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SR-NSCC-2003-21

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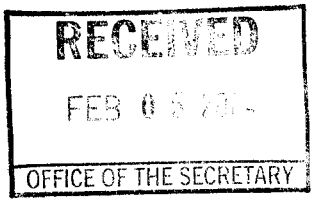

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: National Securities Clearing Corporation; Proposed Rule Change Relating to the New Separately Managed Accounts Service; Release No. 34-48846; File No. SR-NSCC-2003-21

Dear Sir:

We represent National Securities Clearing Corporation ("NSCC").

On October 16, 2003, pursuant to Section 19(b)(1) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"),[1] and Rule 19b-4 thereunder, NSCC filed with the Securities and Exchange Commission (the "SEC" or the "Commission") a proposed rule change on Form 19b-4 (the "Rule Filing") to add a new Rule 59 to the Rules and Procedures of NSCC (the "Proposed Rule").[2] On December 3, 2003, pursuant to Section 19(b)(1) of the Exchange Act, the Commission published notice of the Proposed Rule in the Federal Register.[3] The Proposed Rule would establish a new service at NSCC called the Separately Managed Accounts Service (the "SMA Service"). In response to the notice, twenty-one comment letters were submitted to the Commission, sixteen in favor of the Proposed Rule[4] and five opposed to it,[5] including a letter

[1] 15 U.S.C. §78s (b)(1), as amended.

[2] A copy of the Rule Filing with the text of the Proposed Rule is available on the NSCC website at www.nscc.com [hereinafter Rule Filing].

[3] Notice of Filing of Proposed Rule Change Relating to the New Separately Managed Accounts Service, Exchange Act Release No. 34-48846, 68 Fed. Reg. 67,714 (Dec. 3, 2003).

[4] Letter from David Lindenbaum, Vice President, Wells Fargo Investments, LLC (Dec. 11, 2003); Letter from Christopher L. Davis, Executive Director, The Money Management Institute (Dec. 11, 2003); Letter from Bevin

submitted on behalf of CheckFree Corporation ("CheckFree") by its law firm, Alston & Bird LLC, and a letter submitted to the Commission by Senator Zell Miller of Georgia. We are also aware that, at a hearing of the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Congressman David Scott of Georgia asked SEC Chairman William H. Donaldson a number of questions about the Proposed Rule.[6]

NSCC would like to take this opportunity to respond to the CheckFree comment letter and, in this connection, provide the Commission with information relevant to the issues raised by Senator Miller and Congressman Scott.

This letter is organized as follows:

Crodian, CEO, Market Street Advisors (Dec. 15, 2003); Letter from Charles Widger, Chief Executive Officer, Brinker Capital (Dec. 18, 2003); Letter from Suzanne S. Akers, Vice President/Managing Director, Franklin Templeton Private Client Group, Franklin Resources, Inc. (Dec. 18, 2003); Letter from Scott C. Sipple, Managing Director, Alliance Bernstein Managed Accounts (Dec. 18, 2003); Letter from Allen J. Williamson, Group President, Managed Assets, Nuveen Investments, LLC (Dec. 18, 2003); Letter from Marc Zeitoun, Senior Vice President, Director, Managed Accounts, and Rick Austin, Senior Vice President, Manager, SMA Operations, Trading & Client Reporting, UBS Financial Services Inc. (Dec. 19, 2003); Letter from R. Mark Pennington, Partner, Director of Separately Managed Accounts, Lord, Abbett & Co. LLC (Dec. 19, 2003); Letter from Kevin M. Hunt, Chief Sales and Marketing Officer, Old Mutual Asset Management (Dec. 18, 2003); Letter from Bruce M. Aronow, Executive Vice President, Chief Operating & Financial Officer, Rorer Asset Management, LLC (Dec. 19, 2003); Letter from James P. Horan, Senior Vice President, DST Systems, Inc. (Dec. 22, 2003); Letter from Vincent J. Lepore (Dec. 23, 2003); Letter from Thomas P. Sholes, Senior Vice President and Managing Director, PFPC Managed Account Services (Dec. 23, 2003) (support subject to certain conditions); Letter from David J. Freniere, Senior Vice President & Assistant General Counsel, Linsco/Private Ledger Corp. (Dec. 23, 2003); and Letter from Michael Wiles, SMA Business Manager, Advent Software Inc. (Jan. 12, 2004).

[5] Letter from Senator Zell Miller, U. S. Senate (Dec. 22, 2003); Letter from Todd Parrott, Mutual Funds/Separate Accounts Consultant, Rockaway Partners Ltd. (Dec. 23, 2003); Letter from Chris Cool, Principal, Business Technology Alliance, LLC (Dec. 23, 2003); Letter from Margaret A. Sheehan, Alston & Bird LLP, on behalf of CheckFree Corporation (Dec. 23, 2003); and Letter from Lee Chertavian, Chairman & CEO, Placemark Investments, Inc. (Dec. 24, 2003).

[6] *U.S. Capital Markets: House Committee on Financial Services: Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Hearing on Capital Market Structure,* 108th Cong. (Oct. 30, 2003) *available at* 2003 WL 22483825 (F.D.C.H.).

I. NSCC and the Proposed SMA Service

A. About NSCC

NSCC is a clearing agency registered under Section 17A of the Exchange Act and a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). NSCC provides its members with a variety of clearance and settlement services. NSCC also provides its

members with a variety of information and messaging services which do not involve clearance and settlement.[7] The proposed SMA Service would be an information and messaging service. Although an information and messaging service is not an activity that, in and of itself, would require the provider to register as a clearing agency under Section 17A of the Exchange Act, NSCC, as a registered clearing agency, is subject to comprehensive regulation by the SEC under the Exchange Act and, therefore, is required to file with the SEC, pursuant to Section 19(b) of the Exchange Act, copies of all of its proposed rules or proposed changes in, additions to or deletions from its existing rules, including both with respect to its existing and proposed clearance and settlement services and its existing and proposed information and messaging services.

B. About the Proposed SMA Service

A separately managed account ("SMA") is a securities account maintained by a wire house, regional broker/dealer or, in some cases, a bank (a "Sponsor") for a high net worth individual or small institutional investor (the "Client") that is professionally managed and customized for the Client by an investment manager who may be, but more often is not, affiliated with the Sponsor (a "Manager"). In some cases, more than one Manager may be involved in the supervision of an account. Managers and Sponsors must continually communicate with each other, and with other participants in the process of distributing and servicing SMAs (such as financial consultants and custodians), for the purpose of exchanging investment, account, portfolio and trade information. The proposed SMA Service is designed to facilitate this process by, first, establishing standardized protocols for exchanging information (the "SMA Service Protocols"), and, second, establishing a centralized communications hub for the transmission of messages (the "SMA Service Hub"). NSCC was asked to develop the SMA Service by The Money Management Institute ("MMI"), the national organization representing portfolio manager firms and sponsors of investment consulting programs.[8] NSCC has also discussed the proposed SMA Service with its own members outside the auspices of the MMI, and has been encouraged by its members to proceed with the Service. It is anticipated that the SMA Service will provide substantial benefits to Sponsors and Managers and other participants in this large and growing industry (the "SMA Industry").[9]

C. About MMI

CheckFree implies that there is something improper about (i) the MMI asking NSCC to develop and provide the SMA Service and/or (ii) the relationship between the MMI and NSCC. CheckFree asserts:

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[7] For a list of information and messaging services provided by NSCC and by other registered clearing agencies to their members see Section II(C) *infra*.

[8] For a complete description of the origins of this industry initiative, and the process through which NSCC was selected to develop the SMA Service, see Rule Filing, *supra* note 2, and the MMI comment letter, *supra* note 4.

[9] For a complete discussion of the anticipated benefits of the SMA Service, *see* Section VI(C) *infra*.

- "...the Proposing Release highlights the significant role that the MMI played in convincing the NSCC to provide the SMA Service."[10]

- "...the MMI is not an impartial actor in its efforts to lobby the NSCC."[11]

- "...it is inappropriate for the NSCC to adopt rules and services to profit some of the MMI members based solely on information provided to it by the MMI." [12]

- "If the NSCC was a private entity serving only the interests of the same constituency as the MMI, its virtually exclusive reliance on the MMI's goals and interests might be appropriate."[13]

- "As presented, both the Rule Proposal and the Proposing Release suggest that it [NSCC] developed Rule 59 [the SMA Service] to satisfy the interests of the MMI."[14]

It is difficult to know what to make of all this.

The MMI[15] is a national organization for the managed account industry. It was created in 1997 to serve as a forum for the industry to address common concerns, discuss industry issues and better serve investors. Membership in the MMI is open to (i) firms that offer financial consulting services to individual investors, foundations, retirement plans and trusts, (ii) professional portfolio management firms and (iii) firms that provide long term services to both sponsor and manager firms.[16] Membership in the MMI is not open to investment advisors or individual investors. The Board of Directors of the MMI is composed of individuals representing most of the leading participants in the SMA Industry.[17]

There is no affiliation between NSCC and the MMI and no relationship between the two organizations other than the fact that the MMI represents a segment of NSCC members

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[10] CheckFree comment letter, *supra* note 5, at 10 (footnote omitted).

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] The information about the MMI set forth in this paragraph is taken from the MMI website at www.moneyinstitute.com.

[16] CheckFree is a member of the MMI. NSCC is not.

[17] The Directors of the SMA include individuals affiliated with A.G. Edwards & Sons, AllianceBernstein, Bank of New York, Brinker Capital, Charles Schwab & Co., Inc, Citigroup Asset Management, Franklin Templeton, ING Managed Account Group, Lazard Asset Management, Lincoln Financial Advisors, Lord Abbett, Mariner Investment Group, Merrill Lynch, Morgan Stanley, Newberger Berman, New York Life, Nuveen/Rittenhouse, Old Mutual US Holdings, Phoenix Investment Partners, Prudential Investments, Rorer Asset Management, Smith Barney, Tremont Capital Management, UBS Financial Services and Wells Fargo.

(participants in the SMA Industry) and the MMI, acting on behalf of its constituents, asked NSCC to develop and provide the SMA Service. In this respect, the relationship between NSCC and the MMI is similar to the relationships that NSCC has with the Investment Company Institute (the national association for the investment company industry), The Bond Market Association (the national association for participants in the bond market) and the Securities Industry Association (the national association for securities firms).

NSCC decided to undertake this project after working with the MMI (including CheckFree on the Operations and Technology Subcommittee on Standards of the MMI),[18] and determining that:

- There is a need for standardized protocols and processes and centralized connectivity in the SMA Industry.
- Participants in the SMA Industry want NSCC (rather than a commercial vendor) to provide the service because inter alia NSCC is an industry utility which is regulated and transparent.
- NSCC has the skills and resources to provide the service, and valuable experience providing an analogous information and messaging service to the mutual funds industry.
- The service will provide substantial benefits to NSCC members, other participants in the SMA Industry and individual investors.[19]

II. NSCC Has the Authority to Offer the SMA Service

A. The CheckFree Comment Letter

CheckFree argues that there is no authority under the Exchange Act for NSCC to offer the SMA Service. CheckFree asserts:

- "Nowhere within Section 17A does Congress state that the SEC should facilitate the establishment of a national service provider system for the sharing of Client Data."[20]
- "[NSCC's] authority under Section 19 does not, however, reach the prompt and accurate transmission of Client Data."[21]
- "The NSCC's proposal to enter into the SMA industry and to provide data sharing services

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[18] *See* Rule Filing, *supra* note 2, at 4, and the CheckFree comment letter, *supra* note 5, at 14-15.

[19] *See* Section VI(C) *infra*.

[20] CheckFree comment letter, *supra* note 5, at 6.

[21] *Id.* (emphasis in the original).

is, therefore, without legislative authorization under either Section 17 or Section 19 of the Exchange Act."[22]

- "Given that there is no clearing or settling of securities transactions component of Rule 59, as required by the Exchange Act provisions related to clearing agencies, there is no statutory authority under Section 17A or Section 19 for the NSCC to enter the SMA industry as proposed."[23]

This line of argument by CheckFree (i) reads into Section 17A of the Exchange Act a prohibition on activities other than clearance and settlement which does not exist in the text of Section 17A[24] or in the legislative history of the Securities Acts Amendments of 1975 (the "1975 Amendments"),[25] (ii) ignores language in the text of Section 17A which indicates that Congress did, in fact, contemplate that registered clearing agencies may engage in activities other than clearance and settlement and (iii) reads out of the history of Section 17A, as it has been interpreted and applied by the SEC since its inception, the numerous services which do not involve clearance and settlement that registered clearing agencies offer to their members.

B. Section 17A of the Exchange Act

Section 17A(b)(1) of the Exchange Act provides that no person may perform the functions of a clearing agency unless such person is registered as a clearing agency under Section 17A(b)(2).[26] Neither Section 17A(b)(1) nor any other section of the Exchange Act nor anything contained in the legislative history of the 1975 Amendments provides that, conversely, a person registered as a clearing agency under Section 17A(b)(2) may not engage in any activities other than clearance and settlement. There is, however, language in Section 17A which indicates that Congress did, in fact, contemplate that registered clearing agencies may engage in activities other than clearance and settlement.

