April 30, 2020

J. Matthew DeLesDernier
Assistant Secretary
United States
Securities and Exchange Commission
100 F Street, NE,
Washington, D.C. 20549-1090.
By electronic mail to: rule-comments@sec.gov

National Securities Clearing Corporation's Haircut-Based Volatility Charge Applicable to Illiquid Securities and UITs

(Release No. 34-88615; File No. SR-NSCC-2020-802 & SR-NSCC-2020-003)

Dear Mr. DeLesDernier:

Lek Securities Corporation ("LSC") is an agency broker and one of NSCC's smaller participants. We applaud NSCC for serving as the primary central counterparty in the United States. It has added much needed stability to the financial markets by allowing broker dealers to trade anonymously without the need to be concerned with counterparty risk. Over the years NSCC has done an excellent job: Participants have failed, but as we understand it, the defaulting participant's margin posted with NSCC has always been sufficient to cover its outstanding obligations. As technology has improved, NSCC has updated its risk assessment methods, so that it currently has one of the most sophisticated systems in the world.

NSCC's current proposal appears to be based on sound scientific methods. The proposed rule change would clarify and enhance the methodology for identifying securities as illiquid for purposes of determining the applicable calculation of the volatility component of the Clearing Fund formula, and would revise the definition of "Illiquid Security" in the Rules to reflect these changes. The proposed rule change would also enhance the calculation of the haircut-based volatility component of the Clearing Fund formula that is applied to positions in Illiquid Securities, i.e. sub-penny securities, IPOs and UITs. Finally, the proposed rule change would eliminate the existing Illiquid Charge, as the risk it was designed to address would be addressed by the other enhancements being proposed.

In principle, the changes appear to be sound technological improvements made possible by enhancements in research and scientific testing. But what NSCC is not telling the Commission and the public is that the proposals are not just better calculation methods. The proposals will also result in a 50 – 100% increase in the overall margin requirement. Given that the existing margin has always been enough to cover a defaulting participant's losses, this is entirely unwarranted. The increased margin will unnecessarily drain much needed liquidity from participants and actually make it more likely for a participant to fail.

In fact, NSCC's margin requirement on illiquid securities is already so burdensome that many participants would prefer to accept counterparty risk than to post margin with NSCC. We have experienced situations in which a customer sold $6,000 worth of stock that resulted in a requirement of more than one million. Therefore many brokers would prefer to forgo NSCC's guarantee, but this is often difficult to do as NSCC has methods of interjecting itself in direct broker-to-broker obligations, so that it can then collect the excessive margin.

NSCC has not shown that collecting more margin is warranted. It's current margin requirements are already so high, that by its own admission a study that back-tested whether margin was sufficient to cover adverse price moves in illiquid securities showed that a roughly 50 – 100% increase in margin would increase the coverage by a mere 3.3% from 96.2% to 99.5%. Although NSCC seems to believe that this is significant, we disagree: Most firms have highly diversified portfolios of un-settled securities, so therefore a shortfall in coverage in one security is highly likely to be fully covered by excess margin in other securities. Moreover, NSCC's study says nothing about the absolute size of the shortfall, which is likely to be small, as positions in illiquid securities are often small in relation to most firm's overall positions. What the study shows is that the proposal is suggesting firms pay a very high price for a paltry increase in coverage.

Even more concerning is that the Illiquid Charge is excluded in NSCC's current calculation of the Excess Capital Premium ("ECP"). The ECP is a penalty that NSCC charges participants when its margin requirement exceeds a firm's excess net capital. At first blush this seems reasonable. A firm with a margin requirement in excess of its capital might have overextended itself. However, a closer examination of the practice revels that it is nothing more than an anti competitive measure aimed at smaller participants that are not affiliated with a bank.

First, NSCC's margin should be, and in fact is, enough to cover the risk. There is no need for a penalty charge.

Second, the charge falls disproportionately on smaller firms, because small firms tend to do all of their business though NSCC, whereas big investment banks incur major risk in other markets that puts them at risk. Small firms rarely trade in overseas markets, OTC derivatives, foreign exchange, CMOs and other exotic products. A big firm might show a lot of capital, and therefore not incur ECP charges at NSCC, but they often incur enormous risks. Particularly because NSCC does not know anything about this exposure, it should be a significant concern. Afterall, during the financial crisis in 2008, small firms were not a problem for NSCC, but Bear Stearns and Lehman caused major issues.

Third, net capital should only be seen as "additional insurance" for agency firms like LSC. NSCC treats all positions as if they were proprietary positions of the participant, but for agency only brokers, like LSC this makes no sense. We collect significant margins from our customers and this money is available to insure that our customers meet their obligations to us and in turn that we meet our obligations versus NSCC. Therefore, when comparing the capital which is available to meet an obligation in a particular security vis-à-vis the clearing house, NSCC should include the margin that we have collected from our customers in that security when computing our capital. If they did this, our excess net capital would increase from around ten million to well over a billion. NSCC's refusal to recognize this major mitigating factor is nothing less than a discriminatory measure targeting smaller firms that tend to trade on an agency only basis. It is unreasonable to expect a firm that is engaged in a low-margin/low-risk agency business to have the same capital as proprietary trading firm that is engaged in a high risk/ high margin business. We use the customer's money to pay for the customer's trades. Our capital is additional insurance if the customer were to default, but it is not the primary source of funds.

Finally, the proposal unfairly benefits large bank affiliated broker dealers that can borrow unsecured from their bank affiliate or alternatively have an "I'll lend to your broker dealer, if you lend to my broker dealer" arrangement with another bank. Banks do not have the same liquidity problems as broker dealers, because banks can use the depositors' money, while broker dealers' customers' money is locked up in the Special Reserve Account at a bank. The bank can use this same money to lend unsecured to either its broker dealer affiliate, or to another bank affiliated broker dealer.

Oddly enough, this creates a reverse Glass-Steagall world. In the past, you could not be in the securities business if you were a bank. Nowadays, you almost have to be a bank to be in the securities business.

DTCC's board is almost entirely made up of representatives from large banks and other big-business personalities. They are rightfully looking after their own interests. The Commission must however weigh NSCC's insatiable appetite for more margin against the need to preserve competition in the securities industry. There is no doubt that NSCC is unfairly discriminating against its smaller participants. Given their ownership and the make-up of their board, this is to be expected. The Commission, however has a duty to look after the national interest and should not permit this to happen.

Finally, small Wall Street firms service small Main Street businesses. Congress has expressed a need to promote and protect small businesses as it has recognized that small business is what drives the US economy. NSCC's proposal will hurt small broker dealers, which in turn will hurt small business.. NSCC's proposal is detrimental to small business capital formation needs. The Commission must not allow this to happen. It works against Congress' goal of supporting the economy which has suffered greatly because of the pandemic. The need to support business simply outweighs NSCC's illusive concerns that it is insufficiently protected.

Respectfully submitted,

Charles F. Lek