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April 29, 2014

Via Email: rule-comments@sec.gov

Kevin M. O'Neill, Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proceedings to Determine Whether to Approve or Disapprove SR-DTC-2013-11 and Grounds for Disapproval Under Consideration

File No. SR-DTC-2013-11

Dear Mr. O'Neill:

We appreciate the opportunity to submit additional comments in connection with the Securities and Exchange Commission's (the "Commission") proceedings pursuant to Section 19(b)(2)(B) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to determine whether the DTC's proposed rule changes concerning deposit chills and global locks (the "Proposed Rules") should be approved or disapproved. At the outset, we commend the Commission on its decision to determine whether the Proposed Rules are consistent with the requirements of the Exchange Act and we appreciate the consideration given by DTC to prior comments.

As previously indicated in our initial comment letter to the Commission on January 14, 2014, Sichenzia Ross Friedman Ference LLP is a corporate securities law firm with offices in New York City that represents many smaller issuers in corporate finance transactions and in periodic reporting obligations under the rules and regulations of the Commission. Over the years, we have served as securities counsel to hundreds of public reporting companies and in the course of our representation, we have acted, from time to time, as securities counsel for companies that have been subjected to DTC imposed deposit chills or global locks (collectively, "DTC Chills"). Accordingly, we believe we are well situated to assist the Commission by providing input on the Proposed Rules and the effect DTC Chills have on the companies least able to survive a DTC Chill should one be imposed erroneously.

We continue to maintain that the DTC's Proposed Rules fail to meet the requirements of Section 17A of the Exchange Act. Specifically, we do not believe that the Proposed Rules meet the requirements of Section 17A(b)(3)(H) which requires that the DTC (as a clearing agency) provide a fair procedure when it prohibits or limits access to its services. Furthermore, we do not believe that the Proposed Rules meet the requirements of Section 17A(b)(5)(B) of the Exchange Act, which requires the DTC (as a clearing agency) to, among other things, provide an opportunity to be heard in determining whether to deny or limit access to its services.

<u>Bank Secrecy Act</u>

As DTC generally indicates in its letters to issuers, DTC has determined that it has responsibilities imposed on it under the Bank Secrecy Act, 31 U.S.C. Sec. 5311 et. Seq. (the

"BSA"). It is from this conclusion that DTC asserts its duty to protect DTC, banks, brokerages and the securities industry generally by assessing law violations and imposing DTC Chills. However, in reviewing DTC's role in relation to the BSA it is not at all clear that Congress intended to either regulate the DTC itself or mandate that it take on a role as an independent market regulator and enforcer. Therefore, as an initial matter, it would be informative if in considering any rules for DTC's activities the Commission first sought further guidance and definitively established that DTC is subject to the requirements of the BSA , rather than merely an SRO that makes referrals of suspicious activity to agencies charged by Congress with enforcement of the securities laws. This is a question that is at the center of the Proposed Rules, which has gone unaddressed

Procedural Due Process Requires the DTC Conduct Oral Hearings Prior to Implementing a DTC Chill

DTC claims with little, if any, affirmative support that Section 17A(b)(3)(H) of the Exchange Act does not require it to provide for a testimonial or oral hearing before it imposes a DTC Chill on issuers and that providing issuers with a Rule 22 style hearing before it imposes a DTC Chill would be inconsistent with the governing principals of Section 17A(b)(3)(H).[1] DTC propounds an oversimplified argument; the gravamen of which is that the Exchange Act does not *specifically* require DTC to provide an oral hearing prior to imposing a global lock.

Section 17A(b)(3)(H) requires DTC to provide "fair procedures." In its comment letter to the Commission dated February 10, 2014, DTC contended that "it is not a state actor" and so it is not subject to constitutional due process.[2] Regardless of DTC's status as a "state actor", the statutory fairness requirement of Section 17A(b)(3)(H) is closely related to the fairness requirements derived from the Fifth Amendment's Due Process Clause.[3] Accordingly, the appellate courts of the United States have assessed the Exchange Act's fairness requirements by relying on traditional due process principles.[4] In turn, the question whether DTC is a "state actor" is simply a red herring.[5]

The proper inquiry is therefore a constitutional one. However, in its February 10, 2014 comment letter, DTC gives short attention to the issue by briefly addressing its responsibilities

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[1] DTC comment letter dated February 10, 2014 at 2.

