

# **DTC SERVICE RESTRICTIONS ON CERTAIN BOOK-ENTRY SECURITIES – PROCEDURES FOR AFFECTED ISSUERS**

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**DTCC**

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# TABLE OF CONTENTS

- INTRODUCTION ..... 4
- RATIONALE FOR RESTRICTIONS ON SERVICES ..... 5
- THE PROCESS FOR ISSUERS TO OBJECT TO RESTRICTIONS ..... 5
  - Deposit Chills ..... 5
    - Issuer Notification of Deposit Chill..... 6
    - DTC Review of Issuer Response to the Deposit Chill Notice..... 6
    - Determination..... 6
  - Global Locks ..... 6
    - Issuer Notification of Global Lock..... 6
    - DTC Review of Issuer Response to the Global Lock Notice..... 7
    - Determination ..... 7
- PROCEDURES FOR REMOVING RESTRICTIONS ..... 7
- CONCLUSION ..... 8

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DTCC has operating facilities and data centers around the world and, through its subsidiaries, automates, centralizes, and standardizes the post-trade processing of financial transactions for thousands of institutions worldwide. With 40 years of experience, DTCC is the premier post-trade market infrastructure for the global financial services industry, simplifying the complexities of clearance, settlement, asset servicing, global data management and information services for equities, corporate and municipal bonds, government and mortgage-backed securities, derivatives, money market instruments, syndicated loans, mutual funds, alternative investment products, and insurance transactions. In 2012, DTCC's subsidiaries processed securities transactions valued at approximately US\$1.6 quadrillion. Its depository provides custody and asset servicing for securities issues from 131 countries and territories valued at US\$37.2 trillion. DTCC's global trade repositories record more than US\$500 trillion in gross notional value of transactions made worldwide.

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## INTRODUCTION

The Depository Trust Company (DTC), an operating subsidiary of The Depository Trust & Clearing Corporation (DTCC), is the central securities depository in the U.S., operating under regulatory oversight of the U.S. Securities Exchange Commission (SEC), the Federal Reserve System and the New York State Department of Financial Services. DTC supports the prompt and accurate clearance and settlement of transactions in securities that are eligible for its depository and book-entry transfer services. DTC was formed in 1973 to immobilize securities in a central holding system in order to resolve the problem of large volumes and values of security certificates moving physically among trading parties, and to reduce risk accordingly.

DTC is a limited purpose trust company, organized under the New York State Banking Law, a State member bank of the Federal Reserve System and a clearing agency registered under Section 17A of the Securities Exchange Act of 1934. DTC is also subject to the anti-money laundering (AML) provisions of the Federal Bank Secrecy Act, as well as the requirements of the U.S. Department of the Treasury, Office of Foreign Asset Control (OFAC).

Among various services DTC provides to the financial institutions that constitute its “participants,” DTC accepts deposits of securities that meet its eligibility requirements for book-entry services. DTC’s eligibility standards are set forth in its SEC-approved Rules and Procedures. A key eligibility criterion is that the securities were distributed in accordance with Section 5 of the Securities Act of 1933 in a manner that does not impose ownership or transfer restrictions, so that the securities are freely transferable. This means that the securities were offered pursuant to an effective registration statement filed with the SEC or pursuant to an exemption from registration that does not impose ownership or transfer restrictions. (There are also special procedures for securities offered pursuant to Rule 144A or Reg S.) Securities must meet these standards to be eligible for DTC’s book-entry services.

Securities deposited at DTC for book-entry services are registered in the name of DTC’s nominee (Cede & Co.), so that DTC holds legal title to the securities vis a vis the issuer. This permits DTC to process transfers of interests in the securities among its participants by book-entry. For securities to be held this way, the interests recorded by each financial institution must be “fungible.” That is, no interest is different than another; each ultimate beneficial owner has a comparable interest (except for the number of units or dollar amount) in the securities credited to its account. As a result, there is no need to exchange physical certificates to evidence changes in beneficial ownership, thus facilitating the huge trading volumes in the modern securities marketplace.

It is for this reason that securities with transfer restrictions cannot be commingled with DTC’s freely transferable inventory.

In order to comply with applicable law and its own Rules and Procedures, if DTC has reason to believe that securities which are not freely transferable have been deposited, DTC may restrict services to these securities pending the issuer establishing that the securities are freely transferrable. These restrictions typically are: (i) not accepting additional deposits of these securities (a “Deposit Chill”), or (ii) it may cease to provide any book-entry services with respect to these securities (a “Global Lock”).

This White Paper is designed to explain the circumstances under which Deposit Chills and Global Locks are applied, and the fair procedures that DTC has developed so issuers have due notice and the opportunity to object to restrictions. DTC proposes to adopt these new procedures in the near future by filing a rule change and advance notice with the SEC. Prior to this submission, DTC invites comments and suggestions in response to this White Paper. DTC requests all comments be emailed to the following address: [issuerfeedback@dtcc.com](mailto:issuerfeedback@dtcc.com).

