

eligible for deposit at DTC.⁵⁷ In this way, these commenters argue, issuers would be better able to protect their shareholders from the negative effects naked short selling has on their securities' share price.⁵⁸ Securities deposited at DTC are registered in the name of Cede & Co. and are held beneficially for DTC participants, who in turn may hold the securities beneficially for their customers.⁵⁹ Since DTC participants and their customers, not issuers, have ownership interest in the securities, DTC participants and their customers have the authority to determine whether to deposit securities with DTC or not. Participants deposit certificates with DTC in order to avail themselves of the efficiencies and safeguards provided by DTC. It would not be consistent with DTC rules to allow issuers to withdraw securities which they have not deposited at DTC or have no ownership interest.

Furthermore, the issues surrounding naked short selling are not germane to the manner in which DTC operates as a depository registered as a clearing agency. Decisions to engage in such transactions are made by parties other than DTC. DTC does not allow its participants to establish short positions resulting from their failure to deliver securities at settlement. While the Commission appreciates commenters' concerns about manipulative activity, those concerns must be addressed by other means.⁶⁰

Several commenters claim that DTC is acting arbitrarily by permitting some issuers to withdraw their securities

while prohibiting others from withdrawing their securities because DTC did accommodate a few earlier requests from issuers in the belief that they were unusual circumstances. However, DTC only withdrew these securities based upon instructions made by participants pursuant to DTC's rules and procedures. DTC bore the substantial expense resulting from coordinating the communications and actions among DTC participants, the transfer agent, and the issuer in order to accommodate each issuer's request. When it became clear to DTC that many more issuers intended to attempt to withdraw their securities from DTC, it decided that it would no longer bear the substantial additional cost and expense of time in accommodating such requests. In none of the situations where DTC assisted an issuer in having its securities withdrawn did DTC act on an issuer's instructions. DTC facilitated the issuer by having DTC participants issue instructions to withdraw the securities.

With regard to commenters' contention that state law permits companies to adopt certain restrictions on publicly traded securities, this filing does not address the validity of such restrictions since the securities that are the subject of this filing are securities which are registered in the name of (*i.e.*, legally owned) Cede & Co. prior to the imposition of any restrictions. The securities of issuers, such as the ones that recently attempted to withdraw their securities from DTC, were issued without restrictions or notice of an adverse claim, and no restrictions were imposed on or claims made against the securities when DTC participants deposited the securities at DTC or when the transfer agent registered them in the name of Cede & Co.

While not a direct subject of this rule filing, we note that actions by some issuers of publicly traded securities to require transfer only by certificate⁶¹ and to restrict ownership of the securities by a depository or financial intermediary could result many of the inefficiencies and risks sought to be avoided when Congress promulgated section 17A of

the Act.⁶² We also note in this connection that section 17A(e) directs the Commission to use its authority "to end the physical movement of the securities certificate in connection with settlement among brokers and dealers of securities transactions by means of the mails or other means or instrumentalities of interstate commerce."⁶³ Consistent with this directive, the Commission has encouraged the use of alternatives to holding securities in certificated form in an effort to improve efficiencies and decrease risks associated with processing securities certificates. Among other things, the Commission has approved the rule filings of self-regulatory organizations that require their members to use the facilities of a securities depository for the book-entry settlement of all transactions in depository-eligible securities⁶⁴ and require that, before any security can be listed for trading, it must have been made depository eligible if possible.⁶⁵ More recently the Commission has approved the implementation and expansion of DRS.⁶⁶

⁶² We note that in the late 1960s and early 1970s, the securities industry experienced a "Paperwork Crisis" that nearly brought the industry to a standstill and directly or indirectly caused the failure of large number of broker-dealers. This crisis primarily resulted from increasing trade volume coupled with inefficient, duplicative, and extensively manual clearance and settlement systems particularly with securities certificates, poor records, and insufficient controls over funds and securities. Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92nd Cong., 1st Sess. 13 (1971). Congress held extensive hearings to investigate the problems and ultimately enacted the Securities Acts Amendments of 1975. Securities Acts Amendments of 1975: Hearings on S. 3412, S. 3297, S. 2551 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 92nd Cong., 2nd Sess. (1972).

⁶³ 15 U.S.C. 78q-1(e). See also *supra* note 46 and accompanying text.

⁶⁴ Securities Exchange Act Release No. 32455 (June 11, 1993), 58 FR 33679 (June 18, 1993) (order approving rules requiring members, member organizations, and affiliated members of the New York Stock Exchange, National Association of Securities Dealers, American Stock Exchange, Midwest Stock Exchange, Boston Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange to use the facilities of a securities depository for the book-entry settlement of all transactions in depository-eligible securities with another financial intermediary).

⁶⁵ Securities Exchange Act Release No. 35798 (June 1, 1995), 60 FR 30909 (June 12, 1995) (order approving rules setting forth depository eligibility requirements for issuers seeking to have their shares listed on the exchange).

⁶⁶ DRS provides an investor with the ability to register her securities in her own name on the issuer's records and to efficiently transfer by book-entry movements her securities positions to her broker. Using DRS, an investor can register a position directly with the issuer and can electronically move the position to a broker of choice for disposition within the current settlement

⁵⁷ Some commenters argued that because some issuers sign an Operating Agreement or Letter of Representation with DTC in order to make their shares eligible at DTC, they should retain the right to withdraw their securities. DTC has informed the Commission that as a general rule only those issuers who issue in "book-entry-only" form (*i.e.*, certain debt and municipal securities where no certificate is available) sign an Operating Agreement with DTC. Furthermore, DTC's Underwriting Service Guide, which describes DTC's eligibility requirements and deposit process, makes clear that generally only issuers of book-entry-only securities must execute a Letter of Representation to make the securities eligible for deposit. Since most equity securities make certificates available, participants make most deposits of securities into DTC.

⁵⁸ A short sale is generally a sale of a security that the seller does not own or as effectuated by the delivery of borrowed securities within the required settlement timeframe. Although the Commission notes that a "naked short sale" is not a defined term, it generally refers to where a seller sells a security without owning or borrowing the security and does not deliver when delivery is due.

⁵⁹ DTC participants holding securities on behalf of a customer are generally obligated to act pursuant to their customers' instructions.

⁶⁰ See *Rhino Advisors, Inc. and Thomas Badian*: Lit. Rel. No. 18003 (February 27, 2003); See also *SEC v. Rhino Advisors, Inc. and Thomas Badian*, Civ. Action No. 03 civ 1310 (RO) (Southern District of New York).

⁶¹ One commenter questioned how AT&T could choose to dematerialize but other issuers cannot choose to issue in certificated form only. AT&T is incorporated in the State of New York and trading on the New York Stock Exchange ("NYSE"). New York law permits companies to issue in book-entry-only and NYSE rules permit listed companies to not offer certificates provided the issuer is participating in DRS pursuant to NYSE rules. However, prior to AT&T dematerializing, the vast majority of AT&T's stock was immobilized at DTC in order to facilitate book-entry transfers at DTC. Only individuals holding certificates were practically effected by AT&T's decision to dematerialize.