

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-66635; File No. SR-NSCC-2012-04)

March 21, 2012

Self-Regulatory Organizations; The National Securities Clearing Corporation; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend Rule 53 of Its Rules and Procedures Relating to the Alternative Investment Product Services to Standardize and Automate the Method by Which Registered AIP Broker-Dealer Members Meet Their Good Control Location Obligations for Uncertificated Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> notice is hereby given that on March 7, 2012, the National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change described in Items I and II below, which Items have been prepared primarily by NSCC. NSCC filed the proposal pursuant to Section 19(b)(3)(A)(iii)<sup>2</sup> of the Act, and Rule 19b-4(f)(4)(i)<sup>3</sup> thereunder so that the proposal was effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the rule change from interested parties.

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

NSCC proposes to amend Rule 53 of its Rules and Procedures with respect to its Alternative Investment Product Services (“AIP”). The proposed rule change is intended to standardize and automate the method by which registered AIP broker-dealer members meet their possession or control obligations for uncertificated securities under Commission Rule 15c3-3(b)(1)<sup>4</sup> when they designate another AIP Member as a “good control location.”

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

<sup>2</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>3</sup> 17 CFR 240.19b-4(f)(4)(i).

<sup>4</sup> 17 CFR 240.15c3-3(b)(1).

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>5</sup>

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

NSCC proposes to amend Rule 53 of its Rules and Procedures. The purpose of the proposed rule change is to standardize and automate the method by which registered AIP broker-dealer members (collectively "AIP Distributors") meet their possession or control obligations for uncertificated securities under Rule 15c3-3(b)(1)<sup>6</sup> of the Act when they designate another AIP Member, which acts on behalf of or under authority of the sponsor, general partner, or any other party responsible for the creation or manufacturing of a participating AIP investment product (collectively "AIP Manufacturers") as a "good control location," as more specifically provided below.

"Good Control Location" Background

Commission registered broker-dealers that hold securities for the accounts of their customers are required to maintain physical possession or control of all customer fully-paid and

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<sup>5</sup> The Commission has modified the text of the summaries prepared by NSCC.

<sup>6</sup> 17 CFR 240.15c3-3(b)(1).

excess margin securities under Rule 15c3-3(b)(1)<sup>7</sup> of the Act. The possession or control requirement means that registered broker-dealers must have securities in their physical possession or in their name for the benefit of their customers at one of the several “control locations” identified by Rule 15c3-3(c)<sup>8</sup> of the Act. Because uncertificated securities cannot be physically held in a broker-dealer’s possession, the broker-dealer must establish that the uncertificated securities are lodged in what are generally referred to as “good control locations.” Under the Commission’s rule, good control locations include registered securities clearing agencies,<sup>9</sup> U.S. banks,<sup>10</sup> certain designated foreign financial institutions,<sup>11</sup> and “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.”<sup>12</sup>

The Commission has allowed broker-dealers to use certain entities, which were obligated to create and maintain the ownership records with respect to such uncertificated securities as good control locations for uncertificated securities subject to certain conditions.<sup>13</sup> The

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<sup>7</sup> 17 CFR 240.15c3-3(b)(1).

<sup>8</sup> 17 CFR 240.15c3-3(b)(1).

<sup>9</sup> 17 CFR 240.15c3-3(c)(1).

<sup>10</sup> 17 CFR 240.15c3-3(c)(5).

<sup>11</sup> 17 CFR 240.15c3-3(c)(4).

<sup>12</sup> 17 CFR 240.15c3-3(c)(7).

<sup>13</sup> See, e.g., Wayne Hummer & Co., SEC No-Action Letter, 1986 WL 65387 (S.E.C.) (publicly avail. Apr. 8, 1986); Letter from Marc J. Hertzberg, Division of Market Regulation, to Brandon Becker, Wilmer, Cutler & Pickering (July 30, 1997); Letter from Mark M. Attar, Division of Market Regulation, SEC, to Brandon Becker, Wilmer, Cutler & Pickering (Sept. 17, 1999); Letter from Bonnie L. Gauch, Division of Market Regulation, SEC, to Michael K. Rafter, Holland & Knight, LLP (Jan. 5, 2000); Letter

conditions outlined in these letters have generally included the broker-dealers' receipt of certain assurances and representations from the securities' record keeper, which assurances and representations have come to be known as the "No Lien Assurances."<sup>14</sup>

In a No-Action Letter dated February 3, 2012 ("2012 No-Action Letter"), the Commission's Division of Trading and Markets ("Division") addressed the use of AIP as a means for establishing good control locations.<sup>15</sup> In it, the Division stated that it would not recommend enforcement action against Charles Schwab & Co., Inc. ("Schwab") if Schwab used AIP to establish good control locations for uncertificated securities of alternative investment products participating in AIP.

