July 21, 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. 34-89145

OTC Markets Group[1] is pleased to submit this comment letter in response to the Securities and Exchange Commission's ("SEC" or the "Commission") July 9, 2020 order instituting proceedings (the "Order") to determine whether to approve or disapprove 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").

The NSCC's Proposal aims to (i) clarify and enhance the methodology for identifying securities as illiquid by revising the definition of "Illiquid Securities", (ii) apply an enhanced haircut-based volatility charge to Illiquid Securities and UITs, (iii) eliminate the existing "Illiquid Charge", and (iv) make other conforming changes. The proposed definition of "Illiquid Securities" would include:

(1) All over-the-counter ("OTC") traded securities;
(2) Exchange-traded securities with market capitalizations under $300 million;
(3) Exchange-traded American Depositary Receipts (ADRs) with an "illiquidity ratio" exceeding a threshold to be determined by NSCC; and
(4) Exchange-traded securities with fewer than 31 business days of trading history over the past 153 business days.

Under the Proposal, NSCC would apply a proposed haircut-based volatility charge to Illiquid Securities, replacing the existing Value at Risk ("VaR") charge.

We submitted comments (hereinafter referred to as our "June Letter") in response to the NSCC's Proposal on June 26, 2020,[2] advocating that the Commission disapprove the Proposal on the grounds that it does not meet the requirements for clearing agency rulemaking under the Securities and Exchange Act of 1934, as amended (the "Act"). Specifically, the Proposal does not contain a sufficiently detailed statement of purpose, statutory basis or analysis on the impact

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[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.
[2] OTC Markets Group Inc., Comment to File No. SR-NSCC-2020-003 (Jun. 26, 2020), available at: https://www.sec.gov/comments/sr-nscc-2020-003/srnscc2020003-7355659-218714.pdf.

on competition. Our June Letter also detailed how any increase in the margin requirements applicable to Illiquid Securities would disproportionately impact smaller broker-dealers, increase fees for investors seeking to settle and clear transactions in small company and OTC-traded securities and exacerbate existing market inefficiencies.

This letter is intended to supplement our June Letter and respond to the Order's request for written comments by addressing the statutory grounds for disapproval under consideration by the Commission. For the reasons set forth below, the Commission should disapprove the Proposal in its entirety.

I. The Proposal is not consistent with the policy requirements of Section 17A(b)(3)(F) of the Act

The Proposal would result in outcomes inconsistent with the policy considerations required for clearing agency rulemaking. Section 17A(b)(3)(F) of the Act requires that clearing agency rules be designed to comply with the following overarching principles:

(1) Promote the prompt and accurate clearance and settlement of securities transactions;
(2) Assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible;
(3) Foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions;
(4) Remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions;
(5) Protect investors and the public interest; and
(6) Not permit unfair discrimination in the admission of participants or among participants in the use of the clearing agency.[3]

The Proposal only attempts to address the first two elements of Section 17A(b)(3)(F), and does so solely by summarily concluding that the proposed "enhancements" will promote prompt and accurate clearance and settlement and assure the safeguarding of funds because it will "enable NSCC to better limit its exposure to Members in the event of a Member default".[4] NSCC claims that the enhanced definition of "Illiquid Security" and additional criteria would make it easier for NSCC to identify securities exhibiting illiquid characteristics and would "provide a better and more accurate measure of volatility", ultimately "enhanc[ing] the clarity and transparency for Members with respect to the volatility component allowing Members to have a better understanding of the Rules."[5] NSCC theorizes that improved rule understanding leads to improved rule following, which will ultimately allow NSCC to clear and settle securities transactions in accordance with the requirements of Section 17A(b)(3)(F) of the Act.

[3] 15 U.S.C. 78q-1(b)(3)(F).
[4] Proposal, pg. 30.
[5] Id. at 33.

NSCC's statutory basis for their proposal is lacking in both logic and detail. Not only does the complex haircut-based volatility charge fail to bring "clarity and transparency" or greater understanding of NSCC rules, the Proposal provides no explanation regarding how the current formula leaves members exposed to default or how the proposed methodology would limit exposure in the event of a member default.

