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August 5, 2013

<u>Via Electronic Mail</u>

Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: **<u>SR-NSCC-2013-02 as amended by Amendment No. 2 to the Proposed Rule Change and Order Instituting Proceedings to Determine Whether to Approve or Disapprove the Proposed Rule Change</u>**

Ms. Murphy:

ITG Inc. ("ITG"),[1] a registered broker-dealer and member of the National Securities Clearing Corporation ("NSCC"), appreciates the opportunity to submit this comment letter supplementing its April 25th comment letter regarding the above-referenced proposal by the NSCC to amend its rules to impose upon certain of its members a supplemental liquidity funding obligation (the "SLD Proposal" or the "Proposed Rule"). At the outset, we note that ITG appreciates the importance of NSCC's role as a central counterparty ("CCP") and supports NSCC's stated goal of "enhanc[ing] [NSCC's] ability to meet its liquidity requirements."[2] As discussed below, however, we request that the Securities and Exchange Commission (the "SEC" or the "Commission") exercise its authority under Section 19(b)(2)(C)(ii)[3] of the Securities Exchange Act of

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[1] ITG (NYSE: ITG) is an independent execution and research broker that partners with global portfolio managers and traders to provide unique data-driven insights throughout the investment process. From investment decision through trading and settlement, ITG helps clients understand market trends, improve performance, mitigate risk and navigate increasingly complex markets. ITG is headquartered in New York with offices in North America, Europe, and Asia Pacific.

[2] <u>See</u> the Proposed Rule, Item 3(a).

[3] <u>See</u> 15 USC § 78s(b)(2)(C)(ii).

1934, as amended (the "Exchange Act") to disapprove the Proposed Rule. ITG also provides in this letter several suggestions for alternative methods of achieving NSCC's stated goal.

In brief, ITG believes that the Proposed Rule will serve as an unnecessary and inappropriate burden on competition that is inconsistent with the requirements of Section 17A(b)(3)(I) of the Exchange Act. As initially proposed and as amended, the SLD Proposal, in contravention of Section 17A(b)(3)(F) of the Exchange Act, will impose a substantially greater burden on NSCC members that are not affiliated with large banks ("Independent Members") and will likely have the unintended consequence of forcing many Independent Members, even relatively large and well-capitalized firms, out of the business of clearing transactions, due to its seriously flawed design. Additional unintended consequences of the Proposed Rule include increasing the concentration of NSCC-cleared transactions within members whose business models pose the greatest systemic risk to the financial markets and increasing NSCC's reliance for liquidity on unfunded lending commitments from the affiliated banks of the very NSCC members most likely to cause NSCC to require supplemental liquidity. There are far less disruptive means for NSCC to increase the liquidity available to it that have not been adequately examined. Furthermore, we believe that the Proposed Rule evinces an overall lack of transparency, contains a number of fundamental technical errors and ambiguities, and is in various elements arbitrary and capricious, all of which features will result in confusion and material business risk to the NSCC member community.

I. <u>The SLD Proposal</u>

The SLD Proposal is submitted by the NSCC in an effort to comply with Rule 17Ad-22(b)(3) of the Exchange Act. Rule 17Ad-22(b)(3), which was adopted pursuant to Section 805 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), requires entities performing CCP services to maintain sufficient financial resources to withstand the default of a participant family to which it has the largest exposure in extreme but plausible market conditions. Rule 17Ad-22(b)(3) does not prescribe the means by which a CCP must maintain sufficient financial resources. The NSCC seeks to comply with Rule 17Ad-22(b)(3) by, among other things, imposing a requirement that the thirty NSCC participants that generate the largest liquidity needs provide what could be a massive supplemental liquidity deposit.[4]

The SLD Proposal has two primary components, (1) the requirement that certain members provide supplemental liquidity deposits in cash, and (2) a provision whereby members may avoid or reduce such deposits by (a) participating as a Lender (defined below) under a committed, but unfunded, credit facility among NSCC, the Depository Trust Company ("DTC") and the lender parties thereto ("Lenders"), and the

[4] The Commission, in adopting Rule 17Ad-22(b)(3), noted that its understanding was that all CCPs registered with the Commission had sufficient financial resources to meet the requirements of the new rule. The Commission went on to identify a report noting that the NSCC has been using this standard since 2009. Exchange Act Release No. 68080 (Oct. 22, 2012), 77 FR 66219 (Nov. 2, 2012) at Note 183.

administrative agent thereto (the "Administrative Agent") (the "Credit Facility")[5] or (b) designating a commercial lending institution to act as a Lender on its behalf.

II. The Proposed Rule Fails to Meet the Standards of the Exchange Act

For the reasons outlined in this section, ITG maintains that the Proposed Rule fails to meet the standards of the Exchange Act in several respects. Each of these failures should provide an independent basis for the Commission to disapprove the Proposed Rule.

A. The Proposed Rule Will Pose an Unjustified and Inappropriate Burden on Competition

Section 19(b)(2)(C)(i) of the Exchange Act requires that a proposed rule change of a self-regulatory organization ("SRO") be consistent with "the requirements of this chapter and the rules and regulations issued under this chapter that are applicable to such organization." Among the applicable standards of the Exchange Act is Section 17A(b)(3)(I), which requires 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."

As NSCC notes in its June 10, 2013 response to comments (the "Response"),[6] the instructions to Form 19b-4 require SROs to provide detailed responses regarding a proposed rule's impact on competition and provide that "[t]he statement concerning burdens on competition should be sufficiently detailed and specific to support a Commission finding that the proposed rule change does not impose any unnecessary or inappropriate burden on competition." The instructions further directed that NSCC "specify the particular categories of persons and kinds of businesses on which any burden will be imposed and the ways in which the proposed rule change will affect them."

