

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57461; File No. SR-NSCC-2007-12)

March 10, 2008

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of a Proposed Rule Change to Provide a New Alternative Investments Products Service

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> notice is hereby given that on July 17, 2007, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) and on February 19, 2008, amended the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NSCC is proposing to establish a new Alternative Investment Products service (“AIP Service”), which would be a processing platform for alternative investment products such as hedge funds, funds of hedge funds, commodities pools, managed futures, and real estate investment trusts (“REITs”).

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

NSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

(A) Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of this rule filing is to amend NSCC’s Rules in order that NSCC may provide its proposed AIP Service, which would be a processing platform for alternative investment products such as hedge funds, funds of hedge funds, commodities pools, managed futures, and REITs. Such products are more fully described below in the section titled “Alternative Investment Products.”

(1) Summary of AIP Service

The AIP Service would provide for processing of information relating to transactions in alternative investment products and for settlement of related payments (“AIP Payments”). It would facilitate, among other things, processing activities such as subscriptions and redemptions, distributions, position reporting, and account maintenance. Activities that would be supported by the AIP Service are more fully described below in the section titled “Scope of AIP Service.”

Settlement of AIP Payments through NSCC would be done on a prefunded basis. NSCC would simply pass-through AIP Payments from AIP members to their respective contraside AIP members without netting or without guarantying payment in the event of contraside default. NSCC would not be liable to make payment to an AIP member in the event of a default in payment by the contraside AIP member. Settlement of AIP Payments (“AIP Settlement”) would be segregated from all other money settlements at NSCC. NSCC would have no exposure to

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<sup>2</sup> The Commission has modified the text of the summaries prepared by NSCC.

credit risk as a result of the operation of the AIP Settlement. AIP Settlement is more fully described below in the section titled “AIP Settlement.”

Participation in the AIP Service would be governed by NSCC’s Rules and procedures applicable to the AIP Service. Each user of the AIP Service (“AIP Member”) would be required to enter into an AIP membership agreement with NSCC that would govern its use of the AIP Service. Entities eligible for membership would include entities subject to regulation under US federal or state laws such as registered broker-dealers, investment advisers, banks, and insurance companies. Because of the unique processing and distribution features of alternative investment products and because NSCC would have no exposure to the credit risk of AIP Members and would have no liability to make payments in the event of an AIP Member’s AIP Settlement default, entities that are not required to register under applicable U.S. federal or state law and entities organized under applicable law outside of the US may also be eligible to become AIP Members. Membership in the AIP Service is more fully described below in the section titled “AIP Members.”

NSCC developed the concept and functionality for the AIP Service at the request of and in consultation with industry participants, many of which were NSCC members in different capacities using other NSCC services. Some of these interested parties committed to become pilot subscribers to the proposed AIP Service and committed to assist NSCC in funding the launch of the AIP Service. These parties are more fully described below in the section titled “AIP Pilot Group.”

(2) Alternative Investment Products

Alternative investment products are typically illiquid, pooled investment products that are exempt from registration under the Security Act of 1933 and the Investment Company Act of

1940 and that are offered through private placements to high net worth individuals and institutional investors such as pension funds.

Alternative investment products may be placed and held by an end investor through a direct relationship with the issuer or manufacturer of an alternative investment product or through an entity acting on behalf of an issuer or manufacturer (called the “AIP Manufacturer” for purposes of NSCC Rules). They may also be placed and held through a distribution channel such as a registered broker-dealer that facilitates transactions as a processing contraparty to the AIP Manufacturer (called the “AIP Distributor” for purposes of NSCC Rules). Alternative investment products are not generally traded in the secondary market. In this respect, the distribution for alternative investment products is similar to the distribution of mutual funds on NSCC’s Fund/SERV system. Alternative investment products have processing characteristics and risk profiles that differ from those of mutual funds, and those differences would be taken into account and reflected in the functionality of the AIP Service and in NSCC Rules and procedures.

Increasingly, investors and their advisers are including alternative investment products as part of their balanced portfolios. The alternative investment products market represents over \$1 trillion in assets and continues to grow. Despite the large asset base, processing remains extremely manual using methods such as delivery of hard copy documents, transmission of information by fax, email messages, telephone calls, and emailed spreadsheets. The lack of automation and standardized, centralized processing is inefficient, prolongs transaction processing time, introduces high costs per transaction, and increases the likelihood of errors - factors that increase in importance as the volume of transactions increases as it has in recent years.

