UNITED STATES OF AMERICA
Before The
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING

File No. 3-20808

In the Matter of the Application of

LEK SECURITIES CORPORATION

OPPOSITION BRIEF OF NATIONAL SECURITIES CLEARING CORPORATION AND THE DEPOSITORY TRUST COMPANY

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National Securities Clearing Corporation ("NSCC") and The Depository Trust Company ("DTC") (collectively, the "Clearing Agencies"), clearing agencies registered with the Securities and Exchange Commission ("SEC" or the "Commission") pursuant to Section 17A(b)(2) of the Securities Exchange Act of 1934 ("Exchange Act"),[1] and self-regulatory organizations ("SROs") subject to Section 19 of the Exchange Act,[2] respectfully submit this brief in opposition to the opening brief of Lek Securities Corporation ("LSC"), filed June 30, 2022 ("Br."), in support of its petition for review of the Clearing Agencies' determinations, as affirmed by a hearing panel's decision dated March 10, 2022. Tab 173[3] (the "Decision").

INTRODUCTION

A panel of board members of the Clearing Agencies' boards of directors (the "Hearing Panel") issued the Decision following a two-day hearing held on February 17 and 24, 2022 (the "Hearing"). The Hearing Panel found that the evidence supported the Clearing Agencies' determinations under their rules to cease to act for LSC and NSCC's determinations under its rules to (i) limit LSC's clearing activity by imposing a cap of $300 million (subsequently increased to $400 million) of aggregate unsettled clearing activity ("Activity Cap") and (ii) censure and fine LSC for violations of the Activity Cap. For the reasons stated herein, the Commission should affirm the Decision.

LSC's appeal centers on the meritless contention that the Clearing Agencies' determinations were based on unarticulated, unreasoned, or non-objective criteria. But that is wrong: the determinations by NSCC and DTC to cease to act were made in accordance with

[1] 15 U.S.C. § 78q-l(b)(3).
[2] 15 U.S.C. § 78s.
[3] Tab references refer to the certified record submitted to the Commission on April 18, 2022.

clear standards under the Clearing Agencies' rules, are firmly supported by the facts and the evidence, and are otherwise proper under the Exchange Act.

The Clearing Agencies' determinations to cease to act for LSC and the Activity Cap were grounded in their rules authorizing such actions based on, among other things, LSC's "financial or operating difficulty" and the Clearing Agencies' well-founded determinations that LSC's management had made numerous material misrepresentations and omissions about its financial condition to the Clearing Agencies, impeding their ability to carry out their duties.

The evidence demonstrates that both grounds clearly apply to LSC. In particular:

- **The deterioration of LSC's Funding Sources.** LSC lost $100 million in bank financing at the same time as its margin obligations increased dramatically, leaving LSC to rely on an undocumented and no-obligation voluntary lending arrangement between LSC, its parent company, and LSC's customers to meet its margin requirements. LSC's appeal ignores that the Hearing Panel's Decision focused on the reliability of Lek's primary funding source, rather than strictly notional quantity[4]; and

- **LSC's untimely, incomplete, false and misleading communications to the Clearing Agencies.** LSC failed to notify the Clearing Agencies about material changes to its sources of capital and liquidity, was proven to have made false statements to the Clearing Agencies about its financial condition, and made false, misleading, or no statements in response to the Clearing Agencies' routine requests for financial information.

LSC, like all of NSCC's and DTC's members, has always been on notice that its membership in the Clearing Agencies is conditioned on its ability to demonstrate sound financial condition—in particular, to have sufficient and reliable capital and liquidity to meet current and future Clearing Fund[5] obligations—and to keep the Clearing Agencies fully and accurately apprised of its condition so they can fulfill their responsibilities under the Exchange Act. As

[4] With respect to notional quantity, the Hearing Panel Decision noted, "LSC has little capital of its own with which to work, and extremely small lines of credit with Lakeside as compared to its margin requirements." Decision 11.
[5] *See* NSCC Rule 4, Procedure XV.

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discussed below, LSC clearly failed on both of these points and cannot claim that there was no clear basis for NSCC and DTC to cease to act or for NSCC to impose the Activity Cap. And, NSCC rules clearly provide that members shall be disciplined by censure, fines, or other appropriate action when they violate the Clearing Agency's requirements—such as when LSC exceeded the Activity Cap. Thus, it should come as no surprise to LSC that NSCC and DTC took the actions they did, which were fully consistent with the rules and the discretion necessarily afforded by them to control the risks posed by members to the Clearing Agencies, to other members, and to investors.

Accordingly, LSC's petition for review of the determinations to cease to act and to impose the Activity Cap should be rejected under Section 19(f) of the Exchange Act because they were proper limitations on service;[6] and NSCC's imposition of censure and fines for LSC's several violations of the Activity Cap should be affirmed under Section 19(e) of the Exchange Act as appropriate discipline.[7]

BACKGROUND

A. NSCC and DTC

NSCC and DTC are wholly owned subsidiaries of The Depository Trust & Clearing Corporation ("DTCC"). Tab 3 ¶ 6. NSCC is a central counterparty ("CCP") and DTC is a central securities depository in the clearance and settlement of virtually all debt and equity securities transactions in the United States. *Id.* As a CCP, NSCC guarantees the completion of each member's unsettled transactions, exposing itself and other members to substantial credit risk in the event of a member default. DTC is exposed to the credit risks associated with each participant's end-of-day net funds settlement of securities transactions on each business day. *Id.*

[6] 15 U.S.C. § 78s(f).
[7] 15 U.S.C. § 78s(e).

Risk management is central to NSCC's and DTC's obligations as registered clearing agencies. Under Section 17A(b)(3) of the Exchange Act and Rule 17Ad-22 thereunder,[8] NSCC and DTC must have rules and procedures designed to manage their legal, liquidity, operational, business, custody and other risks, and their credit exposures to each member "fully with a high degree of confidence."[9] NSCC, in particular, must have a "risk-based margin system" designed "to cover its potential future exposure to members in the interval between the last margin collection and the close out of positions following a member default" to a level of confidence exceeding 99 percent.[10]

To achieve these objectives, NSCC and DTC have adopted a rigorous risk-management program designed to protect the Clearing Agencies, their members, and the securities marketplace against the credit and other risks stemming from a member's default. Tab 3 ¶ 9; Tab 2 ¶¶ 7–8. Among other things, NSCC implements a risk-based margin system by collecting a Clearing Fund deposit from each member to cover clearance and settlement risk associated with the member's trading activity. *See* NSCC Rule 4 and Procedure XV. The Clearing Fund requirement is intended to provide sufficient funds for NSCC to close out the member's unsettled positions in the event the member defaults on its trading obligations. NSCC's Clearing Fund requirement, along with the rest of the Clearing Agencies' risk-management program, is administered according to the Clearing Agencies' rules approved by the SEC in accordance with Section 17A(b)(3) and Section 19(b) of the Exchange Act. In approving the rules, the Commission must determine that the rules are "consistent with the requirements of [the

[8] *See* 15 U.S.C. § 78q-l(b)(3); 17 C.F.R. § 240.17Ad-22.
[9] *See* 17 C.F.R. § 240.17Ad-22(e)(3)(i) and (e)(4)(i).
[10] *See* 17 C.F.R. §§ 240.17Ad-22(e)(6)(iii); 240.17Ad-22(a)(13) (defining "potential future exposure" to mean "maximum exposure estimated to occur at a future point in time with an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure").

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Exchange Act] and the rules and regulations issued under [the Exchange Act] and "do not impose any burden on competition not necessary or appropriate in furtherance of [the Exchange Act]."[11]

The Exchange Act provides that NSCC and DTC may limit a member's access to the Clearing Agencies' services, including by ceasing to act for the member, if the member can no longer meet the Clearing Agencies' standards of financial responsibility or operational capability and thus poses a risk to the Clearing Agencies, their members, and others.[12] Moreover, a member must adhere to NSCC's rules as a condition of membership, and the Exchange Act requires NSCC to enforce its rules by imposing appropriate discipline for violations.[13]

B. LSC

LSC is a broker-dealer registered with the SEC, a member of the Financial Industry Regulatory Authority ("FINRA"), and is a wholly-owned subsidiary of Lek Securities Holdings Limited ("Lek Holdings"). LSC provides equity trade order management and clearing services to institutions and professional traders, including its affiliates. LSC has been a member of NSCC and a participant in DTC since 1999. Tab 2 ¶ 9.[14]

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[11] 15 U.S.C. § 78q-l(b)(3)(I); 15 U.S.C § 78s(b)(2)(C).

[12] *See* 15 U.S.C. § 78q-l(b)(4)(B) (providing SROs "may deny participation to . . . any person if such person does not meet such standards of financial responsibility, operational capability, experience, and competence as are prescribed by the rules of the clearing agency"); *see also Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Changes to Institute a Clearing Fund Premium Based Upon a Member's Clearing Fund Requirement to Excess Capital Ratio*, Release No. 34-54457 (Sept. 15, 2006), 71 Fed. Reg. 55239, 55242 (Sept. 21, 2006) ("[T]he [Exchange Act] does not provide broker-dealers with the right to be direct members in a clearing agency. [Firms affected by higher excess net capital requirements] have a choice to raise excess regulatory capital or to limit their trading activities so that the risk to which the clearing agency and its other members is exposed is proportionate to the firm's excess regulatory capital.").