NSCC provided no such detail in the Proposed Rule. NSCC does not provide any information about how many of the members likely to be impacted by the Proposed Rule would be eligible to participate in the Credit Facility, nor does it provide even indicative information about the size of the supplemental liquidity deposit that would be required by the Proposed Rule relative to the excess net capital of members subject thereto. NSCC merely alleges that any burden on competition will not be unreasonable or inappropriate.[7] NSCC has not furnished any evidence that it seriously considered the potential impact on competition. Furthermore, contrary to NSCC's claim in the Response to have "provided documentation to the top 30 firms that (i) outlined the (then) current structure and calculation of the SLD, and (ii) included an impact study to show potential SLD

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[5] See SR-NSCC-2013-803 seeking SEC approval for the Credit Facility. The Administrative Agent under the current Credit Facility is JPMorgan Chase Bank, N.A.

[6] See Letter from Larry E. Thompson, Managing Director and General Counsel, DTCC, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated June 10, 2013.

[7] See Amendment No. 2, Item 4 and the Response, Section I(C).

requirements to the affected Member were the SLD Proposal to be adopted by NSCC," NSCC did not consult with ITG, or, upon information and belief, several other Independent Members prior to submitting the SLD Proposal to the Commission.[8] As a result, we do not see how NSCC could have made a determination with respect to the effect of the Proposed Rule upon competition, as it did not consult one of the key constituencies upon whom the Proposed Rule would have the greatest potential impact.

In the Response, NSCC simply states that it believes that the Commission could find that the Proposed Rule does not impose an undue burden on competition and that "[a]ny burden on competition must be viewed against the requirements of the Exchange Act as an entirety, including the rules and regulations thereunder." [9] NSCC goes on to cite a completely unrelated proposed rule change relating to the Clearing Agency Standards rule.[10] We agree that rules may have an impact on competition and that the Commission may, nevertheless, approve them. In finding those rules consistent with the Exchange Act, the Commission must find that, to the extent that there is a burden on competition, it is necessary and appropriate in furtherance of the purposes of the Exchange Act. Here, NSCC has not provided the Commission with data sufficient to determine whether the burden on competition imposed by the Proposed Rule is necessary or appropriate.

In its statement regarding the Proposed Rule's burden on competition in Amendment No. 2 to the Proposed Rule ("Amendment No. 2"), NSCC has amended the boilerplate language regarding the burden on competition to address changes that have been made to the Proposed Rule in response to industry comments. However, the analysis is still vague and incomplete and cannot form the basis for the Commission to approve the Proposed Rule.[11] For example, there are still no estimates of what the

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[8] In adopting Rule 17Ad-22, the Commission stated that it "believes that Rules 17Ad-22(1)-(4) are appropriate minimum standards for registered CCPs and that they are consistent with existing international standards of practice. <u>However, we agree that the process of evaluating, testing and refining CCP risk management standards will be ongoing and necessarily include an open dialogue among the CCPs, investors, the Commission and various other interested parties.</u> In particular, <u>the Commission will carefully consider further input from interested parties obtained through outreach to various constituencies</u> and in response to any rules or rule amendments that may be proposed by the Commission upon considering the international standards developed by CPSS-IOSCO in the FMI report." (<u>Emphasis added.</u>) In this regard, we note that, despite the importance and complexity of the Proposed Rule, NSCC did not publish the Proposed Rule for comment by NSCC members prior to filing it with the Commission.

[9] <u>See</u> the Response, Section I(C).

[10] We note that in the final rule release for the Clearing Agency Standards rule, the Commission indicates that it considered the rule's impact on competition, noting that adopting the rule "should have the beneficial result of greater competition". <u>See</u> Securities Exchange Act Release No. 68080 (Oct. 22, 2012), 77 FR 66219 (Nov. 2, 2012).

[11] If the Commission is unable to evaluate, based upon the information provided by the SRO, the impact of the proposed rule on competition, it must disapprove the proposed rule change. <u>See, e.g.</u>, Securities Exchange Act Release No. 68269 (Jan. 11, 2013), 78 FR 3928 (Jan. 17, 2013) (Order Disapproving File No. SR-NASDAQ-2012-59).

deposit amounts are likely to be.[12] Further, NSCC does not appear to have considered how many of its current members, at various levels of SLD requirements, will be forced to surrender their NSCC membership and exit self-clearing or the potential impact of such changes on securities markets. Indeed, NSCC appears to dismiss this point entirely, stating in the Response that comments like this are "made every time that the clearing agency has a risk mitigation proposal that requires firms to provide funding." [13] While it is likely the case that demands for additional funding are rarely met with acclamation by members, we do not recall a previous rule proposed by NSCC that could require some of NSCC's largest members to provide funding to NSCC in amounts in excess of that member's entire net capital. As such, we believe that in this case the complaint deserves special attention.

In addition to failing to consider how many of its members may be required to forfeit their NSCC membership, NSCC does not appear to have considered what the impact on competition will be if certain of NSCC's thirty largest members are forced to surrender their NSCC membership. Each time an Independent Member surrenders its NSCC membership because it is unable to meet its deposit requirement, that member would be replaced in the top thirty by an even smaller member that itself may be unable to make its required deposit. As a result, one likely consequence of the deposit requirement is that clearing activity will be concentrated at a small number of large, bank-affiliated members, which would increase systemic risk. Furthermore, smaller firms may rely on members within or near the top thirty for their own settlement and clearing activities, and if those firms are rapidly pushed out of self-clearing, firms relying on such members will have to scramble to find an appropriate broker-dealer with which to establish a correspondent clearing relationship. This could have a cascading effect on securities markets when supplemental liquidity deposits are called.[14]

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[12] The letter submitted to the Commission by the Securities Industry and Financial Markets Association ("SIFMA") on June 24, 2013, concerning the Proposed Rule contains an extensive discussion of the ways in which NSCC has failed to articulate a substantive basis for the SLD Proposal and the ambiguities and lack of transparency evinced by its calculation methodologies, such as they are. We fully endorse these arguments. Furthermore, the promises by NSCC to seek additional financing resources and to use such resources, in their sole discretion, to reduce or offset the Regular Activity Liquidity Obligations is cold comfort given (a) the general willingness expressed by NSCC in the Response to find alternative sources of liquidity, and (b) that any such offset would apparently be entirely within NSCC's discretion.

