



June 13, 2013

By Electronic Mail

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Re: *Proposed Rule Change by National Securities Clearing Corporation to Institute Supplemental Liquidity Deposits to Its Clearing Fund Designed To Increase Liquidity Resources to Meet Its Liquidity Needs; Release Nos. 34-69313, 69571; File Nos. SR-NSCC-2013-02, 802*

On March 21, 2013, National Securities Clearing Corporation (“NSCC”) filed a proposed rule change and advance notice¹ with the U.S. Securities and Exchange Commission (the “SEC” or “Commission”) that would require some NSCC clearing members to make supplemental liquidity deposits to NSCC to help ensure that NSCC has sufficient financial resources in its clearing fund to meet its liquidity needs (the “SLD Proposal”).² Citadel LLC appreciates the opportunity to provide comments on the proposal.³ Because the SLD Proposal does not meet applicable requirements, we urge the Commission to disapprove the SLD Proposal under the Securities Exchange Act (“Exchange Act”) and to issue a notice of objection under the Payment Clearing and Settlement Supervision Act (“Clearing Supervision Act”).

Collectively, the Exchange Act, SEC Rule 17Ad-22, and the Clearing Supervision Act require a systemically important clearing agency like NSCC to design its clearing member liquidity requirements to facilitate the ability of members to plan ahead and, if needed, adjust their business activities to control their liquidity obligations to NSCC. To meet this goal, NSCC’s rules should be designed with the following principles in mind.

¹ Exchange Act Release Nos. 34-69313 (April 4, 2013), 78 FR 21487 (April 10, 2013); 34-69451 (April 25, 2013), 78 FR 25496 (May 1, 2013).

² Unless otherwise specified, capitalized terms in this letter have the same meaning as in the SLD Proposal.

³ Established in 1990, Citadel is a leading global financial institution that provides asset management and capital markets services. With over 1,100 employees globally, Citadel serves a diversified client base through its offices in the world’s major financial centers including Chicago, New York, London, Hong Kong, San Francisco and Boston. Citadel Securities operates an industry leading market making franchise and an institutional markets platform. On an average day, Citadel accounts for over 14 percent of U.S. listed equity volume and over 19 percent of U.S. listed equity option volume.

First, whenever feasible, the metrics that a clearing agency uses to compute liquidity requirements for clearing members (“liquidity metrics”) should be metrics that clearing members can control through adjustments to their activities in the securities markets. Using metrics that are within the control of clearing members promotes prompt and accurate clearance and settlement by allowing clearing members to reliably manage their liquidity requirements. Second, to the extent that it is necessary or appropriate for a clearing agency to use liquidity metrics that are beyond the control of clearing members, the clearing agency should choose metrics that members can measure and model. Third, clearing agencies should provide a sufficient description of liquidity metrics, and regular and frequent reporting of liquidity metrics not otherwise directly available to members, to allow members to reasonably predict the operation of those metrics and the liquidity consequences.

Unfortunately, NSCC’s SLD Proposal is designed in a manner that departs drastically from these principles. As discussed in detail below, the SLD Proposal would require some clearing members to post extraordinarily large amounts of cash to NSCC on short notice and to do so for prolonged periods. Moreover, the size of these deposits would be determined according to NSCC’s use of metrics and computations that are opaque, unnecessarily outside of the control of members, and not sufficiently transparent or well explained to allow clearing members to measure or predict their consequences.

Beyond matters of control and transparency, the SLD Proposal also falls short because of the undue discrimination that it would impose. For example, the SLD Proposal favors clearing members affiliated with large banks in ways that discriminate against, and would burden the competitiveness of, other NSCC clearing members. This discrimination and burden on competition is not necessary or appropriate to further the purposes of the Exchange Act applicable to clearing agencies, and it would likely result in further concentration of risk at the largest NSCC clearing member firms.

The SLD Proposal also provides little explanation of why NSCC chose to design its SLD methodology in the manner proposed, and no explanation is given of alternative approaches NSCC may have considered or the reasons why any such alternatives were rejected.⁴

⁴ We note that NSCC recently filed a letter with the SEC dated June 10, 2013 in which it responds to a number of comment letters on the SLD Proposal that were previously filed. In response to certain clearing member concerns, NSCC also contemporaneously filed several amendments that are posted on the website of The Depository Trust & Clearing Corporation. It appears to us that the changes incrementally mitigate some of the deficiencies of the SLD Proposal, and in connection with this letter we will review them in full to determine their collective effect. Even with the changes NSCC describes, however, we believe that fundamental deficiencies and concerns remain.