[2] DTC comment letter dated February 10, 2014 at 4.

[3] C.f. Gold v. SEC, 48 F.3d 987, 991 (7th Cir. 1995); see also Cody v. SEC, 693 F.3d 251, 257 (1st Cir. 2012).

[4] Gold, 48 F.3d at 991.

[5] We note that the Courts of the United States have not reached a consensus regarding whether entities performing essential market regulatory functions, such as the DTC and FINRA are state actors. See Cody, 693 F.3d at 257. Notwithstanding, the Courts have clearly evinced the intention to evaluate an SRO's behavior according to the principal of procedural due process. C.f. id. It is axiomatic that DTC must, therefore, propose rules that take those considerations into account.

under the Constitution in a footnote.[6] And there, only by listing a number of cases where the courts have held that an oral, Rule 22 style hearing prior to the suspension of rights was not required. Notably however, DTC made no effort to analogize the procedures under the Proposed Rules to the facts of any of these cases[7] nor did it discuss the three-factor test enunciated in DTC's lead Supreme Court case of *Mathews v. Eldridge*.[8]

Like Section 17A(b)(5)(B), due process requires the opportunity to be heard.[9] According to *Mathews*,[10] an analysis of the dictates of due process requires consideration of the following three distinct factors;

(1) the private interest that will be affected;[11]

(2) the risk of erroneous deprivation and the value of additional procedural safe guards; and

(3) DTC's interest, including the fiscal and administrative burdens that the additional substitute procedural requirements would entail.[12]

The Private Interests Affected

The imposition of DTC Chill affects many private interests: the issuer/company is affected; each shareholder of the company is affected; the accused bad actor's interests are

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[6] DTC comment letter dated February 10, 2014 at 4 n. 19.

[7] To take DTC's lead case as an example, the facts of the Supreme Court case of, Mathews v. Eldridge, 424 U.S. 319, (1976), are distinguishable from the procedures set forth in the Proposed Rules. In Mathews, the Supreme Court found that the respondent was not denied procedural due process when he was not granted an evidentiary hearing prior to the initial termination of social security disability benefit payments in part because the system for termination of disability benefits already provided for an evidentiary hearing before an administrative law judge at a later stage in the decision-making process. In contrast, under the Proposed Rules, if DTC determines to impose a deposit chill or global lock, there is no opportunity for a pre-deprivation hearing at any stage unless an issuer initiates an action before the SEC or the courts.

[8] See Mathews v. Eldridge, 424 U.S. 319 334-35 (1976).

[9] See id.

[10] See id.

[11] In its February 10, 2014 comment letter, DTC relies heavily on a perfunctory distinction between self-regulated organizations such as FINRA and NASDAQ and itself, claiming that the comparison is "inapposite." DTC predicates this argument on its claim that DTC does not perform "policing" or "fact finding" functions similar to FINRA and NASDAQ and so it is different from the foregoing organizations, which do. While we dispute this claim, we believe this is not the proper inquiry. The appropriate inquiry is not to look into what role DTC is fulfilling in the market place, but rather, the character of the property right DTC seeks to suspend in relation to its interest in imposing a chill.

[12] Id. at 335.

affected; and the integrity and reliability of the markets are affected. The Proposed Rules do not take into consideration – and DTC has not analyzed – the effects that the suspension of property rights has on each of these parties when the DTC implements a chill or lock.

When access to DTC's clearing services are suspended innocent investors who have relied upon access to a trading market lose their property. In addition to being entitled to the monetary value of the equity, ownership of a public traded security includes the right to sell the security on the public market. This right to sell the security is just as tangible an interest to the owner as the right to receive cash in exchange for the issuer's shares. The issuer is also affected by the inability to access capital markets and realize the benefits of a public trading market, but the principal impact of DTC's activities, and the Proposed Rules, falls mainly and squarely on the innocents who have not been suspected of any wrongdoing. If, *by some means*, there was a way for DTC to isolate its actions to the accused that is suspected of improper activities, and not affect the innocent shareholders or issuer itself, the Proposed Rules could be potentially viable. We do not believe, however, that in in an anonymous electronic marketplace of undifferentiated shares this can be addressed by DTC. Indeed, the imposition of DTC Chills creates the perverse result of penalizing the very group of stakeholders that regulators (and DTC) purport to claim to seek to protect. The Proposed Rules, by undermining the national system of electronic clearance and settlement mandated by Congress for shareholders, even those who are not suspected of wrongdoing, vitiates DTC's very *raison d'etre*.