[13] See the Response, Section III(C).

[14] See Systemic Financial Crises: Resolving Large Bank Insolvencies, Changes in the Structure of the U.S. Financial system and implications for Systemic Risk, Timothy F. Geithner, "[t]he increased size and scope of [complex, bank-centered financial institutions] necessarily exposes them to a wider array of potential shocks and risks and means that the failure of one of them could have a broader impact than in the past and be considerably more difficult to resolve."

In response to comments relating to the disparate impact of the Proposed Rule on Independent Members, NSCC states that:

> "[a]ny such disparate effects arising out of choices made by individual Members with diverse business models and strategies (including their relative levels of capitalization) should not be seen as due to action by the clearing agency having an impact or imposing a burden on competition."[15]

Here, in the absence of a satisfactory substantive response, NSCC inappropriately attempts to shift to a subset of NSCC members its statutory obligation to ensure that its rules do not impose an undue burden on competition. To be clear, and as quoted by NSCC in the Response, Exchange Act Section 17A(a)(3)(i) states that a clearing agency shall not be registered unless its "rules … do not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the [Exchange Act]". In evaluating the impact on competition of a proposed rule change, the Commission must evaluate the impact of the rule on the market as it exists. This analysis must include consideration of the impact of the rule on all market participants, including NSCC members whose business models do not include acting as a commercial lender. It is this very diversity that Section 17A(a)(3)(i) is designed to protect. The obligation to protect it cannot be shifted from NSCC to its members.

In sum, the NSCC's totally unsupported assertion, in the absence of any evidence that the NSCC has actually considered the Proposed Rule's potential impact on competition, is insufficient and cannot constitute the basis upon which the Commission determines to approve the Proposed Rule.

B. <u>The Proposed Rule's Treatment of Certain Members with Respect to the Credit Facility Creates an Undue Burden on Competition</u>

As noted above, the Credit Facility is an important part of the SLD Proposal. However, the Proposed Rule is deficient both in form and substance with respect to how the Credit Facility interacts with the supplemental depository requirement.

As a preliminary matter, the terms of the Credit Facility are confidential and have not been made available to NSCC members who are not potential Lenders. This deprives interested parties of access to a critical element of the SLD Proposal. The Commission should require that the terms of the Credit Facility be made public before the Commission agrees to approve the SLD Proposal given the extent to which the Proposed Rule is intertwined with the functioning of the Credit Facility. At a minimum, public disclosure of the terms of the Credit Facility and the annual process of funding it should be a requirement of any final approved rule on this matter, otherwise subject members will be entirely in the dark regarding a key component of a formula that could determine the continued viability of their businesses.

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[15] <u>See</u> the Response, Section V(B).

Regarding the standard for proposed rules of SROs set forth above, NSCC has failed to address the competitive and other affects of establishing a nexus between a regulatory supplemental liquidity deposit requirement and a commercial lending agreement that will necessarily discriminate against Independent Members. Under the Proposed Rule, members that provide Commitments (as defined in the Proposed Rule) as Lenders under the Credit Facility receive dollar-for-dollar credit for those Commitments against their required supplemental liquidity deposit. However, despite the modest changes to the Proposed Rule under Amendment No. 2, access to the Credit Facility may still be limited—either by the terms of the Credit Facility itself (whether currently or in the future) or for practical reasons—to members that are affiliated with banking institutions. Furthermore, there is nothing in the Proposed Rule as amended that requires the Credit Facility—as opposed to NSCC—to operate in any particular fashion or possess any particular criteria in order to qualify as the "Credit Facility" for purposes of the Proposed Rule. Under the terms of the Proposed Rule, NSCC could revise the terms of the Credit Facility to be as attractive or unattractive to Lenders as the NSCC chooses, thereby dramatically changing the potential SLD requirements of members without any need for NSCC to amend its rules. Although the Proposed Rule now contemplates that members may designate a lender on its behalf for purposes of the Credit Facility, the Proposed Rule does not explicitly require (i) that the Credit Facility itself include such an option, (ii) what the criteria for lending would be, or (iii) what limits, if any, such designated lending would be subject to. All assumptions regarding the operation of the current Credit Facility are merely that—assumptions—and are in no way guaranteed by the Proposed Rule or otherwise to hold in future iterations of the Credit Facility. Furthermore, it should go without saying that even with a designated lending option, there is no guarantee that such funding would be available in future years, and thus members with affiliated banks are still being given significant preferential treatment under the Proposed Rule.

The only explanation offered by NSCC for such preferential treatment is that it incentivizes large financial institutions with affiliate banks to join the Credit Facility in the first place. However, in addition to the offset mentioned above, if a member is affiliated with a Lender, that affiliate Lender will not only enjoy the facility fees associated with being a Lender under the Credit Facility, it will enjoy the security provided by the collateral posted by NSCC in the event of any borrowing. It seems that these benefits and others should be incentive enough for such banks, and that broker-dealers affiliated with such banks should not be accorded special treatment as a result. It is unclear how such special treatment is justified or warranted in view of the stated rationale for the Proposed Rule.