The Proposal does not address, nor does it meet, the remaining four elements of Section 17A(b)(3)(F). The Proposal will not foster cooperation and coordination between the various market participants engaged in processing transactions in Illiquid Securities. Instead, increased margin requirements will disadvantage smaller firms, exacerbating the trend of firms ceasing to provide liquidity in thinly-traded stocks due to overly burdensome regulatory costs. The Proposal will not remove impediments but would impose additional requirements and increase the already prohibitive transactional costs involved in clearing and settling OTC and small company stocks, making already thinly-traded securities more illiquid. Rather than protect investors, these costs will likely be passed to the retail shareholders in these companies.[6] Finally, the Proposal will unfairly discriminate against smaller firms, as increased margin requirements will constitute a larger portion of their available net capital, when compared to the "too-big-to-fail" firms.

The Proposal must not be approved until NSCC provides sufficient information regarding each element outlined in Section 17A(b)(3)(F) of the Act and addresses the above concerns.

II. The Proposal is not reasonably designed to cover NSCC's credit exposure in accordance with Rule 17Ad-22(e)(4)(i) under the Act

We appreciate that NSCC seeks to maintain sufficient resources to manage credit exposure in the event of a member default. However, the Proposal does not contain adequate information explaining how the changes to the definition of "Illiquid Security" and the enhanced volatility charge would help NSCC to mitigate any credit risk not already addressed by the current VaR formula.

Rule 17Ad-22(e)(4)(i) requires that clearing agency rules be reasonably designed to effectively identify, measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes, including by maintaining sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence.[7]

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[6] *See* The Securities Traders Association of New York, Inc. (STANY), Comment to File No. SR-NSCC-2020-003 (Jun. 30, 2020), available at: https://www.sec.gov/comments/sr-nscc-2020-003/srnscc2020003-7369483-218828.pdf ("We are extremely concerned that the increased margin requirements and the burdens imposed by the Proposal will cause additional firms to exit the already costly business of providing liquidity in thinly-traded stocks, to the ultimate detriment of retail investors and small companies. If the Proposal causes more NSCC members to exit self-clearing, the likely result will be further concentration of risk at the largest NSCC clearing member firms. We are equally concerned that there may be fewer firms willing to accept the deposit of thinly-traded stocks, or impose exorbitantly high fees to do so, thereby discouraging entry to the public market by small and growing companies and impairing capital formation. Additional requirements that increase the already high costs and difficulty of clearing and settlement of small securities, will negatively impact small company liquidity and shareholder value.")
[7] 17 CFR 240.17Ad-22(e)(4)(i).

The Proposal states that the existing VaR charge, a model-based calculation that relies on predictability, may be less reliable for measuring market risk of securities that exhibit unpredictable illiquid characteristics.[8] While this is presumably the reason for proposing a switch to the haircut-based volatility charge, the Proposal does not indicate why the proposed methodology is superior and how it would enable NSCC to better manage its credit exposure.

NSCC posits that the proposed enhancements to the volatility charge would "provide NSCC with a more effective measure of the risks that may be presented to NSCC by positions in the securities."[9] In support of this statement, the NSCC offers an undisclosed impact study as an example, noting only that the study indicated a 99.5% increase in the average backtesting coverage percentage for short positions in sub-penny securities and securities priced between one cent and one dollar, as compared to the current methodology.

Without disclosure and discussion of the underlying impact study and related details, the conclusory, self-serving summary provided by NSCC makes it impossible to determine how the proposed volatility charges enable NSCC to more effectively measure risk and cover credit exposure to its members.

III. The Proposal does not include sufficient information to enable member firms and market participants to identify and evaluate the risks and costs associated with the Proposal in contravention of Rule 17Ad-22(e)(23)(ii) under the Act

Perhaps the most glaring inadequacy of the Proposal is its failure to address the impact on members. Rule 17Ad-22(e)(23)(ii) requires that clearing agencies establish rules that enable participants to identify and evaluate the risks, fees, and other material costs they incur by participating in the covered clearing agency.[10]

The Proposal does not include Rule 17Ad-22(e)(23)(ii) in its statutory basis analysis. Instead, in its "Statement on Burden on Competition", the Proposal merely concludes "the proposed changes could burden competition because they would result in larger Required Fund Deposit amounts for Members". The Proposal goes on to cite impact studies suggesting the proposed changes "would have resulted in an approximate 2.6% increase on average of NSCC's daily Clearing Fund had [they] been in place over the period from November 2017 to October 2018."[11] It remains unclear whether or why NSCC's daily Clearing Fund may be inadequate now, and why a 2.6% increase would be necessary. As noted above, the "impact studies" referenced in the Proposal are not disclosed. Further, an aggregate increase in the Clearing Fund over one year does not account for daily variances that would impact each member firm independently.