I. ANALYSIS OF THE SLD PROPOSAL

A. The SLD Proposal Fails to Meet the Transparency, Adequacy, and Clarity Requirements of SEC Rule 17Ad-22

1. The Requirements of SEC Rule 17Ad-22

The SEC recently adopted certain standards for clearing agencies in its Clearing Agency Standards⁵ release and corresponding Rule 17Ad-22.⁶ In addition to reflecting regulations that the SEC now uses to evaluate proposed rule changes by clearing agencies under the Exchange Act, these standards also apply to advance notices as part of the Clearing Supervision Act.⁷ Rule 17Ad-22 therefore applies to the SLD Proposal in full because it is both a proposed rule change and an advance notice. The SLD Proposal fails to meet these standards.

Applied to NSCC, several of the requirements of Rule 17Ad-22 coalesce around the theme that NSCC's rules must represent a clear legal framework and provide users of its facilities with sufficient information to be able to evaluate the risks and costs of NSCC's services. Below, we describe these requirements in detail. We also discuss their specific application to the SLD Proposal and refer to them collectively as the "Information Transparency, Clarity, and Adequacy Requirements."

Rule 17Ad-22(d)(9) requires NSCC to provide market participants with sufficient information to identify and evaluate the risks and costs associated with use of NSCC's services. The nature and extent of the information required to be provided is expected to be tailored to the needs of market participants based on the risks and costs to which they are exposed.⁸ As an example of the specific type of information targeted by the rule, the SEC specifically notes its belief in the Clearing Agency Standards that "information regarding [NSCC's] margin methodology and information regarding the extreme but plausible scenarios that [NSCC] uses to stress test its margin requirements are among the categories of information that participants could use to identify and evaluate risks and costs. . . ."⁹

Rule 17Ad-22(b)(2) requires NSCC to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models to set margin requirements. Guidance in the Clearing Agency Standards clarifies that this at least in part means that NSCC "must submit [its] risk management procedures, including margin methodology to the Commission for review and public comment as a proposed rule change under

⁵ Exchange Act Release No. 34-68080 (October 22, 2012), 77 FR 6620 (November 2, 2012) ("Clearing Agency Standards"), <http://www.gpo.gov/fdsys/pkg/FR-2012-11-02/pdf/2012-26407.pdf>.

⁶ 17 CFR 240.17Ad-22.

⁷ Securities Exchange Act Release No. 34-68935 (February 14, 2012) 78 FR 12121 (February 21, 2013) (SR-OCC-2012-801), <http://www.gpo.gov/fdsys/pkg/FR-2013-02-21/pdf/2013-03969.pdf> .

⁸ Clearing Agency Standards at 66253.

⁹ Id.

Rule 19b-4.”¹⁰ Disclosure of the margin-setting methodology facilitates prompt and accurate clearance and settlement by enabling market participants to better plan for margin costs associated with their securities activities. With respect to the appropriate level of detail, the amount of information in a proposed rule change must be sufficient to allow meaningful comment.¹¹ The Clearing Agency Standards release also notes that any reasonable process of implementing margin practices should involve detailed communications with clearing members regarding the expected results of those practices.¹²

Furthermore, under Rule 17Ad-22(d)(1) NSCC must have a well-founded, transparent, and enforceable legal framework for each aspect of its activities in all relevant jurisdictions. To achieve compliance with this requirement, NSCC’s rules that address significant aspects of its risk management regime must be clear. Accordingly, a legal risk that is meant to be redressed by this rule is that NSCC’s policies and procedures are incomplete or opaque.¹³

Rule 17Ad-22(d)(11) requires NSCC to establish default procedures that ensure it can take timely action to contain losses and liquidity pressures and continue meeting its obligations in the event of a participant default and to make key aspects of such default procedures publicly available. A primary aim of Rule 17Ad-22(d)(11) is to help provide certainty and predictability to participants about NSCC’s default process and how it manages its related liquidity demands so that participants may plan accordingly.¹⁴

As more fully described below, the SLD Proposal fails to meet these requirements.