Furthermore, members subject to the supplemental liquidity deposit do not receive any collateral that can be used by the members to finance the deposit. This is a serious flaw in the design of the SLD Proposal as it will require members unable to obtain a Designated Lender to borrow funds for a term and on an unsecured basis in order to provide liquidity that NSCC needs only on a revolving and secured basis. Members that do not participate in the Credit Facility will enjoy no fees or benefits in connection with their cash deposits (other than interest earned from investment by NSCC, as members earn today on investments from the NSCC Clearing Fund[16]). Instead, barring changes to the Proposed Rule and Credit Facility, they will be scrambling to identify alternative forms of financing to fund their supplemental liquidity deposit.

III. The Proposed Rule is Arbitrary and Capricious and/or Contains Numerous Technical Deficiencies

For the reasons outlined in this section, ITG maintains that the Proposed Rule contains various features that are arbitrary and capricious and/or other technical deficiencies, any of which warrants disapproval of the Proposed Rule.

A. Application of the Supplemental Liquidity Deposit to the Thirty Members With the Largest Gross Settlement Debits

While we appreciate NSCC's attempt to levy the costs of the supplemental liquidity deposit on the members that are most likely to cause NSCC to need it, NSCC's application of the supplemental liquidity deposit to the thirty members with the largest gross settlement debits is both arbitrary and capricious in its underlying principle and flawed in design.

First, basing inclusion in the top thirty on gross settlement debits on that entity's single peak liquidity day over a six-month period is arbitrary and capricious. Although we recognize that days of high volumes have an impact on overall liquidity risk, NSCC fails to explain how this method achieves the objectives of Rule 17Ad-22(b)(3). NSCC makes no effort to justify its apparent operating assumptions that (a) one instance of peak liquidity is correlated with increased liquidity risk over a future time horizon (as opposed to measures of day-to-day volatility, financial or balance sheet stability, trading fail rates, and other more meaningful metrics), and (b) that a single peak day over a six-month period is correlated to future peak days and/or increased liquidity risk on any given day. Furthermore, looking at a single peak day may draw stable and low-risk firms into the top thirty by virtue of anomalous activity while ignoring parties that consistently create much higher levels of volatility or risk over a given time horizon.

Second, using gross settlement debits to determine risk posed by a particular member also ignores the relatively lower risk presented by agency-only members that settle transactions on a delivery-versus-payment ("DVP") basis. Such firms play a vital role in the securities markets and have a substantially lower risk profile than members that have a principal trading operation, engage in market-making, and/or depend on customer credit balances to fund large margin lending activities. If the theory behind selecting the top thirty firms is truly to apportion costs across those members most likely to require assistance, NSCC should adjust its calculation method to reduce the relative burden on DVP firms. NSCC addresses this point in the Response, stating that agency brokers are obligated, as principal (with NSCC similarly obligated guarantor), to settle a transaction, regardless of whether their institutional customer completes the other side of

[16] See the Proposed Rule, page 9.

the transaction.[17] This willfully misses the point repeatedly made by agency brokers. While NSCC's obligations in the event of a failure of an agency DVP broker may be identical to its obligations in the event of a failure of a proprietary trading member or prime broker, the actual risk of insolvency of agency DVP brokers is substantially different than the risk of member firms whose business models make them more prone to substantial and sudden losses, customer runs and similar credit events.[18] NSCC in its Response appears to argue that agency DVP brokers pose the same risks as other large NSCC member firms, noting that "…agency brokers are not immune from the risk of failure, as recent events have shown that they, like other firms, remain subject to market events, technology risks, etc." [19] Apparently, NSCC's best response to comments that agency DVP brokers pose less of a credit risk is to vaguely allude to an incident involving a proprietary trading error by a large proprietary trading firm. We fail to see how this incident supports NSCC's response.

Third, setting the threshold for receiving a demand for cash deposits based on the relative rank of a member among those with the largest gross settlement debits, rather than establishing the threshold at a fixed dollar sum of gross settlement debits, makes it impossible for members to (a) know when they will become subject to the requirements of the Proposed Rule, or (b) adjust their activities in advance to avoid such requirements until it is too late. The Proposed Rule makes liquidity planning by members far more difficult than if NSCC established, for example, a fixed dollar sum of gross settlement debits above which the NSCC would require a supplemental liquidity deposit. Such thresholds would allow a member firm to manage its activity and engage in appropriate business planning rather than be surprised by unexpected demands for substantial increases in their NSCC deposit requirements.

Furthermore, even if members could plan in advance—which they cannot under the Proposed Rule—those within or near the bottom of the top thirty will likely not have sufficient time to ensure that cash will be available to make the deposit should they receive an unexpected deposit call. The sixty days' notice contemplated by the Proposed Rule[20] is insufficient for most firms to arrange for what is likely to be a massive funding requirement. Indeed, it is likely that members in or near the bottom of the top thirty will fall into and out of the top thirty on a regular basis. As a result, these members could be

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[17] See the Response, Section III(C).

[18] Indeed, in its net capital rules, the SEC implicitly recognizes the difference in the risk profile presented by agency brokers versus dealers by requiring substantially lower net capital for agency brokers. See 17 CFR 240.15c3-1(a)(2). Separately, we note that brokers are not required to apply a haircut to the value of agency transactions. Haircuts are required for proprietary positions. See 17 CFR 240.15c3-1(c)(2)(vi).

[19] See the Response, Section III(C).

