

[13] We understand that the regional exchanges have plans to move to real-time submission.

[14] SEC Release No. 34-47638 (April 7, 2003). The Sound Practices Paper was issued jointly by the SEC, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency.

- an out-of-region business center capable of carrying out all critical DTCC clearing, settlement and asset servicing functions in the event of a loss of the primary business center,
- the ability to recover and resume operations, assuming the catastrophic loss of the Northeast data centers, within two hours, and
- substantially increased processing capacity.

As noted in the Sound Practices Paper, the requirement for core clearing and settlement organizations to be able to recover (i.e., restore clearance and settlement activities) and resume (i.e., have the capacity to accept and process new transactions) clearing and settlement activities within two hours after an event includes

> "recovery of clearance and settlement activities that would normally be performed by core clearing and settlement organizations and significant firms within a particular market's business hours on the day of the disruption. These activities include inputting material transaction data or payment instructions, and performing all steps necessary to clear and complete material transactions on their regular value or settlement dates."[15]

Similarly, the IOSCO Recommendations for Central Counterparties[16] states that contingency plans should, "at a minimum, provide for the recovery of *all* [emphasis supplied] transactions at the time of the disruption to allow systems to continue to operate with certainty." The submission of trade data on a real-time basis is necessary to prevent loss of substantial trade data not yet transmitted to the clearing agency in the event of a disruptive event, and thereby enable NSCC to complete the clearance and settlement of those transactions on their regular settlement dates.[17] The safety and soundness of the clearance and settlement system is thus compromised without all of the trade activity.

In addition to promoting business continuity, the proposal also promotes risk mitigation, because pre-netting practices mask intraday trading patterns that may expose NSCC (as well as clearing firms, with respect to their correspondents) to unknown risks, and warehousing transactions for later submission to NSCC (in compressed form) prevents the clearing agency from accurately monitoring the activity of those firms for whom the Corporation may have particular financial or operational concerns. Moreover, receipt of trade data on a real-time basis will enable NSCC to record and report to Members trade data earlier in the day, thereby promoting intra-day reconciliation of transactions at the participant level. These benefits are particularly

---

[15] Id., at footnote 8.

[16] The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, Recommendations for Central Counterparties, November 2004, at 34 (Key Issue #2 for Recommendation 8: Operational Risk).

[17] The 2003 report commissioned by the Group of 30, entitled Global Clearing and Settlement—A Plan of Action, at 44-45, also discusses the importance of having a real-time trade repository.

important for clearing brokers, who are responsible for the clearance and settlement of their correspondents' trades, and thus benefit from earlier knowledge of their correspondents' activities.[18] The prohibition of pre-netting also promotes trade reconciliation. In fact, the practice of correspondent brokers pre-netting their trade data prior to submitting that data to their clearing broker compromises the clearing broker's ability to reconcile a trade break in a compressed or summarized transaction, without having all the underlying trade details.

Finally, those Members who submit, or whose trades are submitted, in real-time and who do not pre-net pay, in the aggregate, higher costs for the same NSCC trade recording services. Thus the cost savings resulting from pre-netting is being used as a competitive tool by certain OTC trading platforms: firms are offering trade compression as a means to attract order flow. If pre-netting practices are not prevented, these practices will likely become even more widespread, resulting in increasing delays in the submission of trade data to the clearing corporation and weakened business continuity protections from the redundant safe storage of the data at the clearing corporation's data center complex. Either the practice is prohibited now, or perceived cost savings and competitive pressures will result in all market participants conducting business in this fashion. The net result would not only remove any competitive advantage currently enjoyed by those firms that pre-net today, it would also substantially exacerbate the significant operational and systemic risk issues already caused by today's limited use of pre-netting.

New Fee Model. As noted in the Filing, the proposed fee model was designed to respond to trading activity trends (in particular the trend towards smaller sized trades), mitigate the anticipated impact of the proposed real-time trade submission requirements, and serve to realign fees with service benefits.

