June 26, 2020

Via Electronic Submission

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
rule-comments@sec.gov

Re: File No. SR-NSCC-2020-003; Release No. 34-88474

OTC Markets Group[1] is pleased to submit this comment letter in response to the National Securities Clearing Corporation's ("NSCC") proposed rule change to enhance the calculation of certain components of NSCC's Clearing Fund formula, including charges applicable to illiquid securities and UITs (the "Proposal") filed with the Securities and Exchange Commission ("SEC" or the "Commission") on March 25, 2020.

As the operator of the primary non-exchange public trading markets for small or "venture" companies in the United States, we hear from a diverse group of market participants – composed of issuers, broker-dealers, clearing firms, corporate counsel, individual investors and transfer agents – about the cost and complexity involved in processing transactions in small company securities, many of which are infrequently or thinly traded. Clearance and settlement costs extend beyond the directly impacted clearing firms and broker-dealers. Capital formation and market efficiency suffer as a result of these back-end difficulties, ultimately reducing the attractiveness of the public markets for small and growing companies.

The Proposal seeks to "enhance" the margin requirements for member firms engaged in processing transactions in "Illiquid Securities", which are defined as any security not traded on a specified securities exchange and any exchange-traded security that falls below certain thresholds based on market capitalization and historical trading activity. This overbroad definition would categorize even the largest OTC traded companies, including those with market capitalizations in the tens of billions, as "Illiquid Securities." The Proposal would also eliminate the existing Illiquid Charge and introduce "enhancements" to the haircut-based volatility component of the Clearing Fund requirement for illiquid and certain other securities.

The Commission should disapprove the Proposal. As a threshold matter, the Proposal does not meet the requirements for clearing agency rulemaking under the Securities and Exchange Act of 1934 (the "Exchange Act") Section 17A and the Rules promulgated thereunder, including Section 17A(b)(3)(F) and Rules 17Ad-22(e)(4)(i) and 17Ad-22(e)(23)(ii). Further, the Proposal's enhanced requirements with respect to "Illiquid Securities" will needlessly impose significant

[1] OTC Markets Group Inc. operates the OTCQX® Best Market, the OTCQB® Venture Market and the Pink® Open Market for 10,000 U.S. and global securities. Through OTC Link® ATS and OTC Link ECN, we connect a diverse network of broker-dealers that provide liquidity and execution services. We enable investors to easily trade through the broker of their choice and empower companies to improve the quality of information available for investors. OTC Link ATS and OTC Link ECN are SEC regulated ATSs, operated by OTC Link LLC, member FINRA/SIPC.

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burdens on smaller member firms that provide liquidity in OTC securities and certain thinly-traded exchange-listed securities.

As set forth below, NSCC must provide sufficient information to enable meaningful industry analysis, discussion and comments. First, NSCC must reassess its Proposal to demonstrate why the current margin requirements are insufficient to cover the credit exposures to its participants. Once this initial burden is met, any new requirements must be proposed with careful attention paid to the impact on competition, retail and other investors, and the general availability of clearing services for small company securities.

I. The Proposal does not contain sufficient information to meet the Exchange Act requirements for clearing agency rule proposals

Rule 17Ad-22(e)(4)(i) requires that clearing agencies maintain rules designed to effectively manage its credit exposures by "maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence".[2] Rule 17Ad-22(e)(23)(ii) requires that such rules "provide sufficient information to enable participants to identify and evaluate the risks, fees, and other material costs they incur" as NSCC members.[3]

The specific requirements for submission and approval of a proposed clearing agency rule submitted pursuant to Section 19(b)(7) of the Exchange Act include, *inter alia*, (1) a statement of purpose containing the reasons for the proposed rule change, problems the rule change is intended to address, the manner in which the proposal will resolve those problems, and how the proposal will affect various persons (e.g. brokers, dealers, issuers and investors), among other requirements; (2) an explanation of the statutory basis for the proposed rule, detailing why the change is consistent with the requirements of the Exchange Act and regulations applicable to NSCC; and (3) "sufficiently detailed and specific" information supporting the premise that the proposed rule change does not unduly burden competition.[4]

The Proposal, on its face, does not meet any of the enumerated requirements for clearing agency rule proposals.

