

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-79488; File No. SR-DTC-2016-003)

December 6, 2016

Self-Regulatory Organizations; The Depository Trust Company; Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1, to Impose Deposit Chills and Global Locks and Provide Fair Procedures to Issuers

I. Introduction

On May 27, 2016, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-DTC-2016-003 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> The proposed rule change was published in the Federal Register on June 9, 2016.<sup>3</sup> The Commission received 10 comment letters to the proposed rule change from five commenters, including three response letters from DTC.<sup>4</sup> Pursuant

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 77991 (June 3, 2016), 81 FR 37232 (June 9, 2016) (SR-DTC-2016-003) (“Notice”).

<sup>4</sup> See letter from Charles V. Rossi, Chairman, The Securities Transfer Association (“STA”), Inc. Board Advisory Committee, dated June 30, 2016, to Brent J. Fields, Secretary, Commission (“STA Letter I”); letter from Dorian Deyet, dated June 30, 2016 (“Deyet Letter”); letter from Ann K. Shuman, Managing Director and Deputy General Counsel, DTC, dated July 21, 2016, to Brent J. Fields, Secretary, Commission (“DTC Letter I”); letter from Harvey Kesner (“Kesner”), Sichenzia, Ross, Friedman, Ference, dated August 11, 2016, to Brent J. Fields, Secretary, Commission (“Kesner Letter I”); letter from Isaac Montal, Managing Director and Deputy General Counsel, DTC, dated August 22, 2016, to Brent J. Fields, Secretary, Commission (“DTC Letter II”); letter from Charles V. Rossi, Chairman, STA Board Advisory Committee, dated August 29, 2016, to Brent J. Fields, Secretary, Commission (“STA Letter II”); letter from Kesner, Sichenzia, Ross, Friedman, Ference, dated August 30, 2016, to Brent J. Fields, Secretary, Commission (“Kesner Letter II”); letter from Norman B. Arnoff (“Arnoff”), dated September 4, 2016 to Secretary Fields (“Arnoff Letter”); letter from Charles V.

to Section 19(b)(2) of the Act,<sup>5</sup> on July 21, 2016, the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.<sup>6</sup> On July 29, 2016, DTC filed Amendment No. 1 to the proposed rule change. On September 6, 2016, the Commission published notice of Amendment No. 1 and instituted proceedings under Section 19(b)(2)(B) of the Act<sup>7</sup> to determine whether to approve or disapprove the proposed rule change.<sup>8</sup>

Section II below provides an overview and brief description of both DTC and the proposed rule change. Section III provides a summary of the comments received and DTC's response to those comments. Section IV provides a discussion of the proposed rule change, the comments received, and details the Commission's findings with respect to the proposed rule change. Finally, Section V concludes that, for the reasons discussed

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Rossi, Chairman, STA Board Advisory Committee, dated October 3, 2016, to Brent J. Fields, Secretary, Commission ("STA Letter III"); and letter from Ann K. Shuman, Managing Director and Deputy General Counsel, DTC, dated October 17, 2016, to Brent J. Fields, Secretary, Commission ("DTC Letter III"). See comments on the proposed rule change (SR-DTC-2016-003), <https://www.sec.gov/comments/sr-dtc-2016-003/dtc2016003.shtml>.

<sup>5</sup> 15 U.S.C. 78s(b)(2).

<sup>6</sup> See Securities Exchange Act Release No. 78379 (July 21, 2016), 81 FR 49309 (July 27, 2016). The Commission designated September 7, 2016, as the date by which it should approve, disapprove, or institute proceedings to determine whether to disapprove the proposed rule change.

<sup>7</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>8</sup> See Securities Exchange Act Release No. 78774 (September 6, 2016), 81 FR 62775 (September 12, 2016).

below in Sections II through IV, the Commission is granting approval of the proposed rule change, as modified by Amendment No.1.

## II. Description of the Proposed Rule Change

### A. Background

#### 1. DTC

DTC plays a critical function in the national clearance and settlement system. It is the nation's central securities depository, registered as a clearing agency under Section 17A of the Act,<sup>9</sup> and its deposit and book-entry transfer services help facilitate the operation of the nation's securities markets. As a registered holder of trillions of dollars of securities, DTC processes enormous volumes of securities transactions facilitated by book-entry movement of interests, without transferring physical certificates. The Financial Stability Oversight Council, pursuant to Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>10</sup> designated DTC as a Systemically Important Financial Market Utility.<sup>11</sup>

DTC's participants ("Participants") are primarily broker-dealers and banks, but as the nation's central securities depository, its role and actions also affect issuers and

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<sup>9</sup> See Securities Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (October 3, 1983) (600-1).

<sup>10</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>11</sup> See Financial Stability Oversight Council, 2012 Annual Report, Appendix A, available at <https://www.treasury.gov/initiatives/fsoc/Documents/2012%20Appendix%20A%20Designation%20of%20Systemically%20Important%20Market%20Utilities.pdf>.

investors.<sup>12</sup> Participants agree to be bound by the Rules, By-Laws, and Organization Certificate of DTC, and other rules and procedures (collectively, “Rules”).<sup>13</sup> DTC performs various services for Participants, including maintaining accounts that list Participants’ securities holdings and allowing Participants to present securities to be made eligible for DTC’s depository and book-entry services. If a security is accepted by DTC as meeting DTC’s eligibility requirements for services<sup>14</sup> and is deposited with DTC for credit to the securities account of a Participant, it becomes an “Eligible Security.” Thereafter, Participants may deposit shares of that Eligible Security (“Deposited Securities”) into their respective DTC accounts.

To facilitate book-entry transfers and other services that DTC provides for its Participants, Deposited Securities are generally registered on the books of the issuer of the Eligible Security (typically, in a register maintained by a transfer agent) in DTC’s nominee name, Cede & Co. DTC maintains Deposited Securities that are eligible for book-entry services in “fungible bulk,” meaning that each Participant whose securities of an issue have been credited to its securities account has a pro rata (proportionate) interest

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<sup>12</sup> See In re International Power Group, Ltd. (“IPWG”), Securities Exchange Act Release No. 66611 (March 15, 2012), 2012 SEC LEXIS 844 at \*24 (March 15, 2012) (Admin. Proc. File No. 3-13687).

<sup>13</sup> Available at <http://www.dtcc.com/legal/rules-and-procedures.aspx>.

<sup>14</sup> See Rule 5, supra note 13; DTC Operational Arrangements (Necessary for Securities to Become and Remain Eligible for DTC Services), January 2012 (the “Operational Arrangements”), Section 1, available at <http://www.dtcc.com/~media/Files/Downloads/legal/issue-eligibility/eligibility/operational-arrangements.pdf>.

in DTC's entire inventory of that issue, but none of the securities on deposit are identifiable to or "owned" by any particular Participant.<sup>15</sup>

2. Overview of DTC's Prior Practice With Respect to Service Restrictions

As detailed in a proposed rule change previously filed by DTC on December 5, 2013,<sup>16</sup> DTC currently imposes two types of service restrictions: (i) a "Deposit Chill" whereby DTC refuses to accept further deposits of an Eligible Security but continues to provide book-entry services for existing shares of that Eligible Security already on deposit with DTC; or (ii) a more stringent "Global Lock" whereby DTC not only refuses to accept further deposits of an Eligible Security, but also ceases to provide all book-entry services for existing shares of that Eligible Security already on deposit with DTC.<sup>17</sup>

Prior to filing the current proposed rule change, DTC's practice was to impose a Deposit Chill upon detecting suspiciously large deposits of a thinly-traded Eligible Security.<sup>18</sup> According to DTC, such large deposits often were a red flag that could indicate a "pump and dump" scheme or other illegal distribution related to that security,

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<sup>15</sup> See Securities Exchange Act Release No. 19678 (April 15, 1983), 48 FR 17603, 17605, n.5 (April 25, 1983) (describing fungible bulk); see also N.Y. UNIFORM COMMERCIAL CODE, § 8-503, OFF. CMT 1 ("... all entitlement holders have a pro rata interest in whatever positions in that financial asset the [financial] intermediary holds").

