

Critical & Constructive Comments on Release No. 34-92570; File No. SR-NSCC-2021-010;

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Proposed Rule Change to Establish the Securities Financing Transaction Clearing Service and Make Other Changes

TL:DR;

The proposed change to rule SR-NSCC-2021-010 should be disapproved under Section 19(b)(2) of the Exchange Act without significant critical changes. Rule change SR-NSCC-2021-010 fails to fulfill the requirements and the spirit of SEC REG SHO and opens the NSCC to RICO violation liability by avoiding pre-existing illegal “naked” short positions without consequence and by permitting the NSCC to further “naked” short securities illegally under the color of law. By backtracking on the Supplementary Leverage Ratio of Basel III the rule change enables the NSCC to socialize liabilities and losses as a result of Member negligence, which removes responsibility and accountability from the NSCC as an SRO to ensure that NSCC Members are following securities and finance laws and agreements and not engaging in high risk behavior. The rule change would therefore serve only to further perpetuate illegal, negligent, high-risk behavior of its Members and not perform any deterrence expected of a regulatory body whatsoever.

Critical Commentary

1. The proposed rule change SR-NSCC-2021-010 is criticized in three general ways: The rule change absolves NSCC members engaged in an SFT of their unlimited liability they knowingly and willingly exposed themselves to when they opened “naked” short positions on securities or became their counterparty; The NSCC imperils itself and its membership to RICO violations via rule changes that enable avoidance of SEC REG SHO legal liability through SFT novation and in SFT clearing; And the rule change sanctions future “naked” short positions by conjuring finite financial liability via leverage in order to avoid their infinite financial liability for the sole benefit of NSCC Members engaged in SFTs.
2. The rule change establishes that the NSCC understands that SFTs allow market participants to make delivery on short-sales, and thereby avoid failures to deliver, “naked” shorts, and similar situations (p4). Acknowledgment of manipulative, abusive and illegal market behavior like this should initiate a close examination of the processes that lead to these situations. Such examination should inform concrete remedial rule changes that aim to deter or preclude their re-occurrence. SR-NSCC-2021-010 does not do this. Instead it follows in the footsteps of the original Buttonwood agreement by avoiding the prohibition of (“naked”) short selling altogether.
3. The Supplementary Leverage Ratio of Basel III addresses deficiencies in financial regulation revealed by the global financial crisis of 2007–08. The proposed rule change reverses this reform by empowering the

NSCC to centrally clear SFT's which allegedly lowers counterparty risk relative to a matched book in the bilateral securities market. This empowerment permits netted positions from NSCC Members engaged in SFTs by reducing the amount of regulatory capital they would need to hold against SFTs under the U.S. "supplementary leverage ratio" and other capital requirements (p5).

4. The netted positions in an SFT include "naked" short positions via SFT novation. This netting service effectively manifests finite liability for NSCC Members engaged in an SFT from the infinite liability of their "naked" short positions. The proposed procedures by which the NSCC performs this service are onward lending (p5), buy-ins (p20), delay of final settlement (p28), and limiting volume according to hedging strategies that meet the NSCC's "default management objectives" (p28). These procedures in total are indistinguishable from "naked" shorting which means the unlimited liability of "naked" shorts is avoided by NSCC Members by transferring it to the NSCC itself as the SFT legal counterparty.
5. It therefore needs to be asked who does this squaring of the circle serve? Nearly all described potential harms in the proposed rule change are specific to NSCC Members who enter into SFT's. Defaulters, i.e. the NSCC Members who precipitate the ostensible necessity of this rule change, strangely benefit from repeated concern over possible declines in the value of their netted positions (p7,8,171,172,) and cross-default (p20). More generally the NSCC believes that having SFTs be centrally cleared by itself would lower the risk of a liquidity drain (p8).
6. However it must be emphasized that in a free and fair market such liquidity drain from total liquidation of a defaulter's gross positions (and ensuing bankruptcy) is exactly the risk one exposes oneself to in the unlimited liability of "naked" short positions. The financial repercussions of the proposed rule change are profoundly counterproductive with regards to the deterrent effect of liability from negligent and abusive market behavior like "naked" short sales. Ergo the cost of this service is not just ballooning debt via the reversal of leverage reforms implemented to prevent another global financial crisis, but the realized losses accrued by past, present and future victims of this negligence and abuse.
7. Similarly the legal repercussions of the proposed rule demand comment as well. SEC REG SHO makes persistent "naked" short positions illegal. As indicated earlier the NSCC understands that SFT's will allow NSCC Members to avoid their "naked" short positions. This avoidance process described in pt. 4 above is the transference of unlimited liability of pre-existing "naked" short positions from NSCC Members in SFTs to the NSCC via opening new "naked" short positions with the NSCC as the legal counterparty. This service is provided without any consideration for the illegality of persistence in "naked" short positions before, during or after. Indeed neither REG SHO nor their requisite "locates" appear at all in the language of the proposed rule change.

8. Beyond legal issues surrounding REG SHO a predicate offense of RICO violations is securities fraud. “Naked” short selling and stock manipulation through persistent failures to deliver are two prime examples of securities fraud, both of which the NSCC understands will be avoided through SFTs. This is prima facie evidence of intention to cover-up present and future RICO violations. Considering the procedures for SFT clearance described in pt.4 above there is compelling evidence that the NSCC itself is willing to commit future securities fraud via new “naked” short positions as the SFT legal counterparty.
9. The rule change proposal boasts of a consultative proposal drafting process that included input from “agent lenders, brokers, institutional firms, and critical third parties, such as matching service providers and books and records service providers.” Clearly this process overlooked both advocates for retail investors, who are the overwhelming majority of victims to negligent and abusive market behaviors, and law enforcement officials. Therefore in order to provide constructive commentary on this proposed rule change the following is offered to help inform necessary future input from retail investor advocates and law enforcement.

Constructive Commentary

1. With regards to law enforcement it has been long understood that prosecuting “naked” short selling on the so-called “reasonable belief standard” of REG SHO is a very difficult case to bring. Entering into an SFT to avoid “naked” short positions is a tacit admission by an NSCC Member that they did not have locates of shares to sell short, i.e. “reasonable belief” disappears. Therefore NSCC Members who enter into SFTs to avoid failures to deliver, “naked” short positions and similar should be required to explicitly and formally admit to the SEC that; i) they never had a locate of shares to sell short; ii) that they were never able to deliver the shares sold short, and consequently; iii) that they knowingly and wilfully committed securities fraud.
2. With regards to retail investor advocates in order to deter future negligent and abusive market behavior any NSCC Member wishing to avoid their “naked” short position via SFTs must remain exposed to the maximum financial liability possible, up to and including total liquidation and bankruptcy. The NSCC proposes an SFT clearing mechanism that conceivably mitigates fire sale risk and collateral damage to non-connected market participants to an SFT. However i) contractual hard locates for all relevant securities must be secured for all SFT clearing; ii) SFT clearing must be completed on “lit” exchanges and in a timeframe that approaches the speed of unencumbered price discovery on the “lit” exchanges to avoid the types of price discovery and security delivery abuse that occurs in “dark pools”, internalizers and similar. Should a defaulting NSCC Member emerge from the SFT clearing process solvent then; iii) the explicit and formal admissions detailed in 1.iii) above can and should be used in civil or criminal proceedings against the offending NSCC Members.