[20] We note that, in Amendment No. 2, NSCC amends Section 3 of the Proposed Rule to add a 30-day notice period in the event that the rule first becomes effective on a date that is not the Effective Date or Reset Date of the Credit Facility then in effect (capitalized terms are defined in Section 2 of the Proposed Rule). For the reasons discussed above with respect to the sixty-day notice requirement contemplated under the Proposed Rule, we do not believe that thirty days notice is sufficient.

required to make a deposit in one calculation period but not the next. This is an untenable situation for Independent Members, particularly given that the potential size of the deposit may be a multiple of a member's available excess capital. Furthermore, any planning efforts are further complicated or rendered futile by the possibility of still-additional interim supplemental liquidity deposit calls[21] and regular activity liquidity calls.[22]

Fourth, the jockeying among members for position to avoid the top thirty is highly likely to have unintended consequences on trading behavior. Smaller Independent Members are likely to game the system to avoid single peak days at all costs, which could drive even larger volumes of trades into larger, bank-affiliated broker-dealers on precisely those large volume days when diversification in the markets is most desirable.

Fifth, among other issues, funds deposited pursuant to the Proposed Rule may not be withdrawn for extended periods of time—in some cases for six (6) months or longer. Member firms have not been given adequate time to evaluate the potential impact to regulatory capital of the SLD Proposal, including financing arrangements in the event that the deposited funds are not treated as allowable assets for regulatory capital purposes. Furthermore, NSCC has not made any comment or provided any guidance to the Financial Industry Regulatory Authority or other interested parties as to how such supplemental deposits should be viewed for these purposes. All of these issues may create serious burdens on competition for affected members.

B. The Proposed Rule's Interaction with the Credit Facility is Arbitrary and Capricious

In addition to the defects of the SLD Proposal itself, the Proposed Rule is fatally arbitrary and capricious given the nature of the interaction between the cash depository obligation and the Credit Facility.

If the goal of the SLD Proposal is, as stated, to "address those daily liquidity shortfalls" that may occur in extreme but plausible market conditions[23], it is arbitrary and capricious for the supplemental depository requirement to be only partially offset by the liquidity already provided by the Credit Facility. The Proposed Rule is not designed—as it easily might have been—to provide for liquidity needed only if the Credit Facility is insufficient on its own. Instead, the Proposed Rule contemplates that only certain contributions to the Credit Facility would reduce the need for supplemental deposits on a dollar-for-dollar basis by offering a dollar-for-dollar offset solely to members that are Lenders (or an affiliate of a Lender) and then offering pro-rata credits to non-Lender members for only certain commitments made by Lenders or Designated Lenders. Despite the Proposed Rule's acknowledgment that such Lender member's Commitments

[21] See the Proposed Rule, Sections 11-14.

[22] See the Proposed Rule, Sections 16-17.

[23] See the Proposed Rule, Item 3(a).

to the Credit Facility contribute to NSCC's available liquidity on a dollar-for-dollar basis, if a member is not a Lender and does not or cannot use a Designated Lender, its cash depository obligation is not properly adjusted to account for this additional liquidity—*i.e.*, even if the daily liquidity shortfall is entirely covered by the Credit Facility.[24] This inconsistent treatment creates two distinct classes of top thirty members – Lenders and their affiliates whose supplemental deposit requirement is reduced dollar-for-dollar by a portion of NSCC's available liquidity, and non-Lenders who supplement deposit requirement is not properly adjusted for the same available liquidity.[25]

Due to the complexity of the Proposed Rule, this point is best illustrated by way of several examples. Let us make the following assumptions:

Scenario 1

1. NSCC's total calculated supplemental liquidity need for a particular regular activity period[26] is $10 billion;
2. The total amount available to NSCC under the Credit Facility is $10 billion;
3. Of the $10 billion available under the Credit Facility, $1 billion (10%) consists of Commitments by parties other than the top thirty members required to make supplemental liquidity deposits under the SLD Proposal ("Non-Top-Thirty Parties");
4. Hypothetical Independent Member ABC ("ABC") is not a Lender under the Credit Facility and is not able to find a Designated Lender;
5. The sum of the Commitments of top thirty members in excess of their obligations under the SLD Proposal is $0; and
6. Pursuant to the SLD Proposal, NSCC has calculated that ABC has a baseline supplemental liquidity deposit obligation[27] of $100 million.

[24] ITG, and, upon information and belief, other Independent Members have been told informally by NSCC that NSCC does not intend to calculate supplemental liquidity deposits in this fashion. For obvious reasons, such anecdotal and informal advice is of little or no value when evaluating the validity of the Proposed Rule and cannot be the basis of any NSCC members comfort that the SLD Proposal will be implemented within the confines of the Exchange Act.

[25] We note that the combination of the Regular Activity Supplemental Deposits, the total amount of Commitments under the Credit Facility, and other liquidity sources are taken into consideration in calculating the Special Activity Liquidity Obligation of each member during the applicable lookback period, but the total amount of Commitments is not taken into consideration for purposes of calculating the Regular Activity Supplemental Deposit itself.

[26] Defined within the Proposed Rule as "Regular Activity Peak Liquidity Need".

[27] Defined within the Proposed Rule as "Regular Activity First Tranche Liquidity Obligation".