#### AIP Background

NSCC's AIP Service is a communications and payments processing platform for eligible alternative investment products, including interests in commodity pools, REIT securities, managed futures and managed currency products, and securities issued by hedge funds, private equity funds and funds of funds (collectively "Eligible AIP Products"). AIP provides for the processing of transactions in these products and for the settlement of related payments on a pre-funded basis without netting and without a guarantee of payment in the event of a contra-side

from Joseph I. Levinson, Special Counsel, Division of Trading and Markets, SEC, to Mark D. Fitterman, Morgan, Lewis & Bockius LLP (June 9, 2009); FOLIO[fn] Investments, Inc., SEC No-Action Letter, 2009 WL 58414 (Jan 6, 2009).

<sup>14</sup> Broker-dealers generally receive the No Lien Assurances by obtaining a hard-copy letter from the issuer or its transfer agent or other record keeper of the securities.

<sup>15</sup> Letter from Michael A. Macchiaroli, Division of Trading and Markets, SEC, to Peter J. Morgan III, Charles Schwab & Co., Inc. (February 3, 2012).

default.<sup>16</sup> Transactions processed through AIP include subscriptions and redemptions, distributions, position reporting, and account maintenance.

Since its implementation, AIP has standardized the way the alternative investment industry communicates information between broker-dealers, fund managers, administrators, custodians, and issuers of alternative investment products. In the last several months, the alternative investment industry has asked NSCC to further standardize and automate communications among these parties by creating a uniform mechanism by which AIP Distributors may satisfy their Rule 15c3-3(c) possession or control obligations when using AIP Manufacturers as good control locations. NSCC believes it can offer a number of control improvements to the current manual, decentralized, and paper-based mechanisms that are used today for establishing good control locations for uncertificated securities of alternative investments.

#### AIP Membership Requirements

Under NSCC Rule 53, the following types of entities are eligible to become AIP users (“AIP Members”):

1. a broker-dealer registered under the Act or a non-U.S. broker-dealer subject to oversight and regulation by the appropriate financial services regulator in its home jurisdiction;<sup>17</sup>
2. a bank or trust company that is a member of the U.S. federal reserve system or that is supervised and examined by U.S. federal or state banking authorities or a non-U.S.

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<sup>16</sup> Securities Exchange Act Release No. 34-57813 (May 12, 2008), 73 FR 28539 (May 16, 2008).

<sup>17</sup> But see fn. 14, infra.

bank subject to oversight and regulation by the appropriate financial services regulator in its home jurisdiction;

3. an investment company registered under the Investment Company Act of 1940 (“Advisers Act”), or an issuer (structured as a fund or other pooled investment vehicle) that is not required to register thereunder;

4. an investment adviser as defined in the Advisers Act regardless of whether it is registered under the Advisers Act or is exempt from registration;

5. a commodity pool operator or commodity trading advisor as defined in the Commodity Exchange Act (“CEA”) regardless of whether the commodity pool operator or commodity trading advisor is registered pursuant to the CEA or is exempt from registration thereunder;

6. an insurance company subject to supervision or regulation under U.S. state insurance law or a non-U.S. insurance company subject to oversight and regulation by the appropriate insurance regulator in its home jurisdiction; and

7. an entity engaged under contract to provide administrative services to one or more alternative investment products that can be processed through AIP.

Before acceptance as an AIP Member, each applicant must submit an executed AIP

Membership Agreement to NSCC, agreeing that, among other things, it will:

1. only use the AIP Service;<sup>18</sup>
2. abide by the rules of NSCC and be bound by all of the provisions thereof and that NSCC will have all of the rights and remedies contemplated by the rules of NSCC;

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<sup>18</sup> An AIP Member may use another NSCC service but only if the AIP Member also executes a separate NSCC Membership Agreement.