2. Application of the Information Transparency, Clarity, and Adequacy Requirements of Rule 17Ad-22 to the SLD Proposal

In terms of the Information Transparency, Clarity, and Adequacy Requirements of Rule 17Ad-22, NSCC misses the mark in its design of the SLD Proposal, as well as with respect to the information that NSCC has provided to clearing members and the public. Below, we discuss how particular aspects of the SLD Proposal are deficient in terms of these requirements and should be improved.

¹⁰ Clearing Agency Standards at 66233.

¹¹ Securities Exchange Act Release No. 34-67286 (June 28, 2012), 77 FR 41602, 41653 (July 13, 2012) (providing in section B. of the general instructions to SEC Form 19b-4 that the form is meant to elicit information necessary for the public to provide meaningful comment on a proposed rule change and that the information called for by Form 19b-4 must be presented in a clear and comprehensible manner), <http://www.gpo.gov/fdsys/pkg/FR-2012-07-13/pdf/2012-16233.pdf>.

¹² Clearing Agency Standards at 66233.

¹³ *Id.* at 66246.

¹⁴ *Id.* at 66254.

The Size of NSCC's Liquidity Need

As noted above, clearing members would be expected to make SLD contributions based on the peak liquidity need caused by a single NSCC clearing member or clearing member family. In addition to this sizing method being beyond clearing member control, NSCC has not provided more fundamental data directly to clearing members or through the SLD Proposal about how NSCC has determined its liquidity shortfall that gives rise to the need for the SLD proposal, including how those liquidity needs may have historically changed during periods of higher volumes or increased market activity. This lack of baseline data makes it difficult for clearing members who are Regular and Special Activity Liquidity Providers to predict how changes in market activity tend to impact NSCC's liquidity demands and how those demands will impact their own liquidity needs. The lack of data also makes the SLD Proposal unclear in terms of whether it is meant to be a full solution to the liquidity shortfall that NSCC has identified or whether NSCC also anticipates that still more liquidity from clearing members will be needed in the near term for NSCC to meet its liquidity needs under Rule 17Ad-22(b)(3). We note that NSCC has not yet adopted a definition of "extreme but plausible market conditions" in connection with its requirements under Rule 17Ad-22(b)(3) and that defining that term is a critical driver of the total amount of financial resources and liquidity that NSCC is required to maintain.

Credit Facility Renewal Contributions

Under the SLD Proposal, the Credit Facility used in connection with Regular Activity Supplemental Deposits would be renewed annually. This means that clearing members would indirectly face a substantial, annual refinancing risk because if the renewal of the Credit Facility goes poorly there would be a sudden and drastic increase in their Regular Activity Supplemental Deposit. The Credit Facility would be open for commitments only for a short period, making it difficult for Regular Activity Liquidity Providers to determine whether to participate. Furthermore, the total size of the Credit Facility would be influenced based on prevailing market conditions, decisions by NSCC regarding the terms of the Credit Facility, and participation by entities that are not affiliated with NSCC members. These factors are beyond the control of clearing members.

This annual renewal of the Credit Facility would not provide clearing members with a controllable or reliable way to predict their liquidity obligations to NSCC. Given the extremely important role that the Credit Facility would play overall in the SLD Proposal and the significant size of the Credit Facility, these aspects of the SLD Proposal reflect a risky and opaque way of raising liquidity.

Interim Adjustments to SLD Contribution Requirements

NSCC would be permitted to make interim recalibrations and liquidity calls to adjust Regular Activity and Supplemental Activity Liquidity Deposits. These adjustments would be subject to undisclosed thresholds determined solely by NSCC at its discretion. This necessarily

precludes clearing members who are Regular Activity Liquidity Providers and Supplemental Activity Liquidity Providers from being able to plan for increased liquidity demands.

The SLD Proposal would also permit NSCC to allocate an interim deposit adjustment on all Regular Activity Liquidity Providers if the aggregate amount of Regular Activity Supplemental Deposits decreases for any reason by an amount that exceeds a threshold as determined by NSCC (e.g., due to retirement of clearing members or NSCC ceasing to act on behalf of a clearing member). Regular Activity Liquidity Providers would have no control over the cause of the additional liquidity allocation (which may be triggered by the activities of another clearing member) and also would not know the degree of the decrease in the Regular Activity Supplemental Deposits that would trigger the allocation.

