

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53655; File No. SR-DTC-2006-03)

April 14, 2006

Self-Regulatory Organizations; The Depository Trust Company; Order Approving Proposed Rule Change to Amend the Criteria Used to Place Participants on Surveillance Status

I. Introduction

On February 3, 2006, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-DTC-2006-03 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposal was published in the Federal Register on March 14, 2006.² The Commission received no comment letters in response to the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

Overview

DTC has developed certain criteria for placing participants on surveillance. Specifically, all broker-dealers from which DTC requires the submission of FOCUS or FOGS reports and banks from which DTC requires the submission of CALL reports³ are assigned a rating that is

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 53435 (March 7, 2006), 71 FR 13198.

³ A small number of DTC member banks which submit CALL reports are not assigned a rating. Because these banks do not make loans and do not take deposits as part of their business activities, their CALL reports do not contain information on asset quality and/or liquidity. Asset quality and liquidity are among the financial figures used in the Matrix. Since these figures would be zero in the Matrix for these banks, their Matrix results would not adequately portray their financial status. DTC has therefore concluded that these banks do not lend themselves to appropriate analysis using the Matrix.

generated by entering financial data of the participant into a risk evaluation matrix (“Matrix”) that was developed by credit risk staff.⁴ Those participants with a “weak” rating (i.e., deemed to pose a relatively higher degree of risk to DTC) are placed on an internal “watch list” and are monitored more closely. All participants that do not fall into the categories of banks and broker-dealers mentioned above are not currently included in the Matrix process but are monitored by DTC’s credit risk staff using financial criteria deemed relevant by DTC.⁵

Procedures

Credit risk staff approaches its analysis of participants in the following manner. First, the required information of designated broker-dealers and banks are entered into the Matrix, and a rating for each participant is generated. Low-rated participants are placed on the watch list. At this point, credit risk staff may downgrade a particular participant’s rating based on various qualitative factors. For example, one qualitative factor might be that the participant in question received a qualified audit opinion on its annual audit. In order for DTC to protect itself and its participants, it is important that credit risk staff maintain the discretion to downgrade a participant’s Matrix rating and thus subject the participant to closer monitoring. All rated participants, including those on the watch list, are monitored monthly or quarterly, depending

⁴ The Matrix is used by DTC and its affiliated clearing agencies, the Fixed Income Clearing Corporation (“FICC”) and the National Securities Clearing Corporation (“NSCC”). In using the Matrix, credit risk staff uses the financial data of each applicable DTC participant and the financial data of each applicable member of FICC and NSCC. In this way, each applicable DTC participant, FICC member, and NSCC member are rated against each other.

⁵ DTC will continually evaluate the matrix methodology and its effectiveness and will make such changes as it deems prudent and practicable within such time frames as it determines to be appropriate. DTC will update the Commission staff periodically on its evaluations of the Matrix.

upon the participant's financial filing frequency, against basic minimum financial requirements and other parameters.

All broker-dealer participants included on the watch list are monitored more closely than those not on the watch list. This means that they are monitored for various parameter breaks which may include, but are not limited to, such things as a defined decline in excess net capital over a one month or three month period, a defined period loss, a defined aggregate indebtedness/net capital ratio, a defined net capital/aggregate debit items ratio, or a defined net capital/regulatory net capital ratio. All bank participants included on the watch list are also monitored more closely for watch list parameter breaks which may include, but are not limited to, such things as a defined quarter loss, a defined decline in equity, a defined tier one leverage ratio, a defined tier one risk-based capital ratio, and a defined total risk-based capital ratio.

Credit risk staff also monitors those participants not included in the Matrix process using similar criteria.⁶ These criteria may include, but are not limited, to such things as failure to meet minimum financial requirements, experiencing a significant decrease in equity, or a significant loss. This class of participants may be placed on the watch list based on credit risk staff's analysis of this information. DTC continues to reserve the right to place a participant on the watch list for failure to comply with operational standards and requirements.⁷

(..continued)

⁶ Participants that are not included in the Matrix are: the banks discussed in footnote 3, United States ("U.S.") branches and agencies of non-U.S. banks, non-U.S. central securities depositories, and U.S. government sponsored enterprises.

⁷ Participants are required to meet the standards of financial condition, operational capability, and character set forth in DTC Rule 2 (Participants and Pledges).

III. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to facilitate the safeguarding of securities and funds which are in its custody or control or for which it is responsible.⁸ The Commission finds that DTC's proposed rule change is consistent with this requirement because it improves DTC's member surveillance process which should better enable DTC to safeguard the securities and funds which are in its custody or control or for which it is responsible.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

⁸ 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-DTC-2006-03) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁹

Nancy M. Morris
Secretary

⁹ 17 CFR 200.30-3(a)(12).