Given the far-reaching impact of a DTC Chill, we expected DTC to be highly concerned about the risk that it may impose a DTC Chill erroneously. Indeed, we anticipated that the Proposed Rules would provide basic procedural safeguards to ensure that the potentially affected shareholders and companies have an opportunity to be heard in accordance with the law "at a meaningful time and in a meaningful manner."[13] Instead, the opportunity to be heard in the Proposed Rules is either non-existent or not meaningful and does not include rights extended to the parties most affected, innocent shareholders. DTC "could" approach its responsibilities differently, by providing early warning to regulators and law enforcement when it would otherwise see a reason to act via a "suspicious activity" report, and not take draconian action itself, in which case the safeguards afforded by the regulators (*e.g.* due process, grand jury, Wells notices) are all left in place.

The Proposed Rules have a Substantial Risk of an Erroneous DTC Chill

The DTC's Proposed Rules establish procedures whereby the risk of an erroneous DTC Chill is high – especially in light of the rights that DTC is entitled to suspend. The Proposed Rules allow DTC to impose a DTC Chill without any kind of pre, ***or post***, deprivation hearing. Stated briefly, and as we noted in our February 24, 2014 comment letter, DTC is vested with broad powers to impose a deposit chill or global lock ***at any time*** not only when faced with imminent harm or injury but in any conceivable situation that the DTC perceives some form of consequence. The DTC can impose a DTC Chill even if that consequence is merely to the DTC (*i.e.* fines or sanctions under the BSA), a participant (*i.e.* its broker-dealer "members") or the securities clearance system generally. The interest of DTC to protect itself and its members, even

[13] Armstrong v. Manzo, 380 U.S. 545, 552 (1965).

if the BSA clearly applied to the DTC, simply does not support draconian measures depriving innocent stockholders and issuers of their rights.

There are two mechanisms by which a DTC Chill may be imposed. Through the first mechanism, a DTC Chill may be imposed either prior to the issuance of a deposit chill or global lock notice, or after such a notice is issued without waiting for applicable notice periods to run. These *no* or *limited notice chills* may be done in order to prevent imminent harm, injury or other such consequences to the DTC, or its participants, or where DTC otherwise reasonably determines that such action is necessary to protect the prompt and accurate clearance and settlement of securities transactions through the DTC.[14] Notably, the Proposed Rules do not give any guidance regarding in what circumstances it is "reasonable" for the DTC to impose a chill.

DTC argues in its February 10, 2014 comments letter that it requires such broad powers in order to prevent further deposits of ineligible securities into the fungible bulk.[15] Explaining this, DTC made the conclusory claim that this is "essential in order to protect DTC participants, the banks and broker dealers that hold securities on the books of DTC, and their customers, the investing public, from having their indirect holding of securities compromised by the inclusion of improperly offered securities."[16]

DTC, however, has not articulated what actual harm is caused to these stakeholders by the presence of ineligible securities in the fungible bulk, or how the persons DTC purports to protect are in fact so protected by (1) losing their property and (2) by preventing the very persons it seeks to protect from all of the benefits of DTC eligibility. DTC has therefore failed to sufficiently state the interest it seeks to protect and that its means are sufficiently tailored to not cause undue harm to the other protected persons and entities.

The second mechanism by which the DTC's Proposed Rules allow it to impose a DTC Chill is upon the limited review of a DTC agent. Specifically, after notice of a deposit chill has been issued and after the affected company has had an opportunity to submit a response in writing, which must include a legal opinion that follows a prescribed form, an officer of DTC (as defined in Section 3.1 of the DTC's Bylaws) who played no part in the decision to issue the deposit notice makes a determination whether the affected company's response satisfies DTC's eligibility standards.[17] In the case of a global lock, the procedure is similar to that of a deposit chill, except that the determination of whether to impose a global lock is not made specifically by an officer of DTC, but rather, it is *presumably* made by those that played a part in the decision to issue the global lock notice.[18]

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[14] See Section 2 of Proposed Rule 22(A) and Proposed Rule 22(B), Section 3(b)(i) of Proposed Rule 22(A) and Section 5(b)(i) of Proposed Rule 22(B).

