January 25, 2013

Elizabeth M. Murphy,
Secretary, Securities and Exchange Commission,
100 F Street, NE,
Washington, D.C. 20549-1090.
By electronic mail to: rule-comments@sec.gov

RE: SR-NSCC-2012-810 / SR-NSCC-2012-10
Elimination of ID Offset in the computation of a participant's clearing fund deposit

Dear Ms. Murphy:

Lek Securities Corporation is pleased to comment on NSCC's proposal to eliminate the ID Offset in computing the margin requirement for its participants. As explained below, the adverse consequences that will flow if the NSCC's proposal is implemented are profound. The elimination of the ID offset will likely eliminate all but the largest banks from being in the business of executing orders on behalf of large institutions. Small and even midsized brokers will be forced out of business.

The premise for the NSCC's proposal is specious as NSCC has never had to use the clearing fund deposits of a non-defaulting participant firm, even as the country recently experienced the steepest and most severe recession since the Great Depression. Moreover, by not considering the significant differences between lower risk agency broker-dealers and higher risk broker-dealers that engage in proprietary trading, the proposal disparately impacts agency broker-dealers. The NSCC has not provided any indication that it has considered and evaluated other alternatives that would address its concerns without creating the devastating effects on agency broker-dealers and the resulting impact that would have on their customers.

The NSCC Guarantee

NSCC acts as a central counterparty and guarantees that market participants will make good on their obligations. If a participant were to fail, NSCC would have to make good on the participant's obligations, which means that it would have to enter the market and replace the defaulting participant's obligations. To mitigate this risk, NSCC collects margin from both the buyer and the seller. The premise underlying NSCC's proposal to eliminated the ID Offset is that the amount of margin posted by the defaulting participant might not be sufficient to cover the ensuing losses.

We applaud NSCC for striving to have sufficient margin from its participants. Clearinghouses such as NSCC play an important role in our financial system and their stability is extremely important. Unfortunately, elimination of the ID offset is a misguided proposal as it will do little to limit NSCC's risk but will inflict enormous harm on agency broker dealers. By eliminating the ID offset, NSCC will possibly seek to collect hundreds of millions of dollars more in margin from agency broker dealers which generally are low margin, low risk businesses that cannot practically bear the dramatically increased levels of capitalization that would be required to comply with the proposal. As a result, these firms will

be forced out of business, or alternatively be forced to sell themselves at deflated prices to federally insured banks that have access to the liquidity that the increased margin will require.

There are other ways that NSCC can accomplish its goals without inflicting this type of damage on the industry. These alternatives should be fully explored and implemented before irreparable harm is done to agency broker dealers.

There is no demonstrated need to significantly raise the margin requirements

Although we support NSCC's goal to have sufficient margin and we applaud their work in constantly reviewing and analyzing the risk that they assume, there is ample evidence that NSCC already collects sufficient margin. There is no need to fix a system that is not broken, and certainly no *demonstrable* need to do so now, especially given the dire consequences to agency broker dealers. NSCC has done an admirable job managing the clearing fund over the years. In fact, as recently as November 2011, the NSCC noted that it has never needed to use the clearing fund deposits of a non-defaulting participant firm — in other words, NSCC has never lost money as a result of a default because, among other things, margins were sufficient. *See* National Securities Clearing Corporation, *Assessment of Compliance with the CPSS/IOSCO Recommendations for Central Counterparties*, pg. 6 (Nov. 14, 2011) (stating that the NSCC has never needed to use the clearing fund deposits of non-defaulting participants to satisfy losses resulting from the liquidation of a defaulting participant's obligations). Given that the existing margin requirements have been more than adequate to prevent the NSCC from having to draw on the clearing fund even in recent years, when the markets were persevering through the extreme volatility caused by the worst recession since the Great Depression, it is virtually impossible to understand why NSCC now believes that current margin requirements are inadequate.

Agency brokers are unlikely to fail

NSCC's research is focused on analyzing how much it could expect to lose if one its participants were to fail. However, it has apparently done little or no work in analyzing how likely it is for a participant to fail in the first place. This overlooked threshold question is a significant shortcoming in NSCC's analysis.

NSCC guarantees the un-settled positions of its participants and is concerned that unfavorable market moves could cause a participant to go under. For a firm that is engaged in proprietary trading, NSCC's calculations may be reasonable. It appears to make a fair estimate of how much a participant could lose as a result of its open positions and computes margin accordingly. However, unlike broker dealers that engage in proprietary trading, agency broker dealers will not lose money as a result of unfavorable market moves because they can rely on their customers to make good on the losing trades. This is particularly true for brokers that use the ID System. The ID System is used to send confirmations of buy and sell contracts to large institutional customers and the affirmation of the confirmation by the institution constitutes a written acceptance by the institution that it is bound by the contract. For an agency broker to lose the same amount of money as a proprietary trading firm as a result of adverse market move, *all* of the agency broker's customers would have to reneg on their obligations at the same time. NSCC readily admits that agency brokers' counterparties are wide and diverse and that it is not uncommon for an agency broker to have open contracts with hundreds, if not thousands, of customers. NSCC has absolutely no credible or logical basis to suggest that all of these customers will simultaneously default on their obligations. As a result, dealing as agent is much less risky and should not require the same margin as dealing as principal. Indeed during the Financial Crises, many proprietary trading firms either failed, or required a bail-out from the Federal Government. By contrast,

not a single agency broker was in this position. NSCC's proposal completely ignores these fundamental differences between these two types of broker dealers.