<sup>16</sup> See Securities Exchange Act Release No. 71132 (December 18, 2013); 78 FR 77755 (December 24, 2013) (SR-DTC-2013-11). The filing was in response to the Commission's opinion and order in IPWG, which directed DTC to "adopt procedures that accord with the fairness requirements of Section 17A(b)(3)(H)" of the Act.<sup>16</sup>

<sup>17</sup> See Notice, 81 FR at 37232; see also SEC Investor Bulletin: DTC Chills and Freezes, <https://www.sec.gov/investor/alerts/dtcfreezes.pdf>

<sup>18</sup> See Notice, 81 FR at 37233.

and a Deposit Chill was necessary to maintain the status quo and avoid allowing DTC's services to be used in furtherance of improper activity.<sup>19</sup> An issuer could obtain the release of a Deposit Chill by providing to DTC a satisfactory legal opinion from independent counsel establishing that the Eligible Security fulfilled DTC's requirements for eligibility.<sup>20</sup> If an issuer were non-responsive to DTC's requests for information or otherwise refused or was unable to provide the required legal opinion, a Deposit Chill could remain in effect for years.<sup>21</sup>

Similarly, DTC's former practice was to impose a Global Lock if it became aware of a judicial or administrative proceeding alleging a violation of Section 5 of the Securities Act of 1933 ("Securities Act") with respect to an Eligible Security on deposit with DTC.<sup>22</sup> According to DTC, such allegations in a formal legal proceeding provided a concrete indication that Eligible Securities could have been involved in an illegal distribution, making a Global Lock necessary to maintain the status quo and avoid allowing DTC's services to be used in furtherance of improper activity. Because of the gravity of the allegations and the risk to DTC and its Participants of potentially allowing DTC's services to be used in furtherance of improper activity, a Global Lock would be released only when (i) the underlying action was withdrawn, (ii) dismissed on the merits with prejudice, or (iii) otherwise resolved in a final, non-appealable judgment in favor of

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<sup>19</sup> See DTC Service Restrictions on Certain Book-Entry Securities – Procedures for Affected Issuers (September 2013), <http://www.stai.org/pdfs/dtc-whitepaperresericesrestrictionsandissuerfairprocess.pdf>.

<sup>20</sup> See Operational Arrangements, Section I.A, supra note 14.

<sup>21</sup> Notice, 81 FR at 37233.

<sup>22</sup> Id.

the defendants allegedly responsible for the violations of federal securities laws. Because many actions are only resolved after several years,<sup>23</sup> a Global Lock also could be maintained for years.

B. Proposed Rule Change

DTC withdrew its prior proposed rule change regarding Deposit Chill and Global Lock procedures, as described above, on August 18, 2014.<sup>24</sup> Since that time, according to DTC, its prior practice of imposing Deposit Chills and Global Locks is no longer effective at preventing the harms those restrictions were originally intended to prevent, including, maintaining the status quo and preventing DTC's book-entry services from being used in furtherance of improper activity.<sup>25</sup> In May 2016, DTC filed the current proposed rule change. Based in part on DTC's determination that the prior process for imposing Deposit Chills and Global Locks (together, "Restrictions") is no longer effective at preventing or affecting the violative behavior the Restrictions were originally designed to combat, DTC now proposes to make significant changes to its processes and procedures for imposing Restrictions. As discussed more fully below, DTC now proposes, with certain limited exceptions as provided in Section 1(d) of the proposed rule change, to limit the circumstances in which it would impose a Restriction to the occurrence of a Financial Industry Regulatory Authority, Inc. ("FINRA") halt,

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<sup>23</sup> See, e.g., SEC v. Kahlon, 12-CV-517 (E.D. Tex., filed August 14, 2012); SEC v. Bronson, 12-cv-06421-KMK (S.D.N.Y., filed August 22, 2012). As of the date of this filing, neither case has been resolved.

<sup>24</sup> See Securities Exchange Act Release No. 72860 (August 18, 2014), 79 FR 49825 (August 22, 2014) (SR-DTC-2013-11).

<sup>25</sup> Notice, 81 FR at 37233.

Commission suspension, or if DTC is ordered to impose the Restriction by a court of competent jurisdiction.<sup>26</sup> According to DTC, limiting Restrictions primarily to these three occurrences would be more effective in preventing DTC's services from being used in furtherance of improper activities.

Accordingly, as modified by Amendment 1, DTC's proposal would add Rule 33 to DTC's Rules to establish the limited circumstances under which DTC would impose a Restriction, as well as the fair procedures for the issuer to receive notice and an opportunity to challenge the Restriction and the standards DTC would apply to determine when to release a Restriction. Section 1 of the proposed rule would establish the four specific circumstances in which DTC may impose either a Deposit Chill or a Global Lock. Section 2 would require DTC to send written notice of the Restriction to the issuer of the Eligible Security detailing the basis for the Restriction and the specific procedures for the issuer to follow to challenge the Restriction. If an issuer chooses to challenge a Restriction under Section 2, Section 3 of the proposed rule establishes DTC's obligations with respect to providing a written decision from an independent Review Officer in response to that challenge. Section 4 identifies the specific bases upon which DTC would release a Restriction, even in the absence of a challenge by an issuer. Finally, Section 5 would clarify and limit the scope and applicability of the proposed rule. Each section of the proposed rule change is discussed in more detail below.

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<sup>26</sup> Id.

1. Section 1: The Specific Conditions Under Which DTC Could Impose a Restriction

Section 1 of the proposed rule establishes the conditions and the type of Restriction that DTC would impose under various circumstances. Under Section 1(a), DTC would impose a Global Lock if an Eligible Security is the subject of a trading halt imposed by the FINRA. Under Section 1(b), DTC would impose a Global Lock if an Eligible Security is the subject of a trading suspension imposed by the Commission. The proposed rule provides, however, that DTC would be permitted to decline to impose a Global Lock under Sections 1(a) and (b) of the proposed rule change if DTC reasonably determines that the Global Lock would not further the regulatory purpose of the trading halt or suspension.<sup>27</sup> For example, DTC could decline to impose a Global Lock if the reason for a FINRA halt is to pause the market to give market participants time to assess news of a pending event that may affect the security's price,<sup>28</sup> or the sole reason for a Commission suspension is the lack of current and accurate information about the company because it failed to file certain periodic reports with the Commission.<sup>29</sup>

Under Section 1(c) of the proposed rule change, DTC would impose a Restriction if ordered to do so by a court of competent jurisdiction. DTC would impose the particular Restriction imposed by court, or if no Restriction is specified, DTC would impose a Global Lock. According to DTC, Restrictions would be necessary in the

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<sup>27</sup> Id. at 37233–34.

<sup>28</sup> The Commission notes that imposing a halt on this basis is, in most instances, outside the scope of FINRA's trading halt authority for unlisted securities. See FINRA Rule 6440.

<sup>29</sup> DTC Letter III at 3.

circumstances described in Sections 1(a)-(c) to prevent settlement of trades that continue despite the halt or suspension, and prevent the liquidation of a halted or suspended position through DTC,<sup>30</sup> and because DTC's facilities should not be available to settle transactions otherwise prohibited by the Commission, FINRA, or a court of competent jurisdiction.<sup>31</sup>

Lastly, under Section 1(d) of the proposed rule change, DTC would be permitted to impose a Restriction, either Deposit Chill or Global Lock, if it identifies or otherwise becomes aware of a need for immediate action to avert an imminent harm, injury, or other such material adverse consequence to DTC or its Participants that could arise from further deposits of, or continued book-entry services with respect to, an Eligible Security. This provision would provide DTC with flexibility to address unforeseen risks to DTC and its Participants, which would not be addressed by the more narrow conditions enumerated in Sections 1(a)-(c). DTC asserts that Section 1(d) would be invoked rarely, and only if such a Restriction would be necessary to avoid a significant material harm to DTC or one or more of its Participants.<sup>32</sup>

2. Section 2: Timing and Procedural Requirements for Written Notice of Restrictions and Opportunity to Object to Restrictions

Section 2 of the proposed rule would establish the timing and procedural requirements for DTC to provide an issuer with notice of a Restriction and for the issuer to object to that Restriction. First, DTC would be required to send a written "Restriction

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<sup>30</sup> Id.

<sup>31</sup> Id.

<sup>32</sup> Id.; see also Notice, 81 FR at 37234.

Notice” to the issuer of the Eligible Security within three business days of the imposition of the Restriction.<sup>33</sup> Section 2(a) would require DTC to include the following information in the Restriction Notice: (i) a statement of the basis for the Restriction under Section 1, which would be required to be set forth with reasonable specificity; (ii) the date the Restriction was imposed; and (iii) that within 20 days of receiving the Restriction Notice, the issuer may submit a written “Restriction Response” setting forth its objection to the Restriction and the basis for that objection under Section 4 of the proposed rule (discussed below). If an issuer submits a Restriction Response, Section 2(b) would permit DTC to request reasonable additional information or documentation from the issuer. Section 2(c) specifies that an issuer who fails to comply with a deadline required under Section 2 would waive its right to make the submission required by the deadline.