In developing the proposed fee model, management met with more than 80 member firms to understand their business practices, and conducted extensive analysis and modeling to estimate which participants were pre-netting their trades, and the amount of such activity. Discussions with firms have indicated that bilateral "compression" arrangements do exist between many QSR's (or the automated execution systems that they clear for) and their customers. The level of compression was then estimated first, by performing a distribution analysis on the trade data by trade share size, marketplace and price, and then by comparing trade share size and prices from those markets where NSCC receives trade submissions on trade-for-trade basis against over the counter activity, which includes QSR submissions.

---

[18] The most notable example of a Member's failure brought about by the activities of its correspondents was the 1995 failure of Adler, Coleman Clearing Corp ("Adler"). Adler was primarily a clearing firm acting for 42 introducing firms and clearing trades for over 66,000 customer accounts. Adler's demise immediately followed the collapse of Hanover Sterling & Company, Ltd. ("Hanover"), one of the introducing firms whose trades Adler cleared. As determined by the SIPC Trustee appointed to liquidate Adler, Hanover's failure was due to massive, organized short selling in various securities as to which Hanover was an underwriter and market maker. The short selling activity that led to Hanover's demise ultimately caused Adler's financial collapse. Through its trade guaranty, NSCC took on and settled Adler's outstanding trade obligations. As a result, NSCC sustained a loss in liquidating those positions.

The projected impact of the new fees was then modeled for over 70 Members including, for certain large firm "families", their affiliates, using actual transaction data from the first quarter of 2005, for November 2005 and again using March 2006 data. Management has met, or discussed the results of its estimates, with over 35 member firms. With respect to those members that summarize or compress trade data, a number of those firms indicated in these discussions that NSCC's estimates of their gross trade activity (level of compression/summarization) and the projected impact of the proposed fee structure were accurate within several percentage points, thus validating NSCC's assumptions about trade compression and summarization.

NSCC is a subsidiary of The Depository Trust & Clearing Corporation ("DTCC"), a holding company owned by its users. NSCC's Board of Directors and its key Board Committees are made up of representatives from its Members; thus NSCC is ultimately user-owned and -governed. We note that the proposals encompassed in the Filing, including the proposed new fee model, together with the modeling results, were reviewed with, and the proposals were approved by, the Board of Directors, through its Operations and Planning Committee, and a special subcommittee formed for that purpose.

III. Rebuttal to Arguments raised by Commenters

A. <u>Incorrect information and assumptions.</u> Wedbush posits that NSCC does not understand the magnitude of compression in the marketplace, and accordingly developed its fee proposal based on incorrect assumptions. It doubts the validity of NSCC's assumption that prohibiting compression will result in only 30% more transaction volume; instead Wedbush (who clears for both Tradebot and GETCO) argues that for many QSRs, NSCC has vastly underestimated the true volume of trades. As outlined above, NSCC engaged in an extensive and comprehensive analysis of member trade submission practices and modeling of the projected impact of the proposed fees over several time periods. NSCC has shared the results of its modeling analysis with many of the member firms whose fees were modeled. To date, aside from the bare assertions set forth in several of the comment letters, the information we have received from our ongoing discussions with member firms bears out the reasonableness of the assumptions underlying the fee proposal.

Wedbush, on the other hand, fails to provide any information to substantiate its claim.[19] Were its assertion that NSCC has drastically underestimated the amount of compression in the marketplace to be correct (with Knight and GETCO suggesting that compression may potentially be in the "millions"), it would imply that firms are not only compressing like-sided transaction data, but also pre-netting buy versus sell side trade data, which presents additional risk issues. As for the impact of our pre-netting

[19] In fact, in conversations with Wedbush staff in early March, 2006, their estimate of the level of Wedbush's trade compression was consistent with the compression estimates NSCC developed for that firm through the modeling process.

estimates on capacity and fee issues raised by the commenters, see the discussion at items D and H below.

