

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-49717; File No. SR-NSCC-2004-01)

May 17, 2004

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Proposed Rule Change to Modify the National Securities Clearing Corporation's Continuous Net Settlement System

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on February 23, 2004, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") and on March 26, 2004, amended the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NSCC is seeking to modify its Continuous Net Settlement ("CNS") system.

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

In its filing with the Commission, NSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

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

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> The Commission has modified the text of the summaries prepared by NSCC.

As part of the securities industry's straight-through processing ("STP") initiative, NSCC has been engaged in a project to update and revise its CNS system ("CNS Rewrite"). The major aspects of the CNS Rewrite include a completely new platform on which the CNS system will run that will accommodate real-time updates to the system, will improve access to CNS and depository information for members, and will provide the capability to add trades to the settlement process on a real-time basis until 11:30 a.m. on settlement day.

The new CNS system, with a targeted implementation date of July 2004, will be able to take in trades until 11:30 a.m. on settlement day and net and settle them that day.<sup>3</sup> Two additional Consolidated Trade Summaries that will report trades settling on settlement date have been developed to support this. CNS will produce the Supplemental Consolidated Trade Summary at or about 2:00 a.m. and at or about 1:00 p.m. on each settlement date. In addition, so that members can update their CNS positions immediately, CNS will provide intraday messages for activity that occurs after the start of the day cycle<sup>4</sup> as a result of settling trades and miscellaneous activity going into CNS on settlement date. These messages will be optional to the member because the same information will also be reported in the second Supplemental Consolidated Trade Summary made available at 1:00 p.m. and in the Daytime Miscellaneous

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<sup>3</sup> At the current time, trades in debt securities compared or recorded through NSCC's Real-Time Trade Matching ("RTTM") system will not utilize this same day settling capability. Instead, as-of trades in such securities compared or recorded through RTTM after its cutoff time on T+2 will not settle in the normal settlement cycle but will be assigned a new settlement date which will be the settlement day following the day the trade is compared or recorded by NSCC.

<sup>4</sup> In general, the day cycle currently begins at approximately 7 a.m. and ends at 3:10 p.m., and the night cycle begins at approximately 7:00 p.m. and ends at 12:00 a.m.

Activity Report<sup>5</sup> issued later in the afternoon on each settlement date. In addition, members will be able to view their CNS positions on a real-time basis on the Participant Browser Service (“PBS”) developed by The Depository Trust Company (“DTC”). The CNS Cash Reconciliation Statement will be updated on a real-time basis and will be available on PBS after night cycle processing.

Another new STP feature available in the new CNS system will be the ability to create automated Deliver Orders (“DOs”) for non-CNS, depository eligible securities.<sup>6</sup> Today, NSCC creates receive and deliver instructions, or balance orders, for non-CNS depository eligible securities which its members then have to enter as DOs at DTC. To automate and streamline the processing of trades in non-CNS, depository eligible issues, at the request of the delivering member, NSCC will create delivery versus payment DOs that will automatically be transmitted to DTC for processing. This is an optional feature that can be activated by the delivery of standing instructions to NSCC that will cover all of the deliverer’s balance orders and special trades.<sup>7</sup>

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<sup>5</sup> The Daytime Miscellaneous Activity Report will also include corporate actions, stock borrows, and any other miscellaneous activity received in CNS after the start of the day cycle.

<sup>6</sup> Transactions in securities that are not eligible for CNS are processed through NSCC’s Balance Order Accounting Operation. Such securities are referred to as “Balance Order Securities.”

<sup>7</sup> All such DOs will be subject to DTC’s applicable DO fees. The DO standing instructions will cover all of the member’s NSCC balance orders and special trades. The delivering member can use DTC’s Inventory Management System if it wishes to control the timing and flow of any particular balance order transaction.

Other new features that will be implemented include the enhancement of the CNS Stock Borrow Program to include acceptance of borrowing instructions for the day cycle and the acceptance and real-time application of CNS "Fully Paid For" securities instructions. The CNS Stock Borrow Program enhancement is intended to maximize the use of excess collateral and reduce the number of CNS fails. In addition to providing instructions for securities available for borrowing in the night cycle, members will now also be able to provide CNS with a new file of available excess collateral from 5:00 a.m. until 1:00 p.m. for use in the day cycle.