[13] *See* 15 U.S.C. § 78q-l(b)(3)(G) (providing that clearing agency members "shall be appropriately disciplined for violation of any provision of the rules of the clearing agency by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, or any other fitting sanction").

[14] For purposes of this submission, "member" refers to "member" and "participant."

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LSC has been among NSCC's and DTC's riskiest members for years. LSC has been on the Clearing Agencies' "Watch List" of members that pose a heightened credit risk since 2006 and had long been assigned a Credit Risk Rating Matrix rating of 7—the riskiest credit rating—including when NSCC and DTC determined to cease to act for LSC and NSCC imposed the Activity Cap. Tab 2 ¶ 11.[15]

C. The Clearing Agencies' Determinations

On October 26, 2021, NSCC sent LSC a notice of NSCC's determinations (i) to cease to act for LSC pursuant to NSCC Rule 46 and NSCC Rule 2A[16] subject to a hearing pursuant to NSCC Rule 37,[17] and (ii) to impose the Activity Cap pursuant to NSCC Rule 46. Tab 4. The same day, DTC sent LSC a notice of DTC's determination to cease to act for LSC pursuant to DTC Rule 10,[18] subject to a hearing under DTC Rule 22.[19] Tab 5.

NSCC and DTC's determinations were based on (1) LSC's weak capital and liquidity, (2) deficiencies in LSC's internal controls, and (3) LSC's failure to report events that materially impacted its business and finances and pattern of providing misleading and inaccurate information with respect to its financial condition and related issues. Tabs 4, 5. The basis for NSCC's imposition of the Activity Cap was the same as the cease to act determinations, and its

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[15] *See* NSCC Rule 1, *available at* https://www.dtcc.com/~/media/Files/Downloads/legal/rules/nscc_rules.pdf; DTC Rule 1, *available at* https://www.dtcc.com/~/media/Files/Downloads/legal/rules/dtc_rules.pdf.

[16] The standards on "Initial Membership Requirements" in NSCC Rule 2A, Section 1, are incorporated by reference in the "Ongoing Membership Requirements" under NSCC Rule 2B. *See* NSCC Rule 2B, Section 1. Rules 2A, 2B and 46 are reproduced in relevant part in Section I.A.

[17] NSCC Rule 37 provides, in relevant part, that a member "may, when permitted by these Rules, request a hearing by filing with the Secretary of the Corporation within 5 Business Days from the date on which the Corporation informed it of an action or proposed action of the Corporation . . . a written request for a hearing setting forth (i) the action or proposed action of the Corporation with respect to which the hearing is requested and (ii) the name of the representative of the Interested Person who may be contacted with respect to the hearing."

[18] DTC Rule 10 is reproduced, in relevant part, in Section I.A.

[19] DTC Rule 22 provides, in relevant part, that a member "shall have an opportunity to be heard on any decision of [DTC] . . . to cease to act for the [member]."

purpose was to protect NSCC, its members, and investors during the pendency of any hearing and implementation of the cease to act determinations. Tab 3 ¶¶ 31–32; Decision 12.

1. LSC's Capital and Liquidity Are Insufficient to Meet its Margin Requirements

i. After LSC's Clearing Fund Requirements Increased Substantially in February 2021, LSC Lost Most of Its Bank Financing

In February 2021, as a result of an NSCC rule change, LSC's Clearing Fund deposit requirements increased significantly, primarily due to its level of trading in illiquid securities. Tab 60 ¶ 42. Over the course of 2021, LSC's Clearing Fund deposit requirement averaged approximately $28 million, frequently exceeded $60 million, and was as high as $84.8 million. Tab 2 ¶¶ 14–16.

Also over the course of 2021, LSC lost $100 million in reliable bank financing when LSC's primary lender and settlement bank, Bank of Montreal-Harris ("BMOH"), terminated their banking relationship and a $75 million line of credit and another lender, Texas Capital Bank ("Texas Capital"), allowed a $25 million line of credit to expire without renewal in March 2021. In NSCC's and DTC's determinations, the loss of those sources of funding greatly compromised LSC's ability to reliably meet its NSCC Clearing Fund obligations and other financial responsibilities.

ii. LSC's Available Capital and Remaining Bank Credit Are Insufficient to Meet Its Higher Clearing Fund Requirements

Historically, LSC's excess net capital ("ENC") and available, non-segregated cash have been low relative to LSC's Clearing Fund deposit requirements—the measure of clearance and settlement risk associated with its trading activity. Tab 2 ¶¶ 14–16. LSC's ENC between January 1, 2021, and September 30, 2021, ranged from $10,501,575 to $13,315,480; and its cash and equivalents in June and July 2021 were $5,439,600 and $6,647,435, respectively. *Id.*

By the time the BMOH and Texas Capital financing had terminated, LSC had only $30 million in bank financing left under two lines of credit from Lakeside Bank, only $10 million of which could be used to finance its Clearing Fund requirements. LSC thus needed additional liquidity to meet those requirements. *E.g.*, Tab 39; Tab 2 ¶ 16; Tab 60 ¶ 36.

iii. The Lek Holdings Note Program Is An Inadequate and Unreliable Funding Source for LSC to Meet its NSCC Clearing Fund Requirements.

In order to meet its heightened Clearing Fund requirements, in or around February 2021, LSC entered into a credit facility with its parent, Lek Holdings, pursuant to which LSC borrows funds under a $100 million promissory note (the "Lek Holdings Note Program").[20] Lek Holdings' financial resources were insufficient to support up to $100 million in loans. In June 2021, Lek Holdings had total equity of approximately $22 million and only $5 million in cash and other current assets. Tab 39. In order to lend substantial amounts to LSC under the Lek Holdings Note Program, Lek Holdings had to borrow the money from third parties. It borrowed that money from LSC's customers. Those customers had no obligation to continue to lend money to Lek Holdings, and Lek Holdings had no obligation to continue to lend money to LSC. Tab 142 ¶ 16.

2. LSC's Reporting Omissions and Misrepresentations about the Loss of Its Bank Financing, the Lek Holdings Note Program and Related Matters

LSC knowingly failed to report the impending loss of the substantial majority of its bank financing under the BMOH credit line, misrepresented the continued existence of its Texas Capital credit line, refused to provide information about the Lek Holdings Note Program and

[20] Mr. Lek admitted that, as a result of LSC's heightened margin requirements due to the NSCC rule change, "LSC knew it would need more unsecured lines of credit to continue its current operations." Tab 60 ¶ 42.

made other material misrepresentations and omissions that impeded the Clearing Agencies' efforts to monitor the risks presented by LSC.

i. Failure to Report the Termination of $75 million Bank of Montreal-Harris Line of Credit

According to correspondence by BMOH's attorneys, on October 22, 2019, BMOH informed LSC that it would reduce and eventually eliminate its NSCC sublimit "and advised LSC to find another bank for NSCC financing." Tab 19. By May 2021, BMOH had informed LSC in writing that it would terminate its settlement bank relationship and withdraw its credit line. Tab 20. On July 8, 2021, BMOH formally notified LSC that it would discontinue its NSCC credit line on September 6, 2021, and terminate the settlement bank relationship on October 6, 2021. Tab 19. In its formal notice, BMOH explained the decision was based on "loss of confidence in LSC and its current management; regulatory concerns prompted by the SEC and FINRA actions; financial and reputational risk; and concerns about LSC's financial status." *Id.* LSC clearly knew that this was a very serious development. Its counsel wrote to BMOH stating: "LSC may be forced to dramatically curtail or cease operations. This would cause immediate and irreparable harm to LSC's customers and the independent introducing broker-dealers to which LSC provides clearing and settlement services." Tab 20. However, LSC did not inform the Clearing Agencies about BMOH's intention to end its settlement bank relationship and credit. Instead, the Clearing Agencies learned about BMOH's decision from FINRA, and the Clearing Agencies wrote to LSC to inquire about the development. Tab 2 ¶ 44; Tab 12.

ii. Failure to Report the Termination of $25 million Texas Capital Bank Line of Credit

LSC failed to inform the Clearing Agencies that its $25 million line of credit from Texas Capital Bank had expired on March 31, 2021, and instead misrepresented that the credit line continued to exist after that date. Tab 2 ¶¶ 18, 40–42.