Even if we accept Wedbush's contention for the sake of discussion, we note that that reinforces the urgency of ending pre-netting practices, since Wedbush's contention suggests that many more trades are not reported to the clearing corporation on a timely basis and, therefore, are at risk of being lost in the event of a serious business disruption. If Wedbush were correct (which we do not believe), the systemic and operational risks associated with the delayed reporting of this larger number of transactions are even more significant, and it is therefore even more important that we move to mitigate them.

B. Proposal competitively disadvantages a sector of the market.

All of the broker/dealer commenters (with exception of Wedbush) argue that the proposal competitively disadvantages that portion of the brokerage community consisting of "wholesalers," automated trading systems and autorouters, and also ECNs. Since the advent of decimalization and other market structure changes, they argue that this sector of the market has seen profit spreads greatly reduced, so that profits arise *only* from volume trading, *and* by reducing costs—such as by compressing or summarizing trades prior to their submission to their clearing broker (if they are a correspondent) or the clearing corporation (if they are a member) for trade recording to reduce clearance fees.[20] Further, these alternative "market venues" compete with the primary markets (exchanges), thus the commenters claim the rule puts these venues at a competitive disadvantage vis-à-vis the exchanges. They assert that, under the proposed fee structure, requiring real-time trade submission without any pre-netting would have the following market consequences-

- there will be less liquidity in the markets those firms serve,
- spreads will widen (due to less competition)
- increased costs could be passed on to investors

ATD and Knight also argue that exchanges have a competitive advantage over electronic communication networks ("ECNs") with respect to clearing fees, as exchanges are not themselves charged clearance fees, but rather each side of the trade they submit is charged. So, as Knight argues, ECNs will be disadvantaged if they cannot compress trades, unless they can "affiliate in some manner" with an exchange.

While, at least facially, the commenters are not objecting to the prohibition on pre-netting per se,[21] but only in conjunction with the proposed new fee structure, in actuality

[20] As ATD states: "With price competition driving ECN profitability to the third or fourth decimal place, every mechanism to control costs *must* (emphasis supplied) be employed to remain at the vanguard."

[21] GETCO, for example, "sees the benefits outlined in the proposal. . ." and notes that it is "noble in its intention". Knight states that it does "not object to the principle [sic] concerns proffered by the NSCC," and Wedbush notes that it "has no objection to the principal concerns expressed by NSCC . . . [n]or do we question its intent and motives."

they are really objecting to the prohibition on pre-netting, because under *virtually any conceivable NSCC fee structure* this segment of the market will pay higher clearance fees. In essence they argue that NSCC can *neither* adopt appropriate risk mitigation measures, *nor* modernize its fee structure to address changes in the marketplace, because they have built their business model specifically to exploit the existing clearing rules and fee structure. This is not an appropriate reason to deny approval of the proposed rule change, particularly in light of its numerous benefits and its inarguable promotion of the prompt and accurate clearance and settlement of securities transactions, the statutory standard upon which NSCC's trade submission practices proposal must be evaluated.

In fact, if the commenters' rationale were accepted as appropriate, trade compression and other pre-netting practices will likely proliferate in the marketplace—including by exchanges. Not only would that greatly *increase* operational and systemic risk, it would also likely result in obliterating any competitive advantage that the ECNs and other segments of the "wholesale" market currently enjoy. We are thus at a loss to understand how this result could be acceptable, even to the commenters themselves.