The Proposal fails to provide the required statement of purpose. NSCC seeks to "enhance" its methodology for calculating certain components of the Clearing Fund. Notwithstanding its intention to bring "greater clarity" and "transparency" to its members, the Proposal is devoid of any detail that would allow member firms and industry participants to properly evaluate the risk-based analysis purportedly underlying the proposed changes and consider the resultant impact on their individual margin requirements. For example, the proposed changes to the "Illiquid Security" definition are supposedly designed to provide member firms with "improved clarity and transparency" into NSCC's methodology and provide NSCC with "additional measures of a

[2] 17 CFR 240.17Ad-22(e)(4)(i).
[3] 17 CFR 240.17Ad-22(e)(23)(ii).
[4] 15 U.S.C. 78s(b)(7). Form 19b-7 provides further instruction as to the information required for Section 19(b)(7) rule proposals for the purpose of "elicit[ing] information necessary for the public to provide meaningful comment on the proposed rule change and for the Commission to determine whether abrogation of the proposal is appropriate because it unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors." 17 CFR § 249.822.

security's liquidity to improve its ability to apply margin that reflects the risk characteristics of that security." However, the Proposal fails to identify the problem the rule change is intended to address and offers no insight into why additional transparency is necessary, nor how the Proposal, as drafted, brings about such transparency.

The statutory basis presented in the Proposal employs circular logic and excludes any demonstration of the need for additional margin to cover existing credit exposures. For example, the Proposal notes that the proposed changes will "enable NSCC to better limit its exposure to Members in the event of a default" because: the proposed enhancements will allow members to have a better understanding of NSCC's rules; clear and accurate rules will help members better understand their rights and obligations with respect to NSCC's services; this improved understanding will allow members to act in accordance with NSCC's rules; and enabling members to comply with the Rules will promote the prompt and accurate clearance and settlement of securities transactions consistent with Section 17A of the Exchange Act. The Proposal does not explain how the introduction of a convoluted, haircut-based volatility component would enable NSCC to better limit its exposure in the event of default and hardly facilitates a better understanding of NSCC's rules or members' rights with respect to such rules.

The Proposal summarily concludes, without valid support,[5] that it "could have an impact on competition", but that NSCC does not believe any burden on competition would be significant. Without disclosure of the referenced "impact studies",[6] NSCC cannot credibly argue that the Proposal contains "sufficiently detailed and specific" information regarding the Proposal's impact on competition.

Prior NSCC proposals have been similarly deficient in their lack of transparency. [7] At a minimum, NSCC must (i) identify the reasons why the Proposal is necessary, beyond "enhancing transparency", (ii) detail why the proposed amendments are appropriately targeted to address these issues, (iii) describe the resultant impact of the Proposal on member firms,

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[5] The Proposal posits that "[i]mpact studies indicate that the proposed changes would have resulted in an approximate 2.6% increase on average of NSCC's daily Clearing Fund had the proposed changes been in place over the period from November 2017 to October 2018." Proposal at 38. This 2.6% increase is flawed. An aggregate increase in the Clearing Fund over one year does not account for daily variances that would impact each firm independently and be disproportionately borne by smaller firms.
[6] The referenced impact studies were filed separately and confidentiality with the Commission and are not publicly available.
[7] In 2013, NSCC proposed rule SR-NSCC-2013-02 to institute supplemental liquidity deposits ("SLD") to NSCC's Clearing Fund designed to increase liquidity resources. A total of 23 comment letters were filed in response to the proposed rule, the overwhelming majority opposing the proposal based on similar concerns raised here, including (i) the proposal's lack of detail and transparency, and (ii) the potential for increased SLDs to drive smaller firms to exit the market, negatively impacting the competitive landscape of the industry and increasing systematic risk by concentrating clearing services with the "too big to fail" firms. Based on these public comments, NSCC amended its proposal several times, including disclosing additional details on the metrics and reasoning behind the proposal to increase the level of transparency and expanding the analysis on the Proposal's burden on competition. NSCC Proposed Rule Changes Related to Institution of Supplemental Liquidity Deposits, 78 Fed. Reg. 21487 (proposed Apr. 4, 2013); Order Approving NSCC's Proposed Rule Changes Related to Institution of Supplemental Liquidity Deposits, 78 Fed. Reg. 75413, 75415-17; Comments to File No. SR-NSCC-2013-02, available at: https://www.sec.gov/comments/sr-nscc-2013-02/nscc201302.shtml.

investors and other impacted market participants, and (iv) provide a meaningful analysis of the Proposal's impact on competition.