Under the Proposed Rule, the cash deposit actually required of Independent Member ABC[28] (the "Deposit Amount") will be calculated by first subtracting the Commitment (if any) that ABC has provided to the Credit Facility, and then additionally subtracting a pro-rata portion of the total amount of (i) Non-Top-Thirty Parties' Commitments (if any) under the Credit Facility, (ii) the sum of the Commitments of top thirty members in excess of their obligations under the SLD Proposal, and (iii) an additional amount to provide each top thirty member with the benefit of a full allocation of the amount in clause (ii) above.[29] In Scenario 1, the calculation will proceed as follows:

ABC Deposit Amount = $100M – ($0) – ($100M/$10B)($1B+$0+$0) = $90M

As such, in Scenario 1 – which uses entirely plausible numbers for each assumption – ABC will have an actual Deposit Amount of $90 million—<u>despite the fact that NSCC does not need *any* funds, because its entire liquidity need is covered by funds available from the Credit Facility</u>.[30] Were ABC required to make this deposit, and even assuming that ABC is the only party so situated, NSCC would now have liquidity totaling $10.09 billion, despite the fact that it identified a need for only $10 billion. However, it seems far more likely that there will be numerous members like ABC, and therefore that the amount of cash raised by the SLD Proposal will far outweigh the amount deemed necessary by NSCC.[31]

[28] Defined within the Proposed Rule as "Regular Activity Supplemental Deposit".

[29] <u>See</u> Proposed Rule, Section 5. It is unclear to us how the component described in Section 5(D)(iii) is intended to operate and no adequate explanation is provided. However, as noted above, it is entirely reasonable to assume—and indeed, we must assume for purposes of properly analyzing the Proposed Rule—that the top thirty members will not contribute more to the Credit Facility than they are required to, hence such "excess" may be assumed to be $0, and therefore any "additional amount to provide each Regular Activity Liquidity Provider with the benefit of a full allocation of [this] amount" must be assumed to be $0 as well.

[30] We note that NSCC has, on several occasions, confirmed to ITG that its goal in establishing the Credit Facility and SLD Proposal was to reach a single sum certain with respect to its liquidity needs—not to exceed or set up a mechanism that could result in exceeding this sum.

[31] Under the Proposed Rule as amended, NSCC has increased the pro rata offset by adding to the numerator any amounts contributed by top thirty members in excess of their obligations under the SLD Proposal. However, we believe this addition to be of little or no benefit to Independent Members, or otherwise. Using the fact pattern set forth here, even if that excess were significant (say, 25% of their $9 billion committed to the Credit Facility), the offset would still only be $32.5 million (versus $10 million in the example as stated), thus leaving the Independent Member with a $67.5 million cash deposit obligation despite the fact that NSCC requires no additional funds. In almost any reasonably foreseeable scenario, an Independent Member will be left with a substantial cash deposit even though NSCC has met or even exceeded its liquidity target.

If we alter the facts slightly, still more arbitrary and capricious situations can be identified. Consider Scenario 2, in which all of the assumptions of Scenario 1 are retained except #3, which is changed as follows:

<u>Scenario 2</u>

3. Of the \$10 billion available under the Credit Facility, \$10 billion (100%) consists of Commitments by Non-Top-Thirty Parties

In Scenario 2, the calculation of the Deposit Amount will proceed as follows:

ABC Deposit Amount = \$100M – (\$0) – (\$100M/\$10B)(\$10B+\$0+\$0) = \$0M

In other words, by merely changing the composition of the syndicate of Lenders within the Credit Facility so that it is comprised entirely of Non-Top-Thirty Parties, ABC's actual Deposit Amount under the SLD Proposal will drop to \$0. Conversely, consider Scenario 3 – which is more likely—in which assumption #3 is changed as follows:

<u>Scenario 3</u>

3. Of the \$10 billion available under the Credit Facility, \$0 (0%) consists of Commitments by Non-Top-Thirty Parties

In Scenario 3, the Credit Facility is fully funded by affiliated banks of top thirty members and NSCC has received the full amount of its supplemental liquidity need (\$10 billion) by virtue of the Credit Facility. Regardless, the Deposit Amount calculation for ABC would proceed as follows:

ABC Deposit Amount = \$100M – (\$0) – (\$100M/\$10B)(\$0B+\$0+\$0) = \$100M

Even though NSCC <u>does not need even \$1</u> in this scenario, ABC's Deposit Amount would still be equal to its baseline calculated supplemental liquidity obligation (\$100 million), simply because the Credit Facility was fully funded by top-thirty members <u>other than itself</u>.[32]

Scenarios 2 and 3 help illustrate the arbitrary and capricious nature of the SLD Proposal by illustrating the extent to which a member's Deposit Amount is largely determined by factors entirely outside its control—or, indeed, any individual party's control (except, perhaps, NSCC and the Lenders)—namely, the percentage of the total Commitments under the Credit Facility that are provided by Non-Top-Thirty Parties and/or the extent to which Commitments by top thirty members exceed the amount of their required deposit under the SLD Proposal. However, this is not the only bizarre

[32] It could be that the Deposit Amount in this scenario is offset slightly because some of the contribution of the top thirty members was in excess of their required deposit amount, but it remains notable that the Deposit Amount for ABC would not be fully offset.

feature of the SLD Proposal. To take a fact pattern ostensibly more favorable to NSCC, let us consider Scenario 4, in which the calculated supplemental liquidity need is greater than the amount of the Credit Facility. We are also adding to this fact pattern a large member firm that has an affiliate bank, which affiliate is a Lender under the Credit Facility.

Scenario 4

1. NSCC's total calculated supplemental liquidity need for a particular regular activity period is $11 billion;
2. The total amount available to NSCC under the Credit Facility is $10 billion;
3. Of the $10 billion available under the Credit Facility, $1 billion (10%) consists of Commitments by Non-Top-Thirty Parties;
4. ABC is not a Lender under the Credit Facility;
5. Pursuant to the SLD Proposal, NSCC has calculated that ABC has a baseline supplemental liquidity deposit obligation of $100 million;
6. NSCC has calculated that hypothetical member BB, which is affiliated with a large lending bank ("BB"), has a baseline supplemental liquidity deposit obligation of $1 billion; and
7. BB's affiliate bank is a Lender under the Credit Facility and has made a Commitment in the amount of $900 million.