Moreover, since GETCO, Knight, ATD and Tradebot are not NSCC Members, but clear through other firms, their real objection is not to NSCC's proposed fees (which are not material compared to the fees charged by clearing firms), but rather to the increased costs that they presumably would be charged by their clearing firms, absent their renegotiating those fees. The same holds true for service bureau fees. However, the clearing and service bureau businesses are vibrant and competitive. Based on discussions with our Members, we understand that these entities use various fee methodologies: Some charge their customer firms a fee per CUSIP processed, while others charge a per item or a flat annual fee. We also understand that most clearing firms share any NSCC fee rebates with their correspondents. NSCC recognizes that brokerage firms will need to address their vendor and clearing firm arrangements, and expects that clearing firms and service providers would renegotiate their fees, or lose business to competitors. Given that NSCC announced the proposed changes back in February of this year, and subsequently announced the extension of the originally proposed timetable,[22] we believe that firms have had sufficient time to commence discussions with their clearing and service providers regarding appropriate fee adjustments.

As for the assertions that liquidity in the marketplace will be reduced and spreads will widen, the commenters present no facts that would indicate the proposed fee structure would impact *either* market liquidity or spreads. In fact it would appear that the current narrowing of price spreads is primarily due to decimalization and the proliferation of electronic trading across all markets. Furthermore, the NYSE, Amex and NASDAQ currently provide trade data to NSCC on a real-time basis without any form of pre-netting, and spreads in those markets remain similar.

[22] See NSCC Important Notices dated February 21, 2006 (A#6208, P&S#5778), and May 24, 2006 (A#6246, P&S#5816).

Claims that the proposal unfairly disadvantages ECNs vis-à-vis exchanges are similarly misplaced. NSCC has always taken (and relied on) trade feeds from self-regulatory entities, including those marketplaces where the trades are executed, as well as clearing organizations such as The Options Clearing Corporation, as efficient and reliable sources of trade data. They submit that data to NSCC in their capacity as an SRO, not as an NSCC Member. As SROs, they are required to comply with significant regulatory burdens designed, in part and as relates to clearance and settlement, to assure the operational capability and reliability of the data so submitted. In fact, to the extent the exchanges act in a principal capacity—as, for example in connection with Intermarket Trading System transactions—NSCC has required them to follow the same membership application procedure as brokerage firm applicants. And NSCC has, and continues to, charge them the same trade recording and clearance fees as charged to Members for their ITS transactions. In contrast, ECNs—if they are themselves a QSR, or the QSR through which they clear—submit trade data to NSCC in their capacity as a Member. We agree that if any ECN is willing to assume the regulatory burdens, and seek to become an exchange, NSCC will treat them accordingly.

C. **<u>Fragmentation.</u>**

ATD correctly notes that, in the Filing, the sole exception to the no "pre-netting" requirement is with respect to internalized trades. That is because internalized trades[23] are never presented to NSCC for clearance and settlement; thus NSCC never becomes central counterparty to those trades, nor does it provide the benefits of its trade guaranty. ATD argues that the result of this exception may be to motivate firms to establish multiple clearing relationships so as to be able to leverage this exception, thereby resulting in fragmentation of clearing process and potentially increasing risk.

Since internalized trades by definition do not require either (i) the exchange of data between clearing firms, or between clearing firms and NSCC, or (ii) settlement through the exchange of securities and money with NSCC, all settlement, risk management controls and recordkeeping functions are contained within the clearing broker. That is the case today, and will continue to be the case in the future. Should a clearing firm wish to take on additional risk with correspondents, and if they can do it more cheaply than the correspondent clearing directly through NSCC, firms are free to use that mechanism. Nevertheless, we would expect that clearing firms would also wish to see all trades and charge for them, rather than clear compressed trades, just as we do.

D. <u>Capacity.</u>

---

[23] The Filing provides that trades executed in the normal course of business between a Member that clears for other broker/dealers, and its correspondent, or between correspondents of the Member, which correspondent(s) is not itself a Member and settles such obligations through such clearing Member ("internalized trades") are not required to be submitted to the Corporation and shall not be considered to violate the "pre-netting" prohibition.

The commenters argue that NSCC has not established that it has adequate capacity to handle all of the volume that will result from preventing QSR compression and summarization.