3. Section 3: Timing and Procedural Requirements for DTC’s Review of and Written Response to an Issuer’s Objection to a Restriction

Section 3 of the proposed rule change establishes the process for DTC to issue a Restriction Decision when, under Section 2, it receives a Restriction Response.

Specifically, Section 3 provides that DTC shall provide the issuer with a written

“Restriction Decision” within 10 business days of receipt of the Restriction Response.<sup>34</sup>

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<sup>33</sup> The Restriction Notice would be send by overnight courier to (i) the issuer’s last known business address, and (ii) the last known business address of the issuer’s transfer agent, if any, on record with DTC.

<sup>34</sup> The deadline may be extended for a reasonable period if DTC has requested additional information or documentation from the issuer pursuant to Section 2(b) of the proposed rule change, or by consent of the issuer, the issuer’s transfer agent, if any, or the issuer’s authorized representatives, if any.

Under Section 3(a), the Restriction Decision would be required to be made by a “Review Officer” who did not have responsibility for the imposition of the Restriction, or his delegate. The Review Officer would be required to be an officer of DTC as defined in DTC’s By-Laws.<sup>35</sup> In conducting his or her review, the Review Officer would be required to look to the standards of review set forth in Section 4 of the proposed rule (discussed below) to determine whether reasonable adequate cause to release the Restriction exists.

After receiving the Restriction Decision, an issuer would have 10 business days to submit a supplemental written response (“Supplement”). However, a Supplement could only be submitted for the purpose of establishing that DTC made a clerical mistake or mistake arising from an oversight or omission in reviewing the Restriction Response. If the issuer submits a Supplement, the Review Officer would provide a Supplement Decision within 10 business days after the Supplement was delivered. Section 3(d) of the proposed rule specifies that, taken together, the Restriction Notice, the Restriction Response, the Restriction Decision, the Supplement, the Supplement Decision, and any other documents submitted in connection with the proposed procedures would constitute the record for purposes of any appeal to the Commission.

4. Section 4: Standards For Determining Whether Adequate Cause Exists for Release of a Restriction

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<sup>35</sup> An officer is defined under the DTC By-Laws to be the Executive Chairman of the Board, Chief Executive Officer, Chief Operating Officer, or a Managing Director or other senior officers or employees of DTC elected or appointed by the DTC Board pursuant to the DTC By-Laws. See supra, note 13.

Section 4 of the proposed rule establishes the specific grounds upon which DTC would be required to release a Restriction imposed pursuant to Section 1 of the proposed rule, even in the absence of a Restriction Response from an issuer, by establishing when adequate cause for the release of the Restriction would be deemed to exist. For Global Locks imposed pursuant to Sections 1(a) or (b) of the proposed rule change (i.e., when FINRA issues a trading halt or the Commission issues a trading suspension), adequate cause to release the Global Lock would exist when the halt or suspension was lifted. According to DTC, because trading would no longer be prohibited by FINRA or the Commission, there should not be any settlement restrictions at DTC, other than operational restrictions imposed in the ordinary course of business as otherwise provided for in DTC's Rules. Similarly, under Section 4(c) of the proposed rule change, for a Restriction imposed pursuant to Section 1(c) of the proposed rule change (i.e., an order from a court of competent jurisdiction), adequate cause would exist to release the Restriction when a court of competent jurisdiction orders DTC to release the Restriction. DTC explains that if the court no longer required the Restriction, there would be no reason for DTC to continue to impose it.

As noted above, Section 1(d) of the proposed rule change is intended to provide DTC with necessary flexibility to address unforeseen risks to it and its Participants, and thus DTC notes it is impossible to outline with specificity all of the scenarios that could give rise to a release of a Restriction under Section 1(d). However, to provide a workable standard for evaluating when the release of a Restriction imposed under Section 1(d), DTC provides that "adequate cause" for the release of the Restriction would exist when DTC reasonably determines that the release of the Restriction would not pose a threat of

imminent adverse consequences to DTC or its Participants – typically meaning that the conditions underlying original basis for the Restriction have abated. For example, a Section 1(d) Restriction would be released when DTC determines that the perceived harm has passed or is significantly remote, or when the basis for the Restriction no longer exists.<sup>36</sup> DTC also notes that, for Global Locks in effect today that were originally imposed based on a judicial or administrative proceeding under the prior procedures described above in Section II.A.2, Section 4(d) of the proposed rule change would require DTC to release the Global Lock, provided there currently is no indication that illegally distributed securities are about to be deposited.<sup>37</sup>

Lastly, Section 4(e) of the proposed rule change would require DTC to release a Restriction if DTC reasonably determined that its imposition of the Restriction was based on a clerical mistake.

5. Section 5: Clarification and Limitation of Scope and Applicability of Proposed Rule 33.

Section 5 of the proposed rule change clarifies the scope and applicability of the proposed rule change. Section 5(a) specifies that the proposed rules would not affect DTC's ability to lift or modify a Restriction, thus preserving DTC's flexibility to release or modify a Restriction based on the needs of DTC and its Participants. Section 5(b) clarifies that the proposed rules do not affect DTC's ability to operationally restrict book-entry services, Deposits, or other services in the ordinary course of business pursuant to other provisions of the DTC Rules, as such restrictions would not constitute Restrictions

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<sup>36</sup> Notice, 81 FR at 37234.

<sup>37</sup> Id.

under the proposed rule change. Sections 5(c) and (d) would permit DTC to communicate with the issuer or its transfer agent or representative, if any, provided that substantive communications are memorialized in writing to be included in the record for purposes of any appeal to the Commission, and to send out a Restriction Notice prior to the imposition of a Restriction (thus giving the issuer or its transfer agent advance notice of the Restriction), respectively.

### III. Summary of Comments Received

The Commission received 10 comment letters in response to the proposed rule change.<sup>38</sup> One comment letter generally supports the proposed rule change.<sup>39</sup> Five comment letters by two commenters, STA and Kesner, object to the proposed rule change.<sup>40</sup> Three comment letters from DTC respond to the objections raised by STA and Kesner,<sup>41</sup> and one comment letter does not specifically comment on any aspect of the proposed rule change.<sup>42</sup>

#### A. Supporting Comment

One commenter generally endorses the proposed rule change, stating that the proposed procedures for fair notice and opportunity to challenge would prevent and mitigate harm to both issuers and innocent shareholders.<sup>43</sup>

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<sup>38</sup> See supra note 4.

<sup>39</sup> See Arnoff Letter.

<sup>40</sup> See STA Letters I, II, and III and Kesner Letters I and II.

<sup>41</sup> See DTC Letters I and II.

<sup>42</sup> See Deyet Letter.

<sup>43</sup> See Arnoff Letter.

B. Objecting Comments

STA and Kesner express general concerns with DTC, which STA and Kesner claim functions as a monopoly in the clearance and settlement of securities, exercising discretion to deny access to its services.<sup>44</sup> More specifically, STA and Kesner argue that the proposed rule change is inconsistent with Section 17A(b)(3)(F) of the Act because it is not designed to protect investors and the public interest, and that it is inconsistent with Section 17A(b)(3)(H) of the Act because the procedures for notice of and opportunity to challenge restrictions imposed by DTC are not fair.<sup>45</sup>

1. The Proposed Rule Change is Not Designed to Protect Investors and Public Interest as Required by Section 17A(b)(3)(F) of the Act

STA and Kesner argue that the proposed rule change is inconsistent with the Act for the following reasons: (i) the proposed basis for the imposition of Restrictions is vague and discretionary and inconsistent with the intent of Section 19 of the Exchange Act; (ii) the proposed basis for imposition of Restrictions would hurt issuers and shareholders; and (iii) Congress did not intend for DTC to be a fraud regulator. Each argument is discussed below.

(i) *Proposed Basis for Imposition of Restrictions Is Vague and Discretionary and Inconsistent with the Intent of Sections 17A and 19 of the Act and Rule 19b-4 Thereunder*

Commenters were generally supportive of the proposed basis for imposing Restrictions under Sections 1(a), (b), and (c) of the proposed rule change,<sup>46</sup> but some

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<sup>44</sup> STA Letter I at 1; Kesner Letter I at 1.

<sup>45</sup> See id.