(3) AIP Pilot Group

Accordingly, several industry participants (many of which were members of NSCC) approached NSCC to explore whether NSCC services could bring automation and standardization to the alternative investment product industry analogous to that which NSCC's Mutual Fund Services has provided to the mutual fund industry. Mutual funds and alternative investment products frequently share similar distribution channels and are frequently both included in an investor's portfolio for which a financial intermediary consolidates asset reporting and servicing.

NSCC solicited its members to assess industry interest. A pilot group of interested broker-dealers, alternative product manufacturers, and fund administrators was formed to determine the feasibility of NSCC providing such a service and to assist in the development of the business requirements and functional specifications for such a service. Some members of the pilot group committed to assist in the costs of development of the service through payment of a fixed amount that would be applied to their respective usage fees when the service was in production. Consistent with this commitment to support the costs of launching the service, NSCC agreed to consult with the members of the pilot group in refining and enhancing the necessary functionality for the service. The functionality for the initial scope of the AIP Service has been developed and is described below in the section titled "Scope of AIP Service."

(4) Eligible AIP Products

Alternative investment products processed through NSCC's AIP Service ("Eligible AIP Products") would initially include the types of products referenced above (i.e., hedge funds, funds of hedge funds, commodities pools, managed futures, and REITs). Additional products could be added in the initial phase or from time to time as requested by industry participants and

as approved by NSCC.<sup>3</sup> Eligible AIP Products would include those registered with the Commission or those not required to be registered. An AIP Manufacturer that submits an alternative investment product for processing through the AIP Service would represent and warrant to NSCC that the offer and sale of the investment product complies with applicable law.

(5) AIP Members

The following type of entities would be eligible to become AIP Manufacturers or AIP Distributors:

- (i) a broker-dealer registered under the Exchange Act or subject to regulation by the appropriate financial services regulator in its home jurisdiction;
- (ii) a bank or trust company under supervision of federal or state banking authorities or a non-US bank subject to regulation in its home jurisdiction;
- (iii) an investment company registered under the Investment Company Act or an issuer (structured as a fund or pooled investment vehicle) that is not required to register thereunder;
- (iv) an investment adviser as defined under the Investment Advisers Act of 1940 regardless of whether it is registered under the Investment Advisers Act or is exempt from registration;
- (v) a commodity pool operator or commodity trading advisor as defined under the Commodity Exchange Act regardless of whether the commodity pool operator or commodity trading advisor is registered pursuant to the Commodity Exchange Act or is exempt from registration thereunder;

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<sup>3</sup> Due to the nature of alternative investment products, NSCC retains the right to refuse to process a specific product or type of product through the AIP Service or to require that it no longer be processed through the AIP service if NSCC deems it to be in the interests of NSCC or its members to do so.

(vi) an insurance company regulated under state insurance law or a non-US insurance company subject to regulation by the appropriate insurance regulator in its home jurisdiction;

(vii) with respect to an AIP Manufacturer, an entity engaged under contract to provide administrative services to one or more Eligible AIP Products; or

(viii) an entity that does not qualify as one of the above entities but that has demonstrated to the Board of Directors of NSCC that its business and capabilities are such that it could reasonably expect material benefit from direct access to the AIP Service.

Because AIP Settlement would be prefunded and because NSCC would be insulated from exposure to the credit risk of AIP Members and would have no liability to make payments in the event of an AIP Member's AIP Settlement default, there are no financial requirements for participation in the AIP Service. Members would be required to meet NSCC's operational requirements and general standards applicable to competency for membership and to meet such other requirements as NSCC may establish from time to time.<sup>4</sup>

(6) Scope of AIP Services

The AIP Service would support communication of information and settlement of AIP Payments between the AIP Manufacturer and the AIP Distributor in order to facilitate the processing of subscriptions and purchases, tenders and redemptions, dividends and distributions, commissions and fees, position reporting, product information, account maintenance, automated transmission of imaged documents, and such other actions as NSCC may determine from time to time. The AIP Service would provide AIP Members with the ability to transmit data in

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<sup>4</sup> NSCC's general standards applicable to competency are designed to screen for any action or condition of an applicant or member that could, in the reasonable judgment of NSCC, present undue risk to NSCC or its members.

connection with transactions whether the payments are made outside of NSCC or through the AIP Service.

As with all NSCC Services, NSCC would not be responsible for the completeness or accuracy of data transmitted through the AIP Services or for any errors, omissions, or delays which may occur in the absence of gross negligence on the part of NSCC.