LSC eventually informed the Clearing Agencies of the expiration of the Texas Capital credit facility in May 2021, only after the Clearing Agencies raised questions about it in a series of inquiries. *Id.* In an April 7, 2021 response to a standard due diligence request from the Clearing Agencies, LSC reported that the $25 million line of credit was an "available line[] of credit" and that "[t]here have been no changes in the terms of [LSC]'s credit facilities." Tab 43. LSC repeated the same misrepresentation on May 3, 2021. Tab 45.[21] LSC's failure to disclose the elimination of the Texas Capital line was particularly egregious since Mr. Lek admitted to the Hearing Panel that LSC knew it would not be renewed "on or about October 19, 2020." Tab 60 ¶ 50.

iii. Failure to Report Information About the Lek Holdings Note Program

LSC failed to respond or to respond fully to the Clearing Agencies' many requests for information about the Lek Holdings Note Program. Tab 2 ¶ 26. The limited information LSC did provide raised serious concerns about the Lek Holdings Note Program's reliability for purposes of meeting LSC's Clearing Fund requirements. Among other things, Lek Holdings' unaudited balance sheet showed that Lek Holdings did not have enough capital to support the Lek Holdings Note Program. The balance sheet and a ledger for the Lek Holdings Note Program also suggested that Lek Securities UK Limited, another Lek Holdings subsidiary, was both a borrower from Lek Holdings and a lender in support of the Lek Holdings Note Program (by itself or for undisclosed lenders). Tabs 75, 85, 142 ¶¶ 17–18.

[21] LSC made additional affirmative misrepresentations about its finances in response to inquiries from the Clearing Agencies. Among other things, in a July 26, 2021 response to a question about LSC's future sources of funding, LSC listed the BMOH line of credit as a "Future" source of funds even though BMOH had advised LSC it would terminate the facility. Tab 13; Tab 2 ¶ 52. LSC's response also reflected $96 million in "Unsecured Notes" as a "Future" source of funds, but it later confirmed (upon further questioning) that this was not a new liquidity source but was the Lek Holdings Note Program. Tab 13; Tab 2 ¶ 25.

3. Activity Cap Violations

LSC violated the Activity Cap on six occasions after it was imposed, and NSCC informed LSC that it would censure and fine LSC pursuant to NSCC Rule 48 based on those violations. Tabs 6, 7.

D. Hearing Panel Decision

Following an evidentiary hearing on the merits, the Hearing Panel issued the Decision on March 10, 2022, which upheld the Clearing Agencies' determinations to cease to act, to impose the Activity Cap, and to censure and fine LSC. Decision.

The Hearing Panel determined that "the cease to act determinations by NSCC and DTC regarding LSC were appropriate and supported by the evidence." *Id.* at 1. Specifically, the Hearing Panel found that NSCC and DTC's determination to cease to act "on the grounds that LSC's capital and liquidity are inadequate was supported by the record." *Id.* at 12. Among other things, the Hearing Panel found that:

- "LSC's capital, as reported to DTCC, falls well short of its usual margin requirements." *Id.* at 7.
- "LSC recognized that by February 2021 its bank financing was inadequate to meet its liquidity needs at NSCC." *Id.*
- "Judged as to whether the Lek Holdings Note Program qualifies as a reliable source of margin funding, we find that it presents numerous disqualifying features." *Id.* at 8.
- "LSC has essentially no liquidity sources, and certainly no reasonably assured liquidity sources, to compensate for significant moves in margin requirements in the time between trade and settlement." *Id.* at 11.
- The Clearing Agencies must "look prospectively and must guard against what may happen," and "LSC conceded that were it to fail even once [to meet an NSCC margin call or other material Clearing Agency obligation] it would be out of business." *Id.*

- "LSC has a 'single threaded' source of liquidity, and that single thread is itself highly suspect and unreliable." *Id.* at 12.

The Hearing Panel also found that LSC had provided "repeated, knowing, misrepresentations, omissions, and failures to provide information in a timely manner . . . ." *Id.* at 19. Among other things, the Hearing Panel found:

- "LSC made several material misrepresentations to DTCC regarding the status of the Texas Capital line of credit in April and May 2021." *Id.* at 14.

- "LSC also made affirmative misrepresentations to DTCC regarding its line of credit with BMOH and the status of its overall relationship with BMOH." *Id.*

- "LSC had previously told DTCC that its only bank lines of credit for its liquidity needs included the BMOH and Texas Capital lines of credit. A change in these lines was material." *Id.* at 16.

And, the Hearing Panel also determined that LSC's arguments and testimony lacked credibility. *E.g.*, *id.* at 15.[22]

The Hearing Panel concluded that "based on all the evidence presented in the course of this proceeding, we find that the cease to act determinations made by each of NSCC and DTC . . . were proper and supported by the evidence. They are affirmed." *Id.* at 20.

[22] For example, Mr. Lek testified falsely about the Lek Holdings Note Program at the Hearing. Mr. Lek testified that, although FINRA raised concerns about the Lek Holdings Note Program, information LSC provided to FINRA about the Program had "alleviated any concerns it had." Tab 60 ¶ 130. However, a transcript and recording of a phone call between FINRA and Mr. Lek established conclusively that FINRA's concerns about the Lek Holdings Note Program had not been alleviated. Decision 9–10. Similarly, a representative from FINRA testified at the Hearing that the "statements in [Mr. Lek's] affirmation are incorrect" and that "FINRA staff continues to have concerns on the subject of whether the Lek Holdings Promissory Note Program adequately addresses liquidity risks associated with the NSCC funding requirements." Tab 144 ¶ 4. The Hearing Panel concluded that "Mr. Lek could not have reasonably believed that his testimony to this Panel regarding FINRA stating that the Lek Holdings Note Program adequately addressed LSC's NSCC liquidity risks was accurate." Decision 10.

E. LSC's Application for Review and Motion to Stay

On April 3, 2022, LSC filed an application for Commission review of the Decision and a motion to stay the effectiveness of the Clearing Agencies' decisions. On May 31, 2022, the Commission denied LSC's motion for a stay and set a briefing schedule.

LSC submitted its opening brief to the Commission on June 30, 2022.

ARGUMENT

LSC's petition for review of the Clearing Agencies' determinations should be dismissed by the Commission under Section 19 of the Exchange Act.

I. The Hearing Panel's Decision Affirming NSCC's and DTC's Determinations to Cease to Act for LSC and NSCC's Determination to Impose the Activity Cap Must Be Upheld under the Standards Set Forth in Section 19(f) of the Exchange Act.

SEC review of the Clearing Agencies' determinations to cease to act for LSC and imposition of the Activity Cap by NSCC are governed by Section 19(f) of the Exchange Act, which contains the standards for review of SRO decisions concerning the "denial of membership or participation . . . or the prohibition or limitation . . . with respect to access to services offered by the [SRO]." Under Section 19(f), the Commission must dismiss proceedings for review of the SRO decision if it finds that (1) "the specific grounds on which [the action] is based exist in fact," (2) the action "is in accordance with the rules of the [SRO]," (3) "such rules . . . were applied in a manner, consistent with the purposes of [the Exchange Act]," and (4) the action does not "impose[] any burden on competition not necessary or appropriate in furtherance of the purposes of [the Act]." 15 U.S.C. § 78s(f).

A. The Hearing Panel's Findings on the Determinations to Cease to Act Were Supported by the Evidence and Based Properly on NSCC and DTC Rules, Which Were Applied Consistent with their Duties as Clearing Agencies Under Section 17A and Rule 17Ad-22.

The Hearing Panel upheld NSCC's determination to cease to act for LSC and to impose the Activity Cap in accordance with NSCC Rules 46 and 2A. Under NSCC Rule 46, Section 1, NSCC "may suspend a [member] . . . or prohibit or limit such [member]'s access to services offered by the Corporation in the event that:

> (c) the participant is in such financial or operating difficulty, that [NSCC] determined, in its discretion, that such action is necessary for the protection of [NSCC], the participants, creditors, or investors . . . (f) such participant has failed to comply with any financial or operational

> requirement of [NSCC], or (g) in any circumstances in which, in the discretion of [NSCC], adequate cause exists to do so."

NSCC Rule 2A, Section 1, provides:

> In furtherance of the Corporation's rights and authority to establish standards for membership, the Corporation shall establish, as it deems necessary or appropriate, standards of financial responsibility, operational capability, experience and competence for membership applicable to Members[.]

NSCC Rule 2A, Section 1, subparagraph G (ii), further provides that:

> [NSCC] may . . . . cease to act for any participant when such participant or its Controlling Management has a record that reflects . . . the applicant or its Controlling Management is responsible for . . . making a misstatement of a material fact or has omitted to state a material fact to [NSCC] in connection with its application to become a Member or thereafter . . . .[23]

In addition, NSCC Rule 2B, Section 2, subparagraph B (b), provides that a member must report "any event that . . . could have a material impact on [the member]'s business and/or financial condition."

The Hearing Panel upheld DTC's determination to cease to act for LSC under DTC Rule 10 and the financial standards under Rule 2.[24]

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[23] Under NSCC Rule 2B, Section 1, members must continue to meet the "Qualifications and Standards" provided in Rule 2A, Section 1, as "Ongoing Membership Requirements," and comply with the ongoing informational and operational requirements under the Rule while they are members of NSCC.

