

April 4, 2013

*Via E-mail*

Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: SR-NSCC-2012-810 Elimination of the ID Offset

Dear Ms. Murphy:

On behalf of ConvergeEx Execution Solutions LLC (“ConvergeEx” or the “Firm”), we submit this comment on the proposal by the National Securities Clearing Corporation (“NSCC”) to amend its rules to eliminate the offset for NSCC members’ institutional delivery (“ID”) transactions when calculating NSCC members’ clearing fund deposit requirement (the “Proposed Rule”).<sup>1</sup> At the outset, we note that ConvergeEx appreciates and understands NSCC’s stated goal to “more effectively manage its credit exposure to participants...limit NSCC’s exposures and losses, and enhance protections against market risk that may arise when NSCC ceases to act for a Member with open ID transaction activity”.<sup>2</sup> The Firm also acknowledges that, for the reasons identified by NSCC in the Proposing Release, open ID transactions that offset open NSCC Continuous Net Settlement (“CNS”) transactions involve some risk to NSCC not accounted for in the calculation of members’ clearing fund deposit requirement and it is reasonable for NSCC to seek protection from that risk.

As discussed below, however, we strongly believe that the unintended consequences of the Proposed Rule will increase concentration of NSCC-cleared transactions by members whose business models pose the greatest systemic risk and that there are far less disruptive means to mitigate NSCC’s risk that have not been adequately examined. The Proposed Rule will, in contravention of Section 17A(b)(3)(F) of the Securities Exchange

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<sup>1</sup> Securities Exchange Act Release No. 34-6821 (Jan. 10, 2013) (the “Proposing Release”).

<sup>2</sup> *Id.*

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Act, as amended (the “Act”), unfairly discriminate against agent-model broker-dealers that primarily settle transactions on a delivery-versus-payment (“DVP”) basis and do not provide customer financing or have access to customer collateral (“DVP Brokers”). In addition, as the Firm expressed to NSCC approximately a year ago, the Proposed Rule will also serve as an unnecessary and inappropriate burden on competition that is inconsistent with the requirements of Section 17A(b)(3)(I) of the Act. The Proposed Rule will drive many DVP Brokers, even relatively large and well-capitalized ones, out of the business of clearing transactions that settle on an ID basis, limiting investor choice and concentrating the availability of DVP brokerage clearing services in large, bank-owned broker-dealers that have access to other customers’ collateral (referred to herein as the “Prime Brokers”) to satisfy NSCC’s increased clearing fund deposit requirement in respect of ID transactions.

#### The Clearing Fund and the ID Offset

According to NSCC, the primary objective of the Clearing Fund is to “have on deposit from each applicable clearing member (“Member”) assets sufficient to satisfy losses that may otherwise be incurred by NSCC as the result of the default of the member and the resultant close out of that Member’s unsettled positions under NSCC’s trade guarantee”.<sup>3</sup> The required Clearing Fund deposit is calculated every day pursuant to an established formula that is designed to ensure that NSCC maintains sufficient collateral to cover the Member’s default risk. Currently, NSCC calculates the required Clearing Fund deposit after taking into account certain confirmed/affirmed offsetting pending ID transactions (commonly referred to as the “ID Offset”). NSCC proposes to eliminate the ID Offset to eliminate the market risk that NSCC would be subject to if the NSCC ceases to act for a Member while the Member has pending ID transactions.<sup>4</sup> The effect of eliminating the ID Offset, however, would be to require the same value-at-risk (“VaR”) based Clearing Fund deposit requirement in respect of a member’s agency transaction as would be required in respect of a member’s proprietary transaction, despite the very different risk profiles that the two business models present to NSCC.<sup>5</sup>

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<sup>3</sup> Id. at 2.

<sup>4</sup> To the best of our knowledge, NSCC has never experienced a loss resulting from an unsettled ID transaction.

<sup>5</sup> We note that the Clearing Fund deposit requirement consists of a number of component calculations, but the VaR-based calculation is the component directly impacted by the Proposed Rule.