<sup>46</sup> See, e.g., Kesner states that the basis for imposing Restrictions under Sections 1(a), (b), and (c) of the proposed rule change is consistent with the approach of

commenters raise objections to Section 1(d) of the proposed rule change. Specifically, STA asserts that the authority to impose Restrictions under Section 1(d) of the proposed rule change is overly broad, arbitrary, permits DTC to exercise unfettered discretion, and would allow DTC to take action without any real evidence of the likelihood of actual harm or violation of objective standards.<sup>47</sup> STA further claims that the authority to impose Restrictions under Section 1(d) is so vague that the Commission has no way of knowing whether DTC is attempting to regulate matters not related to (i) the purposes of Section 17A of the Act, (ii) the administration of the clearing agency, or (iii) consistent with the requirements of the Act, as required by Sections 17A(b)(3)(F) and 19(b)(2)(C) of the Act.<sup>48</sup> Likewise, STA states that the authority to impose Restrictions under Section 1(d) of the proposed rule change is inconsistent with the intent of Section 19 of the Act and Rule 19b-4 thereunder, which encourages transparency by requiring a clearing agency to seek approval of a stated policy, practice, or interpretation.<sup>49</sup> Therefore, STA argues that the proposal is contrary to the openness envisioned by Congress.<sup>50</sup>

Similar to STA, Kesner expresses concern that Section 1(d) of the proposed rule change would give authority to DTC to impose Restrictions merely upon the initiation of an investigation or enforcement proceeding where it concludes a threat is imminent

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DTC being directed by a regulator or court. Kesner Letter I at 6. Meanwhile, STA states that it applauds the certainty afforded by the Sections 1(a), (b), and (c) of the proposed rule change. See STA Letter I at 3.

<sup>47</sup> STA Letter I at 1-3; see also STA Letter II at 2.

<sup>48</sup> STA Letter III at 2.

<sup>49</sup> Id.

<sup>50</sup> Id.

requiring immediate action.<sup>51</sup> Kesner states that the Commission has not directed DTC to adopt rules to protect DTC or DTC’s financial institution owners and DTC has not articulated how exercising discretionary authority satisfies its obligation for a fair process.<sup>52</sup>

According to Kesner, DTC’s previous imposition of Restrictions, in many cases, were only based upon “flimsy legal footing, notice of commencement of an investigation or inquiry, anecdotal observations or even unproven news stories.”<sup>53</sup> Kesner states that the proposed rule change does not address the “unfortunate results that befall innocents caught up by a [Restriction], nor the immensity of the costs and burdens placed on issuers and investors seeking to clear a [Restriction].”<sup>54</sup> Kesner states that small issuers do not have the resources to defend themselves and even with the potential of an appeal Restrictions cause irreparable damage.<sup>55</sup> Rather, the imposition of Restrictions would best be left to exchanges and other “regulatory bodies” that have sufficient resources and could direct DTC to impose a service restriction when warranted.<sup>56</sup>

(ii) *Proposed Basis for Imposition of Restrictions Would Hurt Issuers and Shareholders*

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<sup>51</sup> Kesner Letter I at 6.

<sup>52</sup> Kesner Letter I at 2, 3; Kesner Letter II at 1.

<sup>53</sup> Kesner Letter I at 2.

<sup>54</sup> Id. at 2, 3; Kesner Letter II at 1.

<sup>55</sup> Kesner Letter I at 2.

<sup>56</sup> Id. at 6.

STA contends that the proposed rule change was not a “good faith attempt” by DTC to comply with the Commission’s order in IPWG and is inconsistent with Section 17A(b)(3)(F) of the Act<sup>57</sup> because imposition of Restrictions would hurt issuers and innocent investors.<sup>58</sup> Specifically, STA asserts that the authority to impose Restrictions under Section 1(d) of the proposed rule change should balance the effect of DTC’s actions on innocent shareholders because a Restriction could have a devastating effect on investors and could cause trading in the shares of an issuer to come to a virtual stop.<sup>59</sup> Therefore, innocent investors may find that their shares are virtually valueless during the period the Restriction is in place.<sup>60</sup>

*(iii) Congress Did Not Intend DTC to Be a Fraud Regulator*

STA states that the proposed rule change is inconsistent with Section 17A(b)(3)(F) of the Act<sup>61</sup> because Congress did not intend DTC to act as a fraud regulator or to enforce laws unrelated to clearance and settlement.<sup>62</sup> Specifically, STA asserts that the authority to impose Restrictions under Section 1(d) of the proposed rule change is inconsistent with Section 17A(b)(3)(F) of the Act,<sup>63</sup> which requires, among other things, that the rules of the clearing agency are not designed to regulate by virtue of

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<sup>57</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>58</sup> STA Letter I at 3. STA Letter III at 2.

<sup>59</sup> STA Letter III at 2.

<sup>60</sup> Id.

<sup>61</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>62</sup> STA Letter III at 2.

<sup>63</sup> 15 U.S.C. 78q-1(b)(3)(F).

any authority conferred by the Act matters not related to the purposes of Section 17A of the Act or the administration of the clearing agency.<sup>64</sup> STA states that the authority for fraud regulation is conferred under other sections of the Act on the Commission and different self-regulatory organizations with respect to their members.<sup>65</sup> Thus, STA contends that DTC does not have the authority to implement the proposed rule change.<sup>66</sup>

2. The Proposed Rule Change Does Not Provide Fair Procedure with Respect to Restrictions Imposed by DTC as Required by Section 17A(b)(3)(H) of the Act

Commenters object to the proposed rule change on the basis that they do not believe that it is consistent with either Section 17A(b)(3)(H) of the Act<sup>67</sup> or the Commission’s order in IPWG. First, Kesner argues that DTC cannot be “fair” and cannot satisfy the requirements set forth in IPWG if DTC sets its own standards and acts on its own accord to impose a Restriction not directed by a traditional regulator or court because DTC does not have the resources, technical expertise, or “commitment to fairness” to undertake such an expansive role in the substantive regulation of securities issuers or to become a “super-gatekeeper.”<sup>68</sup>

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<sup>64</sup> STA Letter III at 2.

<sup>65</sup> Id.

<sup>66</sup> Id.

<sup>67</sup> 15 U.S.C. 78q-1(b)(3)(H).

<sup>68</sup> Kesner Letter I at 2, 4-5; Kesner also stated that the Commission has not “direct[ed] DTC to adopt[] rules to protect DTC or DTC’s financial institution owners and DTC has not articulated how exercising discretionary authority satisfies its obligation for a fair process.” Kesner Letter II at 1; see also STA Letter II at 3; STA Letter III at 2.

Second, Kesner states that DTC's imposition of Restrictions under Section 1(d) of the proposed rule change, if approved, should include specific methods by which an issuer can successfully appeal and require DTC to remove the Restriction (or provide for automatic removal after a short period) that are fair and reasonable and that do not burden smaller issuers with excessive costs or delays during the denial of the DTC's essential services.<sup>69</sup> Kesner argues that to do otherwise would hurt innocent investors and shareholders.<sup>70</sup>

Third, STA contends that Section 3 of the proposed rule change as originally proposed (i.e., before DTC filed Amendment 1) was procedurally deficient because there were no time periods specified in the proposed rule change for the DTC Review Officer's review to be completed. Thus, in some cases issuers and investors could be harmed for an indefinite period while waiting for DTC to reach a decision.<sup>71</sup> Specifically, STA asserts that DTC should limit its Restriction, under Section 1(d) of the proposed rule change, to only a single 10-day period, with any "fair process" occurring during that 10-day Restriction.<sup>72</sup> DTC could resolve concerns based on a "misunderstanding" or inform the Commission or FINRA of its concerns, allowing either organization to take further action to protect DTC, its Participants, or investors from the imminent harm.<sup>73</sup> STA also asserts that notice of a Restriction should occur prior to or, at least, contemporaneously

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<sup>69</sup> Kesner Letter I at 6.

<sup>70</sup> Id.

<sup>71</sup> STA Letter I at 4.

<sup>72</sup> Id.

<sup>73</sup> Id. at 4.

with imposition of the Restriction, particularly in the case of a Restriction imposed based on DTC's assessment of imminent harm, under Section 1(d) of the proposed rule change, not three days after the Restriction is imposed.<sup>74</sup>

Fourth, STA expresses concern that the Review Officer tasked with reviewing a Restriction Response could be located in an office near the person that imposed the Restriction, could have been involved in imposing the Restriction, and could be charged with overturning the decision made by a colleague.<sup>75</sup> Similarly, Kesner questions the independence of the Review Officer and asserts that IWPG requires that appeals should be heard by parties independent of DTC and suggests that "representatives of the securities bar, [STA], transfer agents, clearing and settlement firms, auditors, and business people, under the guidance of the DTC General Counsel, should constitute the panel of hearing officers making recommendations for imposition and removal of [Restrictions], continuations and appeals whenever DTC acts."<sup>76</sup>

Finally, commenters raise other points that either did not pertain to the proposed rule change, or did not suggest how such issues would make the proposed rule change inconsistent with the Act.<sup>77</sup> As such, those points are beyond the scope of the proposed rule change and, therefore, are not further summarized or discussed in this order.