[24] DTC Rule 10 provides, in relevant part:

> Based on its judgment that adequate cause exists to do so, [DTC] may at any time (a) cease to act for a [Member] with respect to . . . transactions generally . . . . Adequate cause for ceasing to act for a [Member] . . . shall be deemed to exist if: . . . (vi) [DTC's] Board of Directors, or a committee authorized thereby, shall have reasonable grounds to believe (A) that the [Member] or its Controlling Management to be responsible for . . . (2) making a misstatement of a material fact or omitting to state a material fact to [DTC] in connection with its application to become a [Member] or thereafter . . . or (B) that such ceasing to act is necessary for the protection of [DTC], other [Members] or Pledgees or to facilitate the orderly and continuous performance of [DTC]'s services . . . .

DTC Rule 2 provides:

> The Corporation shall approve applications only upon a determination by the Corporation that the applicant meets the standards of financial condition, operational capability and

In upholding the Clearing Agencies' determinations, the Hearing Panel found that: (i) "LSC's capital and liquidity are inadequate" and the Lek Holdings Note Program "[wa]s simply not sufficiently reliable or robust" (Decision 12), and (ii) LSC's "repeated, knowing, misrepresentations, omissions, and failures to provide information in a timely manner justify and support NSCC's and DTC's determinations to cease to act for LSC" (*id.* 19). The Hearing Panel's findings are fully supported by the evidence and consistent with the Clearing Agencies' rules, which, at all times, provided ample notice of the scope of LSC's financial obligations to the Clearing Agencies, as well as the conduct expected of LSC and the implications for non-compliance with those standards.

1. LSC's Weak Capital and Liquidity

As the Hearing Panel recognized, "[u]nder both DTC and NSCC rules, membership can only be granted or maintained by a member that has the capability, in DTCC's judgment, to meet its financial obligations to DTCC." Decision 5.[25] The Hearing Panel made a number of factual findings about LSC's weak capital and liquidity, all of which are grounded in the evidence. The Clearing Agencies' determinations, which were made under NSCC Rules 2A, 2B and 46 and DTC Rules 2 and 10, that LSC can no longer reliably meet its financial obligations under the Clearing Agencies' rules are clearly supported by the Hearing Panel's findings.

i. LSC's Capital and Bank Liquidity Were Insufficient to Meet its Margin Requirements as Prescribed by NSCC Rules, and

> character defined below: (a) the applicant has demonstrated that it has sufficient financial ability to make any Required Participants Fund Deposit and Required Preferred Stock Investment and meet all of its anticipated obligations to the Corporation . . . .

[25] The Decision mistakenly refers to NSCC Rule 2A, Section 1, as NSCC Rule 1. The requirements in NSCC Rule 2A, Section 1, are incorporated in the ongoing membership requirements of NSCC Rule 2B. *See supra* n.16.

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the Lek Holdings Note Program Was Not a Reliable Source of Funding to Satisfy those Requirements.

NSCC's and DTC's rules make explicit that a member must have sufficient resources to meet its financial obligations under the rules. NSCC Rules 2A, 2B; DTC Rule 2. NSCC's rules include specified "Qualifications and Standards of Financial Responsibility, Operational Capability and Business History,"[26] which provide for minimum net capital and other financial requirements, and NSCC Rule 4 and Procedure XV set dynamic standards for members' Clearing Fund obligations in relation to the business they conduct through NSCC.

Over the course of 2021, LSC's Clearing Fund deposit requirement, as calculated under NSCC Rule 4 and Procedure XV, averaged approximately $28 million, frequently exceeded $60 million, and was as high as $84.8 million. Tab 2 ¶¶ 14–16. LSC's available cash and excess net capital were at all times well below its Clearing Fund requirements. *Id.*; Decision 7 ("LSC's own capital, while exceeding the regulatory minimum, is plainly inadequate to meet its liquidity needs."). There is ample evidence in the record, including testimony by LSC's CEO, Mr. Charles Lek, and LSC's expert witness, to support the inadequacy of its financing—for example, LSC had less than $7 million in available cash and only $10 million "unsecured" bank financing to cover up to $84 million in Clearing Fund liability. Tab 39; Tab 2 ¶ 16; Tab 60 ¶ 36. Mr. Lek himself admitted in his testimony that an NSCC rule change "in February 2021 resulted in increased margin requirements for LSC that could not be met by LSC's existing or contemplated bank lines of credit." Decision 7 (citing Tab 60 ¶¶ 42–43).

Without sufficient capital and bank liquidity, LSC had to rely on the Lek Holdings Note Program to meet its NSCC Clearing Fund requirements, and the Hearing Panel was fully justified in focusing heavily on the adequacy and reliability of the Lek Holdings Note Program in

[26] NSCC Rules, Addendum B (cited in NSCC Rules 2A and 2B).

reaching its conclusion that LSC did not have sufficient resources to meet its Clearing Fund obligations with the high degree of assurance required by the Exchange Act.

ii. The Clearing Agencies Had Sufficient Grounds to Conclude that Lek Holdings Note Program Is Not a Reliable Source of Liquidity.

The evidence before the Hearing Panel was more than sufficient for it to conclude that the Lek Holdings Note Program "presents numerous disqualifying features" that rendered it an unacceptable and insufficiently reliable source of liquidity to ensure that LSC could meet, on an ongoing basis, its Clearing Fund deposit requirements. Decision 8.

The record demonstrated that Lek Holdings did not have sufficient capital and liquidity on its own to lend even a fraction of the $100 million in liquidity that the Lek Holdings Note Program supposedly represented. The record showed that Lek Holdings only had approximately $5 million in cash and other current assets as of June 2021, and that its cash position the prior year was substantially less. *See supra* Background Section C.1.ii.[27] The Lek Holdings Note Program instead needed to rely on LSC's customers as uncommitted lenders to Lek Holdings under separate promissory notes.

In addition, Lek Holdings had no legal, contractual or otherwise documented obligation to provide continuous financing to LSC. Decision 8; Tab 164 87:10–16. Moreover, just as Lek Holdings was not obligated to continue to lend money to LSC, the Hearing Panel found that the LSC customers similarly had no obligation to continue to lend money to Lek Holdings. *Id.* at 8; Tab 60 ¶¶ 43–46; Tab 127. Consequently, the Lek Holdings Note Program relied on LSC's

[27] Lek Holdings' financials are insufficient for a separate, independent, reason: it is undisputed that Lek Holdings does not have audited financials that the Clearing Agencies could review in order to make a reliable assessment of its financial condition.

customers' ongoing willingness to lend money to Lek Holdings and Lek Holdings' willingness to continue to fund LSC, despite none of them having an obligation to do so.

The Hearing Panel also found that LSC did not provide the Clearing Agencies with sufficient information to enable them assess the financial condition of the customers lending to Lek Holdings under the Lek Holdings Note Program. Decision 17; *see also* Tab 142 ¶¶ 17–19. Indeed, the Clearing Agencies had no information on any of the lenders—not even their identities—since the middle of 2021.

LSC admitted that it did not provide this information about its customers, calling that information "irrelevant" because LSC contends that its system of controls prevent it from incurring Clearing Fund liability if it does not obtain the funding for it under the Lek Holdings Note Program. Br. 16. Specifically, LSC said that it does not accept certain trades until LSC's customers responsible for them fund the resulting NSCC margin requirements through the Lek Holdings Note Program. *Id.* at 11. Specifically, LSC said it "has an electronic pre-trade risk control process" to "carefully limit its margin exposure." Br. 10. However, the Hearing Panel found that the risk controls were insufficient. Decision 9, 13. The Hearing Panel also found that there were no written procedures documenting the pre-trade controls that LSC alleges are fundamental to the operation of the Lek Holdings Note Program. *Id.* at 8 n.12 (citing evidence); *see also* Tab 164 79:15–80:16.[28]

The Hearing Panel found that even with respect to any policies and procedures that did exist, "LSC has advanced no evidence that gives [the Hearing Panel] any confidence it can

[28] At the Hearing, Mr. Lek testified about the operation of the Lek Holdings Note Program and pointed to certain risk management documentation, but those documents did not reference the Lek Holdings Note Program at all or govern how it operated. *See* Decision 8 n.12 (citing evidence).

adequately control its own processes." *Id.* at 9 (referring to "outdated risk management controls" and LSC's "misleading statements . . . regarding its internal controls").

The Hearing Panel found that even if the Lek Holdings Note Program worked exactly as LSC described it, the controls did not adequately account for the potential for large swings in margin requirements. Decision 10–11. LSC's expert, Dr. Emre Carr, conceded that the Lek Holdings Note Program only dealt with the margin requirement at the time of the trade and the calculator used to measure it did not include all of the factors necessary to assess accurately the end-of-day margin requirement. Tab 128 ¶ 30; Tab 164 210:10–213:12.

The Hearing Panel found that "[n]ot a single one of these steps (other than LSC's requirement to post margin at NSCC) is required through any contract, rule, or other legally binding requirement." Decision 8. The Hearing Panel also considered "LSC's argument that it has a strong incentive to make the program work properly," which LSC repeats here, but found "that is not the same as everyone involved, some of whom may not share LSC's incentive, being legally obligated to fulfill their part in the arrangement." *Id.*

iii. The NSCC and DTC Determinations Concerning LSC's Weak Capital and Liquidity Were Made in Accordance with their Rules and the Exchange Act.

The evidence is clear that LSC cannot meet its Clearing Fund requirements with its cash and available bank liquidity and that the Lek Holdings Note Program is not sufficiently reliable.