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The Proposed Rule Will Increase Systemic Risk

The Proposed Rule will have a disproportionate adverse impact on DVP Brokers versus Prime Brokers due to DVP Brokers generally not being able to rehypothecate or pledge customer securities to satisfy NSCC's Clearing Fund deposit requirement. The Proposed Rule, to the extent that it disfavors DVP Brokers also gives the appearance that such firms pose a greater systemic risk, or are otherwise less safe, which is simply not the case. The proposed elimination of the ID Offset appears to reflect the view that NSCC's risk varies solely with respect to its obligations on individual transactions and is unrelated to the risk of the member's actual activities. Indeed, elimination of the ID Offset has the perverse effect of establishing collateralization requirements for DVP Brokers that are identical to (i) Prime Brokers, even though Prime Brokers' continued access to customer collateral can be threatened when they experience financial distress and (ii) broker-dealers engaged in significant proprietary trading activities, even though the financial risks posed by rehypothecation of customer securities and proprietary trading on one hand, and institutional agency brokerage on the other hand, are substantially different. Elimination of the ID Offset will have a material impact on DVP Brokers' Clearing Fund deposit requirement and its unpredictability (due to buy/sell imbalances) would likely cause DVP Brokers to either severely curtail the level of ID-settled orders they could accept or to cease clearing ID transactions entirely, introducing such transactions to the Prime Brokers for settlement. We respectfully submit that these unintended consequences, namely, concentration of NSCC's membership in a smaller number of larger firms and creation of a bias against DVP Brokers and towards the Prime Brokers, actually increase NSCC's own risk as well as general systemic risk.

The Proposed Rule Unfairly Discriminates Against DVP Brokers

The disproportionate impact of the Proposed Rule on agency firms is inconsistent with the requirements of the Act. Among other things, Section 17A(b)(3)(F) of the Act requires registered clearing agencies to have rules that "are not designed to permit unfair discrimination in the admission of participants or among participants of the clearing agency". In addition to the likely result that many DVP Brokers will curtail or cease clearing ID transactions, the Proposed Rule will also act as a barrier to entry for DVP Brokers. The increase in and unpredictability of Clearing Fund deposit requirements in the absence of the ID offset will require DVP Brokers to find substantial additional sources of unsecured financing, thus preventing new firms from providing DVP brokerage clearing services, effectively ensuring the competitive advantage of Prime Brokers that are able to utilize customer funds and/or proprietary trading positions to finance their Clearing Fund deposit requirements.

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On the surface, limiting the institutional DVP brokerage business to firms with access to greater levels of collateral may seem like a desirable result, however the source of the collateral and the risks posed by the business models of such firms cannot simply be ignored. Moreover, the reduction of competition among brokers that may result would likely drive up commissions and fees and, in the face of substantially reduced competition, stifle innovation and generally reduce the quality of service received by institutional investors. Finally, as discussed above, in practice, the Proposed Rule actually has the greatest impact on the firms that are least likely to fail, rendering this disparate treatment unfair and inconsistent with the requirements of the Act.

#### NSCC's Statement Regarding Impact on Competition is Legally Insufficient

In its statement regarding the Proposed Rule's burden on competition, NSCC states 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". NSCC then discusses the perceived benefits of the Proposed Rule. Specifically, NSCC states that the Proposed Rule will "mitigate market risk that may arise after NSCC has ceased to act for [a] Member if it is unable to complete...ID transactions" and that it will "contribute to the goal of financial stability in the event of Member default." Finally, NSCC states that the benefits of the Proposed Rule will "render not unreasonable or inappropriate any burden on competition that the changes could be regarded as imposing".

These statements, which are entirely unsupported, are not sufficient to meet the statutory standard in Section 17A(b)(3)(I) of the Act, that the rules of a clearing agency "not pose any burden on competition not necessary or appropriate in furtherance of the purposes of this title." NSCC has not furnished any evidence that it has seriously considered the potential impact on competition. In the Proposing Release, NSCC simply states that any burden on competition will not be unreasonable or inappropriate. This bald assertion alone is insufficient and must be supplemented with real evidence before the Commission can approve the Proposed Rule.