Section 17A(b)(1) provides, with respect to the registration of a clearing agency, that "[a] clearing agency or transfer agent shall not perform the functions of a clearing agency and a transfer agent unless such clearing agency or transfer agent is registered in accordance with this subsection [dealing with the registration of clearing agencies] and subsection (c) of this subsection [dealing with the registration of transfer agents]."[27] This limited restriction on the activities of a registered clearing agency -- that it not also engage in the activities of a transfer

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[22] *Id.*

[23] *Id.* at 8.

[24] *See* 15 U.S.C. §78q-1.

[25] *See* S. REP. 94-75 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179; H.R.CONF. REP. NO. 94-229 (1975), *reprinted in* 1975 U.S.C.C.A.N. 321.

[26] 15 U.S.C. §78s(b)(2).

[27] *Id.* at §78q (b)(1).

agent unless it is also registered as a transfer agent under subsection (c) -- is the only restriction contained in Section 17A on other activities of a registered clearing agency. What this language in Section 17A(b)(1) demonstrates is, not a legislative intent to generally prohibit registered clearing agencies from engaging in activities other than clearance and settlement, but rather (i) a legislative concern with combining the functions of a clearing agency and a transfer agent in one organization and (ii) a legislative determination that the Commission should, in this circumstance, decide, on a case by case basis, whether to let an organization perform both functions.

C. Services That Do Not Involve Clearance and Settlement

NSCC and other registered clearing agencies provide their members with a wide variety of services which do not involve clearance and settlement. CheckFree mentions one such service of NSCC, the Mutual Funds Profile Service,[28] to which CheckFree does not object because it filled a "remaining void with respect to the sharing of data between mutual fund industry participants"[29] but, in fact, there are many such services offered by NSCC and other registered clearing agencies, and the authority of NSCC and other registered clearing agencies to provide these services to their members has been established by SEC order and long practice.[30] For example:

- NSCC: Insurance Processing Services (communication of information relating to annuities and insurance);[31] and Mutual Fund Profile Service (communication of information relating to mutual funds).[32]

- The Depository Trust Company ("DTC"): TaxReclaim (tax reclaim calculations and reclaim forms for tax refunds);[33] TaxRelief (communication of information relating to

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[28] Order Approving a Proposed Rule Change to Establish the Daily Price and Rate File Phase of the Mutual Fund Profile Service, Exchange Act Release No. 34-37171, 61 SEC Docket 2207 (May 8, 1996) [hereinafter Profile Order].

[29] CheckFree comment letter, *supra* note 5, at 5.

[30] NSCC and other registered clearing agencies have typically developed and offered services which do not involve clearance and settlement in response to requests from their members or industry groups. *See, e.g.*, Notice of Filing and Immediate Effectiveness of a Proposed Rule Change by DTC Relating to a New Tax Service Called DALI; Exchange Act Release No. 34-43640, 65 FR 76688-01 (Dec. 7, 2000) (request from consortium of participants) [hereinafter DALI Release].

[31] Order Approving a Proposed Rule Change Relating to the Establishment of the Annuities Processing Service; SEC Release No. 34-39096, 62 FR 50416-01 (Sept. 25, 1997); Notice of Filing and Immediate Effectiveness of Proposed Rule Change Regarding NSCC's Annuities Processing Service; SEC Release No. 34-41477, 64 FR 31666-01 (June 11, 1999).

[32] Profile Order, *supra* note 28.

[33] Order Approving a Proposed Rule Change Relating to the Establishment of an Automated Foreign Tax Reclaim Service, Exchange Act Release No. 34-41677, 70 SEC Docket 559 (July 30, 1999).

foreign income);[34] DALI (communication of information relating to tax matters);[35] Custody Service (custody of physical securities not DTC eligible);[36] Transfer Agent Drop Service (facility to receive and deliver physical securities);[37] Prospectus Repository System (electronic repository of prospectuses and offering memorandums);[38] and IPO Tracking (automated system to track securities during underwriting stabilization period).[39]

- Fixed Income Clearing Corporation: Electronic Pool Notification Service (communication of information relating to mortgage-backed securities).[40]

Accordingly, there is ample precedent for NSCC to offer an information and messaging service like the SMA Service.

III. NSCC Does Not Seek to Regulate the SMA Industry

A. The CheckFree Comment Letter

CheckFree argues that, by virtue of the Proposed Rule or by operation of the SMA Service, NSCC is seeking to become an SRO (self-regulatory organization) for the SMA Industry. CheckFree asserts:

- "In addition, through their collaboration [referring to the collaboration between MMI and NSCC] in the development of the SMA Service at the heart of NSCC's Rule Proposal, both entities have inferred that SRO oversight and rulemaking authority is necessary to achieve these goals [the goals of standardized protocols and processes and centralized connectivity].[41]

- "... the NSCC is creating an extremely broad and vague new role for itself as an SRO for

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[34] Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Electronic Dividends Function, Exchange Act Release No. 34-29814, SEC Docket 1608 (Oct. 11, 1991).

[35] DALI Release, *supra* note 30.

[36] Order Granting Accelerated Approval of a Proposed Rule Change to Establish a Custody Service For Certain Non-Depository Eligible Securities, Exchange Act Release No. 34-37314, 62 SEC Docket 393 (June 14, 1996).

[37] Order Approving a Proposed Rule Change Establishing Procedures to Establish a Drop Window Service, Exchange Act Release No. 34-37562, 62 SEC Docket 1526 (Aug. 13, 1996).

[38] Order Granting Approval of a Proposed Rule Change to Establish the Prospectus Repository System, Exchange Act Release No. 34-47410, 68 FR 10558 (Mar. 5, 2003).

[39] Order Approving a Proposed Rule Change Implementing the Initial Public Offering Tracking System, Exchange Act No. 34-37208, 61 SEC Docket 2365 (May 13, 1996).

[40] Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change Requesting Permanent Approval of the Electronic Pool Notification Service, Exchange Act Release No. 34-36540, 60 SEC Docket 2093 (Nov. 30, 1995).

[41] CheckFree comment letter, *supra* note 5, at 8 (footnote omitted).

the SMA industry, a role for which there is no statutory authority."[42]

- "... the NSCC does not have the legislative authority to meet this need [the need for standardized protocols and processes and centralized connectivity] by declaring itself the SRO of the SMA industry through the adoption of Rule 59 without Congress' adoption of additional legislation granting this authority."[43]

B. The Proposed Rule Will Not Give NSCC Regulatory Authority Over the SMA Industry

NSCC does not seek to become an SRO for the SMA Industry, and there is nothing in the Proposed Rule that, if approved by the SEC, would give NSCC any "SRO oversight and rulemaking authority" in the SMA Industry or allow NSCC to either become "an SRO for the SMA industry" or declare itself "the SRO of the SMA industry."[44] By virtue of the Proposed Rule, NSCC is only seeking approval to offer the SMA Service to Sponsors and Managers that wish to use it. No person will be required by NSCC to use the SMA Service. Any person that does choose to use it will be required to follow the SMA Service Protocols so that messages may be transmitted quickly and accurately through the SMA Service Hub -- but NSCC will have no involvement in the content of such messages or in any of the business activities of Sponsors or Managers with respect to SMAs.

IV. The SMA Service Will Not Jeopardize the Safe Harbor of Rule 3a-4

A. The CheckFree Comment Letter

CheckFree notes that Rule 3a-4 under the Investment Company Act of 1940 (the "Investment Company Act") provides a safe harbor from the definition of "investment company" under the Investment Company Act for programs that provide discretionary investment advisory services to clients, so long as those programs have certain characteristics, including that (as summarized by CheckFree) "each account is managed, traded, and custodied as a unique entity for individual ownership."[45] CheckFree then argues that the adoption of the Proposed Rule and the operation of the SMA Service by NSCC could jeopardize the availability of the safe harbor or have other adverse effects on the SMA Industry. CheckFree asserts:

- "The NSCC's adoption of Rule 59 could ... jeopardize this safe harbor for the SMA industry by requiring the SMA Managers and Sponsors to homogenize the data regarding

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[42] *Id.* at 15-16.

[43] *Id.* at 17.

[44] *Id.* at 8, 15-17. Although CheckFree repeatedly asserts that NSCC is seeking to become an SRO for the SMA Industry, CheckFree offers no support for this reading of the Proposed Rule or the intentions of NSCC.

[45] *Id.* at 7 (footnote omitted).

the accounts of their individual investors."[46]

- "In addition, the NSCC's imposition of new standards could have the unintended consequence of encouraging SMA sponsors to design or modify their SMA programs to treat all accounts in a like manner and not adhere to the tenets and principles of uniqueness required by Rule 3a-4."[47]

B. There is Nothing in the Proposed Rule and Nothing about the Proposed SMA Service That Would Affect the Safe Harbor of Rule 3a-4 Under the Investment Company Act

Rule 3a-4 under the Investment Company Act provides a non-exclusive safe harbor from the definition of "investment company" for any program that provides discretionary investment advisory services to a client, so long as such program has the following characteristics (as summarized in the Investment Company Act release adopting Rule 3a-4): [48]

> (i) each client's account must be managed on the basis of the client's financial situation and investment objectives, and in accordance with any reasonable restrictions imposed by the client on the management of the account; (ii) the sponsor of the program must obtain sufficient information from each client to be able to provide individualized investment advice to the client; (iii) the sponsor and portfolio manager must be reasonably available to consult with each client; (iv) each client must have the ability to impose reasonable restrictions on the management of the client's account; (v) each client must be provided with a quarterly account statement containing a description of all activity in the client's account; and (vi) each client must retain certain indicia of ownership of all securities and funds in the account.[49]

The first argument made by CheckFree with respect to Rule 3a-4 -- that the adoption of the Proposed Rule could jeopardize the safe harbor by requiring Managers and Sponsors to "homogenize the data regarding the accounts of their individual investors" -- assumes (i) that, by virtue of the adoption of the Proposed Rule, NSCC would have the power to cause Managers and Sponsors to homogenize their data and (ii) that, for some reason, NSCC would exercise such power for such purpose. As pointed out above,[50] (i) NSCC does not seek to become an SRO for the SMA Industry or to regulate participants in the SMA Industry and (ii) there is nothing in the Proposed Rule that would give NSCC that authority or impose on NSCC that responsibility. Even if NSCC had, by virtue of the adoption of the Proposed Rule, SRO power to cause

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[46] *Id.* (footnote omitted).

[47] *Id.*

[48] Final Rule: Status of Investment Advisory Programs Under the Investment Company Act of 1940, Exchange Act Release No. IC-22579, 62 FR 15098 (Mar. 31, 1997).

[49] *Id.* at 62 FR at 15099.

[50] *See* Section III(B) *supra*.

Managers and Sponsors to "homogenize" data, there is no reason why NSCC would exercise such power for such purpose, and CheckFree provides no basis for the statement in its letter to the Commission that NSCC would do so.

The second argument made by CheckFree with respect to Rule 3a-4 -- that the operation of the SMA Service might encourage Managers and Sponsors to "treat all accounts in a like manner and not adhere to the tenets and principles of uniqueness required by Rule 3a-4" -- has no basis in fact or logic. CheckFree does not explain (i) what it is about the SMA Service that might encourage Managers or Sponsors to do this or (ii) why Managers and Sponsors would do something so contrary to their interests (preserving the safe harbor of Rule 3a-4) and the interests of their Clients (having customized investment accounts). CheckFree also does not explain why, if they (CheckFree) now provide "precisely the type of service the NSCC intends to provide,"[51] their service does not have this same adverse consequence of encouraging Managers and Sponsors to "treat all accounts in a like manner and not adhere to the tenets and principles of uniqueness required by Rule 3a-4."

V. The Proposed Rule Filing Complies Fully With the Exchange Act

A. The CheckFree Comment Letter

CheckFree argues that there is a procedural problem with the Rule Filing because, if the Proposed Rule is approved, NSCC will thereafter be able to set fees and modify the SMA Service in any way it chooses without public comment. CheckFree asserts:

- "The risk inherent in the adoption of Rule 59 in its current state is that the NSCC will use the 19(b)(3) process to adopt subsequent rules that fully define the SMA Service, that determine the breadth of the NSCC's regulatory reach in the SMA Industry and that outline the fees to be charged, without allowing interested parties to effectively comment, participate and publicly debate the rules' impact on the industry and on investors."[52]

- "The NSCC's two-step methodology for obtaining approval for the full scope of the proposed rule, therefore, is inappropriate and inconsistent with the requirements of the Exchange Act and contrary to the protection of investors."[53]

B. The Requirements of Section 19(b) of the Exchange Act

Pursuant to Section 19(b)(1) of the Exchange Act, an SRO files a proposed rule change "accompanied by a concise general statement of the basis and purpose of such proposed rule change," the Commission publishes notice of the proposed rule change and interested persons

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[51] CheckFree comment letter, *supra* note 5, at 19.