LSC contends that the Clearing Agencies and the Decision did not identify "objective standards or other metrics that LSC failed to satisfy" with regard to its capital and liquidity position. Br. 8. In this regard, LSC says that the Clearing Agencies never advised it of a specific amount of capital and level of credit facilities that it was required to maintain. *Id.* LSC's complaint appears to be that the Clearing Agencies' rules do not explicitly state the specific amount of available capital and bank financing LSC must maintain. *Id.*

But NSCC Rule 4 and Procedure XV prescribe the amounts required over and above the minimum capital requirements in Addendum B. NSCC Rule 4 and Procedure XV provide explicit standards that explain how a member's activity is used to calculate its Clearing Fund deposit requirement each day. In this regard, NSCC's rules are clear in that they communicate to members that their financial capability will be assessed against the level of business they conduct through NSCC. NSCC Rule 4 and Procedure XV are highly objective and set clear expectations for LSC and all members—they are required to demonstrate that they have sufficient and reliable liquidity to meet the Clearing Requirement each day. Under those measures, LSC needed to have at least as much available capital and reliable liquidity to meet its demonstrated Clearing Fund requirements at present and with high assurance in the future. In addition, Mr. Leibrock of DTCC testified that DTCC made clear on several occasions that LSC was required to carry sufficient capital and liquidity to cover is Clearing Fund requirement as calculated under Rule 4 and Procedure XV. *E.g.*, Tab 2 ¶ 61, Tab 164, 252:17–253:2.

By focusing on the discretion NSCC and DTC have under their rules to assess the reliability of the Lek Holdings Note Program, LSC would lead the Commission to believe that the Clearing Agencies' determinations about the unreliability of the Note Program were arbitrary. Not so. The Clearing Agencies' rules that provide NSCC and DTC the discretion to cease to act based on financial considerations are valid and were approved by the Commission under Section 19(b) of the Exchange Act. Indeed, many SRO rules vest discretion in the agency and the agency is afforded discretion in their administration. *See, e.g.*, *Heath v. S.E.C.*, 586 F.3d 122, 138–39 (2d Cir. 2009) (collecting various cases in support of proposition that SROs are entitled to deference in administering their own rules); *Shultz v. S.E.C.*, 614 F.2d 561, 571 (7th Cir. 1980) (acknowledging necessity of discretion under Exchange Rules since "[s]uch a

standard could not be fully spelled out in a series of specific prohibitions"); *cf. Intercontinental Indus., Inc. v. Am. Stock Exch.*, 452 F.2d 935, 940 (5th Cir. 1971) (finding exchange's determination that information disclosure was "not the prompt action required by both the letter of the rule and the spirit of the listing agreement" reasonable). The Commission should defer to the Clearing Agencies' exercise of discretion where they had a rational basis for the actions they took and their determinations were made in good faith. *Id.* There are ample grounds supporting the Hearing Panel's findings in this regard, and LSC has not alleged they were made in bad faith.

LSC's contention that it does not pose a financial risk because it has always been able to meet its Clearing Fund deposit requirements in the past ignores the Clearing Agencies' statutory responsibilities to look to the future in managing clearance and settlement risk. Br. 6–7. The Decision properly recognized that the Clearing Agencies' "mission is to look prospectively and [they] must guard against what may happen." Decision 11. NSCC especially must ensure that LSC can meet its Clearing Fund obligations *in the future* with a level of assurance that approaches 100 percent.[29] Moreover, because each member's risk of default is mutualized, NSCC relies on *every member* to cover its Clearing Fund obligations at the peril of the other members who must account for the member's shortfall risk in the event of a default. As the Decision recognized, "[a] failure by LSC would not be a failure for LSC alone. It would cause harm to DTCC and potentially the entire financial system." *Id.* at 11. This would be directly contrary to the Clearing Agencies' obligation under Rule 17Ad-22 to assure adequate financial risk coverage on a go-forward basis into the future. As recognized in the Decision, "[a] failure of this system could cause default after default, with the effect of jeopardizing the entire financial system." *Id.* at 6.

[29] *See* 17 C.F.R. § 17Ad-22(e)(3)(i), (e)(4)(i) and (e)(6)(iii).

2. LSC's Failures to Report Material Adverse Developments to Its Financial Condition, Failures to Respond to Clearing Agency Inquiries, and Inaccurate and Misleading Representations in Response to those Inquiries

The Hearing Panel found that LSC's reporting failures, inadequate responses, failures to respond, and inaccurate and misleading representations supported the Clearing Agencies' determinations to cease to act under their rules. Decision 13; *see also* NSCC Rule 2A, Section 1.G.ii, *supra* at 15; NSCC Rule 46, Section 1, *supra* at 14; DTC Rule 10, *supra* at 15 n.24. The Hearing Panel found, based on the evidence, that LSC breached its duty to the Clearing Agencies by (1) failing to report the loss of the substantial majority of its bank financing, as a material business development, (2) failing to respond timely and accurately to inquiries from the Clearing Agencies, and (3) providing inaccurate and misleading information in response to those inquiries.

i. LSC Failed to Report the Elimination of Two of its Largest Bank Credit Facilities as Required By the Clearing Agencies' Rules.

The Hearing Panel found that LSC failed to meet the standards required by the Clearing Agencies' rules when it failed to report the actual and impending termination of its two largest sources of bank financing, as it was required to do under NSCC and DTC rules. *See* NSCC Rule 2B; DTC Rule 2; *accord* Decision 16. LSC conceded that it had a duty to keep the Clearing Agencies informed. Tab 13 at 2.

BMOH. The Hearing Panel found that LSC failed promptly to report BMOH's intention to terminate its banking relationship with LSC. LSC's $75 million line of credit with BMOH was the largest source of credit that LSC had disclosed to the Clearing Agencies. But when BMOH informed LSC of its intention to terminate the line of credit and its settlement bank relationship with LSC, LSC did not report those developments to the Clearing Agencies.

In addition, although Mr. Lek testified before the Hearing Panel that he did not inform the Clearing Agencies of BMOH's decision to eliminate the credit line because he considered it "not material," that testimony was in direct contradiction of the representations made by LSC's attorneys. Tab 60 ¶¶ 53, 65–66, 172. When confronted with this glaring contradiction during cross examination, Mr. Lek claimed that he viewed his lawyers' statements as "embellishments," as opposed to serious business communications, which the Hearing Panel viewed as "problematic." Tab 164 (Tr. 2.17.22 pp. 99–100); *see also* Decision 16.

The loss of the BMOH financing, which LSC had previously identified to the Clearing Agencies as comprising the majority of its bank financing, plainly was material and required to be reported under NSCC Rule 2B, Section 2.B.(b). Tab 2 ¶¶ 43–52; Tab 142 ¶¶ 24–27. BMOH's stated reasons for terminating the relationship are also significant.[30]

Texas Capital. Likewise, the Hearing Panel found that LSC failed to report the impending expiration of its line of credit with Texas Capital as required under NSCC Rule 2B. Rule 2B, Section 2.B.(b). "LSC did not inform [the Clearing Agencies] in a timely manner that [the Texas Capital line of credit] had expired." Decision 14.

LSC claims that the expiration of the Texas Capital credit facility was not material. Br. 13. However, the Texas Capital facility (and, by extension, its expiration) was plainly material. LSC disclosed the facility in prior due diligence reports to the Clearing Agencies, which asked LSC to disclose all of its funding for carrying on its business. Tab 40. It was certainly material to the Clearing Agencies inasmuch as they had requested information about it previously and it represented almost a quarter of LSC's bank financing (the loss of which was particularly material

[30] In the July 8th letter, BMOH stated in plain terms that its "decision to terminate the relationship is grounded in numerous valid concerns, including but not limited to: loss of confidence in LSC and its current management; regulatory concerns prompted by the SEC and FINRA actions; financial and reputational risk; and concerns about LSC's financial status." Tab 19.

in view of the impending loss of substantially the rest of its bank financing in the BMOH line of credit). Tab 2 ¶¶ 40–42. Under the circumstances, there is no question the Clearing Agencies found the information important and needed to know it in order to carry out their oversight responsibilities under the Exchange Act.

The Hearing Panel correctly found that the information LSC withheld about the termination and expiration of its bank financing was material: "LSC had previously told the DTCC that its only bank lines of credit for its liquidity needs included the BMOH and Texas Capital lines of credit. A change in these lines was material." Decision 16.

Moreover, the circumstances demonstrate that the omission was intentional. As the Hearing Panel Decision noted, LSC's self-serving determinations of materiality resemble those made by the sanctioned respondent in the case of *In re Schellenbach*, Exchange Act Rel. No. 30030, 1991 WL 288493, at *2–3 (Dec. 4, 1991), *aff'd*, 989 F.2d 907 (7th Cir. 1993), where the respondent conceded that the firm avoided telling FINRA about its net capital problem because it believed that if it had disclosed the problem, FINRA would have shut it down. Decision 16 n.23.

ii. LSC Failed to Provide Information in Response to the Clearing Agencies' Requests and Provided Inaccurate and Misleading Information in Responding to Others.

