

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-57542; File No. SR-DTC-2007-11)

March 20, 2008

Self-Regulatory Organizations; The Depository Trust Company; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, to Amend its Operational Arrangements as it Applies to Structured Securities

I. Introduction

On September 7, 2007, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-DTC-2007-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ The proposed rule change was published for comment in the Federal Register on November 26, 2007.² The Commission received four comments to the proposed rule change.³ On December 14, 2007, DTC filed Amendment No. 1 to the proposed rule change.⁴ The proposed rule change, as Modified by Amendment No. 1, was published for comment in the Federal Register.⁵ The Commission

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 56795 (November 15, 2007), 72 FR 66009.

³ Simon Griffiths, Vice President, JP Morgan (December 10, 2007); Tom Migneron, Principal, Edward Jones (December 11, 2007); Dan W. Schneider, Baker & McKenzie LLP, Counsel to the Association of Global Custodians, Chicago, Illinois (December 12, 2007); Norman Eaker, Chairman, Securities Industry and Financial Markets Association, Operations Committee, Gussie Tate, President, Securities Industry and Financial Markets Association, Dividend Division, and Thomas Hamilton, Vice Chairman, Securities Industry and Financial Markets Association, MBS and Securitized Products Division Executive Committee (December 19, 2007).

⁴ As explained below, Amendment No. 1 replaced and superseded the original filing in its entirety. Amendment No. 1 removed reference to the imposition of a processing fee on January 1, 2008, and corrected the identity of the party that will identify an issue as conforming or non-conforming and will submit a written attestation giving the reason for non-conformance.

⁵ Securities Exchange Act Release No. 57283 (February 6, 2008), 73 FR 8384.

received one comment to Amendment No. 1.⁶ For the reasons discussed below, the Commission is approving the proposed rule change, as amended.

II. Description

DTC's Operational Arrangements is a contractual agreement between DTC, issuers, and paying agents that outlines the procedural and operational requirements for an issue to become and remain DTC eligible. The proposed rule change amends DTC's "Operational Arrangements Necessary for an Issue to Become and Remain Eligible for DTC Services" ("Operational Arrangements") as it applies to Structured Securities in order to: extend the deadline by which paying agents of such securities must submit periodic payment rate information to DTC; establish Structured Securities classifications; establish an exception processing fee applied to certain Structured Securities whose features prevent paying agents from complying with the extended deadline; and provide that DTC track and make publicly available reports on paying agent performance as it relates to timeliness and accuracy of Structured Securities payment rate information submitted to DTC.

A Structured Security, such as a collateralized mortgage obligation or asset-backed security, is a bond backed by a pool of underlying financial assets. The underlying assets generally consist of receivables such as mortgages, credit card receivables, or student or other bank loans for which the timing of principal payments by the underlying obligors may be variable and unpredictable. A Structured Security may also incorporate credit enhancements or other rights that affect the amount and timing of payments to investors.

Communication of periodic payment rates of principal and interest ("P&I") to the end investors in Structured Securities depends on application of stringent time frames for information

⁶ Carol A. Jameson, Vice President and Senior Counsel, The Depository Trust Company (March 5, 2008).

reporting and significant interdependencies among servicers of the underlying assets, specifically trustees, custodians, paying agents on the securities, DTC, and the financial intermediaries that act on behalf of the investors. Given the complexity of structure and calculations of cash flow from the underlying assets through the issuer to the end investor and given the interdependencies on timeliness and accuracy of performance throughout the chain of servicers and intermediaries, timely and accurate submission of payment rate information on Structured Securities may be difficult to achieve. As a result, payment rates typically are announced late on a significant number of issues, and the number of post-payable adjustments made to correct inaccurate payments resulting from inaccurate payment rate information is higher than for any other security type. Furthermore, the volume of P&I payments for Structured Securities processed through DTC has grown rapidly in recent years and currently represents approximately 25% of all P&I payments processed through DTC. Incorrect and late payment rate reporting causes increased operations processing costs, inefficient cash management, and loss of income.