DTCC continuously monitors CPU and data storage usage, and can readily process 160 million transaction sides daily with the capabilities that are currently in effect. In addition, in anticipation of the prohibition of trade compression, DTCC is in the process of increasing this capacity significantly, and recently successfully stress tested the system's capacity to well in excess of 160 million daily transactions. Further, this process has eliminated any capacity constraints at the application level, so that any additional capacity needs can be met easily and quickly through deployment of additional CPU and data storage resources. As we do currently, we will continue to monitor capacity, and make adjustments as needed. We are therefore confident that DTCC has the capacity to clear whatever number of transactions NSCC may receive from the QSRs.[24]

E. <u>Validity of the Proposal's Risk Concerns.</u>

A core argument made by the commenters is that business continuity concerns do not justify requiring real-time trade submission and the prohibition of "pre-netting" practices, particularly as brokerage firms themselves have been required to adopt business continuity measures since September, 2001.

While we agree that the securities industry has certainly improved its business continuity capabilities since 9/11, the SEC and the Federal Reserve have only mandated that clearing agencies must have their backup facilities located out-of-region, giving due regard for the separation of power grids and telecommunications connectivity. Accordingly, DTCC and the rest of the critical clearing and settlement infrastructure have been required to and have implemented, as noted above, back-up capabilities hundreds of miles away, on separate power grids and telecommunications hubs. We maintain that infrastructure to ensure continued operation in spite of any conceivable disaster, and the industry and regulators are justly confident that this structure is capable of responding to incidents well within a two-hour recovery period. The rest of the industry is not required to meet these same stringent standards.

Moreover, as noted in the Introduction, allowing clearing and executing firms to "warehouse" trade data throughout the day (so that they can summarize or compress it later) makes it extremely unlikely that NSCC could meet the targeted recovery and resumption objectives with respect to those "warehoused" transactions within the mandated time requirements because, in the event of a marketplace disruption (or even the operational failure of a significant QSR), NSCC would have to rely on the business continuity capabilities of a myriad of firms and organizations, many of whom are not

[24] Transaction volume today from QSRs represents approximately 20% of NSCC's volume (about 10-11 million sides a day). The estimated 30% volume increase translates to an assumed 100% volume increase from the QSRs. So, even if the actual uncompressed trade volume is 5-600% greater than estimated, that would be well within DTCC's existing CPU capacity.

themselves NSCC Members, to promptly and accurately supply it with the missing trade data. For example if Knight was not providing its trades to Merrill Lynch, its NSCC Clearing Firm, on a real-time basis, then in the event of a market disruption Knight would first have to restore its trade data (relying on its business continuity capabilities), and transmit that data to Merrill Lynch. Merrill Lynch, once it had restored and resumed its own operational capabilities would, in turn, submit that data, together with other similar correspondent trade data, to NSCC for trade recording. Such a complex process, at minimum, clearly could not be coordinated within the desired recovery time, and the process would be at greater risk for potential data loss due to the absence of redundant data storage at the clearing corporation.

Even the commenters acknowledge that their business continuity capabilities do not cover all gaps:

> "These [recent firm business continuity] changes permit delayed but near-complete submission to NSCC in worst case scenarios." (UBS at 3)
>
> "For the failure envisioned by the NSCC to occur, both parties to a trade would have to lose their data. Moreover this data is also captured through trade reporting systems such as NASD's Automated Confirmation Transaction ("ACT") service and the exchange trade reports. In the event of a disaster, these alternative sources of data could be used to obtain certainty in clearing these obligations." (ATD at 4)

ATD ignores the problems that would arise should ATD lose trade data—even if all its customer counterparties were able to recover their respective data. Reconstructing and confirming the transactions represented by the lost data would require a massive reconciliation effort, even if NSCC and Wedbush, its clearing broker, were to rely on ACT or other sources to supply the missing data. GSCC's experience post 9/11 clearly bears this out.