[15] DTC comment letter dated February 10, 2014 at 9.

[16] Id.

[17] See Section 2 of Proposed Rule 22(A).

[18] See Section 2 of Proposed Rule 22(B).

In the absence of an actual pre-deprivation hearing, it is unclear how the DTC's Proposed Rules provide an opportunity to be heard "at a meaningful time and in a meaningful manner." The prescribed formulas for responding to the DTC coupled with the lack of independent review in a Rule 22 style hearing give the appearance of fair procedures while practically depriving issuers of the fundamental – and necessary –safeguards of due process.

It is useful for a moment to contrast the procedures afforded to issuers where the DTC determines that an eligible security ceases to be such under existing DTC Rule 22. In such a case, an issuer may submit a request for an opportunity to be heard, within a prescribed period, with a written statement setting forth its basis for objection and whether it chooses to be represented by counsel. A hearing takes place before a panel of three members selected by the Chairman of DTC's Board from a pool of persons employed by or partners of DTC participants. Any person who had responsibility for the action, or proposed action of the DTC, as to which the hearing relates is disqualified from sitting on the panel. At the hearing, the issuer is afforded a right to be heard and to be represented by counsel and a record is kept of the hearing. Within a prescribed time, the panel shall advise the issuer of its decision in writing and if such decision is adverse to the issuer, the panel provides its reasons.

In light of the meaningful due process safeguards built into the Rule 22 hearings and considering the far-reaching consequences of imposing deposit chills and global locks, as well as the protections usually afforded by the government's regulatory agencies when assessing issues surrounding securities violations, it is perplexing that the DTC opposes affording Rule 22 hearings in the case of DTC Chills. This is all the more so because there is no meaningful distinction between a determination by DTC that an eligible security ceases to be such, which triggers a right to a Rule 22 hearing, and a determination by DTC to impose a DTC Chill, which would trigger a process that does not entitle an issuer to any kind of hearing at all. As the Commission stated in its opinion *In The Matter of the Application of International Power Group, Ltd.*:

> "DTC has not articulated an adequate rationale for providing a hearing to an issuer for whose securities DTC will provide no services, but not to an issuer whose securities are denied those clearance and settlement services that go to the heart of DTC's role as a clearing agency." [19]

Accordingly, in the absence of a pre-deprivation hearing modeled on DTC's own Rule 22, the Proposed Rules fail to provide an opportunity to be heard for the purposes of Section 17A of the Exchange Act.

Conclusion

Taken as a whole, the Proposed Rules would appear to punish issuers who DTC concludes bear a much greater risk to the clearing system based on the presumption that the BSA

[19] *In the Matter of the Application of Int'l Power Group, Ltd For Review of Action Taken by The Depository Trust Co.*, SEC Release No. 34-66611, 2012 SEC LEXIS 844 (Mar. 15, 2012).

entitles DTC to regulate these issuers directly. Indeed, as shown here, the investors in these issuers are most vulnerable to the DTC's Proposed Rules. Without a meaningful opportunity to be heard, the shareholders who have not been suspected of any wrong doing are the most heavily affected. While DTC purports to protect them from their offending shareholder brethren, DTC makes no effort to hear the plight of the innocent shareholder of an affected company in making its determination to impose a DTC Chill. An oral hearing in advance of such action might provide this opportunity.

Accordingly, and for all the reasons discussed in this letter, we respectfully submit that the Proposed Rules are inconsistent with the due process requirements of Section 17(A)(b)(3)(H) and 17A(b)(5)(B). We request that the Commission disapprove the Proposed Rules and direct DTC to review its procedures in order to account for the impact on all affected interests and tailor its activities to avoid penalizing the very persons it claims to be seeking to protect.

Very truly yours,

/s/ Harvey Kesner

Harvey J. Kesner

/s/ Gary Emmanuel

Gary M. Emmanuel

/s/ Matthew P. Canini

Matthew P. Canini