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<sup>74</sup> STA Letter I at 4.

<sup>75</sup> Id.

<sup>76</sup> Kesner Letter II at 2.

<sup>77</sup> Examples of points raised by the commenters about the proposed rule change that did not address whether the proposed rule change is or is not consistent with the Act include STA stating that the proposal should also apply to transfer agents seeking initial access to DTC's facilities (STA Letter I at 4), and Kesner stating that (i) the Commission should not act on the proposal without specific comments

C. DTC's Response

As discussed more fully below, DTC argues that the proposed rule change is consistent with the Act in that it is consistent with Section 17A(b)(3)(F) of the Act because it is designed to protect investors and the public interest, and it provides fair procedures as required by Section 17A(b)(3)(H) of the Act.

1. The Proposed Rule Change is Designed to Protect Investors and the Public Interest as Required by Section 17A(b)(3)(F) of the Act

(i) *Response to Comments that the Proposed Basis for Imposition of Restrictions Is Vague and Discretionary and Inconsistent with the Intent of Sections 17A and 19 of the Act and Rule 19b-4 Thereunder*

In response to STA's comment that the basis for imposition of Restrictions under the proposed rule change is vague, DTC asserts that Sections 1(a)-(c) of the proposed rule change provide specific, objective trigger events for imposing Restrictions and would be the primary focus of the Restriction program going forward.<sup>78</sup> Further, while DTC

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from major exchanges and OTCLink regarding coordination with DTC and the Commission concluding that DTC's actions under the proposal would not interfere with the objectives of exchanges and other regulators and not hamper the functioning of the markets; (ii) DTC would need to give up its immunity from lawsuits in order for there to be a potentially fair process in the imposition and appeal of Restrictions; (iii) investors should have standing to appeal a Restriction; and (iv) the Commission should require DTC to undertake a study and submit all of its statistics surrounding Restrictions. Kesner Letter I at 4, 6; Kesner Letter II at 3. Similarly, Arnoff asserted that the proposal should clarify that DTC should not be immune from civil liability, particularly if DTC cannot establish that it acted in good faith and with reasonable judgment, because DTC is not acting in a governmental capacity in the settlement and clearance process. Arnoff Letter. Moreover, Arnoff stated that because DTC is not infallible and the risk of error always exists, DTC should be required to purchase "errors and omissions insurance" to protect innocent issuers and investors and to add an "additional dimension of loss prevention." Arnoff Letter.

<sup>78</sup> DTC Letter I at 2.

acknowledges that it cannot anticipate each circumstance under which immediate action could be needed under Section 1(d) to prevent harm to DTC or its Participants,<sup>79</sup> it provides specific examples of such circumstances, including: (i) if DTC receives information from an authorized officer of the issuer that another company has usurped the identity of the company and issued unauthorized shares; (ii) if DTC has corroborated and plausible information that forged securities are being deposited at DTC; (iii) a foreign regulatory authority raises credible concerns about an Eligible Security; or (iv) there is a material recordkeeping issue that raises questions about the Eligibility of a specific security.<sup>80</sup> DTC also asserts that STA's position that the Commission should not approve the proposed rule change if it includes Section 1(d) would deny DTC the flexibility to impose Restrictions that could be necessary to avoid imminent harm to DTC or its Participants,<sup>81</sup> thereby subjecting DTC and its Participants to significant potential harm. DTC states that it needs such flexibility to protect itself and its Participants from an imminent harm that may not warrant or be covered by a trading halt or suspension.<sup>82</sup>

In response to Kesner's comment that Section 1(d) of the proposed rule change would give authority to DTC to impose Restrictions merely upon the initiation of an investigation or enforcement proceeding where DTC concludes a threat is imminent and requires immediate action, DTC asserts that the Commission recognized in In re Atlantis

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<sup>79</sup> DTC Letter I at 3; DTC Letter III at 3.

<sup>80</sup> DTC Letter III at 3.

<sup>81</sup> Id. at 2; DTC Letter III at 3.

<sup>82</sup> DTC Letter I at 3; DTC Letter III at 3.

Internet Group (“Atlantis”)<sup>83</sup> and IPWG that DTC has such authority and that it is critical to the self-regulatory function of DTC to retain discretion to avert imminent harm, including the discretion to take action before providing notice to the issuer, if necessary.<sup>84</sup> DTC states that Section 1(d) of the proposed rule change would be used only for urgent situations and exercised rarely, such as in the example scenarios listed above.<sup>85</sup>

(ii) *Response to Comments that the Proposed Basis for Imposition of Restrictions Would Hurt Issuers and Shareholders*

DTC states, generally, that the proposed rule change would assure the safeguarding of securities by providing a mechanism for DTC to act quickly and efficiently to screen out prior to deposit, or restrict after deposit, securities that pose an imminent harm to DTC or its Participants, or for which trading has been prohibited by a court or applicable regulator.<sup>86</sup> Specifically, DTC states that Sections 1(a) and (b) of the proposed rule change provide objective trigger events for imposing Restrictions when the Commission imposes a trading suspension or FINRA impose a trading halt.<sup>87</sup> DTC explains that, although trading activity takes place outside of DTC, DTC provides a settlement location for market traders or other transfers of interests in securities.<sup>88</sup> Thus,

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<sup>83</sup> Atlantis, Securities Exchange Act Release. No. 75168 at 7-8, 2015 SEC LEXIS 2394 (June 12, 2015) (Admin. Proc. File No. 3-15432).

<sup>84</sup> DTC Letter I at 3; DTC Letter II at 2.

<sup>85</sup> DTC Letter III at 3.

<sup>86</sup> See Notice, 81 FR 37235.

<sup>87</sup> DTC Letter III at 2.

<sup>88</sup> Id.

absent a DTC Restriction, other book-entry transfers might continue (e.g., pledges, repos, or securities lending), notwithstanding a Commission suspension or FINRA halt.<sup>89</sup> A Restriction would freeze these Participant activities, which DTC believes would further the regulatory purpose of the Commission suspension or FINRA halt.<sup>90</sup>

Further, DTC emphasizes that it would not impose a Restriction if DTC believes that the suspension or halt does not implicate concerns that DTC believes should lead to a Restriction.<sup>91</sup> For example, under Section 1 of the proposed rule change, DTC could decline to impose a Global Lock if (i) in the case of a FINRA halt, if the reason for the halt is to pause the market to give market participants time to assess news of a pending event that may affect the security's price; or (ii) in the case of a Commission suspension, if the sole reason for the suspension is the lack of current and accurate information about the company because it failed to file certain periodic reports with the Commission.<sup>92</sup>

With respect to Section 1(d) of the proposed rule change, DTC asserts that it believes that Section 1(d) is consistent with the Act because it would provide DTC with the flexibility it needs to protect its fungible bulk, which it holds on behalf of its Participants, from imminent harm that could arise from circumstances that would neither justify nor be affected by a trading halt or suspension,<sup>93</sup> while still providing sufficient notice of the types of circumstances that could trigger a Restriction under Section 1(d).

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<sup>89</sup> Id.

<sup>90</sup> Id.

<sup>91</sup> Id. at 2, 3.

<sup>92</sup> Id. at 3.

<sup>93</sup> DTC Letter I at 2; DTC Letter III at 3.

DTC also reiterates that it does not anticipate imposing Restrictions pursuant to Section 1(d) of the proposed rule change frequently,<sup>94</sup> and has provided specific examples of circumstances under which imminent harm could arise in the future, as described above.<sup>95</sup>

(iii) *Response to Comments that DTC Would Be Acting as a Fraud Regulator*

In response to comments that Congress did not intend DTC to act as a fraud regulator or to enforce laws unrelated to clearance and settlement, DTC asserts that Sections 1(a)-(c) of the proposed rule change would further the regulatory purpose behind a Commission, FINRA, or court action by stopping the flow of questionable securities in other book-entry transfers that may continue despite other regulatory action.<sup>96</sup>

With respect to Section 1(d), DTC states that there are situations that would require DTC to impose a Restriction that might not require a Commission suspension or FINRA halt.<sup>97</sup> For instance, DTC could impose a Restriction (i) if DTC receives information from an authorized officer of the issuer that another company has usurped the identity of the company and issued unauthorized shares; (ii) if DTC has corroborated and plausible information that forged securities are being deposited at DTC; (iii) a foreign regulatory authority raises credible concerns about an eligible security; or (iv) there is a material recordkeeping issue that raises questions about the eligibility of a specific security. The Commission also notes that, as discussed below, a Restriction

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<sup>94</sup> DTC Letter III at 3.