Similarly, the commenters dismiss, as unnecessary, the benefits of earlier trade reconciliation and straight through processing. With respect to trade reconciliation, ATD argues there is no need to achieve intra-day trade reconciliation. Wedbush, ignoring NSCC's current and long established practice of providing multi-batch intra-day trade recording output, argues that since NSCC does not provide real-time trade recording output, intra-day trade reconciliation is somehow not valid. Both firms ignore the burden pre-netting imposes on clearing firms' ability to reconcile trade breaks, as well as the impact of increasingly smaller trade size and continually rising volumes. In such an environment it is becoming more important, for efficiency and operational risk reasons, to enable firms to see transaction data on a trade-for-trade basis and to begin the trade reconciliation process earlier. As for straight-through processing, the practice of warehousing trades so they can be compressed or summarized at a later time requires active intervention and disruption of the post-trade process, itself contrary to straight-through processing objectives. If such practices continue and become even more widespread, it will be extremely difficult – we believe, as a practical matter, virtually impossible – ever to move to shortened processing cycles.

Finally, while the commenters do not dispute the risk mitigation importance of NSCC's being able to view trades on an uncompressed basis real-time, Knight, ATD and UBS believe that NSCC could adopt other, "less invasive", approaches to achieve this result while still permitting trade compression. In its letter, ATD asserts that "NSCC has systems in place (such as the Inventory Management System) which accept trade information prior to settlement processing."[25] From this they somehow conclude that NSCC has the ability to review raw trade data from a risk perspective without otherwise "processing" that data. In fact, in conversations with ATD on May 25, 2006, ATD blithely suggested that NSCC could design a separate real-time feed of "raw" trade data (whether that would come from the marketplaces, the reporting tape, or the firms themselves, was never clear), while separately maintaining the existing feeds for trade recording purposes.[26]

This is not a credible proposal or option. First, as with all the commenters' other arguments, accepting this approach would imply that trade compression and other forms of "pre-netting" is a legitimate policy for the industry as a whole. If the firms have the ability to send us their trade data on a trade-for-trade basis at or near real-time, then they should do so. There is no reason to then permit them to send a separate end-of-day feed for recording and billing purposes solely to enable one sector of the marketplace to maintain a competitive fee advantage. (Further, the proposal seems to expect that other participants – who do not pre-net today – should pay still more fees to support this redundant recording of trades so that the commenters can continue to evade paying recording fees through their pre-netting practices!)

Secondly, this approach is not feasible from an operational perspective. Not only would it require significant systems changes and take up (duplicative) processing capacity, it would require a means of balancing the raw data (which presumably would include internalized trade data not ultimately meant to clear through NSCC) against the recorded "compressed" data. This would introduce an additional level of operational risk. And, in any event, the costs of implementing a "dual feed" approach would be significant and borne by our participants. Accordingly, we are at a loss to understand how it would either mitigate risk, or result in lower fees.

H. Proposed Fee Structure is Revenue Neutral.

---

[25] The Inventory Management System is a DTC, not an NSCC, service and queues previously agreed transactions for settlement processing. It could not serve the purpose ATD proposes.

[26] ATD appears to be laboring under the incorrect assumption that The Options Clearing Corporation uses this "dual" processing approach: "It is understood in the industry that the Options Clearing Corporation accepts real-time trade submissions and runs its risk reviews while allowing forms of trade netting and compression." We understand from discussions with OCC management that OCC receives real-time trade submissions from all of its options exchanges but one, which provides its data multi-batch. The exchanges do not summarize their option data, and OCC uses the submissions for both recording and risk management purposes. Moreover, in contrast to NSCC, total OCC volume averages only about 7-8 million transactions per day. At the end of each day OCC balances its data by confirming with the exchanges what was sent versus what OCC received.

The commenters complain that the proposed fee structure is not "revenue neutral" to all firms, as it will result in higher fees for those entities who today compress the most. UBS, staking out the most aggressive position on fees, argues that the fees should be revenue neutral to each and every firm, and proposes we revise the fee schedule to achieve this result.