Credit Facility Eligibility

The terms that define eligibility for and participation in the Credit Facility are also not sufficiently detailed in the SLD Proposal to enable clearing members, market participants, and the public to understand the terms of access and participation. Particularly in view of the central role that the Credit Facility would play in NSCC's liquidity solution and the substantial liquidity obligations of Regular Activity Liquidity Providers, significantly more detail should be provided to comply with the Information Transparency, Clarity, and Adequacy Requirements of Rule 17Ad-22.

B. The Information Transparency, Clarity, and Adequacy Deficiencies of the SLD Proposal Would Frustrate the Ability of Broker-Dealer Clearing Members to Meet the Expectations of FINRA Notice 10-57

All of these SLD Proposal deficiencies would also frustrate the ability of FINRA registered broker-dealers who are Regular and Special Activity Liquidity Providers to meet the funding and liquidity expectations applicable to them under FINRA Regulatory Notice 10-57. Regulatory Notice 10-57 provides that FINRA members need to develop and monitor funding and liquidity risk management programs that plan for a broad range of adverse circumstances, including extraordinary credit events, to maximize the likelihood that the broker-dealer can continue to operate under adverse circumstances.¹⁵ If the terms of the liquidity program at NSCC are permitted to remain vague and driven by inputs that are beyond clearing members' control or ability to predict (e.g., targeting the peak liquidity exposure of a separate member, subject to secret thresholds for further interim liquidity demands, etc.), that would directly undermine broker-dealers' ability to plan for funding and liquidity risks as provided in Regulatory Notice 10-57.

¹⁵ FINRA Regulatory Notice 10-57, (November 2010), <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122388.pdf>.

C. Uncertainty About Capital Treatment Under SEC Rule 15c3-1 for SLD Contributions Would Further Frustrate the Ability of Clearing Members to Anticipate the Costs of the SLD Proposal

Under SEC Rule 15c3-1, broker-dealers are generally required to hold a certain amount of net capital, which may involve holding reserves against certain illiquid or unsecured receivables. The SLD Proposal does not specify the capital treatment under Rule 15c3-1 that would apply to collateral pledged by clearing members. More specifically, it is unclear if cash SLD contributions would be considered non-allowable assets due to the lock-up periods. It is also unclear whether Credit Facility participation would result in a capital charge to a clearing member who is a Regular Activity Liquidity Provider even if the loan is never drawn.

Without first establishing capital treatment, NSCC cannot adequately assess the impact of the SLD Proposal on clearing members and compare it to other potential approaches that could lead to more favorable outcomes for clearing members and the clearing system. Moreover, if a capital charge would apply, then the size of the liquidity obligations involved would very likely be a significant constraint on the resources of broker-dealers that are Regular and Special Activity Liquidity Providers. Allowing this uncertainty to remain would be inconsistent with the purposes of the Exchange Act applicable to clearing agencies because it would not foster cooperation and coordination with persons engaged in the clearance and settlement process and would not remove impediments to or perfect the mechanism of a national system for prompt and accurate clearance and settlement.¹⁶

D. The SLD Proposal Would Unnecessarily and Unfairly Discriminate Among Clearing Members in Their Use of NSCC's Services

The Exchange Act requires NSCC to maintain rules that do not unfairly discriminate among participants in their use of the clearing agency.¹⁷ The Commission staff has stated that a clearing agency may discriminate among persons in their use of its facilities if the discrimination is based on standards of financial responsibility, operational capability, experience, and competence and such discriminations are fair when viewed in light of the public interest and the requirements of the Exchange Act applicable to clearing agencies.¹⁸

The SLD Proposal does not meet this standard in several respects. For instance, it would unnecessarily and unfairly discriminate among clearing members by requiring some clearing

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

¹⁷ 15 U.S.C. 78q-1(b)(3)(F) (Rule 17Ad-22(d)(2) was also recently adopted to promote compliance with the requirement that a clearing agency's rules may not be designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency).

¹⁸ Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980) (providing SEC staff analysis on the collective meaning of Exchange Act Sections 17A(a)(2) and (b)(3)(A), (F) and (I) and when a clearing agency may properly impose a burden on competition, including discriminations between clearing members in their use of the clearing agency's facilities), <http://www.sec.gov/rules/other/34-16900.pdf>.

members that are Regular Activity and Special Activity Liquidity Providers to lock-up assets based on the Peak Regular or Special Liquidity Exposure to NSCC caused by an entirely separate clearing member. This approach would fail to correlate SLD contributions to the risks that each clearing member poses to NSCC. Instead, it would require them to be accountable for the trading activity of another clearing member over which they have no control. Furthermore, the SLD Proposal would isolate 30 NSCC clearing members and impose the entirety of its liquidity burdens on them without any contributions from the remainder of the clearing members that benefit from the use of NSCC's facilities. This discrimination has not been sufficiently explained or justified.