The real-time acceptance of CNS "Fully Paid For" instructions is intended to further facilitate members' compliance with securities segregation requirements. At the current time, a member that delivers securities in its possession or control in anticipation of receiving securities from CNS as a result of allocations during the night cycle may instruct NSCC to move the open CNS long position from its CNS A (long valued) Account to its Fully-Paid-For E Subaccount to meet its customer segregation requirements. NSCC makes such movements at the end of the processing day and concurrently debits the member's settlement account for the value of the position in the E subaccount. NSCC then segregates the funds received as a result of such debit so that it constitutes a control location within the meaning of Securities Exchange Act Rule 15c3-3.<sup>8</sup>

The proposed CNS changes modify this procedure to (a) expand the capability of a member to utilize the Fully-Paid-For E Subaccount in anticipation of CNS allocations in the day cycle as well as the night cycle and (b) permit fully-paid instructions to be received and applied

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<sup>8</sup> 17 CFR 240.15c3-3.

on a real-time basis during the day cycle up through 2:45 p.m. By accepting such instructions on a real-time basis, any securities received into a member's Fully-Paid-For E subaccount can automatically be updated to the member's memo seg position at DTC on an intraday basis at the member's election through standing instructions.<sup>9</sup>

The following is a summary of the proposed rule changes needed to implement the modifications to the CNS system:

(1) Rule 11, "CNS System," is being amended to reflect the addition of the Supplemental Consolidated Trade Summaries that will be produced on each settlement day. Because of the new system's ability to take in trades, net them, and update CNS processing on a real-time basis on settlement day, Rule 11 is also being amended to make clear that with respect to trades settling on that day, a member's obligation to deliver or pay for and receive CNS securities will be fixed each time the member's net settling position is determined using CNS processing and the net settling position is made available by NSCC.

In addition, Section 9 of Rule 11 is being amended to provide the mechanism whereby a member with trades in CNS or Balance Order securities designated as "Special Trades" (which must be settled on a member-to-member basis) may issue NSCC standing instructions to provide automated DO instructions to DTC.<sup>10</sup> Any such instructions will cover all of the delivering member's balance orders and Special Trades.

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<sup>9</sup> For a description of DTC's memo seg service, refer to Securities Exchange Act Release No. 26250 (November 3, 1988), 53 FR 45638 [File No. SR-DTC-88-16].

<sup>10</sup> A technical change is also being made to this section to delete the reference to such trades having the status of "security balance orders." This deletion should have been made at the same time Rule 18 was amended in 2000 clarifying that Special Trades are to

(2) Rule 44, “Deliveries Pursuant to Balance Orders,” is being amended to provide the mechanism whereby a delivering member can issue standing instructions to NSCC to provide automated delivery instructions to DTC. Any such instructions will cover all of the delivering member’s balance orders and Special Trades.<sup>11</sup>

(3) Procedures II, “Trade Comparison Service,” and III, “Trade Recording Service (Interface Clearing Procedures),” are being amended to make conforming changes to account for same day settling trades by indicating that the cutoff times for trade comparison and recording of as-of trades to settle on their originally designated settlement schedules will now be the cutoff time set on T+3 (instead of T+2). T+3 and older as-of trades received thereafter will be assigned a new settlement date, which will be the following settlement day.<sup>12</sup>

(4) Procedure V, “Balance Order Accounting Operation,” is being amended to reflect that security balance orders will be shown on the initial and Supplemental Consolidated Trade Summaries issued on each settlement day. An indicator will be added to these reports to reflect

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be settled directly between the members. Securities Exchange Act Release No. 42747 (May 2, 2000), 65 FR 30170 [File No. SR-NSCC-98-14].

<sup>11</sup> Once this functionality is implemented, NSCC will no longer provide the PDQ Delivery System for Compare Municipal Transactions. This service currently provides for automated DTC delivery instructions for compared municipal bond transactions.

<sup>12</sup> At this time, no corresponding change is being made to Procedure II.D. because both the Fixed Income Transaction System (“FITS”) and its successor, RTTM, do not have same day settling trade capability. They will continue to maintain their current T+2 cutoff times so that trades received for comparison or recording by FITS or RTTM after T+2 will be assigned a new settlement date, which will be the settlement day following the date the trade is compared or recorded. A subsequent rule filing will be made to make any necessary conforming changes at such time as the RTTM system is modified to accept and process same day settling trades.

any standing instructions given by the member for the issuance of DOs for balance orders and Special Trades.

(5) Procedure VII, “CNS Accounting Operation,” is being amended to reflect (a) NSCC’s ability to accept through 11:30 a.m. and process on a real-time basis on settlement date trades settling on that day, (b) the issuance of the two Supplemental Consolidated Trade Summaries on each settlement day, (c) the updated reports and methods of reporting information (including through real-time message updates, the web-based PBS screens which report updated CNS positions on a real-time basis, and additional Miscellaneous Activity Reports), and (d) certain conforming changes to properly reflect current processing.