This assertion, of course, is completely irrelevant, since, under the statutory provisions of the Exchange Act, fee changes are not required to be "revenue neutral" to each and every participant.[27] Given the diversity of our members' businesses, that would be virtually impossible. Rather, the applicable standard for evaluating the appropriateness of the proposed fees is that they be reasonable, and allocated among participants on an equitable basis.[28] We believe that the proposal more than meets this standard because:

- It treats all Members equally
- It appropriately reflects changes in the marketplace (smaller average trade sizes) by adjusting the minimum/maximum trade size for trade recording fees,
- It is designed to charge for the value NSCC provides its Members by netting (and the risk NSCC thereby assumes as central counterparty), as represented by the into and out of the net fees, and
- It is set at a level designed to be as low as possible while covering NSCC's costs (with any excess being rebated to Members)

While it may be true that the total of fees charged in certain categories may rise for firms that today pre-net, we would also note that for those firms that ultimately net out of their positions, they should be charged little, if any, "out of the net" fees, offsetting the increase in initial trade recording fees.

Wedbush argues the "value" components of the trade clearance fee improperly ties value to market price. We disagree with Wedbush's assertion that tying into and out of the net fees to security market value is not an appropriate indication of the value of NSCC's services. The value of the clearance netting service – which reduces Members' settlement obligations -- is a function of the difference between the absolute value of the securities traded, versus the value of the residual position that ultimately settles through NSCC. Accordingly, the merits of the fee structure to firms with electronic trading platforms is that because, after netting, they should have little, if any, residual settling positions, their netting fees will be lower than those firms whose trading practices result in higher residual settling positions. Therefore, we believe that market value is an appropriate measurement of the value of NSCC's netting service.

---

[27] The Filing explains that in approaching the fee restructuring, NSCC sought to make the new fees revenue neutral to it—so as to be clear to participants that the new fees were not designed as a way to increase NSCC's aggregate revenues.

[28] Section 17A (b)(3)(D) of the Exchange Act.

NSCC recognizes that some firms will pay higher fees due to the nature of their business and their current level of trade compression. However, to the extent actual trade volume exceeds the estimates on which these fees were predicated, NSCC will review, and adjust as necessary, its fees. NSCC has historically done this each year as it has reviewed its fees, and as volumes have steadily increased.

NSCC's pricing policy is set forth in its Rules & Procedures (Addendum A.VIII), and makes clear that our policy is to retain only those revenues which are required to maintain an adequate revenue base in order to cover current production costs, provide for continuing product enhancements and development, provide for a discount when volume levels equal or exceed projections, and provide for retained earnings as directed by the Board of Directors. Excess revenues before adjustment are adjusted by discount, and are rebated pro rata, so that those paying the highest fees will receive their pro rata share of the rebated amount.

From 1994 through 2005 year-end, by virtue of fee reductions NSCC has provided its participants with more than $3.8 billion of cumulative savings (exclusive of rebates). This history more than amply demonstrates NSCC's commitment to reducing costs and promoting efficiencies for the industry, and we reject any assertion that we have not properly considered the effects of the proposal.

I. <u>Timeframe for Implementation in light of the requirements of Regulation NMS.</u>

A number of the commenters have asked that, if the Filing is approved, that the implementation timeframe be extended. They argue that the burdens of complying with the implementation of Regulation NMS warrant pushing out the time within which they should be required to comply with the Filing's trade submission requirements.