The Hearing Panel found and the record demonstrates that LSC repeatedly failed to produce information requested by the Clearing Agencies and made numerous misrepresentations in response to requests by the Clearing Agencies. LSC failed to provide information or misrepresented the facts about several material aspects of its financial and operational condition, including: (1) the Lek Holdings Note Program; (2) the report of a FINRA-ordered independent consultant related to LSC's internal controls ("BRG Report"); (3) LSC's relationship with BMOH; (4) the Texas Capital line of credit; and (5) the availability of LSC bank lines of credit to meet its NSCC Clearing Fund requirements.

The Clearing Agencies' rules make clear that members must respond timely, fully and accurately to requests for information. *See* NSCC Rule 2A, Section 1; DTC Rule 10. Failure to respond or, worse, providing inaccurate or misleading information is inconsistent with the Clearing Agencies' rules and prevents NSCC and DTC from performing their clearing agency and SRO duties properly under Sections 17A and 19 of the Exchange Act.

(1) Lek Holdings Note Program. Once it became apparent that LSC was relying on the Lek Holdings Note Program as its primary source of funding to cover its Clearing Fund requirements, the Clearing Agencies requested information and documentation about how the Lek Holdings Note Program operated. LSC failed to provide the requested information. *E.g.*, Tab 142 ¶¶ 15–19; Tab 164 303:16–305:7. The Hearing Panel found that, in spite of numerous requests, LSC never provided a written description of how the Lek Holdings Note Program operated. Decision 17 ("We note that LSC never provided DTCC with, among other things, a narrative explanation of the operation of the Lek Holdings Note Program."). In this regard, LSC admits that it never provided financial or other information about the LSC customers that were actually funding the Lek Holdings Note Program. Br. 16. LSC argued that "[d]etailed financial information about the customers making the initial loans is irrelevant because LSC does not place any trade that will result in significant margin until it has the money from the customer in hand." *Id.* Whether LSC believed that such information was relevant or not is beside the point. The Clearing Agencies had the right to request the information and LSC had an obligation to provide that information timely on request.

(2) BRG Report. LSC failed to provide the Clearing Agencies with a copy of the BRG Report, prepared by an independent consultant that LSC was ordered to retain in connection with a 2019 settlement with FINRA. Though the BRG Report issued in April 19, 2021, Tab 42, there

is no dispute that LSC failed to provide a copy to the Clearing Agencies until June 2021, even though the Clearing Agencies had requested a copy on several occasions. Tab 2 ¶¶ 64–69; Tab 60 ¶ 170; *accord* Decision 18.

The Hearing Panel found that the Clearing Agencies "had a right—indeed, the obligation—to ask for the report and LSC had an obligation to provide it. *See* NSCC Rule 2B; DTC Rules 2 and 9(A)." Decision 19.

LSC did not contest that it failed to timely provide the Clearing Agencies with a copy of the BRG Report. It instead said that its delay in providing the report was excusable due to what it refers to as the Clearing Agencies' "poorly worded requests." Br. 15–16. While LSC contends the requests were ambiguous, the Hearing Panel found that LSC's interpretation of them "mak[es] no sense because it reads one of the requests out of any meaning whatsoever." Decision 18. "LSC interpreted the request for the report of the Independent Monitor Optima, because the request included in parentheses 'three-year engagement,' and only Optima, and not BRG, was subject to a three-year engagement." *Id.* The Hearing Panel justifiably concluded that LSC's assertion of ambiguity was not credible, because instead of responding to the Clearing Agencies' requests by identifying the Optima Report, it failed to respond to *either* question. Tab 45 at PDF p.5; Decision at 18–19.

(3) BMOH. In addition to failing to timely report the developments with BMOH, LSC has also misrepresented the facts surrounding the termination of the BMOH line of credit. In its opening brief to the Commission, LSC claims that it "disclosed the pending closure of the BMOH credit line shortly after receiving the July 8th letter." Br. 14. But the Hearing Panel found and the evidence clearly demonstrated that BMOH made LSC aware of its intention to terminate the line of credit by October 19, 2020 (Tab 126) and then explicitly advised LSC again

of the planned termination date in May and June 2021 (*id.*; Tabs 19, 20). In this regard, LSC's contention that "[t]here is no evidence that, in the months leading up to the July 8, 2021 BMOH letter, BMOH and LSC discussed the termination of the BMOH facility" is patently false. Br. 15.

(4) Texas Capital. Likewise, LSC has misrepresented the facts surrounding the termination of the Texas Capital line of credit. In response to customary due diligence questions from the Clearing Agencies, LSC represented that the Texas Capital was still in place and was due to be renewed at the end of March 2021. Tab 43 at p.4. But that was a misrepresentation—the Texas Capital line of credit expired without renewal on March 2021. And the Hearing Panel also found that "even after [the] expiration [of the Texas Capital line of credit], LSC represented to DTCC that it was still in place." Decision 14. LSC's knowing misrepresentation that the Texas Capital line of credit was continuing was a failure to comply with the Clearing Agencies' rules requiring candor and subverts the Clearing Agencies' ability to rely on information from their members to satisfy their obligations under the Exchange Act.

While LSC contends that the financial table it copied and pasted into its disclosures included a reference to "Renewal / Termination," LSC's response clearly indicated that the Texas Capital Bank line of credit was continuing when it stated: "There have been no changes in the terms of [LSC]'s credit facilities." Tab 43 at p.4. Mr. Lek admitted in his testimony that LSC's response concerning Texas Capital Bank could have been clearer. *See* Br. 14 (admitting that "the information about the status of the Texas Capital facility could have more clearly stated that the facility had not been renewed" and that its representation of the Texas Capital facility as being renewed was a "mistake"). But as the Hearing Panel found "LSC could have plainly stated that Texas Capital had ended its line of credit with LSC, but it did not so state." Decision 14.

LSC did not disclose the termination of the Texas Capital line of credit until it was responding to direct questions from the Clearing Agencies during a virtual site visit after it had submitted its written responses. Tab 2 ¶ 42.

(5) Availability of Bank Financing to Meet Clearing Fund Requirement. In its responses to standard due diligence questions, LSC represented that all of its bank financing, including the entire Texas Capital, BMOH, and Lakeside Bank lines of credit, was available to cover all of its financial obligations, including its Clearing Fund deposit requirement. *See, e.g.*, Tab 40. Only *after* the Texas Capital line expired and the Clearing Agencies learned of BMOH's intention to terminate its relationship with LSC did LSC begin to argue that only the *unsecured* portions of the credit lines were available or "useful" for covering its Clearing Fund deposit requirements. LSC argued this in order to blunt the impact of the massive reduction in available financing that it was experiencing, and LSC continued to argue this point before the Hearing Panel and again to the Commission in its opening brief. LSC's prior representations regarding the availability of bank financing therefore were inaccurate.

iii. The NSCC and DTC Determinations Concerning LSC's Reporting Failures, Failures to Respond, and Misrepresentations Were Made in Accordance with Their Rules and the Exchange Act.

LSC's chief complaint with regard to the Hearing Panel's finding that it provided misleading and incomplete information is that the "Decision does not cite to any rule from either the NSCC or DTC that defines 'material' information requiring disclosure." Br. 12. LSC's argument in this regard amounts to a complaint that the Clearing Agencies' rules do not expressly provide a definition of materiality. But the concept of materiality is well understood in case law and statutory interpretation. For example, the Supreme Court has long held that information is "material" where a reasonable person—*e.g.*, shareholder, investor, etc.—would

consider the information important under the particular circumstances. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Moreover, the Commission, when confronted with similar arguments concerning the lack of an express definition of materiality in rules and regulations, refers to the long-standing definition found in the case law. *See Selective Disclosure and Insider Trading*, SEC Release No. 33-7881 ("The regulation does not define the term[] 'material' . . . but relies on [the] existing definition[] . . . established in the case law. Information is material if 'there is a substantial likelihood that a reasonable shareholder would consider it important' in making an investment decision.") (citing *Basic Inc.* and *TSC Indus.*). The information that LSC misrepresented and failed to report here is plainly material under that definition.

LSC also suggests that the recitation of three exemplary events that qualify as material in NSCC Rule 2B, Section 2.B.(b) means that those are the only events that can be considered "material" under the rules. *See* Br. 13. Not so—NSCC Rule 2B, Section 2.B.(b) is explicit that the listed events are exemplary only: "Each Member shall submit to [NSCC] written notice of any event that . . . could have a material impact on such participant's business and/or financial condition, including *but not limited to*" the three exemplary events.

LSC also argues that it "did not intentionally provide inaccurate information and ultimately LSC provided all of the requested information within a brief period of time." Br. 13. As discussed below, the evidence is more than sufficient to support the Hearing Panel's conclusion that LSC's failure to provide complete and accurate information was intentional. It is well settled that misleading statements can be evidence of deception. *See Ultramares Corp. v. Touche*, 255 N.Y. 170, 186 (1931) (Cardozo, C.J.). Regardless, the Disqualification Criteria under NSCC Rule 2A, which provides bases for ceasing to act for a member, including "making

a misstatement of a material fact or [omitting] to state a material fact to [NSCC] in connection with its application . . . or thereafter," are distinct from "fraudulent acts," and therefore do not require that every misstatement made by LSC have been intentional. It is sufficient that, in NSCC's and DTC's determinations, LSC's pattern of reporting deficiencies and material misrepresentations and omissions would hinder their abilities to carry out their duties as clearing agencies and SROs under the Exchange Act.