1. Extending the Deadline for Reporting on Payment Detail

Currently, the majority of Structured Securities have features that prevent paying agents from being able to meet the current Operational Arrangements payment rate reporting deadline. DTC is amending the Operational Arrangements to require that the payment notification regarding Structured Securities be provided to DTC by the paying agent preferably five business days but no later than one business day prior to the payable date.⁷ In addition, DTC is extending its current processing deadline for receipt of payment rate files from 7:00 PM to 11:30 PM. The extended reporting period deadlines should allow paying agents to provide payment rates in a

⁷ Prior to this filing, payment notifications regarding Structured Securities had to be provided to DTC by the paying agent preferably five business days but no later than two business day prior to the payable date.

timely and accurate fashion for a majority of Structured Securities issues and should permit the securities to remain eligible for DTC's services while still providing DTC with adequate time to process the information and make timely payments to its participants.

2. Securities Classifications

Due to the complexity of certain Structured Securities, it is anticipated that the paying agents for certain issues will still not be able to meet the amended Operational Arrangements requirements for timely payment rate reporting even with the extended reporting period.⁸ Therefore, DTC is categorizing Structured Securities as "conforming" or "non-conforming." Non-conforming Structured Securities will be issues for which the underwriter and paying agent have concluded that the security has features that will likely preclude the paying agent from submitting payment rate information to DTC in conformity with the requirements of the Operational Arrangements. The conforming/non-conforming identification will be made at the time the security is made eligible at DTC. For each Structured Securities underwriting that the underwriter and paying agent identify as non-conforming, the underwriter and paying agent shall submit a written attestation giving the reason(s) why the paying agent will be unable to submit payment rate information to DTC in conformity with the requirements of the Operational Arrangements. DTC will in turn identify non-conforming Structured Securities to participants and other relevant parties and will add an indicator to the appropriate DTC systems functions to denote non-conforming securities. Paying agents also shall be required to evaluate their entire

⁸ Although approximately 15% of Structured Security issues currently fail to have rates submitted to DTC in a timely manner, it is estimated that approximately only half of these have structural impediments to meeting the new requirements. Late reporting in other instances is believed to be curable by improved servicing and reporting on the securities.

portfolio of Structured Securities that have previously been made eligible and are currently on deposit at DTC to identify non-conforming securities.

3. Exception Processing Fee Applicable to Non-Conforming Securities

Late payment rate reporting leads to increased costs to DTC and to servicers and intermediaries. In order to recoup the increased processing costs, DTC is imposing an exception processing fee to the managing underwriter of each non-conforming issue at the time of underwriting. No exception processing fee will be charged retroactively for issues already on deposit at DTC prior to the implementation of the fee. The exception processing fee of \$4,200 per CUSIP was calculated based upon anticipated additional costs of P&I processing for non-conforming Structured Securities.⁹

The aggregate net amount of the exception processing fees will be allocated and rebated on a pro rata basis annually to the DTC participants for whom DTC processed Structured Securities P&I allocations. For each participant, DTC will compare the participant's total number of allocations to the total number of all participants' allocations, and the resulting percentage would be applied against the total exception processing fund with the resulting amount being rebated to the participant. The total exception processing fund will be the sum of all exception processing fees less DTC's cost to administer the program.

4. Evaluation and Publication of Paying Agent Performance

DTC will track and evaluate paying agent performance with regard to timeliness and accuracy of payment rate reporting on Structured Securities and make these evaluations available to DTC participants and to the public. The purpose of these evaluations is to identify poor reporting and payment performance by paying agents.

⁹ The fee was filed with the Commission as part of DTC's annual establishment of fees. Securities Exchange Act Release No. 34-57193 (January 24, 2008), 73 FR 5614.

DTC plans to expand its paying agent evaluation reports (“Report Cards”) that are currently used to compare rate submission performance and accuracy of Structured Securities paying agents. Currently the Report Cards are only distributed among the paying agents being compared. DTC will now make the Report Cards available on its website. The Report Cards will track and will report on a monthly basis performance by paying agent with respect to the number of collateralized mortgage obligations and asset-backed securities announcements processed, the number of late and amended announcements, the payment dollars, late payment dollars, the number of payments, and the number of late payments. Timeliness of payment rate notification on non-conforming Structured Securities will not be included in the Report Cards. With respect to all the other items set forth above, paying agent performance information for both conforming and non-conforming Structured Securities will be included in the Report Cards.