## RATIONALE FOR RESTRICTIONS ON SERVICES

As a critical part of the U.S. securities industry infrastructure, and to comply with legal requirements, DTC cannot allow marketplace actors to use the depository and its book-entry system to facilitate the illegal distribution of securities. DTC monitors transactions and regulatory or enforcement actions involving eligible securities in order to comply with the Bank Secrecy Act's AML provisions and other Federal requirements, including OFAC restrictions. As part of this routine monitoring, DTC identifies unusually large deposits of thinly traded, low-priced securities, which have been identified by regulators and law-enforcement authorities as a "red flag" alert for the potential illegal distribution of securities.

Where DTC determines, based on suspicious large-share deposit volumes, that securities deposited at DTC for book-entry services may not be freely transferable, DTC may impose a Deposit Chill, preventing further deposits until the issuer convincingly demonstrates that the securities are freely transferable. If DTC determines there is "definitive evidence" that non-transferable shares have been deposited, DTC may impose a Global Lock. In this context, "definitive evidence" typically means that the SEC or another regulatory or law enforcement agency has brought an enforcement action alleging that the securities are restricted and not freely transferable.

DTC recognizes that Deposit Chills and Global Locks are disruptive to issuers and their investors and can create significant processing challenges for market participants. To achieve a balance between these competing concerns, DTC has been working diligently to develop and implement fair procedures for issuers whose securities may be subject to restrictions, while continuing to comply with DTC's legal and regulatory obligations.

For well over one year, DTC has been giving notice to issuers about restrictions on their securities and has worked with issuers to help release restrictions, where the issuer has been able to demonstrate to DTC that the securities are suitable for holding and processing. In other cases, DTC has not imposed restrictions after clarifying exchanges with the issuer. A primary tool for the issuer in this process is to provide DTC with an opinion of independent counsel that supports and confirms the eligibility of the securities for DTC book-entry services.

The balance of this White Paper describes the procedures that DTC has implemented with respect to Deposit Chills and Global Locks, which are reflected in the proposed rule change that DTC will submit to the SEC.

## THE PROCESS FOR ISSUERS TO OBJECT TO RESTRICTIONS

DTC's proposed rules will formalize the process for issuers to receive notices of restrictions and to have their objections heard:

- Issuers will be notified in writing of any service restriction
- Issuers will have reasonable time frames to respond
- Issuers will have clear guidelines to support a release or prevent restrictions
- DTC will respond to issuers within stated time frames
- Throughout the notice and review process, DTC and its counsel will be available to consult with issuers and their counsel regarding compliance with these requirements

## DEPOSIT CHILLS

As noted above, DTC may impose a Deposit Chill if it detects large-share deposit activity in a thinly traded, low-priced security, because this activity is a recognized red flag for distributions of securities in violation of Section 5 of the Securities Act of 1933.

### **Issuer Notification of Deposit Chill**

DTC will provide the issuer with written notice of the Deposit Chill by overnight courier. DTC will send the notice no later than twenty business days prior to the imposition of the Deposit Chill or, if the Deposit Chill is imposed prior to giving notice, no later than three business days after the Deposit Chill is imposed. DTC will impose a Deposit Chill prior to notice where there is a threat of imminent harm or injury to DTC or the industry, including if circumstances suggest that advance notice might accelerate improper deposits. If DTC acts prior to notice, the issuer will have the opportunity to show that there is no meaningful risk of imminent harm or injury.

The Deposit Chill notice will require, among other things, the issuer to submit a legal opinion from its independent outside counsel. The opinion must confirm that the affected securities are freely transferable and address such other matters of concern as DTC may identify. To guide the issuer, DTC typically provides a template legal opinion. DTC and its counsel are available to an issuer and its counsel to discuss the opinion and related issues.

### **DTC Review of Issuer Response to the Deposit Chill Notice**

DTC will respond in writing to the issuer's response to the Deposit Chill notice within twenty business days or, if the Deposit Chill has been imposed prior to notice, within ten business days.

An officer of DTC who played no role in the Deposit Chill decision will decide whether the issuer's response satisfactorily addresses transferability and any other matters requested. The officer may consult with counsel regarding the review. DTC will contact the issuer within the response time frame if further information or clarification seems warranted, and provide the issuer ten additional business days to respond.

### **Determination**

If the DTC officer determines that the issuer's response reasonably establishes that the securities are freely transferable and not otherwise impaired, DTC will promptly lift the Deposit Chill or, in notice-first cases, DTC will not impose the Deposit Chill.

If the issuer does not respond within twenty business days (or any extended period) or if the DTC officer finds that the response does not satisfy the requirements, the Deposit Chill will continue and DTC may impose a Global Lock. Before doing so, DTC will give the issuer an additional ten business days for a supplemental response; issuers should bear in mind that the supplemental response will be limited to proving the original response was properly submitted within the required time frame or that DTC made a clerical mistake in review of the original response. The supplement will not be an opportunity to begin the review process again.

The proposed rules impose strict deadlines on both issuers and DTC. The proposal also gives DTC the discretion to lift or modify a Deposit Chill if it reasonably believes that it is in the best interest of DTC and its participants.