In addition, the Fully-Paid-For Account procedures included in Procedure VII, “CNS Accounting Operation,” are being amended to reflect the extension of this program to the day cycle allocation process, the real-time acceptance of instructions through the day cycle, and the real-time application of such instructions. Also the Note accompanying Procedure VII.E.5. is being modified because the portion relating to stock loan recalls is no longer applicable.<sup>13</sup>

(6) Addendum C, “NSCC Automated Stock Borrow Procedures,” is being amended to reflect the extension of this service to the daytime processing cycle and to provide the mechanism whereby members can loan their available securities to NSCC in the morning of settlement day. These securities will be used for any shortfalls that the CNS system has in the day cycle.

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<sup>13</sup> The portion of the Note relating to stock loan recalls was made inapplicable pursuant to a no-action letter dated June 28, 1985 from Michael Macchiaroli, Assistant Director, to Robert J. Woldow, Senior Vice President and General Counsel, NSCC (June 28, 1985).

The daytime stock borrow process will be separate from the nighttime stock borrow process. Securities that members make available for the nighttime process will not be applied in the daytime process. Members will have the option to participate in the nighttime stock borrow program, the daytime stock borrow program, or in both programs. The proposed changes also reflect the member's ability to be advised of any borrows through intraday messages so that members have the ability to make movements into their Fully-Paid-For Accounts as needed.

(7) Addendum G, "Fully-Paid-For Account," is being amended to reflect that this application will be available to members on a real-time basis during the day cycle on each settlement day in order to facilitate members' compliance with their securities possession or control requirements.

At this time a clarification is also being made to Rule 12, "Settlement," consistent with NSCC's collection and segregation of amounts debited with respect to positions in the Fully-Paid-For Account. It has always been understood that the movement into the E (Fully-Paid-For) subaccount was contingent upon the member's due payment of the funds debited with respect to the value of that position. It is the collection and segregation of such funds that permits NSCC to guarantee the position "free of payment" by a SIPC trustee and thus be a "control location." Thus, Rule 12 is being amended to make clear that any movement of a long valued position to the Fully-Paid-For E subaccount will not become final until the member satisfies its end-of-day money settlement obligation.

(8) Addendum K, "Interpretation of the Board of Directors—Application of Clearing Fund," is being amended to reflect that with respect to trades received by NSCC after commencement of the nighttime processing cycle and prior to 11:30 a.m. on each settlement day,



NSCC's trade guaranty will attach to such trades as of the completion of trade comparison or trade recording processing of such trades.

(9) Consistent with NSCC's extension of its trade guaranty to same day settling trades, Rule 15, "Financial Responsibility and Operational Capability," is being amended to make clear that additional clearing fund payments that may be assessed on members may also include charges relative to such same day settling trades.

In addition, the proposed rule change will make a number of technical corrections, including the following:

(1) It will define the terms "Settlement Date"<sup>14</sup> and "settlement day"<sup>15</sup> which are used throughout NSCC's Rules & Procedures and will make clear that the Consolidated Trade Summary is issued on each day that is a settlement day.

(2) It will revise Procedure I, "Introduction," to delete references to SIAC as NSCC's facilities manager and to codify NSCC's longstanding established practice of setting data submission thresholds to minimize data transmission errors and data field requirements.

(3) It will change the heading of Procedure II, "Trade Comparison Service," to "Trade Comparison and Recording Service," to reflect that this procedure covers trade recording as well as trade comparison.

Subject to Commission approval, NSCC intends to implement these changes on or about July 9, 2004. At that time, all CNS Rewrite functionality will be implemented except for

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<sup>14</sup> "Settlement Date" is defined as the date specified for a transaction to settle.

<sup>15</sup> "Settlement day" is defined as any business day on which settlement may be made through NSCC's facilities.

processing same day settling trades and the two supplemental Consolidated Trade Summaries that support same-day trade settlement. NSCC intends to begin processing same day settling trades and the supporting Consolidated Trade Summaries on or about August 5, 2004.

NSCC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act<sup>16</sup> and the rules and regulations thereunder applicable to NSCC because it will promote the prompt and accurate clearance and settlement of securities transactions by providing greater functionality and capacity to CNS and by allowing members to focus less attention on exception processing.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NSCC does not believe that the proposed rule change will have an impact on or impose a burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

No written comments relating to the proposed rule change have been solicited or received. NSCC will notify the Commission of any written comments received by NSCC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve such proposed rule change or

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<sup>16</sup> 15 U.S.C. 78q-1.

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an E-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2004-01 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NSCC-2004-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth

Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NSCC and on NSCC's Web site at [www.nsccl.com/legal](http://www.nsccl.com/legal). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NSCC-2004-01 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>17</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>17</sup> 17 CFR 200.30-3(a)(12).