The SLD Proposal also would discriminate among clearing members by requiring clearing members that are Regular Activity Liquidity Providers and do not have a bank affiliate to satisfy their Regular Activity Supplemental Deposit in cash, while clearing members with a bank affiliate would be eligible to satisfy some or all of their deposit using the Credit Facility. Because the Proposal does not mandate that all Regular Activity Liquidity Providers would be eligible for the Credit Facility (e.g., as a matter of NSCC rules and the terms of the Credit Facility), the SLD Proposal would advantage some clearing members over others by allowing them to retain more cash on hand for use in their businesses. This discrimination on the basis of corporate form is not properly risk-based and would discourage activity in the execution markets by effectively imposing a transaction cost on clearing members that do not have a bank affiliate, making it more expensive to clear and settle trades than for members that do have a bank affiliate. Self-clearing would be discouraged by the costs of this structure, and that would promote greater concentration of clearing activity and risk within a few large market participant firms.

The SLD Proposal does not explain why these discriminations are fair, in the public interest, and would promote the purposes of the Exchange Act. Instead, it declares that the funding obligations are appropriate because they would be allocated in proportion to the liquidity needs that a Regular Activity or Special Activity Liquidity Provider poses to NSCC and because the end result of the SLD Proposal is more liquidity for NSCC. This is an "ends justify the means" argument that misses the point that it *is* important to the financial system *how* NSCC meets its liquidity needs. It also fails to recognize that the "proportional allocation of contributions" is performed only after the peak liquidity exposure caused by a single clearing member or clearing member family is used to benchmark the total liquidity requirement that all other members must satisfy. In these ways, the SLD Proposal does not attempt to justify its true burdens and discriminations with respect to how NSCC's total liquidity need would be sized and the segregation of non-bank affiliate clearing members from participation in the Credit Facility.

Ultimately, we believe that these burdens are so significant that they cannot be reasoned to be fair when viewed in light of the public interest and requirements of the Exchange Act. The deleterious effect on self-clearing alone would create undesirable concentration risks in the U.S. clearance and settlement system.

E. Justifications are Not Given for Key Metrics of the SLD Proposal and It is Therefore Impossible to Determine Whether the SLD Proposal is Consistent with Applicable Requirements

The SLD proposal does not provide reasons for several key metrics that would govern Regular Activity Supplemental Deposits and Special Activity Supplemental Deposits and that therefore directly affect the liquidity impact on NSCC clearing members. Given the requirement in Form 19b-4 that enough information be provided to enable meaningful comment, we believe that it is necessary for NSCC to provide explanations concerning why the following choices were made in the SLD Proposal and that these explanations should be extensive enough to satisfy the Information Transparency, Clarity, and Adequacy Requirements of Rule 17Ad-22:

- Only gross settlement debits are used to size SLD contributions;
- The number of Regular Activity and Supplemental Liquidity Providers is 30;
- Regular Activity Supplemental Deposits are satisfied in cash or through the Credit Facility while Special Activity Supplemental Deposits must be in cash;
- Credit Facility participation is not available for all Regular Activity and Supplemental Activity Liquidity Providers;
- Historical lookback periods of one year and 24 months are the appropriate data sets respectively to size Regular Activity Supplemental Deposits and Special Activity Supplemental Deposits;
- Regular Activity Supplemental Deposits, adjusted semi-annually, should remain on deposit for approximately 364 days;
- Semi-annual review of the Regular Activity Supplemental Deposits is appropriate;
- Prefunded Regular Activity Supplemental Deposits must remain on deposit for 7 business days;
- All Special Activity Supplemental Deposits (including prefunded deposits) must remain on deposit 7 business days after the end of the Options Expiration Activity Period;
- Special Activity Liquidity Deposits that are the result of an interim collateral call by NSCC should be held until 2 business days preceding the end of the next Options Expiration Activity Period;
- Regular and Special Activity Liquidity Providers have 3 business days to post additional collateral if NSCC determines that Regular or Special Activity Deposits are required to increase;
- Regular Activity Liquidity Providers that are over collateralized are entitled to receive a refund within 5 business days if there is no longer a requirement to

contribute and within 10 business days if contributions are being refunded in part; and

- Special Activity Liquidity Providers that are overcommitted are entitled to receive a refund within 7 business days.