<sup>95</sup> Id.

<sup>96</sup> Id. at 2, 3.

<sup>97</sup> Id. at 3.

could be necessary to prevent DTC's services from being used to facilitate an unregistered distribution or other violation of the securities laws.

2. The Proposed Rule Change Does Provide Fair Procedure with Respect to Restrictions Imposed by DTC on Access to Its Book-Entry Services by Issuers and Shareholders as Required by Section 17A(b)(3)(H) of the Act

DTC states that the proposed rule change is consistent with Section 17A(b)(3)(H) of the Act<sup>98</sup> and IPWG. Specifically, in response to STA's and Kesner's comments that the proposed rule change does not provide for fair procedures nor satisfy the requirements of IPWG, DTC highlights that the Commission's decisions in both Atlantis and IPWG<sup>99</sup> recognize that DTC must retain discretion to avert imminent harm, including the discretion to take action before providing notice to the issuer, if necessary.<sup>100</sup>

In response to STA's specific claim that the proposal is procedurally deficient because it lacks a stated time period for the Review Officer to complete the review, DTC submitted Amendment No.1 to Section 3 of the proposed rule change, which, as described above, establishes a 10 business-day deadline, with limited extension, for the Review Officer to complete its review of the Restriction Response and for DTC to provide a Restriction Decision.<sup>101</sup>

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<sup>98</sup> 15 U.S.C. 78q-1(b)(3)(H).

<sup>99</sup> Atlantis, 2015 SEC LEXIS 2394 at \*7, 8.

<sup>100</sup> DTC Letter I at 3.

<sup>101</sup> Prior to filing Amendment No. 1, DTC also contended in its first response letter that a reasonable review by the Review Officer in a timely manner is implicit in the proposed process, recognizing that DTC is bound to perform a prompt review, and to do otherwise may conflict with its obligations under Section 17A of the Act. DTC Letter I at 4; 15 U.S.C. 78q-1.

Similarly, in response to both STA's and Kesner's comments that Restrictions imposed under Section 1(d) of the proposed rule change should be automatically removed after a short period or expire after 10 days, DTC states that it would not be effective, reasonable, or practical for DTC to premise its proposed rule change on the assumption that the Commission or FINRA would or could take action quickly enough to protect DTC, its Participants, or investors.<sup>102</sup> DTC explains further that imminent harm to DTC or its Participants could arise from circumstances that may not be addressed by or may not justify a trading halt or suspension, such as the impending deposit of illegally distributed securities at DTC.<sup>103</sup> DTC also reiterates that it does not anticipate imposing Restrictions pursuant to Section 1(d) of the proposed rule change frequently.<sup>104</sup>

In response to STA's and Kesner's comments on the independence of the Review Officer, and STA's comment that notice of a Restriction should be at least contemporaneously with the imposition of the Restriction, DTC states that it believes the proposed rule change is sufficiently clear to require that the Review Officer not be conflicted and that the Review Officer's decision would be unbiased and independent,<sup>105</sup> and that both Atlantis and IPWG recognize that DTC must retain discretion to take action before providing notice to the issuer, if necessary.<sup>106</sup>

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<sup>102</sup> DTC Letter I at 3; see also DTC Letter II at 2.

<sup>103</sup> Id.

<sup>104</sup> Id.

<sup>105</sup> DTC Letter I at 4.

<sup>106</sup> Id. at 3.

#### IV. Discussion and Commission Findings

Section 19(b)(2)(C) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization.<sup>107</sup> After carefully considering the proposed rule change, the comments received, and DTC's responses thereto, the Commission finds that the proposed rule change, as modified by Amendment No. 1, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to DTC. In particular, the Commission finds that the proposed rule change is consistent with Sections 17A(b)(3)(F) and 17A(b)(3)(H) of the Act, as discussed in detail below.

##### A. Consistency with Section 17A(b)(3)(F) of the Act

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of the clearing agency are designed to assure the safeguarding of securities in the custody or control of the clearing agency and, in general, protect investors and the public interest.<sup>108</sup>

Sections 1(a) and (b) of the proposed rule change, respectively, would authorize DTC to impose a Global Lock where FINRA has issued an order for the halt of trading of an Eligible Security or the Commission has issued an order for the suspension of trading of an Eligible Security. Section 1(c) of the proposed rule change would authorize DTC to impose a Restriction when ordered to do so by a court of competent jurisdiction. In such a situation, DTC would impose the Restriction specified by the court, or a Global Lock if no Restriction was specified. As noted above, commenters are generally supportive of

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<sup>107</sup> 15 U.S.C. 78s(b)(2)(C).

<sup>108</sup> 15 U.S.C. 78q-1(b)(3)(F).

the proposed basis for imposing Restrictions under Sections 1(a), (b), and (c) of the proposed rule change.<sup>109</sup> A halt, suspension, or court order would raise questions as to whether the security at issue would continue to meet the eligibility criteria set forth in DTC's Rules. The Commission therefore agrees that DTC should have the authority under its Rules to place a Restriction on such securities if doing so will help prevent potentially ineligible securities from tainting DTC's fungible bulk, thereby protecting DTC and DTC's Participants from facilitating wrongful activities, and investors from having Eligible Securities tainted by securities of the same issue that do not meet DTC's eligibility criteria. The Commission also agrees that providing DTC with authority to impose a Restriction on securities that are the subject of a FINRA halt or Commission suspension would help protect investors and possibly stop further wrongdoing, because the Restriction would stop deliveries, redemptions, pledges, lending, deposits, and other types of transfers and settlements made via DTC's book-entry services that may not be addressed by the trading halt or suspension.

The proposed rule change would provide DTC the discretion to *not* impose a Global Lock, even if FINRA or the Commission issued a halt or suspension of trading of an Eligible Security, if such a Restriction would not further the regulatory purpose of the halt or suspension. For example, if a halt or suspension was imposed for a reason unrelated to the eligibility of the security for DTC's book-entry services,<sup>110</sup> DTC would

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<sup>109</sup> See supra Section III.B.1.i at note 46.

<sup>110</sup> For example, DTC states that it would not impose a Restriction where an alleged improper issuance of shares were deposited at DTC several years earlier, or the chief executive officer of a company was convicted of a corporate crime that had no apparent effect on the eligibility of the company's securities at DTC. DTC Letter III at 4.

not be required to impose a Restriction. This provision protects issuers and investors from the burdens of unnecessary Restrictions by providing DTC with flexibility to avoid imposing a Global Lock if doing so would not be in the interest of protecting DTC, DTC's Participants, issuers, or investors.

Section 1(d) of the proposed rule change would authorize DTC to impose a Restriction upon identifying or becoming aware of a need to take such action to avoid imminent harm, injury, or other such material adverse consequence to DTC or its Participants that could arise from further deposits of, or continued book-entry services to, a particular Eligible Security. As described above, commenters generally raise three objections to Section 1(d): (i) Section 1(d) is impermissibly vague, thereby granting DTC unfettered discretion to impose Restrictions under it; (ii) issuers and investors would be harmed by Restrictions imposed under this provision, including because it would stop all book-entry services for that security, possibly affecting the value of the security;<sup>111</sup> and (iii) by exercising its discretion under Section 1(d), DTC would be improperly acting as a fraud regulator. With respect to the first objection, one commenter also states that the need to impose a Restriction under Section 1(d) of the proposed rule change should be balanced with the interests of shareholders of the security.<sup>112</sup>

The Commission does not find that Section 1(d) of the proposed rule change is impermissibly vague, or that it would grant DTC unfettered discretion to impose Restrictions without a proper basis or adequate protections for issuers. First, Section 1(d) is not impermissibly vague because it establishes specific criteria for imposing a

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<sup>111</sup> STA Letter III at 2.

<sup>112</sup> Id.