[52] *Id.* at 18 (footnote omitted).

[53] *Id.*

then have an opportunity to comment. [54] The proposed rule change may take effect in one of three ways:

- Pursuant to Section 19(b)(2) of the Exchange Act, within 35 days after notice of the proposed rule change is filed (or such longer time as the Commission may designate up to 90 days), the Commission may either (i) approve the proposed rule change or (ii) institute proceedings to determine whether to disapprove it (and at the conclusion of such proceedings the Commission may either approve the proposed rule change or disapprove it). [55]

- Pursuant to Section 19(b)(3)(A) of the Exchange Act and Rule 19b-4(f) thereunder, if the SRO designates that the proposed rule change relates to certain specified matters, the proposed rule change may take effect upon filing. [56]

- Pursuant to Section 19(b)(3)(B) of the Exchange Act, if the Commission determines that such action is necessary for certain specified reasons, the Commission may order the proposed rule change into effect summarily. [57]

The Rule Filing to establish the SMA Service was duly filed by NSCC pursuant to Section 19(b)(1) of the Exchange Act. Any future proposed rule changes filed by NSCC that relate to the SMA Service will also be filed by NSCC in accordance with Section 19(b)(1) of the Exchange Act and will go into effect pursuant to subsection (b)(2), unless (i) NSCC determines that the conditions for accelerated effectiveness pursuant to subsection (b)(3)(A) have been satisfied or (ii) the Commission determines that the circumstances for summary effectiveness pursuant to subsection (b)(3)(B) exist.

The concern expressed by CheckFree -- that NSCC may avoid any further public comment on its proposed rule changes by the expedient of making all future filings pursuant to subsection (b)(3)(A) -- is misplaced. With respect to any future proposed rule changes filed by NSCC that relate to the SMA Service, NSCC will (as it always has done) comply with the requirements of the statute and the rule in determining whether to proceed under subsection (b)(2) or subsection (b)(3)(A). In any event, as CheckFree notes,[58] the Commission always has the power under subsection (b)(3)(C) to abrogate any rule change that became effective pursuant to subsection (b)(3)(A) or subsection (b)(3)(B).

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[54] 15 U.S.C. §78s (b)(1).

[55] 15 U.S.C. §78s (b)(2).

[56] 15 U.S.C. §78s (b)(3)(A).

[57] 15 U.S.C. §78s (b)(3)(B).

[58] *See* CheckFree comment letter, *supra* note 5, at 18 n. 80.

VI. The SMA Service Will Benefit the Entire SMA Industry

A. The CheckFree Letter

CheckFree argues that a new messaging service, at least a new messaging service operated by NSCC, is not needed because vendors (specifically CheckFree) can and do provide adequate service to the SMA Industry. CheckFree asserts:

- "Although the NSCC suggests that a 'centralized communications platform' is necessary, the current levels of electronic communication within the SMA industry are already extensive due to the significant efforts made by Sponsors to provide Managers with electronic data." [59]

- "The NSCC's proposal will do nothing more than create a redundant processing hub; it will not improve the Sponsor's ability to make data available that is contained within the MMI Data Standards."[60]

- "Because there is no need for a separate clearing and settling service for the SMA industry and the NSCC does not currently provide or propose to provide any clearing or settling function related specifically to SMAs, the NSCC's attempted insertion of itself into the SMA industry is unwarranted and unnecessary."[61]

- "Throughout the Proposing Release, the NSCC lists rationales for the industry's adoption of uniform standards and the need for a centralized communications platform; however, the NSCC fails to justify why it is appropriate for an SRO to fulfill that role."[62]

B. The Interest of CheckFree in Maintaining the Status Quo

Preliminarily, it must be noted that the claims made by CheckFree that the SMA Service is not needed are claims made by a party with a vested interest in the status quo -- a status quo that may benefit CheckFree but does not necessarily benefit other participants in the SMA Industry or individual investors. About CheckFree:

- CheckFree currently maintains 1,400 separate interfaces between Sponsors and Managers,[63] including interfaces between 39 of the 50 largest Sponsors and 36 of the 40

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[59] *Id.* at 3.

[60] *Id.* at 5.

[61] *Id.* at 5-6 (footnote omitted).

[62] *Id.* at 11 (footnote omitted).

[63] *See id.* at 2.

largest Managers.[64]

- CheckFree is the dominant service provider in this space.[65]

- The large number of separate interfaces that CheckFree maintains between Sponsors and Managers, and its dominant position in this space, makes it difficult for other vendors to compete against CheckFree and leaves Managers and Sponsors with little choice. [66]

C. The Benefits of the SMA Service to the SMA Industry and Individual Investors

While CheckFree may assert that the SMA Service is not needed, many others in the business believe that the SMA Service is needed and will provide substantial benefits to the SMA Industry and individual investors. The SMA Service will provide the following benefits:

- The SMA Service will establish standardized protocols and processes (the SMA Service Protocols) for the communication of SMA data between Sponsors and Managers.

- The SMA Service will provide centralized connectivity (the SMA Service Hub) for the processing and transmission of messages between Sponsors and Managers, and Sponsors

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[64] See the following press releases from CheckFree: Prudential Investments Managed Accounts Consulting Group Licenses M-Pact from CheckFree Investment Services, *PR Newswire* (Jan. 6, 2004); Principal Global Investors Enters into Separately Managed Accounts with CheckFree APL, *PR Newswire* (Dec. 10, 2003); Quantitative Advantage Looks to CheckFree APL as its 'Steering Wheel' in Separately Managed Accounts, *PR Newswire* (Dec. 2, 2003); Kelmore Automates Performance Reporting with CheckFree APL, *PR Newswire* (June 2, 2003); Capital Advisors CheckFree APL, *PR Newswire* (Apr. 23, 2003); Three Managers Begin Using CheckFree APL Multiple Strategy Portfolio Functionality, *PR Newswire* (Apr. 1, 2003); Placemark Investments Integrates CheckFree APL's Multiple Strategy Portfolio Functionality With its TOTAL Overlay Portfolio Management Services, *PR Newswire* (Mar. 31, 2003); CheckFree to License M-Pact to Charles Schwab, *PR Newswire* (Feb. 19, 2003); NorthRoad Capital Management Live on CheckFree APL, *PR Newswire* (Jan. 13, 2003); U.S. Piper Jaffray Signs With CheckFree Investment Services, *PR Newswire* (Nov. 18, 2002).

[65] *See Banking on SMA Funds*, US BANKER, Aug. 2002, at 46 (stating, "In SMA technology, Jersey City, NJ-based CheckFree APL's software dominates 75% of the industry..."); Chris Kentouris, *DST's New Wrap Account Software Challenges CheckFree*, SECURITIES INDUSTRY NEWS, Aug. 13, 2001, *available at* 2001 WL 6553965 (stating, "CheckFree holds the dominant share of the wrap business in the U.S.").

[66] *See* Anthony Guerra, *Separately Managed Accounts Expected to Explode; Dominant Vendor, CheckFree, Gets Competition from DST; Big Fish Enters the Market*, WALL STREET & TECHNOLOGY, Mar. 1, 2002, at 35 ("CheckFree, because of their market share, operates a little bit like a monopoly and therefore it is tough to get the kind of pricing levels you really would like and what you think are fair. To get resources from CheckFree, sometimes it really depends on how big you are," quoting Greg Horn, CEO of Advisorport. "[T]hose problems (pricing) only matter if there is a viable competitor and right now there isn't," quoting Jamie Punisill, an analyst at Forrester Research); Ivy Schmerken, *Tapping the Mass Affluent -- Separate Accounts Go Mainstream*, WALL STREET & TECHNOLOGY Sept. 1, 2002, at 20 ("Managers tend to use CheckFree APL because it has interfaces to all the sponsors' systems," quoting Kevin Keefe, a consultant at Financial Resource Corporation). For a general description of problems with the *status quo* and alternatives to the *status quo* that would benefit the greatest number of participants in the SMA Industry and individual investors, see also Ivy Schmerken, *Separate Accounts Mired in Complexity*, WALL STREET & TECHNOLOGY, Jul. 17, 2003.

and Managers will be able to link to the SMA Service Hub either (i) directly or (ii) through communications service providers.

- The SMA Service will provide a robust infrastructure with superior disaster-recovery capability.
- The SMA Service will increase efficiency and lower costs for Sponsors and Managers.
- The SMA Service will introduce competition in an area where there has not been meaningful competition (the communications area), and promote competition among Sponsors (the brokers/dealers) and Managers (the portfolio firms).
- The SMA Service will stimulate technical and operational innovation and price and service competition.
- Individual investors will be the ultimate beneficiaries.

With respect to the anticipated benefits of the SMA Service to the SMA Industry and individual investors, note particularly the MMI comment letter, describing (i) the rapid growth experienced by the SMA Industry in recent years, (ii) the problem of limited scalability because of the absence of standardized protocols and processes and centralized connectivity, (iii) the recommendations of Deloitte & Touche with respect to the need for an industry-wide approach and the creation of a platform-neutral facility and (iv) the decision to turn to NSCC, as an industry utility with a proven record of success with mutual fund processing, to develop and implement the connectivity solution for the SMA Industry.[67] Note also what the MMI describes as an additional benefit of an SMA Service operated by NSCC:

> MMI believes that centralizing communications in an industry utility such as NSCC will foster competition among service providers to the SMA industry. Use of NSCC's systems to provide a robust and economic network of connectivity among the many sponsors and investment managers that work with separately managed accounts will encourage other companies to develop new and improved front office and back office processing services, thereby benefiting the industry and the investing public. [68]

Note also the other comment letters submitted in support of the Proposed Rule with respect to (i) how the SMA Service will promote competition and innovation in the SMA Industry[69] and (ii) why NSCC was chosen to be the organization to provide the Service. [70]

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[67] *See* MMI comment letter, *supra* note 4, at 2-3.

[68] *Id.* at 3 (emphasis added).

[69] *See* Market Street Advisors, Inc. comment letter, *supra* note 4 (citing as benefits of the proposed SMA Service (i) greater efficiencies providing more investment options for investors, (ii) opening up competition for back office

NSCC believes that, for all of the reasons set forth above, far from "[undermining] the private sector and [preventing] the industry from innovating according to the demands of the market,"[71] the introduction of the SMA Service will promote competition, choice, innovation, efficiency and economy in the SMA Industry. While the SMA Service may not benefit CheckFree, [72] it certainly will benefit individual investors.

D. Sponsors and Managers Should Have an Opportunity to Subscribe to the SMA Service

Ultimately, the only way to determine whether or not there is a need for the SMA Service, and whether it will provide the benefits which NSCC and the SMA Industry anticipate, is to offer the Service and let the marketplace of Sponsors and Managers decide (i) whether, as NSCC and most of the SMA Industry contend,[73] the SMA Service will provide substantial benefits to Sponsors and Managers and their Clients, or (ii) whether, as CheckFree and those who support its position contend, the SMA Service would be "redundant" or "unwarranted and unnecessary"

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providers and (iii) reducing barriers to entry for smaller managers); Vincent J. Lepore comment letter, *supra* note 4 (citing as benefits of the proposed SMA Service (i) enhancing competition in the industry, (ii) providing a better service to investors, (iii) reducing costs to investors, (iv) lower fees for services and (v) improvement in the clarity of communications among sponsors and mangers). *See also*, Wells Fargo Investments, LLC comment letter; Old Mutual Asset Management comment letter; Nuveen Investments, LLC comment letter; AllianceBernstein Managed Accounts comment letter; Brinker comment letter; Franklin Resources, Inc. comment letter; Lord, Abbett & Co. LLC comment letter; Rorer Asset Management, LLC comment letter; Linsco/Private Ledger Corp. comment letter; PFPC Managed Account Services comment letter and Advent Software Inc. comment letter, *supra* note 4.

[70] *See* UBS Financial Services, Inc. comment letter *supra* note 4 (stating that "UBS Financial Services believes that as a not for profit organization, the NSCC is the best organization to play this role. The NSCC has a history of bringing the investment community together to solve problems through the development of electronic platforms (e.g., mutual fund processing). We believe they can do the same for the managed accounts business"); DST Systems, Inc. comment letter, *supra* note 4 (noting that "in our view, the NSCC's leadership in clearance and settlement of securities transactions provides good credentials for this endeavor [the SMA Service]...The same business model that the NSCC so successfully employed 15 years ago with the mutual fund industry applies in the SMA context today").

[71] CheckFree comment letter, *supra* note 5, at 5.

[72] *See* Thomas Coyle, *Battle Lines Drawn on Managed Account Ops Hub*, FUNDFIRE (Dec. 18, 2003) ("The first beneficiaries [of the proposed SMA Service] would be investors, then advisors, then managers, then sponsors, and lastly the technology providers. CheckFree, however, doesn't view itself as a beneficiary. You have to keep in mind that no one has invested more money into communication capabilities than CheckFree and some of the big sponsors" quoting Daniel Sievert, a managing partner at 3C Financial Partners, an investment bank and consulting firm.). *See also* Wells Fargo Investments, LLC comment letter ("We are aware that some vendor firms currently providing communications services to sponsor and manager firms may claim that they will be disadvantaged by the NSCC proposed system and we believe this viewpoint is both shortsighted and unjustified. NSCC has stepped forward with its proposal, at the request of The Money Management Institute, precisely because the current system is inefficient and unable to handle projected growth"), *supra* note 4. With respect to possible benefits of the operation of the SMA Service to CheckFree, see Section IX.

