

Mr. Robert J. Woldow

National Securities Clearing Corporation

55 Water Street New York, New York 10041

Dear Mr. Woldow:

This is in response to your letter of March 19, 1981, on behalf of National Securities Clearing Corporation ("NSCC"), requesting that securities represented by a long free account as described below be designated as a good control location pursuant to paragraph (c)(7) of Rule 15c3-3 of the Securities Exchange Act of 1934 (17 CFR 240.15c3-3).

I understand the pertinent facts to be as follows:

In the course of its daily operations, NSCC's Continuous Net Settlement System often has priority needs for securities that NSCC makes available via participant deliveries to clearing. These needs include buy-ins, deliveries to other clearing corporations as a result of interface transactions, special order-outs and general broker priority requests.

In order to improve the efficiency of the clearing system in dealing with these situations, NSCC's Board has authorized the implementation of limited automated stock borrow procedures, (the "Stock Borrow Program") to satisfy priority needs 'for stock that are not filled by normal deliveries from participants.

At present, NSCC's Stock Borrow Program operates as follows: On any given day, participants determine their excess security positions at Depository Trust Company ("DTC"), if any, and notify NSCC by 5:00 P.M. of any excess which may be made available for borrowing. Participants have an option, however, of submitting to NSCC an exception listing by 6:00 P.M. of the same day, removing from the list securities already lent by the participant during the day. On the basis of this information, NSCC determines if any or all of the securities made available are necessary to satisfy system needs.

During its nighttime processing cycle, NSCC determines its priority needs for the following day and borrows securities from participants. NSCC will borrow the full amount made available by one participant before borrowing from the next

participant. The selection of participants from which NSCC will borrow is done on a random basis according to a predetermined formula so as to be fair to participants.

At 8:00 A.M. the next day, NSCC informs participants what securities have been borrowed. At this time, various entries are made on both NSCC's and DTC's books. The shares borrowed are journaled short against the participant's 9000 sub account and long against the participant's 6000 sub account on NSCC's books. At DTC, the borrowed shares will be transferred from the loaning participant's account to NSCC's account where they will be delivered out on priority needs. This will cause the participant's 9000 sub account to flatten out and NSCC will make a notation to credit the participant with the value of the securities borrowed at the 3:00 P.M. settlement. In addition, the participant's 6000 sub account will be marked to the market daily. When the borrowed securities are later returned to the participant, the participant must pay in order to obtain them.

Paragraph (c)(1) of Rule 15c3-3 provides that securities under the control of a broker or dealer shall be deemed to be securities which:

"... are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges or of a registered national securities association, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of Rules 8c-1(g) and 15c2-1(g), the delivery of which certificates to the broker or dealer does not require the payment of money or value, and if the books or records of the broker or dealer identify the customers entitled to receive specified quantities or units of the securities so held for such customers collectively...."

In your letter you note that, under the NSCC's present Stock Borrow Program, securities loaned to NSCC in the manner described above would not be deemed to be in a good control location pursuant to paragraph (c)(1) of Rule 15c3-3 since the participant must pay in order to have the securities returned to him.

Indeed, in a letter dated June 23, 1980, the Division advised NSCC that securities loaned to NSCC in such a fashion may not be considered to be in the possession or control of the broker or dealer. Without the benefit of this control status, you claim

that many participants are being discouraged from making their excess securities available for borrowing by NSCC.

In order to solve this problem, NSCC proposes to modify its Stock Borrow Program as follows: If the lending participant, when notified at 8:00 A.M. next day of what has been borrowed, finds that his "seg account" is now deficient due to a recalculation of the firm's requirement and the borrowing, the participant would notify NSCC. NSCC would convert the lending participant's right to receive back from NSCC securities borrowed, versus payment, represented by a long valued position, into a right to receive back from NSCC without payment, the securities borrowed represented by a separate long free account. NSCC would charge the participant's settlement account for the value of those securities in this separate long free account thus reversing the credit which otherwise would have been extended at the 3:00 P.M. settlement.

The proposed procedure would eliminate the obligation of the trustee of an impaired lending broker to pay for customer securities, when they are returned by the Corporation. When backed by the Corporation's unconditional guarantee of return of those fully-paid-for securities, such a procedure, from the trustee's point of view, creates a virtual riskless situation.

Paragraph (c)(7) provides in pertinent part that securities under the control of the broker or dealer shall be deemed to be securities which:

"... are held in such other locations as the Commission shall upon application from a broker or dealer find and designate to be adequate for the protection of customer securities."

At this time, the Division will recommend no action to the Commission if a broker or dealer participating in NSCC's Stock Borrow Program creates a deficit in the amount of securities of which it must have possession or control pursuant to Rule 15c3-3 as a result of making available for borrowing securities pursuant to NSCC's Stock Borrow Program which are in fact borrowed by NSCC. The broker or dealer, however must on the day it is notified of the borrowing (and is thereby placed in deficit) direct NSCC to convert its right to receive back securities versus a payment (represented by a long valued position) into a right to receive back from NSCC without payment the securities represented by a separate long free account.

Furthermore, the broker or dealer may deem the securities carried in this long free account as in its control under Rule 15c3-3 provided that the broker or dealer does not make available to NSCC additional securities of the same class and issuer to be borrowed at the same time that it is owed securities by NSCC via the long free account.