Restriction and would require DTC to meet a high standard before it would be permitted to do so under that provision. Specifically, DTC would be required to identify (i) a need for *immediate* action (ii) to avert an *imminent*, (iii) harm, injury, or other such *material* adverse consequence, (iv) to DTC or its Participants, (v) that could arise from further deposits of, or continued book-entry services to, an Eligible Security. As such, DTC's discretion to impose restrictions under Section 1(d) would be constrained. Indeed, in light of the standards set forth in Section 1(d), DTC acknowledges that Restrictions under this section would only be imposed in rare and exigent circumstances,<sup>113</sup> where imminent harm is present.<sup>114</sup> DTC's discretion would also be limited by Section 19(g) of the Act, which requires DTC, as a registered clearing agency and self-regulatory organization, to administer all of its rules in a manner consistent with its obligations of compliance with the federal securities laws and other applicable laws.<sup>115</sup>

Regarding DTC's discretion under proposed Section 1(d), the Commission agrees that it would be impossible for DTC to predict and codify every possible circumstance that could taint DTC's fungible bulk, and thus harm DTC, its Participants, issuers, and investors. Without Section 1(d) of the proposed rule change, DTC would not have the authority or discretion to impose a Restriction when a significant concern arises that would not fall under Sections 1(a)-(c) because it is not related to a halt, suspension, or

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<sup>113</sup> See DTC Letter I at 2.

<sup>114</sup> See Notice, 81 FR at 37234.

<sup>115</sup> 15 U.S.C. 78s(g).

court order.<sup>116</sup> The Commission finds that such discretion is necessary to allow DTC to protect not only itself and its Participants, but also investors and issuers who, but for a Restriction imposed by DTC, could be unwilling participants in fraudulent activity, or victims of improper conduct.<sup>117</sup> For example, in the event that DTC becomes aware that all or some portion of the fungible bulk of an Eligible Security may have been sold or distributed in violation of Section 5 of the Securities Act, it could be necessary for DTC to limit further deposits and/or book-entry services for that security to prevent DTC and its Participants from participating in or otherwise facilitating an ongoing Section 5 violation. Without the authority and discretion granted by proposed Section 1(d), DTC might not have the authority under its Rules to take such action. Likewise, the discretion provided by proposed Section 1(d) would enable DTC to protect current shareholders from potential fraudulent deposits of securities that could compromise the value of their securities of the same issue.

The Commission also does not find that the potential harm that could be caused to issuers and investors by Restrictions imposed under Section 1(d) outweighs the benefits to DTC, DTC's Participants, issuers, and investors gained by permitting DTC to impose Restrictions in the limited circumstances, and subject to the processes and procedures, that would be established by the proposed rule change. Any such potential harm would

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<sup>116</sup> For example, DTC could have a concern about a foreign issuance, but FINRA or the Commission may not share that same concern and may not impose a trading halt or suspension; yet, DTC may believe it necessary to impose a Restriction to protect DTC and its Participants. See DTC Letter III at 3.

<sup>117</sup> For example, as DTC suggests, if DTC became aware of a current corporate hijacking, it would be able to impose a Restriction immediately, under Section 1(d) of the proposed rule. See DTC Letter III at 3.

be mitigated not only by the issuer's ability under the proposed rule change to challenge a Restriction with DTC, but also by the issuer's ability to then appeal DTC's Restriction Decision to the Commission. Further, DTC, DTC's Participants, issuers, and investors could all be harmed if DTC did not have the authority to impose a Restriction in the circumstances described in Sections 1(a)-(d). Rather, the Commission finds that Section 1(d) of the proposed rule change is necessary to provide DTC with adequate flexibility and authority to prevent and avoid imminent harm to DTC and its Participants, as well as issuers and investors, that could arise as a result of unforeseen and unpredictable events outside DTC's ability to predict or control. In addition, the Commission believes that DTC's flexibility to impose a Restriction under Section 1(d) is appropriately balanced with the interests of issuers and shareholders of the security by Section 4(d) of the proposed rule change, which would require DTC to release the Restriction when it reasonably determines that the original basis for the Restriction has abated, and release of the Restriction would no longer pose a threat of imminent harm, injury, or other such material adverse consequent to DTC or its Participants.<sup>118</sup>

Finally, with respect to commenters' third objection, that Section 1(d) of the proposed rule change is inconsistent with Section 17A(b)(3)(F) of the Act because Congress did not intend DTC to act as a fraud regulator or to enforce laws unrelated to clearance and settlement,<sup>119</sup> the Commission finds that the proposed rule change is directly related to DTC's administration of its book-entry clearing and settlement services, which are directly related to the purposes of Section 17A of the Act, including

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<sup>118</sup> See Notice, 81 FR 37234.

<sup>119</sup> STA Letter III at 3.

the establishment of the national system for clearance and settlement of securities transactions.<sup>120</sup> As the Commission noted in both Atlantis and IPWG, one of the reasons DTC's book-entry clearing and settlement services are fundamentally important services is because any suspension by DTC of its clearance and settlement services with respect to an issuer's securities means that all trades in that issuer's stock would then require physical transfer of the stock certificates.<sup>121</sup> As the central depository of securities in the United States, DTC has an obligation to ensure that by allowing book-entry services on deposited shares, it is not facilitating the illegal distribution of unregistered shares or helping to perpetrate a fraud, in violation of Section 5 of the Securities Act. Such actions are necessary to help assure the safeguarding of securities in the custody or control of DTC, and, in general, protect investors and the public interest. Further, DTC is a registered clearing agency and self-regulatory organization under Section 19 of the Act. As such, the Commission previously concluded in Atlantis and IPWG that DTC has the authority to impose restrictions on its book-entry services.<sup>122</sup>

Based on the above, the Commission finds that the proposed rule change, is designed to help assure the safeguarding of securities in the custody or control of DTC, and, in general, protect investors and the public interest, as required by Section 17A(b)(3)(F) of the Act.

B. Consistency with Section 17A(b)(3)(H) of the Act

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<sup>120</sup> 15 U.S.C. 78q-1.

<sup>121</sup> Atlantis, 2015 SEC LEXIS 2394 at \*7–8 n.4; IPWG, 2012 SEC LEXIS 844 at \*24.

<sup>122</sup> Atlantis, 2015 SEC LEXIS 2394 at \*7–8 n.4; IPWG, 2012 SEC LEXIS 844 at \*24.

Section 17A(b)(3)(H) of the Act requires, among other things, that the rules of a clearing agency are in accordance with the provisions of Section 17A(b)(5)(B) of the Act, and, in general, provide a fair procedure with respect to the prohibition or limitation by the clearing agency of any person with respect to access to services offered by the clearing agency.<sup>123</sup> Section 17A(b)(5)(B) of the Act<sup>124</sup> requires that, in any proceeding by a registered clearing agency to determine whether a person shall be denied participation or prohibited or limited with respect to access to services offered by the clearing agency, the clearing agency shall notify such person of, and give that person an opportunity to be heard, the specific grounds for denial or prohibition or limitation under consideration and keep a record.<sup>125</sup> A determination by the clearing agency to deny participation or prohibit or limit a person with respect to access to services offered by the clearing agency shall be supported by a statement setting forth the specific grounds on which the denial or prohibition or limitation is based.<sup>126</sup>

In Atlantis and IPWG, the Commission concluded that issuers are “persons” under Section 17A(b)(3)(H) of the Act, and, thus, are entitled to Commission review of DTC’s actions that deny or limit issuers access to DTC services.<sup>127</sup> The Commission

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<sup>123</sup> 15 U.S.C. 78q-1(b)(3)(H).

<sup>124</sup> 15 U.S.C. 78q-1(b)(5)(B).

<sup>125</sup> Id.

<sup>126</sup> Id.

<sup>127</sup> Atlantis, 2015 SEC LEXIS 2394 at \*7, 8 n.4; IPWG, 2012 SEC LEXIS 844 at \*24.

further found that, to comply with Section 17A(b)(3)(H) of the Act,<sup>128</sup> DTC must provide the issuer with notice of DTC's determination to impose a Restriction, specifying the basis for DTC's action, and that DTC must also provide an issuer with an opportunity to be heard,<sup>129</sup> but that a formal hearing is not required.<sup>130</sup> The Commission stated that DTC may design fair procedures in accordance with its own internal needs and circumstances.<sup>131</sup>

The Commission also held in Atlantis and IPWG that if DTC believes that circumstances exist that justify imposing a suspension of services with respect to an issuer's securities, in advance of being able to provide the issuer with notice and an opportunity to be heard on the suspension, it may do so,<sup>132</sup> provided that, in such circumstances, the process to impose such a suspension should balance the identifiable need for emergency action with the issuer's right to fair procedures under Section 17A(b)(3)(H) of the Act.<sup>133</sup> Under such procedures, DTC would be authorized to act to

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<sup>128</sup> 15 U.S.C. 78q-1(b)(3)(H).