[73] For a very thorough review of the benefits of the SMA Service, see Steve Winks, *DTCC Fills Technology Leadership Vacuum; Plans to Offer a Standardized, Centralized Communications System for Separately Managed Accounts*, SENIOR CONSULTANT (Dec. 2003) Vol. 6, No. 12 (available at www.srconsultant.com).

etc.[74] While CheckFree may want to protect their platform from competition -- by persuading the Commission to disapprove the SMA Service rather than by meeting the SMA Service head-on in the marketplace -- Sponsors and Managers should have the opportunity to choose to (i) subscribe to the SMA Service or (ii) continue to interface through the CheckFree platform or (iii) connect to the SMA Service Hub through a communications service provider.

VII. The SMA Service Should Be Introduced As Soon As Possible

A. CheckFree Comment Letter

CheckFree argues that -- even if NSCC has authority to offer the SMA Service and even if the SMA Service is needed by the SMA Industry -- now is not the right time to introduce it because of the abuses that have been discovered in the mutual fund industry. CheckFree asserts:

- "As the SEC staff is well aware, it is an especially sensitive time for an SRO like the NSCC to attempt a unilateral expansion of its statutory authority."[75]

- "As the creator of the omnibus structure for mutual fund trading within which the market-timing and late-trading activities took place, even the NSCC has had to defend its role in the scandals."[76]

- "During a time in which Congress and individual investors are demanding answers and solutions from SROs like the NYSE and from the mutual fund industry, the NSCC is engaging in aggressive tactics to expand its role in the marketplace as a vendor of services."[77]

B. The Mutual Fund Scandal is Irrelevant to this Rule Filing.

This argument -- that now is not the right time to introduce the SMA service because NSCC (and everyone else) should instead be focusing on problems in the mutual fund industry -- is not so much an argument as it is an attempt to smear NSCC with the wrongdoing of other participants (not subject to NSCC supervision or control) in the mutual fund industry, specifically those who have engaged in or permitted late-trading and other abuses.

NSCC has not engaged in any wrongdoing nor has it failed to perform any of its obligations as a registered clearing agency and SRO. NSCC has not had to "defend its role in the scandals" as CheckFree alleges, [78] and the Wall Street Journal article cited by CheckFree as the source or

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[74] *See* CheckFree comment letter, *supra* note 5, at 5-6.

[75] *Id.* at 8.

[76] *Id.* at 8-9 (footnotes omitted).

[77] *Id.* at 9.

[78] *Id.* at 9 n.40.

basis for this statement[79] does not support it. The article merely paraphrases Ann Bergin, a Managing Director of DTCC, telling the reporter (correctly) that NSCC (i) does not police the fund-trading network, (ii) is not a party to contracts between mutual fund companies and distributors and (ii) expects its member firms to play by the rules.

NSCC is held in high regard for its integrity and expertise by the SEC and participants in the mutual fund industry, as most recently and tellingly demonstrated by the amendments proposed by the SEC to the rules governing the pricing of mutual fund shares, which, if adopted as proposed, will have the effect of making NSCC the only intermediary authorized to "time-stamp" the receipt of orders for the purchase or sale of mutual funds shares.[80] In other words, NSCC is part of the solution to the problem of late-trading and other abuses in the mutual fund industry.

It might just be noted that, in connection with its argument that now is not the right time to introduce the SMA Service, CheckFree suggests that, instead of rolling out the SMA Service, "[a]n example of an issue NSCC could tackle that would financially benefit the investors instead of the industry players is the elimination of conflicts of interest that taint the achievement of 'best execution.'"[81] Of course, as a registered clearing agency, NSCC has no involvement in, or any authority or responsibility with respect to, the execution (as opposed to the subsequent clearance and settlement) of trades.

Also in connection with its argument that now is not the right time to introduce the SMA Service, CheckFree suggests that Chairman Donaldson sees some potential impropriety in the business practices of NSCC or some potential conflict of interest in its role as an SRO. Referring to his testimony concerning market structure issues, CheckFree states "Chairman Donaldson noted that '[an SRO] has an inherent conflict of interest between its roles as a market and as a regulator.'"[82] The full sentence from which this language was taken reads, "However, an SRO that operates a market has an inherent conflict of interest between its roles as a market and as a regulator."[83] Of course, as a registered clearing agency, NSCC (as opposed to an exchange like the NYSE) does not operate a market (and was not the subject of the concern expressed by Chairman Donaldson in his testimony).

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[79] Karen Damates, *Fund-Order Processing: Fast, Flexible, Flawed*, WALL STREET JOURNAL, Oct. 27, 2003, at C7.

[80] *See* Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. IC-26288, 68 FR 70388 (Dec. 17, 2003), and the text of proposed amended Rule 22C-1 under the Investment Company Act, specifically paragraph (b)(2).

[81] CheckFree comment letter, *supra* note 5, at 9 n.41.

[82] *Id.* at 9 n.43.

[83] Statement of William H. Donaldson, Chairman, Securities and Exchange Commission, *supra* note 6.

C. This is the Right Time to Introduce the SMA Service

Contrary to what CheckFree claims, this is precisely the right time to introduce the SMA Service.

The problems confronting the SMA Industry have been studied and identified. As Deloitte & Touche point out in their report on the current state of operations in the SMA Industry:[84]

- With respect to the front office: "Current trade order management processes in the SMA industry are manually intensive and inefficient. The current situation points to an inherent lack of scalability in the front office. The ultimate aim of the industry should be the development of trading methodologies that are platform neutral (i.e. independent of the trading systems used by industry participants) and electronically based. For the industry to be platform neutral, data must flow freely, efficiently and securely between all interested parties."[85]

- With respect to the back office: "Much like the front office, the back office operations are a mix of one-off interfaces, manual uploads and downloads, emails, phone calls and faxes. Errors with economic impact are a direct result of a lack of connectivity and standardized protocols between the sponsors and managers and are more prevalent in the industry than many find acceptable." [86]

Likewise, the solutions for the problems confronting the SMA Industry have been studied and identified. As Deloitte & Touche recommend in their report:

> SMA industry leaders should look beyond their current technology and operations platforms (which are functional but not scalable and cost more to use than most realize) and envision an industry-wide approach to data standardization, platform-neutral trading and centralized clearing. The parallel to where the mutual fund industry found itself twenty years ago is striking. The fund industry, led by distribution firms and investment managers working together, developed standard protocols and processes and thereby helped to usher in a period of staggering asset growth combined with very cost efficient operations. As a result, the fund industry enjoyed a solid generation of remarkable growth.[87]

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[84] DELOITTE & TOUCHE, OPERATIONAL INTERFACES IN THE SEPARATELY MANAGED ACCOUNT INDUSTRY: A DESCRIPTION OF THE CURRENT STATE OF CONNECTIVITY AMONG SPONSORS AND INVESTMENT MANAGERS (Aug. 2002).

[85] *Id.* at 4.

[86] *Id.*at 5.

[87] *Id.* at 7 (emphasis added).

By facilitating prompt and accurate communications between Sponsors and Managers, eliminating the barriers to universal connectivity and leveling the operational playing field, the SMA Service will make it possible for more Managers to work with more Sponsors, giving Clients increased choice among Managers and Sponsors competing for their business on the basis of performance and price.

As far as the problems in the mutual fund industry are concerned, suffice it to say that NSCC has the skills, resources and commitment to do whatever is required on its part to deal with the late-trading and other abuses that have been uncovered, while at the same time continuing its mission to develop and implement new services for participants in the securities industry, including without limitation the SMA Service for participants in the SMA Industry.

VIII. The SMA Service Protocols Will Be Open Protocols

A. The CheckFree Comment Letter

In the Rule Filing, NSCC made clear that the standardized protocols and processes developed by NSCC for the SMA Service (the SMA Service Protocols) will be available to all users and that all vendors will be permitted to build interfaces to the service (the SMA Service Hub) on a non-discriminatory basis. Specifically, NSCC stated that:

- "[The] standardized data elements are available to all vendors, sponsors and managers to use in programming their various applications," noting that such standardized data elements are available on the NSCC and MMI websites.[88]

- "As is the case with all NSCC products, NSCC will allow vendors to build interfaces to NSCC's SMA Service on behalf of NSCC members."[89]

- "NSCC will nondiscriminately support interfaces with any vendor which acts as a service provider to an NSCC member."[90]

CheckFree argues -- despite the clear language of the Rule Filing -- that the standardized protocols and processes for the SMA Service may not, in fact, be open to all Sponsors and Managers and their communications service providers, citing (i) copyright notices on the MMI website, (ii) questions about whether NSCC is adopting the MMI data standards as the data standard for the SMA Service[91] and, finally, (iii) their professed belief that "it was the understanding of CheckFree and many participants of the Technical Working Group [of the

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[88] Rule Filing, *supra* note 2, at 4.

[89] *Id.* at 5.

[90] *Id.* at 7.

[91] CheckFree comment letter, *supra* note 5, at 14.

MMI] that the standards were to be open and available to all industry participants for use in developing competing data sharing technology."[92]

B. The SMA Service Protocols Will Be Open to All Users of the SMA Service and All Vendors Will Be Permitted to Build Interfaces to the SMA Service Hub

NSCC wishes to be very clear on this subject. The SMA Service Protocols will be made available by NSCC to subscribers and their communications service providers for the purpose of connecting to the SMA Service Hub and using the SMA Service, and NSCC will ensure that such subscribers and their communications service providers shall have the legal right to do so. The SMA Service Protocols will not be made available by NSCC to any persons for the purpose of developing technology to compete with the SMA Service, just as NSCC would not expect other vendors of messaging services to provide their system information and specifications to NSCC.

IX. CheckFree and the Proposed SMA Service

Although NSCC will not make the SMA Protocols available to CheckFree for the purpose of developing technology to compete with the SMA Service,[93] CheckFree (i) may, if it chooses (using its own resources and technology), continue to operate its platform and (ii) may, if it chooses (like any other communications service provider), help customers connect to the NSCC platform. In this regard, it should be noted that:

- The SMA Service will be available to all Sponsors and Managers that wish to use it. No Sponsors or Managers will be required by NSCC to use the SMA Service.

- All Sponsors and Managers which currently interface through the CheckFree platform may continue to do so. Although NSCC believes that the SMA Service Hub will offer users a better solution for connectivity than the CheckFree platform, NSCC understands that many Sponsors and Managers, at least initially for one reason or another, will choose to continue to interface through the CheckFree platform.[94]

- Any Sponsors and Managers which choose to use CheckFree or another vendor as a communications service provider to connect to the SMA Service Hub (instead of doing it internally) may do so.

As the foregoing indicates, if the Rule Filing is approved by the Commission, Sponsors and Managers will have increased choices. They may connect to the SMA Service Hub or they may

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[92] *Id.* at 15 (emphasis added).

[93] *See* Section VIII(B) *supra.*

[94] *See DTCC's SMA Service to Attract Technological Laggards*, Operations Management (Nov. 10, 2003); Coyle, *supra* note 72, at 2.

continue to interface with each other through the CheckFree platform or they may use CheckFree or another vendor as a communications service provider to connect to the SMA Service Hub.[95]

As far as CheckFree is concerned, if the SMA Service goes into operation, (i) CheckFree may continue to be an interface service provider for participants in the SMA Industry that wish to continue to use its interface service and/or (ii) CheckFree may find new opportunities as a communications service provider linking Sponsors and Managers to the SMA Service Hub and, in any event, (iii) CheckFree presumably will continue to offer the products and services it now provides to the SMA Industry that do not involve connectivity and would not be directly affected by the SMA Service, viz, (A) its portfolio management products and services and (B) its investment performance and reporting products and services.[96]

X. The Proposed Rule Will Foster Competition in the SMA Industry

A. The CheckFree Comment Letter

In the Rule Filing, NSCC states that "NSCC does not believe that the proposed rule change will impose a burden on competition not necessary or appropriate in furtherance of the [Exchange] Act."[97] NSCC also states that it had been advised by several participants in the SMA Industry that the SMA Service would foster competition among vendors offering other services to the industry, i.e., services other than the SMA service.[98] In their comment letter, CheckFree asserts that they "firmly [disagree] with the NSCC's assertion in the Proposing Release that Rule 59 will have no impact on competition."[99] CheckFree goes on to assert that "the NSCC's position as an SRO will give it an unfair advantage in three respects, viz, that NSCC will dictate parameters to vendors, NSCC will impose technological standards on the industry and NSCC will subsidize the

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[95] In fact, NSCC has been advised by at least one Manager that, if the SMA Service is launched, they will use the SMA Service Hub to connect to some Sponsors but will use the CheckFree platform and the platform of another vendor to connect to other Sponsors.