Because NSCC does not explain why these particular parameters are appropriate, we believe there is insufficient information in the public record to enable meaningful comment and for the Commission to be able to make findings that the SLD Proposal would be consistent with the requirements of the Exchange Act and the Clearing Supervision Act.

II. ALTERNATIVE APPROACHES TO MEET NSCC'S LIQUIDITY NEEDS

A. Inadequate Discussion of Alternatives in the SLD Proposal

The SLD Proposal is silent about alternative liquidity solutions NSCC may have considered and the reasons why NSCC rejected those alternatives in favor of the SLD Proposal. To enable the SEC and the public to make an informed judgment about the SLD Proposal, NSCC should explain the reasonable alternatives considered and NSCC's reasons for choosing one approach over another. Below, we make a number of suggestions for improvements to the NSCC liquidity framework. It is likely that a number of these alternatives would work best in combination. We assume that NSCC may have considered and rejected some of these alternatives for specific reasons. By including those reasons in the rule filing, the SEC and the public will have the information needed to assess those reasons, and more importantly, to subsequently comment on whether there are ways to address potential obstacles.

B. Expansion of Fundraising Methods

First, NSCC should consider permitting clearing members to meet their SLD contribution requirements through secured lending arrangements as an additional means of providing NSCC with liquidity. Reliance only on the Credit Facility (*i.e.*, not permitting securities lending arrangements as part of the liquidity solution) would discriminate against clearing members that do not have bank affiliates and that, as part of their business model, may be better positioned to meet liquidity demands through securities lending arrangements than through Credit Facility participation. Including letters of credit as a means by which clearing members could satisfy their SLD contributions should also be considered.

Second, Given NSCC's AA+ credit rating, NSCC should consider one or more bond offerings with staggered maturities as a mechanism that would provide liquidity. This mechanism would have the added benefit of providing a form of liquidity to NSCC that typically has a much longer maturity period than is planned for the Credit Facility.

Third, if NSCC ultimately decides that all non-bank affiliate Regular Activity Liquidity Providers should not be eligible to participate in the NSCC Credit Facility, NSCC should consider alternative methods of participation. For example, clearing members should be permitted to enter other credit facility arrangements to offset their Regular Activity Supplemental

Deposit. These arrangements could be subject to specific and reasonable conditions imposed by NSCC and its regulators. NSCC should also consider permitting indirect participation in the Credit Facility through correspondent participation arrangements. These arrangements could be negotiated between members that do not qualify for direct Credit Facility participation or who choose not to participate and Regular Activity Liquidity Providers or other banks that do.

We note that Regulation W of the Bank Holding Company Act imposes quantitative and qualitative limits on the ability of a bank to extend credit to an affiliate. As indicated in footnote one of the SLD Proposal, these regulations generally impose a responsibility on banks to make arm's length credit decisions concerning affiliates, including their broker-dealer affiliates. Because numerous banks are making commitments to the Credit Facility on behalf of their affiliates, it must be the case that credit worthy clearing members that do not have bank affiliates could also successfully obtain agreements from unaffiliated banks to meet their SLD contribution requirements. Unfortunately, no such arrangements for Credit Facility participation are recognized by NSCC under the original SLD Proposal.

C. Redesign of the Allocation Methodology of the SLD Proposal

Rather than allocating the Regular Activity and Special Activity Peak Liquidity Needs based on the peak activity liquidity exposures of the members in the group of 30 relative to one another, Regular Activity and Special Activity Peak Liquidity needs should be allocated using a tiered structure that concentrates a greater proportion of the allocation to the Regular and Special Activity Liquidity Providers that generate the largest exposures to NSCC. For example, SLD contributions could be sized for each clearing member based solely on the maximum liquidity exposure that particular member caused to NSCC during the relevant period. Any remaining shortfall in NSCC's ability to meet its liquidity need could then be allocated to those clearing members who are responsible for generating the most material liquidity exposures—for example, to the clearing member responsible for the largest liquidity exposure, the five clearing members responsible for the five largest liquidity exposures, or some other appropriate contingent of clearing members representing the most material exposures. Through this type of tiered structure, more clearing members would be in complete control of their SLD contributions. And, those clearing members who choose to engage in activities that truly generate the largest liquidity exposures to NSCC would be those responsible for funding the risk of those liquidity exposures.

