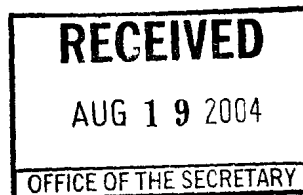




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August 19, 2004



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

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Re: Release No. 34-49809, File No. S7-24-04, Issuer Restriction or Prohibition on
Ownership by Securities Intermediaries

Dear Mr. Katz:

The Depository Trust Company ("DTC") and the National Securities Clearing Corporation ("NSCC") write in further support of the Securities and Exchange Commission's (the "Commission") proposed rule to prohibit registered transfer agents from effecting any transfer of equity securities if such securities are subject to any restriction or prohibition on transfer to or from a securities intermediary (the "Proposed Rule"). Specifically we write to supplement DTC's letter of July 8, 2004 and to respond to certain allegations raised by other comment letters ("Commentors") with respect to NSCC's Stock Borrow Program ("SBP").

The Commentors allege that the reason certain issuers have attempted to restrict the registration and/or ownership of shares by securities intermediaries or "street name" is because the shares of these issuers have been subject to "naked short selling." The Commentors further allege that the SBP facilitates naked short selling by creating "phantom shares" and that restricting the ownership of the shares in street name will limit or eliminate the naked short selling. As shown below, these allegations are baseless.

The Stock Borrow Program

The SBP was implemented in order to satisfy priority needs for stock that are not otherwise filled via normal deliveries from members of NSCC. The SBP was approved by the SEC in 1981 and is described and governed by NSCC's Rules. See *National Securities Clearing Corp.; Proposed Rule Change*, SEC Release No. 34-17422, 46 Fed. Reg. 3104 (Jan. 7, 1981) (approving and adopting as permanent the SBP) (hereafter, the "SBP Approval Order"); see also *Self-Regulatory Organizations, Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Securities Clearing Corp. Relating to Fees*, SEC Release 34-22130, 1985 WL 547213 (June 10, 1985) (soliciting comments on proposed rule changes to the SBP). Since then, NSCC has operated the SBP in accordance with its Rules, as approved by the Commission. Attached as Exhibit A is a copy of NSCC Rules, Addendum C, governing the SBP.

Subsidiaries:
The Depository Trust Company
National Securities Clearing Corporation
Fixed Income Clearing Corporation
Emerging Markets Clearing Corporation

Under the SBP, NSCC borrows shares of stock **voluntarily** made available for loan by its Participants for the purpose of settling transactions where other Participants have not made sufficient shares available to satisfy delivery obligations. SEC Release No. 34-18027, 46 Fed. Reg. 41892 (Aug. 18, 1981) (explaining daily operation of SBP). Each member of NSCC, who is also a member of DTC, has the option (**although no obligation**) to make available for loan all or some of the shares of any stock that member actually has available in its DTC account. *Id.* Only shares that are: (i) **actually on deposit at DTC**; and (ii) **are otherwise unencumbered** can be loaned in the SBP. Assuming there are delivery obligations that remain unfilled and there are shares that a Participant made available under the SBP, the lender's account at DTC is debited for the number of shares loaned and, in its place, the lender is granted a right to receive back the amount of shares that it loaned.¹ *Id.* The borrowed shares are used to satisfy unfilled receive positions – it does not relieve the Participant that has failed to deliver from its obligations.

Contrary to the unsupported assertions of the Commentors, however, the lender no longer has ownership rights with respect to the shares it has actually lent – it only retains a right to receive back the equivalent number of shares. The lender cannot “re-lend” those shares because they have been taken from its DTC account. Allegations by the Commentors that the SBP “has had the effect of creating millions of unregistered, illegal free trading shares of the issuer” and “amounts to stock kiting” are completely baseless, and reflect either a fundamental misunderstanding of the SBP or an intentional attempt to mischaracterize the SBP.²

Equally baseless is the implication that all fails to deliver are covered by the SBP (thereby, in Commentors' view, relieving brokers who have not received delivery from

¹ NSCC records the loan as both a short and a long position in the lending member's account at NSCC, because every transaction at NSCC must have both a short and a long; *i.e.*, both a buyer and a seller. The short position, reflecting the lender's obligation to make delivery of the shares it loaned, is covered by taking those shares from the lender's DTC account. The long position, reflecting the member's right to return of those shares, remains open and is settled as an open position in the same manner as all other open positions at NSCC. *See* NSCC Rules, Addendum C.

