

Banks' ("FRBs") Net Settlement Service ("NSS") to satisfy their end-of-day settlement obligations.² The NSCC and DTC proposed rule changes propose that NSCC and DTC consolidate their settlement processing operations.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Changes

In their filings with the Commission, NSCC and DTC included statements concerning the purpose of and basis for the proposed rule changes and discussed any comments they received on the proposed rule changes. The text of these statements may be examined at the places specified in Item IV below. NSCC and DTC have prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.³

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Changes

1. Consolidated Settlement Processing Operation

Currently, DTC and NSCC settlements are run on two separate systems each of which is fed throughout the day with debit and credit data generated by participant/member activities. At the end of the processing day, the data is summarized and reported by product category (*e.g.*, in the case of NSCC, continuous net settlement, mutual funds, envelope services, *etc.* and in the case of DTC, delivery orders, stock loans, dividends, redemptions, *etc.*) on the Participant Terminal System ("PTS") via separate DTC and NSCC screens. The data is netted separately at DTC and at NSCC to produce an aggregate debit or credit at each clearing agency.

Following the determination of final net numbers for each participant/member for each clearing agency, a participant/member's credit balance at one clearing agency is netted against any debit balance at the other ("cross-endorsement"). The settling banks subsequently authorize settlement for their participant customers in an "acknowledgement" process and then transmit or receive funds to or from DTC's account and to or from NSCC subaccount at the Federal Reserve Bank of New York ("FRBNY").

In order to promote operating efficiencies, improve risk management, and lower transaction processing costs, DTC and NSCC are seeking to introduce a consolidated settlement processing operation. A consolidated settlement processing operation will provide participants/members with consolidated NSCC and DTC settlement reporting, a single point of access for both NSCC and DTC settlement information, and reduced settlement risk. This consolidation is intended to be operational only. It is not intended to affect the legal relationship that participants/members and their settling banks have with NSCC or DTC.

The new consolidated settlement processing operation will provide DTC and NSCC participants/members and their settling banks with a single set of enhanced PTS functions. Each participant/member will be able to view its DTC and NSCC settlement activity and will be provided a consolidated end-of-day netted DTC/NSCC settlement obligation. A participant/member's debits and credits at DTC and at NSCC will be separately summarized in one consolidated activity statement which will show the final DTC and NSCC balances and the netted amount for each participant/member.

2. Net Settlement Service

To reduce settlement risk and to permit settling banks to settle their net-net debits at NSCC and at DTC with a single payment, NSCC is amending its procedures to require that NSCC settling banks satisfy their daily net-net debit balances at NSCC through the use of NSS.

The change being sought is consistent with DTC's requirement that its settling banks utilize NSS.⁴

As more fully described below, NSS will permit DTC, as NSCC's settlement agent, to submit instructions to have the FRB accounts of the NSCC settling banks charged for their NSCC net-net debit balance. By centralizing DTC and NSCC's settlement processing and by adopting NSS as the payment mechanism, each settling bank's balance at NSCC (whether a net-net debit or a net-net credit) will also be aggregated or netted with its settlement balance at DTC resulting in only a single debit or single credit having to be made to the settling bank's FRB account. Utilization of NSS by NSCC members and their settling banks will eliminate the need for a settling bank to initiate a wire transfer in satisfaction of a net-net debit balance, which should reduce the risk a settling bank may incur a late payment

fee due to a delay in wiring settlement funds and will permit the aggregation or netting of such amounts with its DTC balance.⁵

NSCC is proposing certain technical corrections to assure that defined terms and other provisions are used consistently. Accordingly, NSCC's Rule 1 (Definitions and Descriptions) is being amended to (1) include a new definition of "Settlement Agent" as DTC will act as NSCC's settlement agent in collecting and paying out settlement monies and (2) set forth the definition for "Net Credit Balance" which is currently used in Rule 12 (Settlement) and elsewhere in the Rules.

NSCC Rule 12 and Rule 55 (Settling Banks) are being amended to make clear that in those instances where NSCC permits a Settling Member, Insurance Carrier Member, or Fund Member to settle other than through a settling bank, it will be deemed to have failed to settle if it fails to pay its Net Debit Balance.⁶ In addition, rule language is being modified to make clear that settlement of monies will be effected in the manner provided for in NSCC's Procedures.

NSCC Procedure VIII (Money Settlement Service) is being amended to reflect the requirement that settling banks use NSS and to provide the procedures whereby settling banks that act as such for both NSCC and DTC ("common settling banks") will have their settlement balances at both clearing agencies aggregated or netted into a single payment or credit amount.

Prior to using NSS, settling banks will be required to sign a Settler Agreement with an FRB which incorporates a requirement that the settling bank agrees to the terms of the FRB's Operating Circular No. 12. Under Section 6.4 of Operating Circular No. 12, the settlement agent (*i.e.*, DTC acts as settlement agent for NSCC) has certain responsibilities regarding allocation among settling banks of a claim for indemnity by the FRB. The allocation of any such claim among NSCC's members will be as described in NSCC Procedure VIII, Section 4(iv). The signed Settler Agreement must be on the settling bank's letterhead, signed by an authorized signer recognized by the FRB, and submitted to the FRB through DTC as NSCC's settlement agent.

⁵ Should NSS not be available for any reason, then Settling Banks will be obligated to settle their NSCC and DTC obligations by wire transfer.

⁶ Net Debit Balance for a business day as used with respect to a Member, Insurance Carrier Member, or Fund Member means the amount by which the Member's, Insurance Carrier Member, or Fund Member's gross debit balance for such business day exceeds its gross credit balance on such business day.

² On September 2, 2003, DTC implemented the requirement that all DTC settling banks use NSS. Securities Exchange Act Release No. 48089 (June 25, 2003), 68 FR 40314 (July 7, 2003) [File No. SR-DTC-2002-06].

³ The Commission has modified the text of the summaries prepared by NSCC and DTC.

⁴ *Supra* note 2.