We do not believe that the SLD Proposal is clear regarding whether Peak Regular and Special Activity Liquidity Exposures would be computed such that netting of exposures would be allowed across a clearing member family. We firmly believe that intra-family netting should not be permitted. To the extent that a clearing member family chooses to participate in NSCC using multiple clearing members and that fragmented structure results in a larger total liquidity exposure under the SLD Proposal than if the clearing member family were organized as a single clearing member, the SLD Proposal should apportion more of the SLD liquidity requirement to that clearing member family. Each clearing member family should be fully responsible for the liquidity burdens that are created by how it chooses to organize its NSCC participation.

We also believe that all NSCC clearing members should be required to satisfy some minimum SLD contribution requirement. This would fairly require all clearing members that use NSCC's facilities to help meet its liquidity needs.

D. Other Risk Management Approaches

NSCC should consider whether credit limits for NSCC clearing members, similar to those already in place at DTC, coupled with robust monitoring of clearing member trading activity and more frequent intraday margin calls would permit NSCC to manage its liquidity needs with lower SLD contributions.¹⁹ This type of approach would provide NSCC with more control over its risk management framework than the SLD Proposal because on a continuous basis it would help prevent the build up of liquidity risks.

By contrast, the SLD proposal relies on historical trading activity of some clearing members to try to predict the size of NSCC's future liquidity needs. This requires clearing members who are not responsible for the largest historical liquidity exposures to NSCC to lock-up significant amounts of assets against *potential* future exposures to NSCC. The consequence is that significant amounts of financial resources cannot be used by those firms to advance their core business operations and to stimulate growth in the U.S. economy.

In Important Notices A7364 and A7372,²⁰ NSCC identified the possibility of using implied volatility as one way to help NSCC ensure that it has sufficient assets on deposit from clearing members to satisfy losses resulting from a clearing member default and the close out of its positions. This approach was recently adopted by the Government Securities Division of Fixed Income Clearing Corporation.²¹ As part of a more comprehensive explanation to clearing members of how NSCC plans to meet the overall financial resources and liquidity obligations that the SLD Proposal attributes to SEC Rule 17Ad-22(b)(3), NSCC should, among other things, explain why it previously announced consideration of implied volatility indicators to enhance its clearing fund deposits but has postponed that enhancement and should also explain whether clearing members may still, in the near term, need to plan for that type of clearing fund enhancement. We understand that the SLD Proposal is primarily focused on addressing NSCC's liquidity needs, but to the extent that the SLD Proposal is one step in a series of expected changes to NSCC's clearing fund structure designed to bolster the sufficiency of its resources,

¹⁹ Although the shorter lock-up periods associated with prefunding would incentivize clearing members to proactively manage their liquidity obligations, this structure still does not provide NSCC with a means to cap the overall liquidity requirement of a clearing member and achieve true control over the peak liquidity exposure.

²⁰ DTCC Important Notice A7364, [Revisions to NSCC Clearing Fund Methodology](http://www.dtcc.com/downloads/legal/imp_notices/2012/nscc/a7364.pdf) (January 27, 2012), http://www.dtcc.com/downloads/legal/imp_notices/2012/nscc/a7364.pdf; DTCC Important Notice A7372, [Postponement of Revision to NSCC Clearing Fund Methodology](http://www.dtcc.com/downloads/legal/imp_notices/2012/nscc/a7372.pdf), (February 27, 2012), http://www.dtcc.com/downloads/legal/imp_notices/2012/nscc/a7372.pdf.

²¹ Securities Exchange Act Release Nos. 34-67059 (May 24, 2012), 77 FR 32153 (May 31, 2012), <http://www.gpo.gov/fdsys/pkg/FR-2012-05-31/pdf/2012-13150.pdf>; 34-67336 (July 2, 2012), 77 FR 4039 (July 9, 2012) (SR-FICC-2012-04), <http://www.gpo.gov/fdsys/pkg/FR-2012-07-09/pdf/2012-16653.pdf>.

that fact ought to be clearly signaled even if the larger context is limited to a thematic explanation at this stage.