This perfunctory analysis, combined with the overwhelming complexity of the proposed haircut-based volatility charge, leaves little to work with to determine the day-to-day risks, fees and costs of the Proposal. Indeed, NSCC member firms have submitted comments stating that

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[8] Proposal, pg. 7.
[9] Id. at 35.
[10] 17 CFR 240.17Ad-22(e)(23)(ii).
[11] Proposal, pg. 38.

NSCC's convoluted methodology and lack of transparency makes it nearly impossible to project how the Proposal would impact their business.[12]

IV. The inclusion of all OTC securities within the definition of "Illiquid Securities" is inconsistent with the requirements of Rule 17Ad-22(e)(6)(i) under the Act

Proposal's deficiencies are highlighted by NSCC's decision to maintain the existing, inherently flawed definition of "Illiquid Security", which, with no justification, includes thousands of well-capitalized issuers.

Rule 17Ad-22(e)(6)(i) requires that a covered clearing agency establish a risk-based margin system that considers, and produces margin levels commensurate with, the risks and particular attributes of each relevant product, portfolio, and market.[13] The Proposal suggests that these requirements are met because the proposed changes to the haircut-based methodology, based on price level and risk profile, rather than a static percent, would enable NSCC to more effectively measure risks inherent to Illiquid Securities, including "increased transaction and market costs to NSCC to liquidate or hedge due to lack of liquidity or marketability of such positions."

Again, the undisclosed "backtesting results" do not provide any concrete support for this conclusion. This alone should be grounds for disapproval. However, the Proposal also fails to consider whether the underlying definition of Illiquid Securities (existing and as proposed) is tailored to capture securities that present the defined liquidation and marketability risks. As discussed in more detail in our June Letter, approximately 6,000 securities of non-U.S. issuers are lumped into the overly-broad definition of OTC securities simply because they are not traded on an exchange. These securities include many internationally recognized, household names such as Roche, Adidas, BNP Paribas, Deutsche Telekom, BASF and Heineken.

The increased illiquidity costs imposed on firms processing transactions in these large, liquid stocks surely are not commensurate with the risks presented by these securities. SEC registered broker-dealers provide approximately $1.8 billion in liquidity each day across our markets – the same brokers that trade exchange-listed stocks.[14] There is nothing inherently "illiquid" about the OTC marketplace. Therefore, OTC Link ATS and OTC Link ECN should constitute "specified securities exchanges" under the Proposal, and any margin requirements related to illiquidity risk 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 it trades.

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[12] *See* Wilson-Davis & Co., Inc., Comment to File No. SR-NSCC-2020-003 (May 1, 2020), available at: https://www.sec.gov/comments/sr-nscc-2020-003/srnscc2020003-7144486-216265.pdf ("We are unable to glean any indication from the proposing release of the likely financial and operating impacts of the proposals. What is the measure of projected NSCC risk production? How will the proposals impact our day-to-day liquidity requirements? Without substantial additional clarification and detail, we are unable to appreciate the likely and reasonable impact of the proposed changes.").
[13] 17 CFR 240.17Ad-22(e)(6)(i).
[14] *See* OTC Markets Group Broker-Dealer Directory, available at: https://www.otcmarkets.com/otc-link/broker-dealer-directory.

V. Conclusion

In conclusion, OTC Markets Group requests that the Commission disapprove the Proposal. Any subsequent proposal from NSCC on this topic must include additional insight into the relevant risks involved in processing certain types of securities, and the coverage required to mitigate these risks. NSCC must also fully address the impact on investors, competition and market efficiency in accordance with the statutory requirements for clearing firm rulemaking. Without additional information, potentially impacted participants cannot engage in meaningful discussion and analysis.

We also recommend that the Commission consider alternative means of achieving transparency and accountability from NSCC, for example the institution of an independent advisory group to review and opine on NSCC's liquidity requirements and regular reporting requirements showing the required liquidity and relative risk of default for member firms.[15]

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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

[15] In response to an overwhelming industry backlash to a 2013 NSCC proposal designed to impose additional Clearing Fund liquidity requirements, NSCC, among other things, (i) made numerous amendments to its original filing, (ii) formed the Clearing Agency Liquidity Council (CALC), an advisory group composed of NSCC and member firms aimed at discussing NSCC's liquidity needs, and (iii) agreed to provide members with monthly and daily reports that would show liquidity exposure during relevant periods. *See* Order Approving NSCC's Proposed Rule Changes Related to Institution of Supplemental Liquidity Deposits, 78 Fed. Reg. 75413 1-2, 16-17, (Dec. 5, 2013), available at: https://www.sec.gov/rules/sro/nscc/2013/34-70999.pdf.