[96] For a more complete description of these other products and services that do not involve connectivity and would not be directly affected by the SMA Service, see the CheckFree Annual Report on Form 10-K for the year ended June 30, 2003, at 9-10 and 25-26, available on the CheckFree website at www.checkfreecorp.com. Note that Cerulli Associates, in their review of the current state of the SMA Industry and the proposed SMA Service, concludes that, even if an industry-wide solution is adopted for the operational problems confronting the business, *i.e.*, the SMA Service, there will still be opportunities for vendors of back-office processing services. *It Keeps You Running,* THE CERULLI EDGE, MANAGED ACCOUNTS ED. (Cerulli Assoc., Boston, MA) 4th Quarter, 2003. They state "Cerulli Associates does assert that many of the services described [back-office processing services] will continue to be viable in the separate accounts industry in the event such a solution [the SMA Service] is adopted. This assertion is based on the example of the mutual fund business where outsourcing, workflow, and other technology solutions are widespread despite almost 20 years of operational efficiencies delivered by an industry-supported communication utility [the NSCC Mutual Funds Service]." *Id.* at 8.

[97] Rule Filing, *supra* note 2, at 6.

[98] *See id.* at 7.

[99] CheckFree comment letter, *supra* note 5, at 19.

development of the SMA Service with revenues generated from existing SRO activities. CheckFree provides no meaningful explanation or support for either of their assertions.

B. Burden on Competition

With respect to competition and Section 17A of the Exchange Act, the Commission has indicated that its 'paramount concern' is encouraging competition among broker/dealers because it is competition at this level that is most beneficial to individual investors.

In its order granting NSCC registration as a clearing agency (the "NSCC Registration Order"),[100] the Commission noted preliminarily that:

> Under Section 17A of the [Exchange] Act, the Commission has an obligation to consider the competitive implications of its actions. The Commission is not required to justify that its actions be the least anticompetitive manner of achieving a regulatory objective. Rather, in exercising its authority, the Commission must balance the maintenance of fair competition and a number of other equally important express purposes of the [Exchange] Act. Indeed, Section 17A specifically recognizes that need and directs the Commission, in exercising its mandate to facilitate the establishment of a national clearing and settlement system, to perform that balancing function "having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents..."[101]

The Commission went on to consider, inter alia, the competitive effect of NSCC charging the same fees for transactions compared, cleared and settled through its branch network with the fees NSCC would be charging broker/dealers in New York City for the same services, i.e., geographic price mutualization or GPM. The Commission concluded that GPM would not adversely affect competition among clearing agencies but that, even if it did, GPM would promote competition among brokers/dealers and that "the encouragement of competition among brokers and dealers is a paramount concern of the [Exchange] Act and represents a direct benefit for the investing public." [102] The Commission went on to explain:

> The effects of competition among brokers and dealers are reflected in services provided to, and commissions charged, individual and institutional customers. While the levels of those services and commissions are affected by clearing and

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[100] *See* In the Matter of the Application of the NSCC for Registration as a Clearing agency; Order Granting Registration and Statement of Reasons, Exchange Act Release No. 34-13163, 42 FR 3916 (Jan. 13, 1977) [hereinafter NSCC Registration Order].

[101] *Id.* at 8 (footnotes omitted).

[102] *Id.* at 28.

> settlement fees, they constitute a relatively small component of the services individual customers receive and the commissions individual and institutional customers pay. The levels of those services and commissions tend to be affected more significantly and more directly by competition among brokers and dealers. Accordingly, although the maintenance of competition among clearing agencies is an important statutory objective, when balanced against the facilitation of competition among brokers and dealers, clearing agency competition must give way to the public interest in maintaining the form of competition which most directly influences the levels of services received and commissions paid by individual and institutional customers. [103]

Bradford National Clearing Corporation and Bradford Securities Processing Services, Inc. petitioned the United States Court of Appeals for the District of Columbia Circuit for review of the NSCC Registration Order and a subsequent order of the Commission approving two rules adopted by NSCC to meet certain conditions for registration imposed on NSCC in the NSCC Registration (the "NSCC Rules Order").[104] The Court affirmed the NSCC Registration Order, while remanding to the Commission for further consideration the issue of geographic price mutualization (and whether NSCC should submit a facilities management contract to competitive bidding), and it affirmed the NSCC Rules Order.[105]

The Bradford decision is noteworthy in terms of the great deference accorded the Commission with respect to matters relating to competition:

> Petitioners argue that the statute [the Exchange Act] charges the SEC with enforcing the antitrust laws or at least with avoiding any unnecessary anticompetitive consequences. Their position thus approaches that taken by the Justice Department in the proceedings below that the Commission must achieve its objectives in the least anticompetitive manner possible. The statute, however, does not support such an interpretation. At most, it only requires the Commission to decide that any anticompetitive effects of its actions are "necessary or appropriate" to the achievement of its objectives. In fact, Congress responding to importunities by the Justice Department explicitly refused to include a "least anticompetitive" requirement in the 1975 legislation...[106]

In its order on remand (the "NSCC Remand Order"),[107] the Commission sustained the use of geographic price mutualization by NSCC (and the decision of NSCC not to submit its facilities

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[103] *Id.*

[104] In the Matter of NSCC, Exchange Act Release No. 34-13456, 42 FR 21881 (Apr. 21, 1977).

[105] Bradford National Clearing Corporation v. SEC, 590 F. 2d 1085 (D.C. Cir. 1978).

[106] *Id.* at 590 F. 2d at 1106.

[107] In the Matter of the Application of the NSCC for Registration as a Clearing Agency; Order Affirming Registration and Statement of Reasons, Exchange Act Release No. 34-17562, 22 SEC Docket 129 (Feb. 20, 1981).

management contract to competitive bidding). The Commission also affirmed the registration of NSCC as a clearing agency. In the NSCC Remand Order, the Commission stated that it "continues to believe that broker-dealer competition is the preeminent competitive consideration in NSCC's registration and that GPM continues to have a positive effect on regionally-based broker-dealers in that it provides NSCC's regionally-based participants access to NSCC's services at the same price as the price paid by NSCC's New York City participants."[108]

Accordingly, it is against this background of Commission concern with promoting competition among broker/dealers, and Commission discretion with respect to the competition provisions of Section 17A, that the Proposed Rule and the SMA Service must be viewed.[109]

As explained in the Rule Filing,[110] the SMA Service is an enhanced messaging service for Sponsors and Managers in the SMA Industry. It is designed to resolve two significant obstacles to growth and participation in this business -- the lack of standardized protocols and processes and the lack of centralized connectivity. The solution proposed by NSCC - the SMA Service Protocols and the SMA Service Hub -- will enable more Sponsors and Managers to connect with each other on a neutral platform. The current operational environment -- inconsistent and archaic data standards and multiple proprietary and vendor interfaces -- limits competition at all levels.[111] It has the perverse effect of reducing the number of relationships that Managers can maintain with Sponsors[112] (or making it prohibitively complex and costly for some Managers to connect at all) and the converse effect of limiting the number of relationships with Managers that Sponsors can offer their Clients. The result is an uneven operational playing field with artificially restricted choices for individual investors.

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[108] *Id.* at 23.

[109] *See also* Order Approving Proposed Rule Changes Regarding Arrangements Relating to a Decision by the Chicago Stock Exchange, Inc. to Withdraw from the Clearance and Settlement, Securities Depository, and Branch Receive Businesses, Exchange Act Release No. 34-36684, 61 SEC Docket 10 (Jan. 5, 1996) at 3-5; Order Granting Partial Permanent Approval and Partial Temporary Approval of Proposed Rule Changes Relating to a Decision by the Philadelphia Stock Exchange, Inc. to Withdraw from the Securities Depository Business and to Restructure and Limit its Clearance and Settlement Business, Exchange Act Release No. 34-39444, 66 SEC Docket 72 (December 11, 1997) at 5.

[110] Rule Filing, *supra* note 2, at 5. For more detailed technical information on the proposed service, *see* The Money Management Institute, Separately Managed Accounts Operations and Standards (Sept. 2002).

[111] *See* Section VI(C), *supra.*

[112] *See* CERULLI, *supra* note 96, at 4C ("Despite rapid expansion of the separate accounts industry from 1995 through 2001 (net asset growth of almost 350% peaking at $321 billion in 2002), asset managers have more recently been awakened to the operational and profitability difficulties of participating in the business. Realizing that more sponsor ties equal additional operational complexity and lower degrees of operational scalability, combined with the fact that more than 70% of industry assets reside at the five New York wirehouse distributors, many managers have pared down their number of sponsor relationships in recent years. Our survey database shows that about 20 major asset managers have cut at least one or more sponsor relationships in the last 12 months, with some firms citing reductions of five or more programs").

NSCC believes that the SMA Service will (i) promote competition among Managers by eliminating infrastructure and cost barriers to Sponsor relationships, (ii) promote competition among Sponsors -- the competition of paramount concern to the Commission -- by expanding the universe of Manager advisers for their SMA programs, (iii) provide competition to CheckFree (which now has a dominant position in this space),[113] (iv) open competition to other vendors of back-office services (which have not been able to overcome the barriers to entry that exist in the current system)[114] and, most importantly, (v) deliver to individual investors the resulting benefits of competition -- increased choice, decreased cost, improved service and the chance to evaluate Sponsors on a level operational playing field on the basis of performance and price.

CheckFree does not articulate how the SMA Service might impose any burden on competition let alone a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. CheckFree suggests that the SMA Service could, potentially, have an adverse effect on its own business[115] but protecting the business of a dominant service provider from competition is not a goal of the Exchange Act. A goal of the Exchange Act is to promote competition which benefits individual investors, i.e., competition among broker/dealers.[116] That is also a goal of the proposed SMA Service.

C. Unfair Competition

With respect to the claim by CheckFree that, in providing the SMA Service, NSCC would have "an unfair advantage" over CheckFree, see the attached memorandum of Shearman & Sterling LLP, antitrust counsel for NSCC, concluding that, if and to the extent the antitrust laws apply, there is "no merit in CheckFree's contentions that NSCC's proposed service will have an adverse impact on competition."

XI. Answers to Questions from Senator Miller and Congressman Scott

In his letter to the Commission, Senator Miller asked a number of questions about NSCC and the proposed SMA Service.[117] The questions that Congressman Scott asked Chairman Donaldson at the subcommittee hearing were similar in substance.[118] Set forth below are brief answers to the questions that have been asked by Senator Miller and Congressman Scott.

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[113] *See* Section VI(B) *supra.*

[114] Market Street Advisors, Inc. comment letter, *supra* note 4.

[115] *See* CheckFree comment letter, *supra* note 5, at 19.

[116] *See* NSCC Registration Order, *supra* note 100; *Bradford, supra* note 105, 590 F. 2d 1085.

[117] *See* Miller comment letter, *supra* note 5.

[118] Testimony of Chairman Donaldson, *supra* note 6.

1. Question/Answer

Is the private sector active in this marketplace and, if so, what would be the impact of this rule on competition? What is the evidence that the existing marketplace is in need of government intervention?

A small number of vendors are involved in the business of providing outsourced communications services to Sponsors and Managers in the SMA Industry. CheckFree is the dominant service provider in this space, with interfaces between 39 of the 50 largest Sponsors and 36 of the 40 largest Managers and approximately 75% of the business. Because of its size and market share, other vendors have not been able to successfully compete with CheckFree. Implementation of the SMA Service would introduce effective competition to this business and, by leveling the operational playing field for Sponsors and Managers, promote competition among Managers (for business from Sponsors) and competition among Sponsors (for business from Clients). Accordingly, the ultimate beneficiaries of the proposed SMA Service will be individual investors.

The proposed SMA Service does not involve any government intervention in the existing marketplace. NSCC is a New York corporation and a wholly-owned subsidiary of DTCC. DTCC is a New York corporation which is owned by the users of the services of its registered clearing agencies subsidiaries. All of the registered clearing agency subsidiaries of DTCC are SROs within the meaning of the Exchange Act but DTCC and its subsidiaries are not (i) government agencies or instrumentalities or (ii) quasi-government entities or (iii) otherwise subject to government direction or control (except for government regulation of their own activities). Note that CheckFree is not subject to any government regulation of its SMA interface business.

2. Question/Answer

How are the investors better protected by the adoption of this rule? What role does the NSCC's desire to keep revenues up, even if it means expanding its authority, play in the creation of this proposal?

Individual investors will be the ultimate beneficiaries of the proposed SMA Service. By making it easier for more Managers to communicate with more Sponsors and vice versa, individual investors will have more choices with respect to the maintenance and management of their portfolios. By introducing effective competition to the business of providing outsourced communications services to Managers and Sponsors in the SMA Industry, and promoting competition among Managers (for business from Sponsors) and competition among Sponsors (for business from Clients), individual investors well benefit from the economies and efficiencies that such competition (at all levels) should generate.