At base, the system of self-regulation under the Exchange Act relies on members to comply with their reporting responsibilities under SRO rules diligently, honestly and completely. SROs, like NSCC and DTC, are justified in ceasing to act for a member that knowingly fails to provide information or provides false or misleading information in response to SRO requests.[31] The SEC has observed that "providing truthful information to regulatory authorities is a fundamental obligation of securities professionals" and providing falsified documents to FINRA "reflect[ed] an attitude toward regulatory oversight incompatible with the principles of investor

[31] For example, in December 2016, FINRA expelled Texas E&P Partners, Inc. for violating FINRA Rule 2010 by providing a falsified document to FINRA during an investigation. *See Tex. E&P Partners*, FINRA Disciplinary Proc. No. 2014040501801, at 33–34 (Dec. 13, 2016). There, an individual executed a key document the day before producing it to FINRA, falsely representing (both on the document, and in later testimony) that it was executed and effective several years before. *Id.* at 12. The member organization, acting through its head of compliance, was aware of the falsification but nevertheless submitted the document to FINRA without disclosing its falsity. *Id.* at 28. Finding that these actions were committed in bad faith or unethically, FINRA determined that the respondents' misconduct was "egregious," no mitigating circumstances were present, and expulsion of the firm from FINRA membership was appropriate. *Id.* at 33. *See also ICV Group, Inc.*, FINRA No. 2021070809102, at 2 (July 22, 2021) (former FINRA member admitted to refusing to respond to FINRA document and information requests in violation of FINRA Rules 8210 and 2010, and consented to its expulsion from FINRA membership). In the context of individual respondents who have failed to respond to a request or have responded in a misleading manner, the SEC has determined that sanctions rising to the level of a full bar or suspension are in keeping with the purposes of SRO reporting and disclosure requirements and overall mission to protect investors. *See In re Saliba,* Exchange Act Rel. No. 91527, 2021 WL 1336324, at *26 (Apr. 9, 2021) (affirming full bar of individual investor for providing backdated compliance forms to FINRA).

protection" and showed that respondent "pose[d] a threat to investors" warranting his suspension and fine.[32]

* * *

For all of the reasons discussed above, the Hearing Panel had a reasonable basis to conclude, based on the evidence presented in connection with LSC's reporting failures (discussed in Section I.A.2.i, above) and LSC's failures to provide complete and accurate responses to the Clearing Agencies' requests for information (discussed in Section I.A.2.ii, above), that "LSC's failures were part of a pattern of deliberate obfuscation designed to mislead DTCC." On that basis, the Clearing Agencies' determinations to cease to act and impose the Activity Cap were well-supported by their rules and the Hearing Panel was justified in concluding "that the repeated, knowing, misrepresentations, omissions, and failures to provide information in a timely manner justify and support NSCC's and DTC's determinations to cease to act for LSC." Decision 19.

B. The Decision to Cease to Act for LSC Does Not Impose an Improper Burden on Competition.

LSC baldly asserts in its "Conclusion" that the Hearing Panel "fail[ed] to weigh the impact on competition" because LSC is "one of the last self-clearing brokers that provides clearing and custody services to underserved Small Firms." Br. 19–20. The issue has no merit. LSC provides no evidence or legal support for its contention, and the issue is not even mentioned in the "Argument" section of its brief.

[32] *In re Fillet*, Exchange Act Rel. No. 75054, 2015 WL 3397780, at *14-15 (May 27, 2015); *In re Schellenbach*, Exchange Act Rel. No. 30030, 1991 WL 288493, at *4 (Dec. 4, 1991) ("[D]eliberate deception" of "regulatory authorities" "reflects strongly on the perpetrator's fitness to serve in any capacity in the securities business.").

LSC provides no evidence that it is "one of the last" brokers that serves "small firms." On the other hand, testimony by DTCC's Tim Cuddihy refutes the idea that there are no other clearing firm members that provide services similar to LSC's.[33] Moreover, any implication that the small firms LSC currently serves would be harmed by the Clearing Agencies decision to cease to act for LSC similarly is unfounded. These small firms have other options, such as by clearing through other firms or under a scenario where LSC could continue to serve them by LSC's clearing through another member. However, should LSC continue to serve the small firms directly, they would be subject to the risk of greater harm from a failure by LSC to satisfy its financial obligations to NSCC and DTC, including its Clearing Fund requirements, because LSC's failure would introduce delay and uncertainty to the settlement of those firms' businesses. The cease to act process provides for an orderly transition that is designed to minimize the impact on those firms. Tabs 4, 5.

When the SEC approved the Clearing Agencies' rules under which they determined to cease to act, the Commission necessarily had to evaluate the effect of those rules on competition.[34] The SEC's approval of those rules implicitly recognizes the overarching benefit to broker-dealers (and investors) generally for the Clearing Agencies to cease to act for members that in their expert judgement do not continue to meet the necessary financial and operational qualifications. LSC offers no evidence that there is any burden on competition from the Clearing Agencies' actions, and the Clearing Agencies have demonstrated there is none. In any event, to

[33] Attached as Exhibit V to LSC Exhibit A (appearing at PDF pages 246–48 of 256 of LSC's combined opening brief and exhibits).

[34] Under Section 19(b)(2)(C)(i) of the Exchange Act, in order to approve an SRO rule, the SEC must make a finding that it is "consistent with the requirements of [the Exchange Act] and the rules and regulations issued under [the Act] that are applicable to such organization." 15 U.S.C. § 78s(b)(2)(C)(i). Under Section 17A of the Exchange Act the Commission must determine that the "rules of the clearing agency do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." *Id.* § 78q-1(b)(3)(I).

the extent there is any burden on competition, NSCC's and DTC's determinations to cease to act for LSC are consistent with their rules and the objectives under Sections 17A and 19 the Exchange Act, it is necessary and appropriate in furtherance of the purposes of the Exchange Act.

C. The Determination to Cease to Act for LSC Is Not a "Sanction" that Can Be Cancelled, Reduced or Remitted as "Excessive" or "Oppressive" for Purposes of Section 19(f).

LSC's contention that the SEC can set aside the cease to act determinations as "overly excessive and oppressive" is incorrect and rests on a mischaracterization of NSCC's and DTC's actions. Br. 18. The actions are not disciplinary "sanctions" reviewable under Section 19(e). 15 U.S.C. § 78s(e).[35] The determinations to cease to act are actions taken by NSCC and DTC to limit or prohibit access to their services because of LSC has failed to meet the standards required to access the services. As limitations or prohibitions of service under Section 19(d), they are reviewable only under Section 19(f) of the Act. *Id.* § 78s(f). There is no language in Section 19(f)—as there is in Section 19(e)—that permits the Commission to cancel, reduce, or remit the prohibition or limitation of service by an SRO if it is justified on the basis that it is "excessive" or "oppressive."

Eligibility and qualification standards—including financial and operational capabilities—are threshold matters that do not contemplate lesser criteria. In matters of discipline reviewable under Section 19(e), where sanctions that are justified may be reduced, the member may still be qualified to receive the SRO's services. However, Section 19(f) governs the situation where, as here, a member is no longer qualified to receive services and the SRO is

[35] This is in contrast to the fines and sanctions NSCC imposed for LSC's violations of the Activity Cap, which are disciplinary sanctions. LSC has not challenged NSCC's imposition of censure and fines as excessive or oppressive. *See infra*. Section II.

justified in limiting or prohibiting the member's access to them. Section 19(f) therefore does not provide latitude to alter the Clearing Agencies' determinations to limit a member's access to services on the grounds that they are excessive or oppressive. 15 U.S.C. § 78s(f).

The cases cited by LSC are distinguishable on this basis, because they concern disciplinary sanctions forbidding individuals from SRO and agency membership, as opposed to limitations on services. Br. 18. In *Saad v. S.E.C.*, 873 F.3d 297, 301 (D.C. Cir. 2017), the SRO action under review was a disciplinary sanction imposing a lifetime ban on an individual which "permanently forbade [him] from associating with any FINRA member firm in any capacity." Likewise, *Paz Sec. v. S.E.C.*, 494 F.3d 1059, 1065 (D.C. Cir. 2007) also concerned disciplinary sanctions; specifically an individual's "exp[ulsion] from membership" in the National Association of Securities Dealers ("NASD") and "bar [] from ever associating with any NASD member firm." So too with *Steadman v. S.E.C.*, 603 F.2d 1126, 1137 (5th Cir. 1979), where the Commission considered the imposition of disciplinary sanctions, rather than the threshold matter of whether a member met the criteria for participation in an SRO.[36]

D. The Hearing Panel's Findings on the Determination to Impose the Activity Cap Were Supported by the Evidence and Based Properly on NSCC's Rules, Which Were Applied Consistent with its Duty as a Clearing Agency Under Section 17A and Rule 17Ad-22.