Fees for the use of the AIP Service have not yet been established and would be the subject of a subsequent proposed rule change filed under Section 19(b)(3)(A) of the Act if this proposed rule filing is approved.

(7) AIP Settlement

AIP Settlement would be in same day funds over fedwire and would be segregated from all other settlement payments at NSCC. Unless otherwise approved by NSCC, AIP Members would be required to appoint a settling bank (“AIP Settling Bank”) for purposes of settlement similar to NSCC settlement procedures for its other money settlements.

NSCC would maintain credit balances and debit balances for each AIP Member to which NSCC would post gross credits and gross debits for settlement on the date designated by the AIP Member (“Settlement Date”). AIP Settlement would be on a gross basis meaning that the credit balance of an AIP Member would not be netted against its debit balance. If NSCC does not receive funds from an AIP Member in the amount of the debit balance by the requisite time on the Settlement Date, NSCC would reduce the corresponding settlement credit balances of the AIP Members that are the contrasides to the AIP Member that did not pay its gross debit balance. Nonpayment of a debit balance would not be deemed a payment default under NSCC Rules, but NSCC may establish fees for late payment or nonpayment and may establish a threshold number

of instances of late payment or nonpayment which would cause other sanctions, including NSCC's ceasing to act for such an AIP Member.

After receipt of an AIP Member's debit balance from the AIP Member's AIP Settling Bank on Settlement Date, NSCC would transfer to the AIP Settling Bank(s) of the contraside AIP Member(s) the settlement credit balance(s). NSCC's payment would include gross credit balances which may have been reduced to reflect the reversal of any credits with respect to debit balance amounts that were not paid by a contraside AIP Member.

Use of NSCC's AIP Service would provide the alternative investment product industry with the ability to process transactions and to settle funds on a centralized, fully redundant platform that would provide more robust business continuity in the event of interruption to processing on a primary system, better audit trails on transactions, lower costs, and fewer errors and delays than are currently the case through manual processing.

Settlement on the basis of gross debits and gross credits without offsets insulates NSCC from any financial risks associated with Eligible AIP Products and AIP Members. Because NSCC's obligation to pay a credit balance would be conditioned upon receipt of the funds by NSCC from the contraside AIP Member, NSCC would not bear the risk that an AIP Member may default at settlement.

(8) AIP Document Transmission

The AIP Service would automate the transmission of imaged hard-copy documents ("paper workflow") between AIP Manufacturers and AIP Distributors. The alternative investment industry has a number of investment instruments that are private or are traded outside of the normal processes and that require the exchange of documentation. Typically, the parties may exchange up to forty pages of hard-copy documents. Subaccount documentation is typically

sent for both initial and subsequent subscriptions, depending on the requirements of the alternative investment product, and for tender offers. The paper workflow component of the AIP Service would allow parties to scan and convert documents to a file format such as portable document format (“PDF”) file for transmission with or without a pending transaction message.

(9) Proposed Changes to NSCC Rules

Under the proposed rule change, a new Rule 53, “Alternative Investment Product Services and Members,” would be added to NSCC’s Rules, and additional confirming changes would be made elsewhere throughout NSCC’s Rules as needed to provide consistency with the new Rule 53.

NSCC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act<sup>5</sup> and the rules and regulations thereunder because by facilitating the transmission of standardized information for alternative investment products on a centralized communications platform and by automating money settlements through a centralized location in the same day funds, the proposed AIP Service would provide increased efficiencies and reduced risks that are typically associated with manual processing. As such, the proposed changes would help remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions.

(B) Self-Regulatory Organization’s Statement on Burden on Competition

NSCC does not believe that the proposed rule change will have any impact or impose any burden on competition.

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<sup>5</sup> 15 U.S.C. 78q-1.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments relating to the proposed rule change have not yet been solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period: (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2007-12 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NSCC-2007-12. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. Copies of such filing also will be available for inspection and copying at the principal office of NSCC and on NSCC's Web site at [http://www.dtcc.com/downloads/legal/rule\\_filings/2007/nscc/2007-12.pdf](http://www.dtcc.com/downloads/legal/rule_filings/2007/nscc/2007-12.pdf). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NSCC-2007-12 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.<sup>6</sup>

Florence E. Harmon  
Deputy Secretary

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<sup>6</sup> 17 CFR 200.30-3(a)(12).