NSCC has undertaken to develop and provide the SMA Service, not to keep revenues up, but in response to a demonstrated need for standardized protocols and processes (the SMA Service Protocols) and centralized connectivity (the SMA Service Hub) in the SMA Industry and the

expressed desire of participants in the SMA Industry that the provider of this solution be NSCC. As a matter of policy and practice, NSCC operates on a not for profit basis. Revenues in excess of expenses (and necessary reserves) are rebated, i.e., returned, to the users of its services.[119] Accordingly, with respect to the SMA Service, NSCC is not motivated by any desire to keep revenues up. Finally, NSCC does not seek, and approval of the Rule Change by the Commission will not grant, NSCC any expansion of its authority as an SRO.

3. Question/Answer

Are revenues derived from mutual fund transactional fees in any way involved with funding or development of this proposed rule? If so, what questions does it raise about the propriety of this entire effort?

No. The cost of developing and rolling out the SMA Service is a charge to the general funds of the corporation and not a charge to the mutual funds service or any other particular existing service of NSCC. As a matter of policy and practice, the cost of each service provided by NSCC to its members is passed through to the users of that service in the form of cost-based use-based fees.

4. Question/Answer

Why are the fees the NSCC plans to charge postponed until some future date? Since the NSCC could raise its fees by administrative fiat, rather than as a result of market dynamics, shouldn't the public know ahead of time what those fees will be?

As set forth in the Rule Filing,[120] the fees to be charged by NSCC for the SMA Service will be the subject of a separate rule filing pursuant to Section 19(b) of the Exchange Act and Rule 19b-4 thereunder. The reason why NSCC has not yet made such a filing is that NSCC has not yet determined the fees. The fees for the SMA Service will be determined by NSCC taking account of (i) the all-in cost of developing and rolling out the Service, (ii) the projected cost of operating the Service, (iii) the demand among Sponsors and Managers for the Service, (iv) anticipated activity levels and (v) other factors that a prudent vendor must consider when pricing a service, including inter alia competition, risk, economic conditions and business opportunities. The filing with respect to fees will be made in advance of the launch of the SMA Service.

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[119] *See* Section VIII of Addendum A of the Rules and Procedures of NSCC, available on the NSCC website at www.nscc.com.

[120] Rule Filing *supra* note 2, at 6.

February 2, 2004

NSCC respectfully requests that the Commission approve the Rule Filing because (i) the SMA Industry needs the standardized protocols and processes and centralized connectivity that the proposed SMA Service offers, (ii) the SMA Industry selected NSCC to develop this project because, as an industry utility, NSCC can provide a neutral platform open to all participants on a non-discriminatory basis, (iii) NSCC has a demonstrated record of success providing a similar service to the mutual funds industry efficiently and at low cost, (iv) NSCC has the authority to offer the proposed SMA Service and (v) the proposed SMA Service is pro-competitive.

NSCC would welcome an opportunity to meet with representatives of the Commission to discuss the SMA Service.

Sincerely yours,

Charles Douglas Bethill.

Charles Douglas Bethill

cc: Carol A. Jameson, Esq.
Senior Counsel and Vice President
The Depository Trust & Clearing Corporation
55 Water Street
New York, New York 10041-0099

Attachment

BY E-MAIL

[TPW: NYLEGAL:205516.6]

SHEARMAN & STERLING LLP

February 2, 2004

Memorandum To: Carol A. Jameson, Esq.
National Securities Clearing Corporation

From: Wayne Dale Collins, Esq.
Shearman & Sterling

Competition Analysis of NSCC'S Separately Managed Accounts Service

You have asked us to review the competition section of CheckFree Corporation's submission to the SEC dated December 23, 2003 ("CheckFree comment letter"), in response to the SEC's request for comments on a proposed new Rule 59 of the Rules and Procedures of NSCC ("Proposed Rule") that would permit NSCC to offer an information messaging system called the Separately Managed Accounts Service ("SMA Service").[1] Specifically, you asked us to examine these comments from a general competition perspective and more particularly to consider whether NSCC's proposed service violates the antitrust laws.

For the reasons explained below, we see no merit in CheckFree's contentions that the NSCC's proposed service will have an adverse impact on competition. Indeed, as we understand the facts, the SMA Service is likely to be affirmatively procompetitive and to benefit the industry as a whole. Moreover, the SMA Service as proposed appears to be fully consistent with the antitrust laws, and we expect that NSCC will be able to implement and operate the Service without running afoul of the antitrust laws, assuming that they apply.

This memorandum proceeds in four parts. First, we very briefly describe the NSCC's proposed SMA Service. Second, we summarize the competition objections CheckFree makes to this service in its December 23 submission. Third, we examine what impact the proposed SMA Service is likely to have on competition, as that term is understood in the context of the antitrust laws. Finally, we consider whether the proposed SMA Service can be implemented and operated in a manner consistent with the spirit of the antitrust laws.

I. THE NSCC PROPOSED RULE

NSCC is a central counterparty that provides centralized clearance, settlement and information services for virtually all broker-to-broker equity, corporate bond and municipal bond, exchange-traded funds and unit investment trust (UIT) trades in the U.S. NSCC is also

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[1] See Notice of Filing of a Proposed Rule Change Relating to the New Separately Managed Account Service, Exchange Act Release No. 34-48846, 68 Fed. Reg. 67,714 (Dec. 3, 2003) ("Proposed Rule Filing").

the major provider of centralized information services and money settlement for mutual funds and insurance and annuity transactions, linking funds and insurance carriers with their broker/dealer, bank and other distribution channels.

NSCC also acts as an industry utility, providing infrastructure and basic services to members and the industry in a way that facilitates securities transactions in general and provides the essential foundation for a wide range of financial services. As an industry utility, NSCC is not engaged in any retail, commercial banking or investment activities and is run on a not-for-profit basis for the benefit of its members and the industry as a whole.

NSCC is registered with the SEC as a clearing agency under Section 17A of the Securities Exchange Act of 1934 and is a self-regulatory organization ("SRO") subject to Section 19(a) of the Act.

The SMA Service will provide a messaging hub for the communication of information among sponsors of separately managed accounts and the investment managers participating in their programs. The SMA Service has two primary features: (1) the adoption of standard protocols for exchange of account information such as opening account data (e.g., account profile notifications, verifications of forwarding accounts) and account maintenance data (e.g., funding deposit account notification); and (2) a common electronic hub or network for the exchange of information using NSCC-supported connectivity. The SMA Service will be made available to all interested members on a non-discriminatory basis and will be inter-operable with other systems that can program interfaces to the SMA Service. Although the fees to be charged for the service have not been determined and will be the subject of a separate rule filing, the SMA Service, similar to other NSCC services, will be provided on a not-for-profit basis.

II. The CheckFree Opposition

On December 23, 2003, CheckFree submitted a comment letter opposing the Proposed Rule. Out of twenty pages, CheckFree devoted slightly over one page to its contention that "[t]he proposed rule would have a negative impact on competition."[2] CheckFree's contention is that NSCC's entry into the market with its SMA Service would harm competition because of the advantages NSCC enjoys as an SRO in three distinct ways:

1. As an SRO, NSCC "has regulatory powers to dictate the parameters in which vendors must operate in this space."[3]

2. The NSCC's "new role may create the potential for the NSCC to impose technological standards on the industry."[4]

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2 CheckFree comment letter 19-20.

3 *Id.* at 19.

4 *Id.*

3. The NSCC "would be at a financial advantage because, given its position as an SRO, the NSCC would be in a position to offer the SMA Services at below cost prices by subsidizing its initial development of the SMA Service as well as its services [sic] with fees generated from its existing self-regulatory activities."[5]

CheckFree concludes that, given these putative advantages, NSCC could "drive out of the market third-party vendors such as CheckFree currently providing similar data transfer and connectivity."[6]

As the following section demonstrates, far from being anticompetitive as CheckFree asserts, the proposed SMA Service will likely be procompetitive and produce significant public benefits.

III. The Proposed SMA Service Will Be Procompetitive and Produce Significant Public Benefits

In modern antitrust law, the competitive impact of a transaction or arrangement is considered in terms of its effect on the consumers of the product or service. In particular, an arrangement is deemed to be anticompetitive if it creates or facilitates the exercise of market power to the detriment of consumers as manifested in increased prices, reduced product or service quality, or a lessening of the rate of technological innovation or product or service improvement. The Supreme Court has repeatedly held that the purpose of the antitrust laws is to protect competition for the benefit of consumers and *not* to protect competitors.[7] While there was a time in early antitrust jurisprudence that the antitrust laws did protect competitors to some degree, that has been not be true since at least the mid-1970s. Today, the competitive effect of an arrangement is judged under the antitrust laws solely by its effect on consumers. If a new arrangement creates additional consumer value or lowers costs, that arrangement is considered procompetitive even if it has the effect of driving some less efficient competitors out of business.

There is support in the SEC rulemaking record that the SMA Service will create additional consumer value and reduce transactions costs. A Deloitte & Touche study dated August 2002[8] and commissioned by the Money Management Institute ("MMI") reports that the rapid growth of the SMA industry—a 21 percent compound annual growth rate for the six-year period ending December 31, 2001—has created numerous technological and operational challenges, especially in the absence of the scalability necessary to accommodate this historical

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5 *Id.*

6 *Id.*

7 *See, e.g.,* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224 (1993); Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 339 (1990); Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 111 (1986); Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 767 (1984); Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 488 (1977).

8 Deloitte & Touche, Operational Interfaces in the Separately Managed Account Industry (August 2002).

growth as well as future expansion.[9] The report finds that a key area of concern in the industry is the lack of standardized protocols and process for communicating and processing data necessary to achieve broad scalability and that the current state of connectivity in the industry does not permit the efficient flow of data, thereby forcing higher than optimal costs on consumers of SMA connectivity services.[10] The report concludes that "[t]he industry is in need of open architecture and platform neutral systems that seamlessly communicate with each other" and that enable sponsors and managers to make operations more efficient.[11] The report recommends that "SMA industry leaders should look beyond their current technology and operations (which are functional but not scalable and cost more to use than most realize) and envision an industry-wide approach to data standardization, platform-neutral trading and centralized clearing."[12]

The MMI, which is the national organization for the SMA industry and is comprised mostly of the consumers of SMA services (portfolio management firms and sponsors of investment advisory and consulting services), endorsed these findings and conclusions.[13] Noting the similarity of the problems faced by the SMA industry to those faced by the mutual fund industry at a comparable point in its development and the role of NSCC in achieving industry-wide solutions to these problems, the MMI invited NSCC to play an analogous role in creating a solution to the current SMA industry.[14] At MMI's request, NSCC became a member of the MMI Technology and Operations Committee that MMI formed to assist the industry in creating and standardizing communication protocols for SMA processing.[15] MMI also asked NSCC, as the industry utility, to develop a central processing utility that would support and utilize these industry standards.[16] The proposed SMA Service implements the MMI's second request.

From an antitrust evidentiary perspective, the support of the MMI for NSCC's proposed SMA Service should be given great weight. Since the antitrust laws are designed to protect consumers, the views of sophisticated, interested consumers are likely to be one of the

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9 *Id.* at 1. According to the MMI, there has been a 16.7 percent compound annual growth rate for the seven-year period ending September 30, 2003. Letter dated December 11, 2003 from Christopher L. Davis, Executive Director, MMI, to Jonathan G. Katz, Secretary, SEC ("MMI comment letter") at 1.

10 *Id.*

11 *Id.* at 6.

12 *Id.* at 7.

13 MMI comment letter 1-2.

14 *Id.* at 2.

15 *Id.*

16 *Id.*

most compelling indicators of the likely competitive effect of a new service.[17] The MMI was created in 1997 to serve as a forum for the managed account industry's leaders to address common concerns, discuss industry issues and work together to better serve investors. MMI's membership consists of (1) firms that offer comprehensive financial consulting services to individual investors, foundations, retirement plans and trusts; (2) related professional portfolio management firms; and (3) firms that provide long-term services to both sponsor and manager firms. With this membership, the MMI represents the very consumers of the services against which the antitrust laws would test the competitive effect of NSCC's proposed service.[18]

The MMI's support for the SMA Service is unequivocal:

> MMI supports NSCC's efforts to design and provide communications and processing service for the managed account industry. MMI believes it will benefit the industry and the investing public by reducing costs and the operational risk that is associated with manual and duplicative processes. As an additional benefit, MMI believes that centralizing communications in an industry utility such as NSCC will foster competition among service providers to the SMA industry. Use of NSCC's systems to provide a robust and economic network of connectivity among the many sponsors and investment managers that would with separately managed accounts will encourage other companies to develop and improved [sic] front office and back office processing services, thereby benefiting the industry and the investing public.[19]

Other comments in the rulemaking record from consumers of SMA services echo this support.[20]

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17 In antitrust merger cases, for example, where the likely future competitive effect of the transaction determines its legality, the Department of Justice Antitrust Division and the Federal Trade Commission rely heavily on the views of sophisticated customers in their investigations as well as any challenges in court.