III. Comment Letters

The Commission received five comments to the proposed rule change.¹⁰ Four of the comment letters were from industry participants, and one was from DTC in response to the other four comment letters. While all of the four industry commenters generally supported the proposal, two raised issues or sought clarification about the proposal.

The comment letters submitted by JP Morgan and Edward Jones both expressed their support for the: (1) extension of the deadline for reporting on payment detail, (2) creation of the conforming and non-conforming securities classifications, (3) creation of the exception processing fee for non-conforming securities, and (4) evaluation and publication of paying agent performance.

The comment letter written on behalf of the Association of Global Custodians expressed its support for the: (1) creation of the conforming and non-conforming securities classifications and (2)

¹⁰ Supra notes 3 and 4.

evaluation and publication of paying agent performance. Although the commenter expressed support for the extension of the deadline for reporting payment detail, the commenter stated that DTC should monitor paying agent performance to determine if the reporting of payment detail trends toward last-minute reporting or if the extended deadline does not correlate with a reduced incidence of errors and adjustments. Although the commenter expressed support for the creation of the exception processing fee for non-conforming securities, it suggested that the aggregate net amount of the exception processing fee should be rebated to participants based on their transactions in non-conforming securities only rather than to participants based on their transactions in all Structured Securities.

The comment letter written on behalf of the Securities Industry and Financial Markets Association expressed support for the: (1) extension of the deadline for reporting on payment detail and (2) evaluation and publication of paying agent performance. Although the commenter expressed support for the creation of the conforming and non-conforming securities classifications, it requested guidance on the criteria to be used to determine whether a Structured Security is non-conforming, whether an issue's classification can be changed, and when the classification determination will be required to be submitted to DTC. The commenter questioned whether it was appropriate to require the underwriter to sign the classification attestation rather than allowing the underwriter to rely on the paying agent's attestation.

While the Securities Industry and Financial Markets Association expressed support for the creation of the exception processing fee, it questioned whether the underwriter is the appropriate party to pay the fee. It stated its belief that the costs created by late and erroneous submissions from conforming issues should not be borne by non-conforming issue underwriters. The commenter also suggested that the aggregate net amount of the exception processing fee should be rebated to

participants based on their transactions in non-conforming securities only rather than to participants based on their transactions in all Structured Securities.

In its comment letter, DTC stated that the criteria for categorizing an issue as “non-conforming” would consist of a general good-faith expectation, based on information available at the time, as to whether it is anticipated that DTC’s deadlines for submission of rate information will be met. It also stated that both the paying agent and the underwriter will be responsible to sign the classification attestation and that imposing the exception processing fee on the underwriter is equitable and consistent with DTC’s general practice. Finally, the commenter confirmed that while it will allocate exception processing fee revenue pro rata to DTC participants for whom DTC processed any Structured Securities, it will review the policy toward the end of 2008 to determine whether future allocations should be directed to participants based only on their transactions in non-conforming securities.

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a registered clearing agency. In particular, the Commission believes the proposal is consistent with the requirements of Section 17A(b)(3)(F),¹¹ which among other things, requires that the rules of a clearing agency are designed to remove impediments to and perfect the mechanisms of a national system for the prompt and accurate clearance and settlement of securities transactions. The Commission finds that by enabling more Structured Securities to be DTC-eligible and by helping to make the reporting of information about Structured more accurate and timely, the proposed rule change,

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

which should make the communication of payment rate information on Structured Securities more quicker and more efficient, is consistent with this statutory obligation.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹² and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹³ that the proposed rule change (File No. SR-DTC-2007-11), as Modified by Amendment No. 1, be, and hereby is, approved.¹⁴

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Florence E. Harmon
Deputy Secretary

¹² 15 U.S.C. 78q-1.

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 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).

¹⁵ 17 CFR 200.30-3(a)(12).