In Scenario 4, the NSCC has a liquidity need of $1 billion above what the Credit Facility provides. BB, the member with a lending affiliate, is creating a significant percentage of the total liquidity need of $11 billion (as evidenced by its preliminary obligation of $1 billion). However, the Deposit Amount calculations of ABC and BB would proceed as follows (with calculations rounded to the nearest million):

ABC Deposit Amount = $100M – ($0) – ($100M/$11B)($1B+$0+$0) = $91M

BB Deposit Amount = $1B – ($900M) – ($1B/$11B)($1B+$0+$0) = $9M

Even though ABC's share of the total perceived liquidity need is small—less than 1%—its Deposit Amount will make up more than 9% of the total shortfall in cash deposits required above the liquidity provided by the Credit Facility ($91 million/$1 billion), while BB's Deposit Amount will make up a negligible amount of that shortfall. While BB may argue that its bank affiliate is providing liquidity to account for $900 million of the liquidity need, one may note that the bank affiliate is being paid for providing that liquidity. In fact, according to a draft term sheet received by ITG, BB's affiliate bank would receive no less than $900,000 per year in exchange for this passive liquidity (0.10% of the aggregate Commitment) and would be paid substantial additional amounts if any borrowing was actually made. We would further add that, upon information and belief, the Credit Facility has never been borrowed against in its twelve-plus year history, while the supplemental liquidity deposit would be required of ABC (along with BB) regardless of whether an actual liquidity risk is present on any given day.

The foregoing examples illustrate some of the ways in which the flawed nexus between the Credit Facility and the supplemental liquidity deposit requirements of the SLD Proposal renders the Proposed Rule arbitrary and capricious and a failure by the standards of the Exchange Act.

IV. Other Deficiencies of the Proposed Rule

A. With Respect to the Credit Facility Generally

Initially, the Proposed Rule did not include any guidelines regarding the operation of the Credit Facility, including, but not limited to, criteria by which a decision is made to permit or deny a member to be a Lender under the Credit Facility. In Amendment No. 2, NSCC amended Section 2 of the Proposed Rule to include a "Designated Lender" concept. Designated Lenders may make commitments to the Credit Facility on behalf of Independent Members to enable Independent Members to avail themselves of the dollar-for-dollar offset available to each Lender under the Credit Facility. There are, however, at least two issues with the concept of the Designated Lender as set forth in the Proposed Rule.

First, the last sentence of the definition of Designated Lender states that "The Commitment of a Designated Lender shall be allocated by such Designated Lender, in a manner specified by the Corporation, to one or more Unaffiliated members or Affiliated Families."[33] The definition appears to indicate that allocation of a Designated Lender's Commitment is determined by NSCC rather than by the Designated Lender and/or the member on whose behalf the Commitment has been made. We feel strongly that the manner in which a Designated Lender's Commitment is allocated should be decided by the Designated Lender and its client. Second, as noted above, there are no other guidelines or requirements specified as to how the Designated Lender mechanism should work, or even that it is required to work at all in order for the Credit Facility to be effective and compliant with the Proposed Rule.

Separately, the Designated Lender concept does not entirely remedy the disparate treatment of Independent Members and affiliated members. First, the Designated Lender concept only applies to the extent that lenders acceptable to NSCC are willing to act as Designated Lenders. Second, NSCC has noted that the Credit Facility contains mechanisms to increase the commitments of existing lenders, but neither NSCC nor the Administrative Agent(s) is required to increase the Credit Facility should a member or its Designated Lender meet certain criteria. Furthermore, unless it is required that all NSCC members and/or their Designated Lenders are given preference over non-members in becoming Lenders, it seems entirely possible that should a member seek to become part of the lending syndicate, it could well be shut out if a non-member has joined the syndicate first and the Credit Facility has reached its desired size. The Proposed Rule has no such requirement to give members preference. Third, it is likely that the cost structure for Independent Members seeking a Designated Lender will be less favorable than that of

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[33] See Amendment No.2 , Exhibit 4, Section 2.

an affiliated member obtaining a Commitment from its affiliate bank. Indeed, there is some concern that lenders that might have otherwise willingly participated in the Credit Facility will decline to do so in an effort to receive additional consideration from Independent Members seeking to arrange for a Designated Lender to satisfy their SLD requirement. For these reasons, among others, NSCC's statement in the prefatory portion of the Proposed Rule that the amendments to the rule "effectively eliminate[] any perceived discrimination in the original SLD Proposal between those Members that have bank affiliates and those that do not"[34] is unconvincing.

Finally, there is no guarantee that the Credit Facility will be renewed from year-to-year. Should the Credit Facility be discontinued, members that relied upon the dollar-for-dollar credit will be required to post cash collateral. Given the potential size of these deposits, the Commission should require NSCC to provide no less than a six-month compliance grace period from the expiration of the Credit Facility to enable members to identify alternative financing for their supplemental liquidity deposit obligation.

B. <u>Grace Periods for Transitioning Members</u>

As discussed above, if the Proposed Rule is adopted in its current form, it is likely that one or more Independent Members will have to surrender their NSCC membership if they are called upon to make significant supplemental liquidity deposits. NSCC has made no provision in the SLD Proposal for an orderly transition into the Proposed Rule's framework or an orderly transition out of NSCC membership, should a member decide that this is the only feasible course of action. Indeed, it appears from the Proposed Rule as amended that NSCC could make the first massive depository call within thirty (30) days of the Commission approving the rule or September 2013, whichever is later. Furthermore, we are not persuaded that the additional reporting provided by NSCC under Section 31 of the Proposed Rule, as amended, will be sufficient to enable firms to adequately prepare for becoming subject to the Proposed Rule, finding suitable alternatives to making the deposit (*i.e.* identifying a Designated Lender), or making arrangements to withdraw from NSCC membership.