When NSCC first announced the proposals in February, 2006, and as provided in the Filing, the proposed implementation timeframes were July 1 for Phase I (i.e., the prohibition on pre-netting, requiring the appropriate use of the correspondent clearing service and adoption of the new fee structure), and January 1, 2007 for Phase II (the requirement to submit data real-time). In May, 2006, recognizing the impact of these proposals, NSCC announced its decision to revise the implementation timeframes so as to provide sufficient time to enable the affected exchanges and firms to make the necessary changes. Accordingly, NSCC has agreed to, and the Filing will be amended to reflect, the following implementation schedule: Phase I will be implemented on the first day of the fourth month following the Commission's approval of the Filing, and Phase II will be implemented six months following the Phase I implementation date, thus providing more than nine months following the Filing's approval date before real-time trade submission would become mandatory. Given both the passage of time since the trade submission proposals and new fee structure were first announced in February of this year, and the proposed revised implementation schedule, NSCC believes that affected firms and exchanges will have sufficient time to make any needed modifications to their trade submission practices and procedures.

J. Other Changes.

In addition to amending the Filing to revise the implementation schedule as discussed above, the Filing will also be amended to provide further clarification, as has been requested by a number of participants, regarding the appropriate use of NSCC's Correspondent Clearing Service. These amendments will clarify that:

(i) the term "original trade" is used solely to distinguish between trades executed in the marketplace, and trades booked for accounting purposes to accommodate the movement of positions between members as permitted in the Correspondent Clearing Service procedures.

(ii) the Correspondent Clearing Service may only be used in the following situations: first, to accommodate a Member with multiple affiliate accounts who wishes to move a position resulting from an "original trade" in the process of clearance from one affiliate account to another, and second, to accommodate a Member that relies on its Special Representative to execute a trade in a market that the Member is precluded from due either to membership requirements (e.g., membership requirements for access to exchanges) or applicable regulation, to enable the resulting position to be moved from the Special Representative to that Member.

K. The beneficial impact of the Filing will outweigh any alleged burden on competition

As noted in the Filing and as discussed in greater detail above, NSCC's proposed rule change regarding trade submission practices is consistent with the requirements of the Act, and the rules and regulations thereunder, as it will reduce operational and systemic risk to NSCC and its Members, and promote the prompt and accurate clearance and settlement of securities transactions. With respect to the proposed fees, they provide for the equitable allocation of fees among NSCC's Members.

We believe that any burden on competition that the proposed prohibition of pre-netting could be regarded as imposing is neither unreasonable, nor inappropriate, given the clear and substantial benefits such requirements will yield. Moreover, the revised fee components are reasonable, and establish a fair and consistent environment among markets and intermediaries. In this regard we believe the Act provides NSCC with adequate authority to prohibit pre-netting, as it does for FICC's similar prohibition.

Conclusion

The foregoing discussion illustrates the importance of the issues addressed in the Filing to NSCC, its participants, and the securities markets NSCC serves. Given the risk mitigation benefits, adoption of the proposals will improve the safety and soundness of the U.S. capital markets, and NSCC's fees will more fairly allocate its costs among participants. Accordingly, we respectfully request that the Filing (upon its amendment as discussed above) be approved, as we believe that it satisfies all of the factors the Commission must evaluate in approving a clearing agency rule filing.

Should you have any questions, please do not hesitate to call me at (212) 855-3240, or Robert McGrail, Executive Managing Director, at (212) 855-1100.

Very truly yours,

Larry E. Thompson

Larry E. Thompson

cc: Christopher Cox, Chairman, Securities and Exchange Commission
Paul S. Atkins, Commissioner, Securities and Exchange Commission
Roel C. Campos, Commissioner, Securities and Exchange Commission
Kathleen L. Casey, Commissioner, Securities and Exchange Commission
Annette L. Nazareth, Commissioner, Securities and Exchange Commission
Jerry Carpenter, Assistant Director, Securities and Exchange Commission
Robert Alumbaugh, Tradebot Systems, Inc.
Leonard J. Amoruso, Knight Capital Group, Inc.
Barclay M. Frey, BNY Brokerage Inc.
Keith F. Karlawish, BB&T Asset Management
Matthew Price, UBS Securities LLC
R. James Richards, Wedbush Morgan Securities, Inc.
Stephen Schuler, GETCO, LLC
Steve Swanson, Automated Trading Desk, LLC