II. The Proposal does not meet the Exchange Act requirements for clearing agency rulemaking

Notwithstanding the deficiencies described above, the Proposal also does not pass muster under Section 17A(b)(3)(F) of the Exchange Act, which sets forth the requirements for clearing agency rules:

> …to promote the prompt and accurate clearance and settlement of securities transactions […] to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency…[8]

The Proposal does not meet these requirements and will likely impose unwarranted additional burdens on smaller firms, further exacerbating the costs and difficulty of clearing and settlement of small securities. This will, in turn, cause small company liquidity to dry up and negatively impact shareholder value.

Over the past decade, we have witnessed a worrisome trend whereby many industry participants are unwilling or unable to process transactions in low-priced, thinly-traded or non-exchange listed stocks, each of which are generally owned by retail, main street investors. While it is now easier than ever for public companies to disclose information to the marketplace and for investors to access, consume and act on that information, ***the back-office infrastructure powering our U.S. capital markets, including NSCC, is not serving small and thinly-traded companies and their investors.***

Increased regulatory concerns and resultant compliance costs have led many brokers and clearing firms to impose significant fees for transactions in these securities – or, in many cases, to exit the OTC equities business entirely – because the added costs outweigh the benefits. This ongoing problem is further aggravated by blanket rules like those offered in the Proposal that rely on an outdated understanding of market structures and fail to distinguish between high and low risk transactions.

Consider, for example, a first-time investor purchasing 1,000 shares (at $1.00 per share) in a small, startup company conducting an online crowdfunded offering under Regulation A of the JOBS Act. While the shares are freely-tradable (subject to state Blue Sky laws) and the company is subject to comprehensive initial and ongoing disclosure under Regulation A, the

[8] 15 U.S.C. § 78q-1 (b)(3)(F).

stock is not traded on a national securities exchange, not registered with the SEC and is priced under $5.00. These features generally trigger additional compliance reviews for retail brokerage firms. As a result, when the investor attempts to deposit these newly-purchased shares in their account, they are either told that the shares cannot be deposited, or they are required to pay a significant fee to deposit the shares. In many cases, these fees will wipe out any gains the investor may have realized, and in some cases may exceed the cost of the transaction.

The example above represents an improper risk allocation that places unwarranted cost and compliance burdens on a specific class of securities, such that the compliance obligations threaten to completely subsume the utility of the Congressionally-authorized, SEC approved Regulation A offering type. Similarly, ***NSCC must design and implement a risk-based margin system that measures credit exposure while taking into account relevant product risk factors***. The Proposal does not articulate a risk-based approach with respect to its poorly defined class of "Illiquid Securities," and as a result it threatens to cause outsized harm to smaller firms, companies, and the investors that rely on each. The Proposal's suggestion that NSCC will calculate the Clearing Fund requirement separately on long and short positions in sub-penny stocks, rather than on the net position, without sufficient explanation or discussion, may cause further harm without identifying an attendant risk that needs to be mitigated.

The Proposal also glosses over the disproportionate costs borne by smaller brokers that serve these retail investors in OTC and thinly-traded stocks. In its limited analysis on the Proposal's burden on competition, NSCC contends that while the Proposal *could* burden members with lower operating margins, higher cost of capital, or higher percentages of Illiquid Securities in their portfolio, the enhanced margin requirements would apply equally to all members. This is akin to arguing that a flat $10,000 tax on the sale of rare books is fair because it applies equally to the local bookshop and Amazon. ***Despite its "equal" application, the Proposal's margin requirements are likely to disproportionately impact smaller firms and harm competition, pushing more business away from the self-clearing firms and towards "too big to fail" clearing firms.***

Recommendations from the SEC's recent Small Business Forums have highlighted these issues and sought further guidance from the Commission to enable brokers and clearing firms to safely deposit and clear low-risk OTC securities within regulatory guidelines.[9] Without transparent disclosure concerning the impact of NSCC's enhanced requirements for Illiquid Securities, the Proposal may only serve to further exacerbate the existing clearing, depositing and liquidity issues faced by small firms and their retail customers.

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[9] The 2017, 2018 and 2019 Small Business Forums requested guidance for broker-dealers, transfer agents, and clearing firms, regarding Regulation A securities and OTC securities. *See* Final Report of the 2017 SEC Government Business Forum on Small Business Capital Formation (Mar. 2018), available at: https://www.sec.gov/files/gbfor36.pdf; *see also* Final Report of the 2018 SEC Government-Business Forum on Small Business Capital Formation (Jun. 2019) available at: https://www.sec.gov/info/smallbus/gbfor37.pdf; *see also* Report on the 28th Annual Government-Business Forum on Small Business Capital Formation (Aug. 14, 2019) available at: https://www.sec.gov/files/small-business-forum-report-2019.pdf.