Institutional customers that use the ID System are some of the most reliable and creditworthy organizations in the world. They do not trade on margin; they cannot assume short positions, and they cannot write options. Indeed, it is difficult to think of a single broker dealer that has failed as a result of its institutional customers renouncing unprofitable trades. This is in sharp contrast to firms that engage in proprietary trading. It is patently unreasonable for NSCC to assume that the risk of dealing with a proprietary trading firm and an agency broker dealer are the same, and the Commission must not ignore this important fact.

The ID Offset is an important relief for agency broker dealers. It makes the assumption that institutions will settle the trades that they have affirmed, and that therefore the agency broker does not have the position and it is disregarded for margin purposes. We do concede that one, or maybe even two, of an agency broker's customers might reneg on their losing trades, notwithstanding the fact that they were affirmed, and as a result the broker would be stuck with the trades and lose money covering them. It would therefore not be unreasonable for NSCC to eliminate the ID offset for perhaps the two largest counterparties of the agency broker. However, to eliminate the ID offset for all institutional customers irrationally assumes that all of the broker's institutional customers will reneg at the same time. Obviously, this is far outside the realm of reasonableness.

Agency brokers require less capital

Agency brokers assume little risk, and as a result they generally do not make the same amount of money (or are exposed to as much potential loss) as proprietary trading firms. Consequently, agency brokers do not have, and they cannot be expected to be able to raise, the same amount of capital that proprietary trading firms have. However, NSCC's current proposal will raise the margin requirement of the agency broker to the same level as proprietary trading firms. This is not practical for agency broker dealers. Accordingly, there is a very real risk that the independent agency firm will cease to exist.

Many institutions prefer to utilize agency broker dealers because those firms do not deal for their own account and have only one goal, which is to provide the institution with the best possible execution. Thus, when an institution deals with an agency broker the interests of the institution and the broker are aligned. They both seek the best price for the institution. The NSCC's proposal will sharply reduce the role of agency brokers, if not eliminate them entirely, and the Commission must carefully consider the impact this will have on American institutions.

Broker dealers should be permitted to use the customers' money to meet the customers' margin requirement

The Form for the Computation of the Reserve Requirement pursuant to Rule 15c3-3 includes margin posted at OCC on behalf of customers as a debit item. In other words, brokers can use the customers' money to meet the customers' margin requirement on account of options positions. The same holds true in the commodities business. Futures Commission Merchants use the customers' money to meet the customers' margin requirement. This makes perfect sense. However, the 15c3-3 Form does not include a line to reduce the lock-up requirement for margin posted at NSCC. In other words, we must use the firm's money to meet the customers' margin requirement. We do not understand the rationale for this differential treatment and guidance and possible relief from the Commission would be very

helpful. There appears to be little reason not to allow brokers to use customer money to meet customer obligations, when and if, the broker can clearly identify the requirement as one that is incurred on behalf of customers.

The elimination of the ID Offset will have a deleterious effect on competition
In its filing with the Commission on Form 19b-4, under the caption "Self-Regulatory Organization's Statement on Burden on Competition", NSCC states as follows:

> "NSCC believes that the proposed rule change will not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The rule change will mitigate the market risk that may arise after NSCC has ceased to act for that Member if it is unable to complete the ID transactions in the time frame contemplated by its Clearing Fund calculation, leaving NSCC potentially under collateralized. By mitigating its exposure to this market risk, the proposed rule change will contribute to the goal of financial stability in the event of Member default, and will render not unreasonable or inappropriate any burden on competition that the changes could be regarded as imposing.
>
> Further, NSCC intends to implement this rule change over an extended period of time, as described herein, allowing Members to address any impact this change may have on their business. This implementation schedule is designed to be fair and not disproportionately impact any Members more than others, and the proposal to implement this rule change over an extended period of time will provide all impacted Members with time to identify alternatives that will mitigate the impact of this proposal on their business."

This statement is simply not truthful. As described above, the proposal will have a disproportionate negative impact on agency broker dealers that will likely force many of them out of business, thereby reducing competition in the securities business and securities markets. NSCC admits that it has received a letter on behalf certain Members seeking further review of the impact of the proposed rule change, and consideration of alternatives, and states that it has forwarded the letter to the SEC. Our firm was one of the signatories of the letter (assuming we are speaking about the same letter) and it outlines the serious impact that the proposed rule will have on independent agency brokers. If the ID Offset is eliminated, a number of independent agency only institutional brokers will be put out of business. This deleterious side effect will have serious impact on competition and must be part of the public discussion, so that all interested parties, as well as Congress, can understand the impact that the rule change will have on the industry.