#### The Phase-In Will Not Ameliorate the Impact of the Proposed Rule

The NSCC has proposed to phase-in the Proposed Rule over a period of 18 months. In the Proposing Release, NSCC states that the purpose of the phase-in is to "mitigate the impact" of the elimination of the ID Offset. At first blush, a phase-in appears to be a reasonable approach, however, all the phase-in will do is delay the inevitable. Simply put, firms that do not carry customer accounts, or maintain balance sheets necessary to support proprietary trading positions or that are unable to secure financing will be forced to cease providing brokerage services to client that settle transactions on an ID basis. The phase-in will give these firms some additional time to see the train coming, but they

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remain tied to the track. Given the nature of the issue, there is no implementation period that will change the economic disincentives for DVP Brokers to clear ID transactions in the face of the elimination of the ID Offset. DVP Brokers will be at a substantial disadvantage in the provision of DVP brokerage clearing services.

#### NSCC Must Explore Less Disruptive Alternatives

On March 16, 2011 a group of NSCC members that will be adversely impacted by the Proposed Rule wrote a letter to DTCC Chairman Donald F. Donahue expressing their concerns and asking, in particular, that NSCC explore less disruptive alternatives to implement their risk mitigation strategy. As far as we are aware, NSCC has not adequately explored alternatives.

We ask that the Securities and Exchange Commission (“Commission”) require NSCC to examine less onerous risk mitigation alternatives. NSCC’s principal stated concern is that counterparties to ID transactions are not NSCC members and are not legally bound to complete ID transactions. As a result, NSCC may have to suddenly commit large amounts of capital should these counterparties refuse to complete their transactions in the event of the insolvency of the NSCC member. At a meeting with NSCC staff in January 2011, a group of member firms suggested several alternatives to the Proposed Rule. These alternatives included, among others, coupling elimination of the ID Offset with other revisions to the calculation of the Clearing Fund deposit requirement that reduced DVP Brokers’ Clearing Fund deposit requirement to properly reflect the risks posed by members’ business models, inducements to increase participation in ID Net (which does not pose the same risks to NSCC) and establishing a separate guarantee fund. NSCC could also require an explicit grant of subrogation rights in respect of ID transactions that would remain subject to an ID Offset. NSCC should be required to study these alternatives to determine whether any of them could achieve NSCC’s reasonable risk mitigation goals without creating a material disincentive to DVP Brokers’ continuing to clear ID transactions.

Even if NSCC were to conclude, upon reasonable examination of alternatives, to move forward with the Proposed Rule, there is no reason why elimination of the ID Offset may not be accompanied by other changes to the calculation of the Clearing Fund deposit requirement that take into consideration the business model of the NSCC member firm and appropriately reduces the Clearing Fund Deposit requirement for DVP brokerage model members to accurately reflect the risks they pose to NSCC.

NSCC could also incorporate some of the risk-mitigation strategies identified above to reduce reliance on the ID Offset and minimize the impact of the Proposed Rule. While solutions like these would not totally alleviate the increased burden on DVP Brokers,

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they may decrease the impact enough to enable them to continue to clear ID transactions rather than further concentrating settlement exposures among the Prime Brokers that are most likely to give rise to NSCC losses and increase systemic risk.

Conclusion

For the reasons discussed above, ConvergEx believes that the elimination of the ID Offset will have a substantial and disproportionately negative impact on DVP Brokers that do not generally have access to customer collateral. NSCC has not demonstrated that the resulting burden on completion is warranted given the magnitude of the anticompetitive impact. We ask that the Commission either disapprove the Proposed Rule or institute proceedings to determine whether to disapprove the Proposed Rule. Before the Commission approves the Proposed Rule, NSCC should be required to demonstrate that it has given serious consideration to a number of viable alternatives that would not pose the same burden on competition. NSCC should also conduct a more detailed study regarding the potential impact of the Proposed Rule, particularly on DVP Brokers.

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ConvergEx greatly appreciates the Commission's consideration of the issues raised above in connection with NSCC's proposed rule change. We would be pleased to discuss these comments in greater detail with the Commission and the Staff. If you have any questions, please contact me at 212-508-6142 or [julian.rainero@bgllp.com](mailto:julian.rainero@bgllp.com).

Very truly yours,



Julian Rainero

cc.: Elisse B. Walter, Chairman  
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