III. Any requirements imposed on Illiquid Securities should be based on characteristics of the security, rather than the venue where it trades

To the extent that NSCC provides sufficient information to justify its proposed (and existing) requirements applicable to "Illiquid Securities", those requirements should not be based on the market where a stock trades and instead should reflect the actual risk posed to NSCC and its members.

The current blanket inclusion of all 10,000 securities traded on OTC Link ATS within the definition of "Illiquid Security" is arbitrary and ignores current market conditions.[10] Despite the fact that many of these OTC-traded securities have a deep, liquid market or would otherwise meet the requirements to be listed on a "specified securities exchange", they are nonetheless categorized as "Illiquid" (under the existing NSCC rules and as proposed).

For example, many large international companies have American Depositary Receipts ("ADRs") and foreign ordinary shares traded on the U.S. OTC markets. Approximately 6,000 securities of non-U.S. issuers with a primary listing in their home country have securities traded on the OTC markets, including Roche Holding Ltd., Adidas AG, BNP Paribas, Heineken N.V., each of which trades on the OTCQX market. These securities have an average market capitalization of $1.8 billion and average daily trading volumes (per security) over $200,000.[11] If traded on an exchange, these securities could be deposited, traded and settled with considerable ease and would not constitute "Illiquid Securities" under the Proposal.[12]

However, these securities traded on the OTC market *automatically* fall within the definition of "Illiquid Securities", causing brokers to incur substantial margin requirements and other compliance costs. The Proposal offers no justification for the categorization of all OTC-traded stocks as "Illiquid Securities". Indeed, 2,500 OTC-traded securities have a market capitalization over $300 million that would otherwise meet "micro-capitalization" test if they were traded on a "specified securities exchange".

NSCC has not provided any data or analysis supporting the proposed definitions of "Illiquid Security" or "specified securities exchange". The Proposal loosely defines "specified securities exchanges" as those that have "established listing services and are covered by industry pricing and data vendors" – ignoring non-exchange markets, such as the OTCQX and OTCQB markets, that have recognized company standards and broad market data distribution. Instead, the Proposal makes a broad-brush distinction based on unsubstantiated statements that specified exchanges "tend to list securities that exhibit liquid characteristics such as having more available public information, larger trading volumes and higher capitalization". Securities falling within the "Illiquid Securities" definition (i.e. every OTC-traded security and certain exchange-traded securities), on the other hand, "tend to exhibit unpredictable illiquid

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[10] While 11,092 securities are currently quoted on OTC Link ATS, the universe of securities impacted by the Proposal includes all securities that are NSCC-eligible and reportable to FINRA's Over-the-Counter Reporting Facility (ORF) for a total of 16,524 securities – more than all of the securities listed on Nasdaq and NYSE combined. Data as of June 24, 2020.
[11] Average market capitalization is as of February 29, 2020 and trading volumes are based on average daily dollar volumes transacted in the U.S. security from December 1, 2019 through February 29, 2020.
[12] Subject to the Proposal's additional "illiquidity ratio test" as applied to ADRs within this group of securities.

characteristics including limited trading volumes or infrequent trading". Rather than pointing to specific risks facing NSCC and its members that might justify the imposition of these overly inclusive categorical definitions, the Proposal relies almost entirely on conjecture and undisclosed reviews, methodologies and analysis.[13]

Accordingly, any requirements imposed on member firms clearing "Illiquid Securities" should be based on definitive characteristics of the security (e.g. market capitalization, trading history, risk of default by the member firm) rather than the venue on which the security trades.

IV. Conclusion

In conclusion, OTC Markets Group requests that the Commission disapprove the Proposal. Any subsequent proposal from NSCC must include additional insight from NSCC into the relevant risks involved in processing Illiquid Securities, and the coverage required to mitigate these risks. Without additional information, potentially impacted participants cannot engage in meaningful discussion and analysis.

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We welcome the opportunity to discuss our comments with the Commission.

Please contact Dan Zinn, General Counsel ([redacted]), or Cass Sanford, Associate General Counsel ([redacted]), with any questions or to request additional information.

Very truly yours,

Daniel Zinn
General Counsel

Cass Sanford
Associate General Counsel

[13] *See e.g.* Proposal at pg. 8 ("NSCC regularly assesses its market and credit risks, as such risks are related to its margining methodologies, to evaluate whether margin levels are commensurate with the particular risk attributes of each relevant product, portfolio, and market. The proposed changes described below are a result of NSCC's regular review of the effectiveness of its margining methodology.")