18 *See* MMI comment letter 1. *See also* http://www.moneyinstitute.com/about/about.html.

19 *Id.*at 3.

20 *E.g.,* Letter dated December 19, 2003 from Marc Zeitoun, Senior Vice President and Director, Managed Accounts, UBS, and Rick Austin, Senior Vice President and Manger, SMA Operations, Trading & Clients Reporting, UBS, to Jonathan G. Katz, Secretary, US Securities and Exchange Commission ("SEC"); Letter dated December 11, 2003 from Christopher L. Davis, Executive Director of The Money Management Institute to Jonathan G. Katz, Secretary, SEC; Letter dated December 11, 2003 from David Lindenbaum, Vice President, Wells Fargo Investments, LLC to Jonathan G. Katz, Secretary, SEC; Letter dated December 15, 2003 from Bevin Crodian, Chief Executive Officer, Market Street Advisors, Inc. to Jonathan G. Katz, Secretary, SEC; Letter dated December 18, 2003 from Kevin M. Hunt, Chief Sales and Marketing Officer, Old Mutual Asset Management, to Jonathan G. Katz, Secretary, SEC; Letter dated December 18, 2003 from Allen J. Williamson, Group President, Managed Assets, Nuveen Investments, to Jonathan G. Katz, Secretary, SEC; Letter dated December 18, 2003 from Scott C. Sipple, Managing Director, AllianceBernstein Managed Accounts to Jonathan G. Katz, Secretary, SEC; Letter dated December 18, 2003 from Charles Widger, Chief Executive Officer, Brinker Capital, to Jonathan G. Katz, Secretary, SEC; E-mail letter dated December 18, 2003 from Suzanne Akers, Vice President/Managing Director, Franklin Templeton Private Client Group to the Secretary, SEC; Letter dated December 19, 2003 from R. Mark

In addition, the rulemaking record contains expressions of support from service firms that would interconnect with the SMA Service.

For example, Market Street Advisors, an Internet based full service provider for handling the back-office administration of wrap accounts on behalf of investment managers and program managers, supports the proposed rule for reasons that directly translate into increased value propositions for the ultimate consumers of SMA services: (1) the SMA Service will create greater efficiencies and thereby provide more investment options for investors; (2) the SMA Service will open competition for back office providers; and (3) the SMA Service will enable some wrap managers to stay in business who would otherwise fail because of high costs.[21] Market Street Advisors concludes: "A universal protocol for connectivity will make the wrap business more attractive to both institutional and private wealth managers. NSCC's provision of the SMA Service will benefit the investing public by increasing the likelihood of a more diverse offering of wrap managers while also offering the possibility of lowering investment costs."[22]

As another example, Advent Software, Inc., a provider of software products, data integration tools and web-enabled services to the financial services industry, supports the SMA Service as the means to create a needed open standard to facilitate communication and data flow among financial institutions, which in turn, Advent believes, will eliminate unnecessary expenses from the industry and ultimately lower the cost of professional investment management for retail investors.[23]

As a final example, DST Systems, Inc., a leading provider of services to investment management and mutual fund companies, supports the SMA Service precisely because it provides a centralized message hub for the communication of information among SMA sponsors and investment managers participating in their programs.[24] DST sees the SMA

Pennington, Partner, Director of Separately Managed Accounts, Lord Abbett & Co LLC to Jonathan Katz, Secretary, SEC; E-mail letter dated December 19, 2003 from Bruce M. Arronow, Executive Vice President, Chief Operating and Financial Officer, Rorer Asset Management, LLC to Secretary, SEC; Letter dated December 22, 2003 from James P. Horan, Senior Vice President, DST Systems, Inc. to Jonathan G. Katz, Secretary, SEC; E-mail letter dated December 23, 2003 from Vincent J. Lepore to Jonathan G. Katz, Secretary, SEC; Letter dated December 23, 2003 from David J. Freniere, Senior Vice President & Assistant General Counsel, Linsco/Private Ledger Corp. to Secretary, SEC; Letter dated December 23, 2003 from Thomas P. Sholes, Senior Vice President and Managing Director, PFPC Managed Account Services, PFPC, Inc. to Jonathan G. Katz, Secretary, SEC; and Letter dated January 7, 2004 from Michael Wiles, SMA Business Manager, Advent Software to Jonathan G. Katz, Secretary, SEC.

21 Letter dated December 15, 2003, from Bevin Crodian, CEO, Market Street Advisors, to Jonathan G. Katz, Secretary, SEC, at 2-3.

22 *Id.* at 3.

23 Letter dated January 7, 2004 from Michael Wiles, SMA Business Manager, Advent Software to Jonathan G. Katz, Secretary, SEC.

24 Letter dated December 22, 2003 from James P. Horan, Senior Vice President, DST Systems, Inc. to Jonathan G. Katz, Secretary, SEC.

Service as a step toward reducing the processing errors and delays that are emerging in the rapidly expanding SMA business in an environment where currently exist many different platforms and methods to transmit information. DST also believes that the SMA Service will reduce if not eliminate barriers to entry into the SMA business, and the concomitant potential of lowering the costs of securities transactions. DST's support draws significantly on the fact that NSCC successfully employed a similar business model in the mutual fund industry 15 years ago.

In contrast to this support, the major opposition in the rulemaking record to the proposed SMA Service comes from CheckFree. CheckFree is a competitor of the proposed SMA Service. The practice by both antitrust enforcement agencies and the courts is to be very skeptical of expressions of opposition by competitors because the incentives of competitors to complain about the competitive effects of an new arrangement or service is often at odds with the interests of the consumers the antitrust laws are trying to protect. If the introduction of a new service is anticompetitive in an antitrust sense, it will raise prices to the detriment of consumers *but to the benefit of competitors*. Therefore, it is usually the case that competitors do not complain about truly anticompetitive deals. On the other hand, if the new arrangement is procompetitive in that it creates a new, more efficient service with a better customer value proposition, then new service is likely to draw customers away from less efficient incumbent competitors, require those competitors to lower their prices, or require additional investments to increase their efficiency that they might have otherwise made. In any event, competitors are harmed by the loss of customers, lower prices, or increase investment costs, while consumers of services are helped. As a result, enforcement agencies and the courts require a clear theory of anticompetitive harm to customers and a high quantum of proof before giving any material weight to competitor complaints about the competitive effect of a new arrangement.[25]

Furthermore, CheckFree's brief comments on the competitive effect of the proposed SMA Service speak to the effect on competitors, not consumers of SMA services, provide no theory of anticompetitive harm to SMA service customers, and provide no evidence to suggest that SMA service customers in fact would be harmed. Especially in light of the support in the rulemaking record of the MMI representing SMA service consumers, as well as individual customers themselves, CheckFree's contentions should be rejected.

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[25] We are aware of three other comments in the record that oppose the NSCC's proposed SMA Service. A two-paragraph comment from Placemark Investments, Inc., questions the need for the service and summarily expresses the opinion that the NSCC's service may be "redundant" since the industry is already served by private companies. *See* Letter dated December 24, 2003, from Lee Chertavian, Chairman & CEO, Placemark Investments, Inc., to Jonathan G. Katz, SEC. But this comment ignores the substantial evidence, reflected in other, supporting comments, that the private sector is not providing needed industry-wide connectivity, scalability, or cost-efficient service and is unlikely to ever do so. A comment from the Business Technology Alliance is similar both in its thrust and brevity. *See* Letter dated December 23, 2003, from Chris Cool, Principal, Business Technology Alliance, LLC, to Jonathan G. Katz, SEC. We read the comment from the Rockaway Partners' consultant as expressing an ideological view that the government should simply stay out the business. *See* Letter dated December 23, 2003, from Tod Parrott, Rockaway Partners, Ltd., to Jonathan G. Katz, SEC. We also understand that Senator Zell Miller has written to the SEC to ask several questions relating to issues also raised in the CheckFree comment letter.

First, CheckFree contends that NSCC could use its regulatory powers "to dictate the parameters in which vendors must operate in this space."[26] Significantly, CheckFree fails to identify what these "dictates" might be, even by way of illustration. The standard protocols for information exchange in the SMA Service do not "dictate" anything, but rather merely provide a common format for the exchange of important account information. Indeed, CheckFree and other vendors will be free to continue to utilize their own proprietary interfaces and connectivity for exchanging information amongst their own customers as well as be able to build interfaces the SMA Services using the NSCC's protocols.

Equally important, CheckFree also does not claim here that the NSCC would act in a way that harmed the industry as a whole or SMA service customers in particular. CheckFree also ignores that the SEC can regulate any anticompetitive conduct by the NSCC. More fundamentally CheckFree presents no reason to believe that NSCC would have any reason to cause harm to the industry or act to the detriment of SMA Service customers.

Indeed, the existing evidence points to the contrary (i.e., that consumers and customers will benefit from NSCC's proposed service). NSCC is an industry utility with the mission and reputation for acting in the interests of the industry. NSCC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"), which in turn is owned by its principal users—major banks, broker/dealers, mutual funds firms, and other companies within the financial services industry. DTCC's Board is made up of 21 directors who also serve as directors of NSCC. NSCC's Board of Directors, and the NSCC membership generally, has an interest in ensuring that NSCC acts even-handedly and in the interest of the industry in all of its activities, including the implementation and operation of the SMA Service. As noted above, NSCC is operated on a not-for-profit basis, and so lacks the financial incentive to attempt anticompetitively to raise artificial barriers to entry or to eliminate incumbent competitors with respect to the provision of SMA services.[27] Finally, the history of NSCC's involvement in addressing similar problems in the mutual fund and insurance industries suggests that NSCC's provision of services to the industry will benefit the industry by increased efficiencies and decreased costs.

Second, CheckFree contends "the NSCC's proposed new role may create the potential for the NSCC to impose technological standards on the industry."[28] The analysis here is essentially the same as for CheckFree's first contention: CheckFree does not suggest how this "potential" might manifest itself, makes no argument that even if technological standards emerged from the SMA Service they would harm the industry as a whole or SMA service

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26 CheckFree Comment Letter at 19.

27 NSCC's pricing policy is set forth in Addendum A to NSCC's Rules: "....to retain only those revenues which are required to maintain an adequate revenue base in order to liquidate current production costs, provide for a continuance of product enhancements and development, provide for a discount when volume levels equal or exceed projections and provide for retained earnings as directed by the Board." NSCC does not pay dividends on its capital stock.

28 *Id.*

customers in particular, fails to recognize the ability of the SEC to step in if any of the technological standards were anticompetitive, and presents no reason to believe that NSCC would act other than procompetitively and in the interest of the industry and SMA service customers in creating technological standards for the SMA Service.

Finally, CheckFree contends that the NSCC "would be at a financial advantage because, given its position as an SRO, the NSCC would be in a position to offer the SMA Services at below cost prices by subsidizing its initial development of its SMA Service as well as its services [sic] with fees generated from its existing self-regulatory activities."[29] Subsidization arguments of this type are well-known in antitrust law and routinely rejected as a theory of anticompetitive harm. First, the source of NSCC's development funds for the SMA Service is irrelevant. Even assuming that NSCC used a portion of its free cash flow resulting from its regulated activities to finance the development of the SMA Service, this in itself does not harm competition in an antitrust sense. If NSCC uses internally generated funds, it and its members and customers pay an opportunity cost of capital just as if NSCC had borrowed the money from a bank as any other firm might.[30] In this sense, NSCC is no different than a non-regulated firm that can equally choose to fund development either through retained earnings or external financing.

As we understand the rulemaking record, the evidence strongly favors a finding that the proposed SMA Service is procompetitive and will benefit the industry as a whole and SMA service customers in particular.

IV. The NSCC's SMA Service Can be Implemented and Operated Consistently with the Spirit of the Antitrust Laws

The NSCC's proposed service will produce significant benefits with no harm to competition. Given the overall thrust of the proposal is procompetitive, it should be easy to implement and operate the SMA Service in a manner consistent with the spirit of the antitrust laws. This section briefly analyzes the application of the antitrust laws to the NSCC's proposed conduct, assuming for the sake of argument that the antitrust laws apply.[31]

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29 *Id.*

30 If NSCC borrows from a bank, it must pay interest on the borrowed principal, and these interest payments ultimately must be covered by NSCC members and customers through higher fees. If NSCC uses internal funds, the members and customers must pay higher fees to cover the internal use, and hence forego the interest they could have earned on the savings of lower fees if the internal funds were used instead to lower service costs.

31 There is an active discussion in the courts over the extent to which the antitrust laws apply to conduct regulated by the SEC. *See, e.g.,* In re Stock Exchanges Options Trading Antitrust Litig., 317 F.3d 134 (2d Cir. 2003); Friedman v. Salomon/Smith Barney, Inc., 313 F.3d 796 (2d Cir. 2002); In re Initial Public Offering Antitrust Litig., 287 F. Supp.2d 497 (S.D.N.Y. 2003). Rather that address the implied immunity question here, we will simply assume for the sake of argument in this section that the antitrust laws apply.