² Thus, to use the example set forth in a complaint against DTC and NSCC, if Seller S fails to deliver the 1,000 shares of the 100,000 total issued and outstanding shares in the issuer's stock by settlement day, NSCC can, if sufficient stock is made available through the SBP, borrow 1,000 shares of the issuer stock that is on deposit in Lender L's DTC account to satisfy Buyer B's open position. Upon delivery, Buyer B now owns those shares and can sell or vote them. Lender L, however, no longer owns those shares. The 1,000 shares have been debited from Lender L's DTC account and, while Lender L has a right to receive 1,000 shares (recorded as a “long position” in Lender L's sub-account), it cannot sell or vote a mere right to receive. Nor can Lender L “re-lend” those shares unless and until it has received them back from NSCC through the settlement process. Thus, the SBP has not “manufactured” 1,000 shares – rather, through book-entry transfers, in order to facilitate the prompt settlement of transactions (as Congress intended), ownership of 1,000 of the originally-issued and outstanding shares has simply changed hands.

the need to exercise buy-in rights). In fact, generally not enough shares are made available by Participants for loan through the SBP to satisfy all unfulfilled obligations to deliver shares. Allegations that the SBP allows sellers to continue to fail to deliver because NSCC can borrow shares from the SBP to cover the fail to deliver positions is simply wrong. By no means are all fails to deliver addressed by the SBP.

Nor does the SBP create or facilitate fails-to-deliver. Fails are created by the marketplace, irrespective of the SBP (and, of course, fails occurred before there ever was a SBP). Since the SBP exists to remedy fails-to-deliver by satisfying unfulfilled delivery obligations, the Commentors' claims that the SBP artificially increases the number of outstanding shares in the market and that naked short selling would not be possible without the SBP, turns reality on its head.

As we have stated previously, to the extent that issuers have legitimate concerns regarding trading activities in securities they have issued to the public they should address those matters through appropriate means with the Commission or otherwise. The SBP however, has no effect on trading activity and does not facilitate naked short selling.

The Proposed Rule furthers the goals articulated by Congress when it adopted Section 17A of the Exchange Act in that the Proposed Rule will, among other things, promote the prompt and accurate clearance and settlement of securities transactions and eliminate the delay, inefficiencies and unnecessary costs inherent in "certificate only" trading sought to be imposed by certain issuers.

For the reasons set forth herein and in DTC's letter of July 8, 2004, we believe that it would be in the interests of the National Market System and consistent with the intent of Section 17A for the Commission to approve the Proposed Rule. The Commission should adopt the Proposed Rule and confirm that issuers are not authorized to restrict the ownership or registration rights of securities intermediaries and prohibit transfer agents from aiding and abetting such wrongful conduct.

Respectfully submitted,

The Depository Trust Company
National Securities Clearing Corporation

By: 
Larry E. Thompson

(ADDENDUM C - 1)

ADDENDUM C

NSCC AUTOMATED STOCK BORROW PROCEDURES

In the course of daily operations, the Corporation's CNS System often has a need for securities that exceeds the shares made available via Member deliveries to clearing. This need can arise from several sources, including the satisfaction of Member priority requests for allocation and buy-ins submitted by Members.

In order to improve the efficiency of the clearing system in dealing with these situations, the Corporation's Board has authorized the implementation of automated stock borrow procedures (the Stock Borrow Program) to satisfy needs for stock that are not filled via normal deliveries from Members.

Members wishing to participate in the program will notify the Corporation each day by such times as the Corporation specifies of the securities they have on deposit at DTC that are available to be borrowed by the Corporation. **Note:** The daytime stock borrow program is a separate process from the nighttime stock borrow process, and securities available to be borrowed that are sent for nighttime processing will not be applied in the daytime process. Members can choose to participate (i) only in the night stock borrow program, (ii) only in the daytime stock borrow program, or (iii) in both the night and daytime stock borrow programs.

After the Corporation's nighttime processing of regular deliveries, any needs remaining unsatisfied will be borrowed from Members who have delivered instructions specifying available securities for the nighttime stock borrow process.¹ Similarly, any share needs remaining unsatisfied at a time designated during the day cycle will also be borrowed from Members who have delivered during the day cycle will also be borrowed from Members who have delivered instructions specifying available securities for the daytime stock borrow process. Any shares borrowed will be entered into a special CNS sub-account and the Member will be advanced the full market value of the shares borrowed until they are returned. Borrowed stock will be returned through normal long allocation against the special sub-account as shares become available.