<sup>129</sup> Atlantis, 2015 SEC LEXIS 2394 at \*7, 8 n.4; IPWG, 2012 SEC LEXIS 844 at \*24.

<sup>130</sup> Atlantis, 2015 SEC LEXIS 2394 at \*19; IPWG, 2012 SEC LEXIS 844 at \*30 n.36.

<sup>131</sup> Atlantis, 2015 SEC LEXIS 2394 at \*19; IPWG, 2012 SEC LEXIS 844 at \*24.

<sup>132</sup> Atlantis, 2015 SEC LEXIS 2394 at \*18 n.9; IPWG, 2012 SEC LEXIS 844 at \*29.

<sup>133</sup> 15 U.S.C. 78q-1(b)(3)(H); Atlantis, 2015 SEC LEXIS 2394 at \*18 n.9; IPWG, 2012 SEC LEXIS 844 at \*29.

avert an imminent harm, but it could not maintain such a suspension indefinitely without providing expedited fair process to the affected issuer.<sup>134</sup>

The Commission finds that the proposed rule change appropriately addresses the Commission's findings in IPWG and Atlantis by, among other things, limiting Restrictions primarily to circumstances in which there would be objective external criteria for the Restriction of which the issuer would clearly be on notice (i.e., a FINRA halt, Commission suspension, or Court order under Sections 1(a)-(c)), or where the Restriction would be necessary to avoid a specific imminent harm to DTC or one or more of DTC's Participants. Sections 2 and 3 of the proposed rule change would establish a clear, unambiguous framework for providing issuers with notice of a Restriction and an opportunity to be heard and object to the Restriction, as well as DTC's obligations to review and provide a response to any such objection. Under Section 2(a) of the proposed rule change, DTC would be required to provide the issuer with notice of a Restriction within three business days after imposition of the Restrictions. The Restriction Notice would be required to set forth with reasonable specificity (i) the basis for the Restriction; (ii) the date the Restriction was imposed; and (iii) the timing and procedural requirements for the issuer to object to the Restriction. The issuer would be permitted to submit a Restriction Response to DTC within 20 business days of receiving the Restriction Notice, setting forth its objection to the Restriction and detailing the reasons that the Restriction should be released pursuant to Section 4(d). Under Section 3 of the proposed rule change, DTC would then have 10 business days to provide the issuer with a Restriction Decision, which would be required to be made by an independent Review Officer,

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<sup>134</sup> Atlantis, 2015 SEC LEXIS 2394 at \*18 n.9; IPWG, 2012 SEC LEXIS 844 at \*29.

defined as an officer of DTC under DTC's By-Laws. Under Section 3(b) of the proposed rule change, in response to the Restriction Decision, the issuer would be permitted to submit a Supplement within 10 business days to establish that DTC made a clerical mistake or an oversight in reviewing the Restriction Response. Finally, DTC would be required to provide the issuer with a Supplement Decision within 10 business days of receiving the Supplement.

As described above, commenters' concerns with the notice and objection procedures that would be established by the proposed rule change were as follows: (i) the proposed rule change could not be fair and could not satisfy the requirements set forth in IPWG if DTC is permitted to set its own standards and act on its own accord to impose a Restriction under Section 1(d) of the proposed rule change;<sup>135</sup> (ii) DTC should limit any Restriction under Section 1(d) of the proposed rule change to only a single 10 day period with any fair process occurring during that 10 day period;<sup>136</sup> and (iii) questions regarding whether the Review Officer would be sufficiently independent,<sup>137</sup> including an assertion by one commenter that IPWG requires that appeals should be heard by parties independent of DTC.<sup>138</sup> In addition, one commenter asserted that the proposed rule change fails to establish fair procedures as required by Section 17A(b)(3)(H) of the Act and the Commission's decision in IPWG because there is no stated time period for the Review Officer to complete its review of the issuer's Restriction Response and issue a

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<sup>135</sup> Kesner Letter at 6.

<sup>136</sup> STA Letter I at 3.

<sup>137</sup> See, e.g., STA Letter I at 4

<sup>138</sup> Kesner Letter II at 2.

Restriction Decision.<sup>139</sup> This comment is obviated by DTC's Amendment No. 1 to the proposed rule change,<sup>140</sup> which modified the initial proposed rule change to add a 10 business-day time period for the Review Officer to complete the review and issue a Restriction Decision.

The Commission believes that the limited discretion provided to DTC under Section 1(d) of the proposed rule change does not render the proposed rule change unfair or unable to satisfy the requirements of Section 17A(b)(3)(H) of the Act and the Commission's decision in IPWG. As the Commission previously articulated in IPWG, DTC may design fair procedures in accordance with its own internal needs and circumstances.<sup>141</sup> Similarly, if DTC believes that circumstances exist that justify imposing a Restriction, even in advance of notifying the issuer of the Restriction, it may do so, as long as DTC's process for imposing the emergency Restriction balances the identifiable need with the issuer's right to fair procedures under the Act.<sup>142</sup> Here, as discussed above, Section 1(d) strikes the appropriate balance between providing DTC with sufficient flexibility to address unforeseen harms and issuers and investors rights with respect to their securities. It also establishes a high standard for imposing a Restriction, and DTC's discretion under that provision is limited.

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<sup>139</sup> STA Letter I at 3.

<sup>140</sup> See Securities Exchange Act Release No. 78774 (September 6, 2016), 81 FR 62775 (September 12, 2016).

<sup>141</sup> 2012 SEC LEXIS 844 at \*30 n.36.

<sup>142</sup> Id. at \*32.

Further, although Section 1(d) of the proposed rule change would authorize DTC to impose a Restriction to avert an imminent harm, DTC could not maintain the Restriction indefinitely without providing expedited fair process to the affected issuer under Sections 2 and 3 of the proposed rule change. Further, to impose a Restriction under Section 1(d) of the proposed rule change, DTC would be required to identify or become aware of the need to avoid an imminent harm that could arise from further deposits or book-entry services, and would be required to provide the issuer notice and opportunity to appeal the Restriction pursuant to the specific procedures set forth in Sections 2 and 3 of the proposed rule change. As described above, these procedures establish a process to require DTC to promptly notify the issuer of a Restriction and give the issuer an opportunity to be heard upon the specific grounds for the Restriction, all within specified periods of time.

With respect to the independence of the Review Officer, Section 3 of the proposed rule change requires an officer of DTC, as defined in DTC's By-Laws, who did not have responsibility for the initial imposition of the Restriction, to review the Restriction Response and provide the Restriction Decision to the issuer. As the Commission previously articulated in IPWG, DTC may comply with the Act by designing fair procedures in accordance with its own internal needs and circumstances.<sup>143</sup> The Commission finds that having a DTC officer who was not involved in imposing the Restriction review a Restriction Response is a fair procedure. This is consistent with similar procedures by other clearing agencies supervised by the Commission. For instance, the Commission has approved as a fair procedure the Options Clearing

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<sup>143</sup> 2012 SEC LEXIS 844 at \*30 n.36.

Corporation's ("OCC's") use of a panel of OCC officers and a director of OCC in the review of suspension decisions.<sup>144</sup>

The Commission believes that the proposed rule change establishes clear, consistent, and fair procedures for the imposition of Restrictions and for providing issuers with notice of Restrictions and opportunity to be heard. Section 1 identifies the specific circumstances under which a Restriction will be imposed, Sections 2 and 3 would establish clear, policies, procedures, and specific requirements for providing issuers with notice of Restrictions and an opportunity to be heard, and Section 4 of the proposed rule change would establish clear standards for determining when adequate exists to release a Restriction. The Commission therefore finds that the proposed rule change, as modified by Amendment No. 1, provides for fair procedures with respect to the prohibition or limitation by the clearing agency of any person with respect to access to services offered by the clearing agency, as required by Section 17A(b)(3)(H) of the Act.

V. Conclusion

On the basis of the foregoing, the Commission finds that the proposal, as modified by Amendment No. 1, is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act<sup>145</sup> and the rules and regulations thereunder.

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<sup>144</sup> See Rule 1110, OCC Rules, available at [http://www.optionsclearing.com/components/docs/legal/rules\\_and\\_bylaws/occ\\_rules.pdf](http://www.optionsclearing.com/components/docs/legal/rules_and_bylaws/occ_rules.pdf).

<sup>145</sup> 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that proposed rule change SR-DTC-2016-003, as modified by Amendment No. 1, be, and hereby is, APPROVED.<sup>146</sup>

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>147</sup>

Robert W. Errett  
Deputy Secretary

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<sup>146</sup> In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>147</sup> 17 CFR 200.30-3(a)(12).