There are four primary antitrust laws: (1) Section 1 of the Sherman Act, prohibiting unreasonable restraints of trade;[32] (2) Section 2 of the Sherman Act, prohibiting monopolization, attempted monopolization, and conspiracies to monopolize;[33] (3) Section 7 of the Clayton Act, prohibiting anticompetitive mergers and acquisitions;[34] and (4) the Robinson-Patman Act, prohibiting certain types of price discrimination in the sale of tangible commodities.[35] We will confine our analysis to Sections 1 and 2 of the Sherman Act, since the SMA Service does not involve any merger or acquisition to which Section 7 of the Clayton Act might apply nor does it involve the sale of any tangible commodity to which the Robinson-Patmen Act might apply.

A. Section 1 of the Sherman Act

Section 1 of the Sherman Act prohibits all "contracts, combinations . . and conspiracies . . . in restraint of trade."[36] Although early courts interpreted Section 1 to prohibit all restraint of trade resulting from concerted action, in Standard Oil Co. v. United States[37] the Supreme Court construed the statute to prohibit only *unreasonable* restraints of trade. The *Standard Oil* Court also created two means by which a restraint of trade can violate the standard of reasonableness.[38]

Under the "*per se* rule", some restraints are deemed so intrinsically anticompetitive and without social value that they can be conclusively presumed to be unreasonable from their very nature without the need for any empirical analysis of their actual marketplace effects.[39] Among these restraints are price-fixing among competitors,[40] customers or territorial market allocations among competitors,[41] minimum vertical price-fixing (usually

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32 15 U.S.C. § 1.

33 15 U.S.C. § 2.

34 15 U.S.C. § 18.

35 15 U.S.C. § 13.

36 15 U.S.C. § 1.

37 Standard Oil of New Jersey v. United States, 221 U.S. 1 (1911).

38 See Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 342 (1990); FTC v. Indiana Federation of Dentists, 476 U.S. 447, 458 (1986).

39 See Nat'l Soc'y of Prof. Eng'rs v. United States, 435 U.S. 679, 692 (1978).

40 Arizona v. Maricopa County Med. Soc'y, 457 U.S. 332, 354 (1982); Catalano, Inc. v. Target Sales, Inc., 446 U.S. 643, 650 (1980) (per curiam); United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940); United States v. Trenton Potteries Co., 273 U.S. 392, 397-98 (1927).

41 Palmer v. BRG of Ga., Inc., 498 U.S. 46, 49-50 (1990) (per curiam); United States v. Topco Assoc., 405 U.S. 596, 608 (1972); Burke v. Ford, 389 U.S. 320, 321 (1967) (per curiam).

called "minimum resale price maintenance"),[42] certain tying arrangements,[43] and certain group boycotts among competitors.[44] Nothing in the implementation or operation of the proposed SMA Service need fall within any of these categories of *per se* illegal conduct and any such conduct can be easily avoided. In particular, the SMA Service need not involve any tying arrangement—that is, selling one service only on the condition that the customer also purchase a separate and distinct service from the seller—since NSCC intends to make the SMA Service available independently of its other services.

The second rule, referred to as the "rule of reason", provides that concerted restraints of trade not subject to the *per se* rule are unreasonable and hence unlawful if and only if they create or facilitate the exercise of market power to the detriment of customers as a whole in the affected market.[45] The implementation and operation of the SMA Service is not anticompetitive and hence not unreasonable for the reasons discussed in Section III of this memorandum.

B. Section 2 of the Sherman Act

Section 2 of the Sherman Act prohibits monopolization, attempts to monopolize, and conspiracies to monopolize.[46] Conspiracies to monopolize are essentially a subset of horizontal price-fixing or market allocation conspiracies that are *per se* unlawful under Section 1 and that were addressed in the previous subsection.

Monopolization under Section 2 has two elements: (1) the possession of monopoly power in the relevant market; and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.[47] Attempted monopolization has three elements: (1)

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42 Dr. Miles Medical Co. v. John D. Park & Sons Co., 220 U.S. 373, 407-09 (1911); but cf. State Oil Co. v. Kahn, 522 U.S. 3 (19977) (overturning per se rule against maximum resale price maintenance).

43 Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 9 (1984); Northern Pac. Ry. v. United States, 356 U.S. 1, 3 (1958); International Salt Co. v. United States, 32 U.S. 392, 396 (1947).

44 United States v. General Motors Corp., 384 U.S. 127, 145 (1966); Radiant Burners, Inc. v. Peoples Gas Light & Coke Co., 364 U.S. 656, 659-60 (1961) (*per curiam*); Klor's, Inc. v. Broadway-Hale Stores, 359 U.S. 207, 212 (1959); Associated Press v. United States, 326 U.S. 1 (1945); Fashion Originators' Guild of Am. v. FTC, 312 U.S. 457 (1941).

45 *See* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 49 (1977); Standard Oil Co. v. United States, 221 U.S. 1, 28 (1911) (rule of reason inquiry whether "the challenged acts are unreasonably restrictive of competitive conditions" in the relevant market); Eichorn v. AT&T Corp., 248 F.3d 131 (7th Cir. 2001) ("The antitrust laws were not designed to protect every uncompetitive activity, but rather only those activities that have anti-competitive effects on the market as a whole.").

46 Section 2 also prohibits conspiracies to monopolize, but the offense of conspiracy to monopolize does not appear to be a colorable avenue of attack on the SMA Service.

47 United States v. Grinnell Corp., 384 U.S. 563, 570-71 (1966); accord Eastman Kodak Co. v. Image Technical Servs., 504 U.S. 451, 481 (1992); Aspen Skiing co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 596 n.19 (1985).

predatory or exclusionary conduct with (2) specific intent to monopolize and (3) a dangerous probability of success in achieving monopoly power.[48]

Significantly, both monopolization and attempted monopolization are conduct offenses. While an actual or emerging large market share in the relevant market is a necessary condition for both offenses—courts usually require a share above 70 percent for monopolization and above 50 percent for attempted monopolization[49]—a large market share by itself is not unlawful. Rather, the offense turns on the firm's engaging in exclusionary conduct to obtain or maintain a large share of the market and the monopoly power that goes with it. Moreover, conduct that simply causes a competitor to exit the market by itself is not necessary exclusionary conduct for Section 2 purposes. To satisfy the conduct elements of monopolization or attempted monopolization the challenged conduct must be anticompetitive, that is, it must exclude competitors with the consequences that consumers in the market are worse off through higher market prices, reduced product or service quality, or a lower rate of technological innovation or product or service improvement. Conduct that excludes competitors but benefits consumers in the marketplace—such as the introduction of a new or more efficient service that draws customers away from incumbent firms because of a better value proposition—is not exclusionary and will not satisfy the conduct elements of either monopolization or attempted monopolization.

Applied here, NSCC's implementation and operation of the proposed SMA Service should not raise Section 2 concerns. In the first instance, a new entrant into the relevant market necessarily will lack the requisite large market share to predicate either a monopolization or attempted monopolization claim. Moreover, even assuming that over time the SMA Service achieves a 50 percent or greater market share in the relevant market, there will be no Section 2 problem at that time if its share results from a more attractive consumer value proposition relative to competitors.

There are two primary variants of exclusionary conduct in monopolization and attempted monopolization cases—predatory pricing and non-price predatory conduct—both of which NSCC should easily avoid in the implementation and operation of the SMA Service.

Price predation. The idea behind predatory pricing is straightforward: the firm charges below-cost prices until it drives out its competitors, and then raises its prices to supracompetitive levels in the absence of competitors and to the detriment of consumers in the marketplace. While superficially appealing, courts—including the Supreme Court—have grown extremely wary of finding predatory pricing in practice. There are two reasons for this.

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48 Spectrum Sports, Inc. v. McQuillan , 506 U.S. 447, 456 (1993).

49 In attempted monopolization cases, courts use the firm's large share as the first evidentiary element in determining the firm's likelihood of achieving monopoly power. Court's usually find that a firm with less than a firm with less than a 50-percent market share will not satisfy the "dangerous probability of success" element of attempted monopolization.

First, in the initial phase of predatory pricing, prices to consumers go down, just as they do in the wake of aggressive price competition. Courts find it very difficult in this initial phase to distinguish between true predatory pricing and aggressive price competition, and if a court mistakenly finds predatory pricing when in fact what exists is aggressive price competition, the court's erroneous finding will harm consumers in the very way the antitrust laws seek to prevent—by forcing higher prices in the marketplace. To help guard against mistakes here, most courts have adopted as a threshold test in a predatory pricing claim that the challenged prices be below average variable costs. In many industries, and especially in the information technology sector, while the fixed costs of the infrastructure may be high, the average variable cost of serving an additional customer or processing an additional transaction will be extremely small.

Second, there are few if any empirical instances of successful predatory pricing, that is, when a firm first lowered its prices to predatory levels, succeeded in driving out its competitors, and then was able to raise its prices to supracompetitive levels for at least a long enough period of time to both recoup its investment in the originally lower prices and then earn monopoly profits. The difficulty for the firm considering a price predation strategy is that may take a deep investment in lower prices for a long period of time to drive its competitors out of the market, requiring it to raise its prices to very high levels in the recoupment period, which in turn attracts new entry and thereby undermines the firm's ability to sustain the high prices necessary to earn back the profits it lost by lowering its prices in the first period. Critically, the anticompetitive harm in predatory prices is the firm's supracompetitive pricing in the recoupment period—the predatory prices in the first phase standing alone are not anticompetitive because they benefit consumers even if they harm competitors. As a result, the Supreme Court has held that in a price-predation case the plaintiff must show that the market characteristics (including market shares, barriers to entry, excess capacity, and all other pertinent factors) must be susceptible to monopoly pricing in the recoupment period to the extent necessary to make the overall predation scheme profitable and hence rational.[50]

The threshold requirements of below average variable cost pricing and recoupment as a practical matter have essentially eliminated predatory pricing as a viable theory of anticompetitive harm in most situations. We suspect that it will be especially difficult to make out a colorable case in connection with the operation of the SMA Service. First, although we have not studied the matter, we have been informed that the average variable cost of processing an additional transaction is very small, and that prices, however low they might be, will not be below average variable costs. Second, the information technology sector generally exhibits rapid evolution and ease of entry. We suspect that the space in which the SMA Service will operate will not permit recoupment, or in any event the risk that recoupment will be possible is so great that a court would not find this element satisfied regardless of the SMA Service pricing levels.

Moreover, a court is likely to consider three other factors that are likely to weigh heavily against NSCC engaging in a predatory pricing strategy. First, as a non-profit-making operation, NSCC does not have either the incentive to earn supracompetitive profits, or even if it

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[50] Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

did, does not have a way to distribute these profits to its owners. Second, NSCC, as well as its parent company, was created as a cost-based industry utility, and NSCC 's members—many of whom may use the SMA Service—are likely to prevent through the NSCC governance mechanism any effort by NSCC to charge either below-cost or supracompetitive prices. Finally, the NSCC is regulated by the SEC, and any effort by the NSCC to charge supracompetitive prices for its SMA Service is likely to be stopped by the SEC.

Non-price predation. Non-price predatory conduct is based on the same principle as predatory pricing—anticompetitive conduct to drive competitors out of the market and a resultant ability to charge supracompetitive prices in the post-predation period—but depends on refusals to deal or other non-pricing behavior rather than prices to drive out the competition. This theory is of more academic than practical interest. The difficulty in using the theory is that it is very difficult to find situations where the non-price conduct of a firm can be used to disadvantage a competitor. The firm, of course, can engage offer customers a better value proposition and draw customers away form other competitors, but that is not a form of anticompetitive conduct necessary to predicate a monopolization or attempted monopolization claim.

With respect to the SMA Service, non-price conduct that might be considered anticompetitively exclusionary might include NSCC's refusal to allow competitors to interconnect with the SMA Service or to supply services to members who purchase investment-related information services from competitors such as CheckFree. Even assuming that such conduct would drive competitors out of business, such refusals are expressly contrary to NSCC's proposal to maintain a SMA Service equally available to NSCC members on all vendors connecting to NSCC on behalf of NSCC members. Moreover, for the reasons discussed above in the analysis of predatory pricing, NSCC as a not-for-profit industry utility lacks the incentive to engage in anticompetitive exclusionary conduct, NSCC members through the governance mechanism are likely to prevent any effort by NSCC to engage in such conduct even if it wanted, and the SEC through its regulatory oversight of NSCC or its rule-making authority can regulate any anticompetitive exclusionary conduct on the part of NSCC in connection with the SMA Service.

V. Conclusion

For the reasons stated above, it appears to us that the weight of the evidence in the rulemaking record strongly supports a finding that the NSCC's proposed SMA Service is likely to be affirmatively procompetitive and to benefit the industry as a whole. Moreover, the NSCC's SMA Service as proposed appears to be fully consistent with the spirit of the antitrust laws, and we expect that NSCC easily will be able to implement and operate the service without running afoul of the antitrust laws, assuming that they apply. Finally, we see no merit in CheckFree's contentions that the NSCC's proposed service will have an adverse impact on competition.