As the Commission and the NSCC are aware, changing clearing platforms is a significant undertaking that cannot be completed quickly. In addition to negotiating a new clearing agreement, exiting members may also have to make significant technological changes to accommodate the changeover from self-clearing to correspondent clearing. Further, many members also clear for other firms, and those firms will also need time to negotiate new clearing agreements and migrate to a new clearing broker.

Members that elect to surrender their NSCC membership would likely be doing so because they are unable to meet a demand for a supplemental liquidity deposit. Under the Proposed Rule as drafted, the NSCC is unable to provide members that have given notice of their intent to surrender their membership any relief from the deposit

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[34] <u>See</u> Amendment No.2, Item 3

requirement. A member that is unable to provide a supplemental liquidity deposit and is surrendering its membership as a result should not be in violation of the Proposed Rule. It is also not possible for a member to immediately terminate its membership without causing serious disruption to its business and that of its correspondents. Accordingly, members that elect to surrender their NSCC membership should be given a one-year grace period from compliance with the Proposed Rule to enable the member to transition into a correspondent clearing arrangement.

C. Failure to Respond to Commenters' Request to Consider Increase in Credit Facility

NSCC's Response failed to respond adequately to comments that NSCC should simply increase the size of the Credit Facility in lieu of the Proposed Rule. In its Response, NSCC implied that the Proposed Rule was favorable to relying on an increased Credit Facility because it increased diversity of NSCC's funding. We fail to see how the NSCC enhances the diversity of its funding by compelling funding from the very members whose insolvency the supplemental liquidity deposit requirement is designed to address. Moreover, while we support the amendment to permit members to utilize Designated Lenders, the amendment would defeat NSCC's claimed purpose in favoring the SLD Proposal over simply increasing the size of the Credit Facility. The SLD Proposal is precisely the wrong way to increase diversity of funding. NSCC would enhance the diversity of its funding by providing attractive enough Credit Facility terms to draw interest from diverse Lenders. Compelling members and the banks they designate to act as Lenders may be the single worst way to increase NSCC's diversity of funding.

V. Alternatives

Given the potential impact of the SLD Proposal, we ask that the Commission require NSCC to consider less disruptive alternatives to the Proposed Rule. In addition to the numerous suggestions for improvements or replacement terms highlighted above, we note several possible alternatives for raising liquidity below.

- Increase the size of the Credit Facility: For at least the last twelve years, NSCC has maintained the Credit Facility (or a similar large, secured, revolving credit facility) to provide liquidity in the event of a member's failure. NSCC has provided no evidence—indeed, it has not even argued—that it is having difficulty raising sufficient liquidity in this fashion, notwithstanding the fact that it increased the size of the Credit Facility from approximately $9.3 billion for the 2011-2012 time period to approximately $14.6 billion for 2012-2013. If, for whatever reason, NSCC establishes that it needs to increase Commitments, it could simply make the terms of the Credit Facility more enticing by paying higher rates or otherwise making the provisions more favorable to Lenders. Members have always directly borne the cost of the Credit Facility through NSCC membership fees and could continue to do so in an increased, more expensive Credit Facility. This option is the least intrusive to members and simultaneously offers the greatest transparency to the financial markets, provided that the Credit Facility and attendant funding process are made public each year.

- Limit the SLD Proposal to Shortfalls: As discussed above, if a supplemental cash deposit is needed beyond the Credit Facility—and NSCC has not provided any evidence that it is—the SLD Proposal should be limited to making up for such shortfall in any given term of the Credit Facility.

- Require that the Credit Facility Allow for Re-Hypothecation of Collateral Securities: Under the current model, in the event of a borrowing under the Credit Facility, the securities posted by NSCC as collateral will be held for the benefit of the Lenders in an account with the Administrative Agent. However, these securities must remain in this account and cannot be re-hypothecated. If re-hypothecation were permitted, additional members—including some Independent Members—may be able to become Lenders who might not otherwise have the capacity to do so, because in lieu of providing cash from its own account a Lender might engage in a stock loan to fund NSCC's obligations using the collateral securities. NSCC is familiar with this model, NSCC's affiliate, FICC, currently permits re-hypothecation of securities posted as collateral.

VI. Conclusion

We believe that the SLD Proposal will have a profound impact on members and, as a result, the securities markets at large. Furthermore, in addition to the regulatory deficiencies cited above, affected firms have little or no clarity about the likely size of deposits that may be required, having received numerous and conflicting indications from NSCC. Most recently, the NSCC made verbal representations to SIFMA and to numerous broker-dealers, including ITG, that there would be "no SLD deposit" due for the period of 2013-2014 because NSCC had fully funded the Credit Facility to its satisfaction. However, for the technical reasons set forth above, it is unclear to us whether or how this would foreclose the possibility of a substantial cash deposit being demanded of certain members—particularly Independent Members—as early as September 2013. We believe that these conflicting statements and fundamental ambiguities have made it impossible for concerned members of the broker-dealer community and the equities securities markets at large to conduct a thorough and proper analysis of the Proposed Rule.

For all of the reasons set forth herein, we respectfully request that the Commission exercise its authority under Section 19(b)(2)(C)(ii) of the Exchange Act to disapprove the Proposed Rule. We further request that the Commission issue a notice of objection to NSCC concerning the SLD Proposal pursuant to Rule 17Ad-22 given its status as an advance notice.

If you have any questions, please do not hesitate to call Jamie Selway at (212) 444-6306, or Mark Solomon at (212) 444-6201.

Sincerely,

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The Honorable Daniel M. Gallagher, Commissioner
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