More specifically, the processing steps will be as follows:

1. Each day, Members wishing to participate in the program will inform the Corporation of the number of shares of each security in their general unpledged account at DTC that are available to be borrowed, and the cycle(s) for which the borrowing availability applies. This information, in the form prescribed by the Corporation, must be submitted to the

¹ Securities subject to a voluntary reorganization will not be borrowed by the Corporation after nighttime processing on E+2 through the end of the protect period.

(ADDENDUM C - 2)

Corporation by the times specified by the Corporation. Data to be submitted to indicate availability will be Member number, CUSIP number, available shares and applicable borrowing cycle. Availability information submitted earlier in the day with respect to the relevant night or day processing cycle can be modified up until such times as determined by the Corporation by completing and returning such information as determined by the Corporation.

2. After regular evening allocation processing, the Corporation will attempt to borrow any needs for stock that still remain unsatisfied. Borrowing will be done versus the Members that have indicated an availability in each security. The full amount indicated as available by a Member will be utilized prior to borrowing anything from the next selected Member in sequence. The actual formula the Corporation will use to determine the order in which it will borrow securities made available by Members to meet the Corporation's system needs is as follows:

Step I: On each day, each Member will be assigned a random allocation number, for each security made available to the Corporation for potential borrowing.

Step II: A factor for each Member will be developed by dividing (1) the percentage of each Members average loans as they relate to the total Corporation borrowings by (2) the percentage of each Members average fees paid for trade comparison, trade recording and clearance as they relate to the total of these fees for all Members.

Step III: Each random allocation number assigned in Step I will then be multiplied by the factor developed in Step II to produce an adjusted random number per position for each Member. Each potential borrow will then be sequenced using the adjusted random number with the lowest number being the first priority for borrowing.

3. Similarly, at the time during the day cycle designated by the Corporation, the Corporation will attempt to borrow any needs for stock that remain unsatisfied at that time. Borrowing will be done versus those Members that have indicated an availability during that day in each security. Any Member that has remaining availability in a security after the evening allocation processing borrowing must submit new availability instructions to participate in daytime stock borrowing. The utilization of such availability will follow the same allocation procedures as used for nighttime stock borrows.
4. When stock is borrowed, the Corporation will create miscellaneous activity updates to the Member's CNS account to record the borrow. When the borrowing is done in the day cycle, the Corporation will make available information in such form as it determines regarding the borrowing activity. The number of shares borrowed will be journaled short against the Member's "D" CNS sub-account and long versus the Member's "C" CNS sub-

(ADDENDUM C - 3)

account. A CNS short cover from the Member's "D" CNS sub-account will automatically occur against the shares on deposit in its DTC account, thus advancing the Member the market value of the stock. The long position in the Member's "C" CNS sub-account will reflect the shares borrowed by the Corporation, and will be marked to the market daily.

5. Shares borrowed will be paid back, and the Member charged back at current market prices, through normal allocation to the Member's "C" CNS sub-account. Borrows will be returned when regular short deliveries for a day exceed all priority needs.
6. In addition to the regular return of borrowed stock, the Stock Borrow Program provides a priority close-out procedure where a Member requires the return of securities borrowed by the Corporation in order to meet the "customer securities segregation" requirements of SEC Rule 15c3-3. In such instances, Members, through use of the CNS priority instructions, can instruct the Corporation to put them on high allocation priority. Alternatively, the Member may initiate buy-in procedures by submitting a Notice of Buy-In.
7. In lieu of utilizing the recall provisions of SEC Rule 15c3- 3, the following procedure is available: If the lending Member, when notified of what has been borrowed, finds that his "seg account" is now deficient due to a recalculation of the Member's requirement and the borrowing, the Member would notify the Corporation. The Corporation would convert the lending Member's right to receive back from the Corporation securities borrowed, versus payment, represented by a long valued position, into a right to receive back from the Corporation without payment, the securities borrowed, represented by a separate long free account. The Corporation would also charge the Member's settlement account for the value of those securities in this separate long free account, thus reversing the credit which otherwise would have been extended.
8. The only fees to Members for this program will be normal short cover (when a borrow is made) and long allocation (when a borrow is returned) charges and, if instructions are received other than in machine readable input, fees for processing paper input.

Facsimile Cover Sheet



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