As competitors are eliminated from the market, commission rates are likely to rise. The independent institutional agency only-broker will cease to exist, and American institutions will have no other alternatives to executing their securities trades through large banks, many of which are likely to have a conflict of interest with the institution, as they often trade for their own account in the same securities that the institution is attempting to buy or sell.

In light of the above, the Commission should disapprove the proposed rule, or at a minimum remand the proposal to NSCC for a frank and open discussion about the significant impact the proposal will have on competition.

While NSCC's proposal will likely force agency broker dealers out of business, it will have almost no impact on brokers that are also Federal Reserve Member banks, or affiliated with Federal Reserve

Member banks, thereby further demonstrating that the proposal will disproportionately impact some Members more than others. Unlike brokers, banks can use customer funds to meet the NSCC margin requirement, or alternatively, a bank affiliated broker can borrow from its parent bank, or where banks have restrictions on lending to affiliates, the banks simply lend to each other's affiliated broker dealers. By contrast however, non-bank broker dealers must lock their customers' funds in the reserve account. The reserve account is held at a bank and is a convenient source of funding for the bank to lend unsecured to its own affiliated broker dealer to meet its NSCC margin requirement. It is clear that the bank is at an enormous advantage and that relief is urgently required to allow brokers, like banks, to use customer money to meet customer margin obligations.

The proposed rule change will create a "reverse" Glass-Steagall Act

Under Glass-Steagall banks were effectively restricted from being in the securities business. If this proposal is adapted, the reverse will be true. In order to be in the brokerage business, you *must* also be a bank. With access to customer funds, and even access to the Discount Window, there will be sufficient liquidity to meet the NSCC margin requirement. Without these sources of liquidity, there will be insufficient funds for traditional brokerage firms to stay in business.

Currently, some brokers can borrow unsecured to meet the NSCC call. However, there are only a couple of banks that make these kinds of loans. The largest are JPMorgan and the Bank of New York. JPMorgan owns JPMorgan Clearing, the former Bear Stearns, and Bank of New York owns Pershing. It is easy to imagine that these institutions might be less than enthusiastic to lend to their affiliates' competitors. Of course, this pro-bank, anti-brokerage firm proposal becomes a lot more understandable if one looks at the composition of DTCC's board. The Executive Chairman spent nearly 16 years at Citi. Other board members are representatives from Wells Fargo, Deutsch Bank, Citi, UBS, and no less than two representatives from JPMorgan Chase Bank. Only the largest of the traditional brokerage firms are represented: Bank of America Merrill Lynch, Goldman Sachs, Morgan Stanley and Pershing, but these firms are also now chartered as banks, or in the case of Pershing, owned by a bank. It is interesting to note that out of the 18 member board, there is not a single representative from a traditional non-bank affiliated brokerage firm.

Section 17A(b)(3)(C) of the Securities and Exchange Act requires that *"...the rules of the clearing agency assure a fair representation of its shareholders (or members) and participants in the selection of its directors"*. While we are not suggesting that the Board's current makeup directly violates the law, the composition the currently serving participant directors looks more like a "Who's Who" in major banking than a fair representation of DTCC's participants. We urge the Commission to prevent the banking industry from strangling the securities industry by draining the latter's sources of liquidity.

NSCC should adopt true risk-reducing measures and explore alternatives

NSCC could implement other approaches to reduce risk without the dire consequences that logically flow from eliminating the ID offset. For example, NSCC representatives have noted that they have systems in place that could be leveraged, where NSCC could act as counterparty to the institution through novation or assignment. Under this system, NSCC would interact directly with the institution, thus assuring that all affirmed ID trades would be completed, even if the original participant that executed the trade were to go under. Experience has shown that the risk of an institution not being willing or able to complete a transaction is small, and, in addition, that the realm of counterparties is likely to be so large, that even if one or two institutions failed to honor their commitments, the ensuing

losses would be minimal. The ID Offset exists today, because NSCC has correctly assumed that an affirmed trade will be completed. This assumption has almost always proven to be correct and it has never proven false to the extent that a participant caused NSCC to suffer a loss.

Conclusion

We appreciate that NSCC seeks to mitigate its exposure to market risk as this will contribute to the goal of financial stability in the event of member default. However, the elimination of the ID Offset will result in collecting vast amounts of additional margin for trades that create little or no risk at all. This in turn will eliminate, or sharply reduce the role of independent agency brokers and as such create an unwarranted and inappropriate reduction in competition. Moreover, there are alternatives that NSCC can employ that will ensure that ID affirmed trades will settle and thus protect NSCC without the unnecessary damage that logically flows from the current proposal.

There can be no dispute that there is no demonstrable need to drastically increase margin requirements by eliminating the ID offset. NSCC has never lost money as a result of a default, because the amount of margin it had from the defaulting member has always been sufficient. Moreover, it is hard to think of a participant that failed as a result of an institution reneging on a trade. We therefore urge the Commission to reject the proposed rule change and encourage NSCC to submit alternative measures for approval that will accomplish the same benefit, without the unwarranted effect of destroying the independent institutional agency broker dealers.

Respectfully submitted,

Samuel F. Lek
Chief Executive Officer