

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51362; File No. SR-NSCC-2003-11)

March 11, 2005

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Granting Approval of a Proposed Rule Change to Amend the Criteria Used to Place Members on Surveillance Status and to Eliminate Member and Applicant Financial Responsibility and Operational Capability Questionnaires

I. Introduction

On May 27, 2003, the National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) and on June 17, 2003, September 15, 2003, December 20, 2004, and March 3, 2005,¹ amended proposed rule change File No. SR-NSCC-2003-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).² Notice of the proposed rule change was published in the Federal Register on February 3, 2004.³ No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

II. Description

A. Risk Matrix

Under the current NSCC rules, management has the ability to place on surveillance status a member that is experiencing conditions which may have an adverse financial or operational impact on NSCC. Once placed on surveillance status, NSCC closely monitors the member’s condition. The current criteria for placing members on surveillance status are broadly written

¹ In the December 20, 2004, and March 3, 2005, amendments, NSCC elaborated on how it will apply and monitor the matrix. The amendments did not modify the substance of the proposed rule change and therefore did not require republication of notice.

² 15 U.S.C. 78s(b)(1).

and capture many NSCC members that pose minimal financial or operational risk to NSCC. This creates administrative burdens for NSCC staff who must more closely monitor these members who pose minimal risk.

To remedy this problem, NSCC has developed new criteria for placing members on surveillance. All full service firms for which NSCC guarantees their trades will be assigned a rating that is generated by entering financial data of the member into a risk assessment matrix (“Matrix”). Those members with a “weak” rating, which are deemed to pose a relatively higher degree of risk to NSCC, will be placed on an internal watch list and will be monitored more closely. Members placed on the watch list may be required to submit additional financial reports and data and/or make additional clearing fund deposits.

The Matrix is used by NSCC and its affiliated clearing agency, Fixed Income Clearing Corporation (“FICC”). Specifically, in order to run the Matrix, credit risk staff uses the financial data of each applicable NSCC member and the financial data of each applicable member of FICC. In this way, each applicable member of FICC and NSCC is rated against other applicable members of FICC and NSCC. Credit risk staff approaches its analysis of members pursuant to the new procedures in the following manner. First, as mentioned above, domestic broker-dealers and domestic banks are run through the Matrix and assigned a rating. Low-rated members are placed on the watch list. At this point, credit risk staff may downgrade a particular member’s score based on various qualitative factors. (For example, one qualitative factor might be that the member in question received a qualified audit opinion on its annual audit.) In order to protect

(..continued)

³ Securities Exchange Act Release No. 49123 (January 23, 2004), 69 FR 5231.

NSCC and its other members, it is important that credit risk staff maintain the discretion to downgrade a member's rating on the Matrix and thus subject the member to closer monitoring and possibly additional reporting and/or additional clearing fund requirements. All rated members, including those on the watch list, are monitored monthly or quarterly, depending upon the member's financial filing frequency, against basic minimum financial requirements and other parameters.

All broker-dealer members included on the watch list are monitored more closely. This means that they are also monitored for various parameter breaks which may include but are not limited to such things as a defined decline in excess net capital over a one month or three month period, a defined period loss, a defined aggregate indebtedness/net capital ratio, a defined net capital/aggregate debit items ratio, and a defined net capital/regulatory net capital ratio. All bank members included on the watch list are also monitored more closely for watch list parameter breaks which may include but are not limited to such things as a defined quarter loss, a defined decline in equity, a defined tier one leverage ratio, a defined tier one risk-based capital ratio, and a defined total risk-based capital ratio. Monitoring for the above more stringent parameter breaks is done only for those members placed on the watch list.

NSCC will continually evaluate the methodology and its effectiveness and will make such changes as it deems prudent and practicable within such time frame as is determined to be appropriate by NSCC. NSCC will update the Commission staff on its evaluations of the Matrix pursuant to a schedule developed by FICC, NSCC, and Commission staff.

B. Questionnaire

Currently, Addendums B, I, Q, and R (standards of financial responsibility and

operational capability for settling, fund, insurance carrier, and third party administrator members and applicants, respectively) include questionnaires that members and applicants are currently required to complete and to return to NSCC. NSCC Rule 15 also provides that NSCC has the authority to examine and to require adequate assurance of the financial responsibility and operational capability of members and applicants. Because NSCC routinely receives information related to its members' and applicants' financial responsibility and operational capability and has the authority to request additional information as the need arises, NSCC is eliminating these questionnaires from its Rules and Procedures. Furthermore, NSCC has found the information contained in the questionnaires to be duplicative of the other information it routinely receives throughout the year.

NSCC has determined to rely on its ability under Rule 15, Section 2 to obtain pertinent information for members and applicants rather than require responses to specific questionnaires. NSCC will solicit such information in such form and within such timeframes as it may require from time to time.

III. Discussion

Section 17A(b)(3)(F) of the Act requires among other things that the rules of a clearing agency be designed to facilitate the safeguarding of securities and funds which are in its custody or control or for which it is responsible and in general will protect investors and the public interest.⁴ The Commission finds that NSCC's proposed rule change is consistent with this requirement because it improves NSCC's member surveillance process which should better

⁴ 15 U.S.C. 78q-1(b)(3)(F).

enable NSCC to safeguard the securities and funds which are in its custody or control or for which it is responsible.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵ that the proposed rule change (File No. SR-NSCC-2003-11) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁶

Jill M. Peterson
Assistant Secretary

⁵ 15 U.S.C. 78s(b)(2).

⁶ 17 CFR 200.30-3(a)(12).