The staff expects to monitor this program to assure that the procedures outlined function in a manner consistent with the objectives of Rule 15c3-3. We ask that you submit to us quarterly until September 30, 1982, in whatever form you think appropriate, the number of brokers or dealers participating in the program, the number of units of securities borrowed pursuant to the program and the number of units of securities which brokers or dealers asked NSCC to transfer to the long free account, including the aggregate dollar amount of the units of securities both borrowed and transferred. Each report should include the transactions for that quarter only.

Sincerely,

Nelson S. Kibler

Assistant Director

Mr. Nelson S. Kibler

Assistant Director Division of Market Regulation

Securities and Exchange Commission

500 North Capitol Street Washington, D.C. 20549

Dear Mr. Kibler:

As we have stated previously, the availability from our participants of stocks and bonds for borrowing enables NSCC to satisfy priority needs that exceed the securities made available via participant deliveries. Major areas where these needs currently arise are, among others: satisfaction of participant priority requests for allocation, buy-ins submitted by participants, and delivery obligations against

omnibus positions with other clearing corporations created as a result of interface transactions.

As a result of our Stock Borrow Program, participants are able to more timely deliver, thus reducing participants' fails and encouraging more active participation by institutions in various certificate immobilization efforts.

In attempting to increase participation in the Corporation's Stock Borrow Program, it has become apparent that the present treatment of securities loaned to the Corporation under 15c3-3 is a significant deterrent. By letter dated June 23, 1980, the Commission staff advised that "securities which are made available to NSCC for borrowing, although technically located in a satisfactory control location, may be loaned and delivered by NSCC prior to notification to the participants, and would at that time no longer be in any of the locations specified in paragraph (c). It is the opinion of the Division, therefore, that such securities may not be considered in the possession or control of the broker or dealer."

While the absence of control location status simply requires a lending broker, who discovers an unintentional deficiency resulting from the use of the Stock Borrow Program, to merely initiate the recall provisions of 15c3-3(d), the reality of the situation is that without the benefits of control status many participants are discouraged from making their securities available for borrowing by the Corporation.

As you are aware, the NSCC Stock Borrow Procedures operate as follows:

1. Generally, participants perform overnight their "seg accounting" and by the morning have determined what security positions are in excess. This excess availability listing is then sent to NSCC.
2. Participants have the option of submitting to NSCC an exception listing by 6:00 P.M. of the same day, removing from their list securities already lent by the participants during the day.
3. NSCC will take the Step 1 list, as modified in Step 2, and determine if any or all of the securities available are needed by NSCC to satisfy system needs.

4. NSCC at 8:00 A.M. the next day will tell the participants what has been borrowed. NSCC will have transferred the borrowed securities from the loaning participant's account at DTC to NSCC's account and NSCC will allocate these securities to satisfy certain fail to deliver obligations of NSCC. Participants whose stock has been borrowed will receive a credit in the afternoon settlement for the full market value of the securities borrowed.

Rule 15c3-3 provides in subparagraph (c)(1) that securities under the control of a broker or dealer shall be deemed to be securities which:

are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either national securities exchanges or of a registered national securities association, or of a custodian bank in accordance with a system for the central handling of securities complying with the provisions of Rules 8c-1(g) and 15c2-1(g), the delivery of which certificates to the broker or dealer does not require the payment of money or value, and if the books or records of the broker or dealer identify the customers entitled to receive specified quantities or units of the securities so held for such customers collectively; ...

By the operation of the NSCC system, the lending broker receives a credit in his afternoon settlement for securities borrowed the night before. When the short valued broker delivers in securities satisfying his delivery obligations, these securities are returned to the lending broker who must pay for these securities. Thus, the major flaw in the NSCC system which would prevent control location treatment appears to NSCC to be that a trustee cannot obtain prompt return of customer securities without payment.

To eliminate this major hurdle, NSCC proposes to modify its own system as follows:

If the lending participant, when notified at 8:00 A.M. the next day of what has been borrowed, finds that his "seg account" is now deficient due to a recalculation of the firm's requirement and the borrowing, the participant would notify NSCC. NSCC would convert the lending participant's right to receive back from NSCC securities borrowed, versus payment, represented by a long valued position, into a right to receive back from NSCC without payment, the securities borrowed, represented by

a separate long free account. NSCC would also charge the participant's settlement account for the value of those securities in this separate long free account, thus reversing the credit which otherwise would have been extended.

The proposed procedure would eliminate the obligation of the trustee of an impaired lending broker to pay for customer securities, when they are returned by the Corporation. When backed by the Corporation's unconditional guarantee of return of those fully-paid-for securities, such a procedure, from the trustee's point of view, creates a virtual riskless situation.

As to this latter point, since all that is required now is that the lending broker implement the 15c3-3(d) recall procedures with no guarantee that such recall will result in the actual physical delivery of the securities, this new procedure, which actually juxtaposes the Corporation as the guarantor to the trustee of the return of the physical securities, places the trustee in a better position than he is in today.

Good control status for the NSCC long free position would thus increase utilization of the Stock Borrow Program, therefore increasing the efficiency of the NSCC system, eliminate the long valued exposure to the Corporation, and increase protection to customers.

Based on the above, we would request your early determination, pursuant to Rule 15c3-3(c)(7) as to the good control location status for securities placed in this new long free account.

Very truly yours,

Robert J. Woldow Vice President and General Counsel

cc: Jack Nelson C. Eston Singletary, Esq. D. W. Schneider, Esq.