LSC's challenge to NSCC's imposition of the Activity Cap should be dismissed under Section 19(f) for the same reasons as the Clearing Agencies' determinations to cease to act.

[36] Suffice it to say that LSC's assertion that it has taken steps to increase its access to capital and liquidity (Br. 7 n.5) is outside the record, and therefore, is not properly up for consideration on appeal. LSC's assertion is not part of the record as defined by SEC Rule of Practice 460 and LSC did not move the Commission for consideration of additional evidence as required by SEC Rule of Practice 452. For their part, NSCC and DTC are not aware of any steps that LSC has taken to increase its capital and liquidity to levels sufficient to reliably meet its Clearing Fund obligations into the future or to address its deficiencies in complying with the Clearing Agencies' reporting and information requirements.

NSCC imposed the Activity Cap to limit its (and its members') exposure to LSC pending implementation of the decision to cease to act. The action was taken under NSCC Rule 46, approved by the Commission (with due consideration for effects on competition), which authorizes NSCC to cease to act where the member has "failed to comply with any financial or operational requirement" and "such action is necessary for the protection of [NSCC], the participants, creditors, or investors." At the Hearing, LSC offered no specific objections to the Activity Cap apart from its arguments that the cease to act was unwarranted. Decision 20. The Hearing Panel rightly determined that the factual findings justifying the Clearing Agencies' decisions to cease to act also supported NSCC's imposition of the Activity Cap. *Id.* The Activity Cap serves the objectives of Section 17A of the Exchange Act and Rule 17Ad-22 by protecting NSCC, its members, and the clearance and settlement system, against the impact of a default by LSC.

LSC complains in its brief that "the Clearing Agencies did not even provide LSC with an opportunity to have its questions or concerns regarding the calculation of the [A]ctivity [C]ap addressed before being subject to such fines" that were imposed on November 5 and 7 for multiple violations of the Activity Cap. Br. 17. Whatever objections LSC may have in mind with respect to the calculation, it did not raise them in the Hearing and therefore should be prohibited from doing so now. *See* 15 U.S.C. §§ 78s(e), (f) (confining review to the "record" below); *cf. In re Newport Coast Secs., Inc.*, Exchange Act Rel. No. 88548, 2020 WL 1659292, at *3 (Apr. 3, 2020) (holding arguments waived); *Canady v. S.E.C.*, 230 F.3d 362, 362–63 (D.C. Cir. 2000) (stating general rule that arguments not raised at trial level are waived and upholding Commission's conclusion that respondent "waived [a] defense by failing to argue it"). Moreover, the statement is not true. Tim Cuddihy of DTCC testified that he had a telephone

conversation with Mr. Lek about the Activity Cap on November 4, 2021. Tab 3 ¶ 34. That conversation led to NSCC's *increase* of the Activity Cap from $300 million to $400 million in response to Mr. Lek's "concerns." Whereupon, LSC proceeded to breach the Activity Cap again the very next day. *Id.* ¶¶ 34–35.

II. The Hearing Panel's Decision on NSCC's Determination to Censure and Fine LSC for Exceeding the Activity Cap Should Be Upheld under Section 19(e) of the Exchange Act.

SEC review of NSCC's determinations to censure and fine LSC for its violations of the Activity Cap are governed by Section 19(e) of the Exchange Act, which concerns SRO disciplinary sanctions. Under Section 19(e), the Commission must "affirm the sanction imposed by the [SRO]" if it finds that (1) the member "has engaged in such acts or practices, or has omitted such acts, as the [SRO] has found him to have engaged in or omitted"; (2) "such acts or practices, or omissions to act, are in violation of such provisions of [the Exchange Act], the rules or regulations thereunder, [or] the rules of the self-regulatory organization"; and (3) "such provisions . . . were applied in a manner, consistent with the purposes of [the Exchange Act]." 15 U.S.C. § 78s(e).

The Hearing Panel's decision upholding NSCC's decision to censure and fine LSC for its violations of the Activity Cap are consistent with NSCC's rules and the purposes of the Exchange Act. Under the Exchange Act, NSCC is required to have rules that provide for adequate discipline of members for violations of its rules. Consistent with that requirement, NSCC Rule 48 provides that NSCC "may discipline any [member] . . . for a violation of any provision of the Rules or the Procedures of [NSCC], such participant's agreements with [NSCC], or for any error, delay or other conduct detrimental to the operations of [NSCC] . . . by expulsion, suspension, limitation of or restriction on activities, functions and operations, fine or censure or any other fitting sanction; provided, however, that the fine for any single offense shall

not exceed the sum of $20,000." LSC does not dispute that it violated the Activity Cap on six occasions or that it was fined the maximum allowable amount for each of those six violations.

The fines were not "excessive" or "oppressive" and should not be canceled, reduced, or modified. Rather, the fines served their proper remedial purpose, to enforce the properly-imposed Activity Cap. Indeed, the censures and fines achieved their remedial effect—once LSC realized NSCC would actually be enforcing the Activity Cap, LSC stopped violating it.

The fact that the disciplinary measures in NSCC Rule 48 have been approved by the Commission in accordance with Section 19(b) of the Exchange Act also supports the conclusion that the censure and fines are not oppressive, are not inconsistent with the requirements of the Exchange Act, and do not impose an undue burden on competition, because the Commission has already made findings to the contrary in approving the rule. 15 U.S.C. § 78s(b)(2)(C); *id.* § 78q-1(b)(3)(I).

III. The Hearing Panel's Decision Charging Costs Was Supported by the Clearing Agencies' Rules.

LSC also challenges the Hearing Panel's decision charging certain of the costs of the Hearing against LSC. Br. 17; Tab 179. LSC alleges that charging costs against it "disincentivizes members, like LSC, from exercising their right to a hearing of the Clearing Agencies' actions." Br. 17. LSC disregards the fact that under the Clearing Agencies' rules costs will not be charged unless the hearing decision is adverse to the requesting party. Those with meritorious challenges are thus not disincentivized from pursuing them. The Clearing Agencies' rules are clear that "the cost associated with the hearing may, in the discretion of the Panel, be charged in whole or in part to the [party requesting the Hearing] in the event that the decision at the hearing is adverse to the" party requesting the Hearing. NSCC Rule 37, Section 4; DTC Rule 22, Section 5. The Hearing Panel's decision to charge costs is therefore consistent

with the Clearing Agencies' rules. Under the rules, costs will not be charged unless the hearing decision is adverse to the requesting party.

LSC's other challenge to the cost award is that the costs of the Hearing Panel's retained counsel should not be charged because "[t]he Hearing Panel did not have to retain lawyers; they chose to." Br. 17–18. But the Hearing Panel's counsel served the indispensable role of administering the proceedings, advising the Hearing Panel with respect to NSCC and DTC rules and providing whatever additional legal support the Hearing Panel requested. The Hearing Panel could not have served its purpose effectively without Hearing Panel counsel. Hearing Panel counsel's role was administrative in the sense that it was impartial and served the role of administering the proceedings, as opposed to advocating on behalf of any of the parties. Hearing Panel counsel's fees and disbursements therefore are properly chargeable as "costs" even under the narrowest interpretation of the term given by LSC. Tab 178.[37]

CONCLUSION

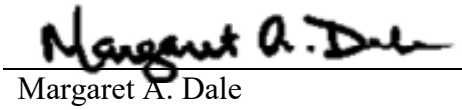
For the foregoing reasons, the Commission should dismiss LSC's petition for review of the Clearing Agencies' determinations to cease to act for LSC and NSCC's determination to impose the Activity Cap on LSC, and should affirm NSCC's determination to censure and fine LSC for its violations of the Activity Cap.

[37] NSCC and DTC have the authority to interpret their own rules. *See* NSCC Rule 47; DTC By-Laws, Article V.

Respectfully submitted,

PROSKAUER ROSE LLP

New York, New York
August 1, 2022

By: 

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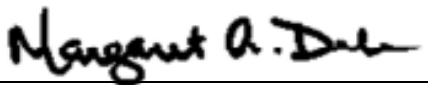
CERTIFICATE OF COMPLIANCE

Pursuant to Rule 450(d) of the Commission's Rules of Practice, I hereby certify that the foregoing document contains 12,910 words, exclusive of the tables of contents and authorities.

Dated: August 1, 2022



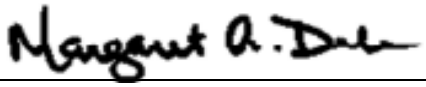
Margaret A. Dale

CERTIFICATE OF SERVICE

Pursuant to Rule 151(d) of the Commission's Rules of Practice, on August 1, 2022, the undersigned caused a true and accurate copy of the foregoing document to be served by electronic mail on the following persons:

DTCC Corporate Secretary (corporatesecretary@dtcc.com)
Kevin J. Harnisch (kevin.harnish@nortonrosefulbright.com)
Ilana B. Sinkin (ilana.sinkin@nortonrosefulbright.com)

Dated: August 1, 2022



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