## **GLOBAL LOCKS**

DTC may impose a Global Lock, which suspends both deposits and book-entry transfers of a security, as well as withdrawals and physical deliveries of the security, based on legal actions commenced by government or law enforcement authorities, most typically the SEC. Additionally, DTC will impose a Global Lock if an issuer fails to satisfy the requirements for lifting a Deposit Chill.

### **Issuer Notification of Global Lock**

DTC will provide the issuer with written notice of the Global Lock via overnight courier. DTC will

send the notice no later than twenty business days prior to the imposition of the Global Lock or, if the Global Lock is imposed prior to giving notice, no later than three business days after the Global Lock is imposed. DTC will impose a Global Lock prior to notice where there is a threat of imminent harm or injury to DTC or the industry. This would include situations where the SEC has alleged that the defendants are in possession of additional unregistered shares that they could deposit into the DTC system. If DTC acts prior to notice, the issuer will have the opportunity to show that there is no meaningful risk of imminent harm or injury.

The Global Lock notice will, among other things, include the reason for the Global Lock and identify the regulatory or law enforcement proceeding upon which the restriction is based. It will note the date the restriction was or will be imposed, and that the issuer has twenty business days to respond, although DTC may provide a twenty-business-day extension for good cause.

The Global Lock notice will afford the issuer the opportunity to demonstrate that the securities deposited at DTC were not the subject of the legal proceeding on which DTC based its restriction. The issuer will also have the opportunity to demonstrate that the proceeding has been withdrawn, dismissed, or otherwise resolved in favor of the defendant that deposited the securities at DTC. Otherwise, DTC will restrict the securities, based on the allegations in the pleadings.

#### **DTC Review of Issuer Response to the Global Lock Notice**

DTC will respond in writing to the issuer's response to the Global Lock notice within twenty business days or, if the Global Lock has been imposed prior to notice, within ten business days.

Where DTC bases a Global Lock on allegations in an SEC enforcement action or other regulatory or law enforcement proceeding, DTC's review is necessarily limited. It will not provide the issuer with an alternative forum in which to litigate the issues pending before a court or administrative agency.

Where a Global Lock results from the issuer's failure to satisfy DTC's eligibility concerns that led to Deposit Chill, the procedure for releasing the Lock is described below.

#### **Determination**

If DTC determines that the issuer's Global Lock response satisfies the conditions set forth in the Global Lock notice, DTC will release or not impose the Global Lock. Otherwise, DTC will impose the Global Lock or maintain one previously imposed.

## **PROCEDURES FOR REMOVING RESTRICTIONS**

DTC's proposed rule will also seek SEC approval to reinstate full services under the following circumstances.

Under the Safe Harbor provision of Securities Act Rule 144, restricted securities may become freely transferable after a specified holding period has elapsed. Because securities that have been Globally Locked have been credited to participant accounts without transfer during the period of the Global Lock, DTC is proposing, by analogy to Rule 144, to release Global Locks after the following periods have elapsed:

***If the Global Lock is the result of a judicial action or administrative proceeding alleging that the issuer's shares had been distributed in violation of Section 5 of the Securities Act:***

- DTC may lift the Global Lock one-year after the latest date on which the outstanding litigation or administrative proceeding has been resolved with respect to any defendant that deposited the securities at DTC. This one-year approach applies to issuers that are not SEC reporting companies,
- DTC may lift the Global Lock six-months after the latest date on which the outstanding litigation or

administrative proceeding has been resolved with respect to any such defendant. This six-month approach applies to issuers that are SEC reporting companies.

***If the Global Lock is the result of an issuer's failure to respond or to respond adequately to a Deposit Chill notice:***

- DTC may lift the Global Lock one-year after the date it was imposed for issuers that are not SEC reporting companies,
- DTC may lift the Global Lock six-months after the date it was imposed, for issuers that are SEC reporting companies.

The release of a Global Lock under these circumstances would only be available to an issuer that is not and never had been, a “shell company” as defined in Securities Act Rule 144(i), unless the issuer had ceased to be a shell company and filed the specified disclosures required by this rule to no longer be deemed a shell company. If new facts come to light during the six-month or one-year period that call into question whether the securities satisfy DTC’s eligibility requirements, DTC may not release the Global Lock (subject to the fair procedures discussed above.)

## CONCLUSION

DTC has designed the proposed rule changes described in this White Paper to provide issuers with fair procedures to receive notice of, and to challenge, Deposit Chills and Global Locks at DTC. The proposal also provides fair procedures for releasing restrictions. Again, DTC welcomes comments and suggestions to the procedures discussed in this White Paper, which should be addressed to [issuerfeedback@dtcc.com](mailto:issuerfeedback@dtcc.com).

This description is for informational purposes. The processes and rules described herein are and will be governed by applicable DTC Rules and Procedures, including its Operational Arrangements and Service Guides, which contain or, after giving effect to the changes described in this White Paper, will contain the full terms, conditions and limitations applicable to the processes described herein. We may provide you with additional information about our products and services from time to time. If at any time you wish to be removed from our distribution list, please send an email to [PrivacyOffice@dtcc.com](mailto:PrivacyOffice@dtcc.com).

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