III. IMPROVING TRANSPARENCY

To the extent that the SLD Proposal is carried forward in one form or another, in compliance with Rules 17Ad-22(d)(9) and the rest of the Transparency, Clarity, and Adequacy Requirements of Rule 17Ad-22, we believe NSCC should provide clearing members with appropriate quantitative data, including some level of back testing and stress testing information, to help explain the goals of the SLD Proposal and properly inform clearing members regarding the risks and costs of their participation. Specifically, we believe that NSCC should provide clearing members with the following information on a daily basis to allow them to manage their participation responsibly:

- Historical data on the liquidity exposure to NSCC caused by each clearing member;
- A way for each clearing member to determine its precise order in the top 30 and its level of activity compared to another clearing member;
- A way for a clearing member to track its current activity compared to other clearing members and to determine whether its order in the top 30 is changing;
- Daily quantitative updates on the liquidity requirements of the top firms; and
- A tool or the ability to project or forecast a clearing member's requirement to determine if it should post collateral in advance of certain periods.

Furthermore, a reasonable degree of quantitative data should be included in the SLD Proposal to allow clearing members, market participants, and the public to provide meaningful comment. We believe this information includes but is not necessarily limited to the following data on an anonymous basis:

- NSCC's clearing fund methodology and size;
- Numerical justifications for the SLD contributions; and
- Relevant narrative and quantitative information concerning back testing, stress testing, and other material aspects of the core risk management program used by NSCC.

Finally, NSCC should establish requirements in its rules to facilitate an appropriate degree of ongoing transparency with clearing members concerning the operation and administration of any SLD contributions. We also believe that the timing for commitment to the Credit Facility should be better coordinated with the semi-annual calculation of Regular Activity Supplemental Deposits so that clearing members may make more timely decisions about whether they have a need to participate in the Credit Facility and, if so, whether Credit Facility

participation makes sense. NSCC should also explore the feasibility of allowing participants to reduce their Credit Facility commitments if the total SLD requirement drops.

IV. A SIGNIFICANT IMPLEMENTATION PERIOD IS WARRANTED

Regardless of the particular mechanism or mechanisms that may eventually be put in place by NSCC to more readily meet its liquidity needs, a significant implementation period should accompany those new liquidity demands on clearing members. The appropriate time frame for implementation would be no sooner than one year from SEC approval of the change and would be the product of a meaningful dialogue between NSCC and its affected clearing members that is reflective of the fact that the increased liquidity demands may require clearing members to change their business models, exit self-clearing (for all or a portion of their trading activity), raise additional capital, or find additional sources of liquidity to meet the new obligations.

V. CONCLUSION

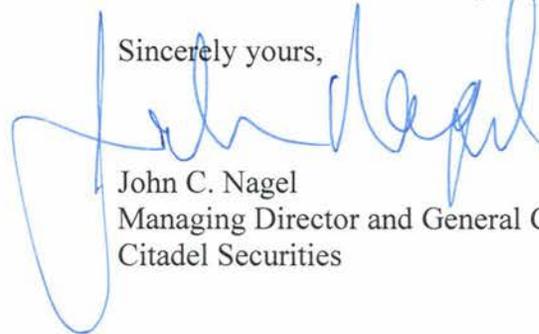
The SEC should disapprove the SLD Proposal because, in its current form, it is not consistent with the requirements of the Exchange Act and the rules and regulations under the Exchange Act applicable to NSCC. Disapproval by the Commission is required because the proposed deposit requirements are opaque and unpredictable, and burden competition without adequate justification. Moreover, NSCC has not provided sufficient information about the choices made in the SLD Proposal to support a finding that the Proposal is consistent with the Exchange Act and the Clearing Supervision Act.

Because the SLD Proposal is also an advance notice, the SEC should issue a notice of objection to NSCC concerning the SLD Proposal. This is appropriate because, as explained above, the SLD Proposal does not comply with the standards of SEC Rule 17Ad-22, which the Commission has identified as the standards for such advance notices.

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If you have any questions, please do not hesitate to contact me at (312) 395-2100.

Sincerely yours,



John C. Nagel
Managing Director and General Counsel
Citadel Securities

cc: The Honorable Mary Jo White, Chairman
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Elisse B. Walter, Commissioner
Mr. John Ramsay, Acting Director, Division of Trading and Markets
Mr. Peter Curley, Associate Director, Division of Trading and Markets
Mr. Michael Macchiaroli, Associate Director, Division of Trading and Markets
Mr. Joseph Kamnik, Assistant Director, Division of Trading and Markets.
Mr. Larry E. Thompson, Managing Director and DTCC General Counsel