3. be bound by the rules of NSCC as to all matters and transactions occurring while the applicant is an AIP Member, notwithstanding that the applicant may subsequently cease to be an AIP Member;
4. not submit, clear, or settle through NSCC any contract or transaction unless the rules of NSCC are part of the terms and conditions of such contract or transaction;
5. pay to NSCC such charges as shall be established by NSCC by rule;
6. not submit or confirm any transaction, charge, request, instruction, or transmission through NSCC's services or otherwise utilize NSCC's services in contravention of any law, rule, regulation, or statute applicable to the AIP Member;
7. not submit any request, instruction, transaction, or other transmission through NSCC's services for which it is not directly or indirectly and whether acting on its own behalf or on behalf of any other entity, duly authorized;
8. pay such fines as may be imposed in accordance with NSCC's rules for the failure of the AIP Member while an AIP Member to comply therewith; and
9. be bound by any amendment to the rules of NSCC with respect to any use of NSCC's services subsequent to the time such amendment takes effect, as fully as though such amendment were now a part of the rules of NSCC; provided, however, that no such amendment shall affect an AIP Member's right to cease to be an AIP Member of NSCC unless before such amendment becomes effective, the AIP Member has opportunity to give written notice to NSCC of the AIP Member's election to discontinue being an AIP Member.

### The Proposed Rule Changes

Currently, AIP provides for two alternative customer account designations either “broker-controlled” or “customer-controlled.” The initial account designation for an AIP account is generally made by the AIP Distributor acting on behalf of its investor customer. However, the AIP Manufacturer may change the account designation at any time. For example, if an investor were to directly notify the AIP Manufacturer that its account should no longer be designated as broker-controlled, the AIP Manufacturer could change the indication on the AIP system. The proposed rule changes to NSCC Rule 53 will apply solely with respect to “broker-controlled” AIP account designations.

NSCC proposes to amend Rule 53 to specify that when an AIP Distributor submits an AIP order for its customer account and requests a broker-controlled designation as part of the order, the AIP Manufacturer accepting the order (and accordingly making and approving the broker-controlled designation as part of the order)<sup>19</sup> will be making continual and ongoing representations and assurances to the controlling AIP Distributor that:

1. the Eligible AIP Product securities held (or to be held) in the account are not subject to any right, charge, security interest, lien, or claim of any kind in favor of the AIP Manufacturer or any person claiming through such AIP Manufacturer;
2. to the knowledge of the AIP Manufacturer, there are no substantial problems of an operational nature which the AIP Manufacturer is experiencing or which may endanger the interest of investors in the Eligible AIP Product;

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<sup>19</sup> As set forth above, broker-dealers are eligible to be AIP Members. However, a broker-dealer’s authority to serve as a good control location is derived from Rule 15c3-3(c)(2) of the Act and applicable Commission and SRO guidance. Nothing in this proposed rule change is intended to contradict existing regulations pertaining to control locations under Rule 15c3-3 of the Act.

3. the Eligible AIP Product securities held (or to be held) in the account are registered with the Commission pursuant to the Securities Act of 1933, as amended, are exempt from such registration, or are not required to be so registered;

4. the Eligible AIP Product securities in the account (or to be held in the account) are registered on the books and records of the AIP Manufacturer or its designee in the name of the controlling AIP Distributor on behalf of its customer;

5. in the case of Eligible AIP Product securities issued outside of the United States, the AIP Manufacturer does not require the controlling AIP Distributor or any of its customers to pay any fees other than for safe custody or administration as a condition for the transfer of the securities; and

6. the AIP Manufacturer understands and acknowledges that the controlling AIP Distributor may be relying on the above representations in order to establish custody in accordance with Rule 15c3-3 of the Act and that failure to comply with the above representations may require that the controlling AIP Distributor remove the Eligible AIP Product securities from the applicable customer's brokerage account.

The AIP Manufacturer representations and assurances in 1-6 above are collectively referred to as the "AIP Manufacturer Representations and Assurances."

The AIP Manufacturer Representations and Assurances will be obtained from each relevant AIP Manufacturer through an "accept" or "decline" option within the record layouts that reside in AIP. The relevant AIP Distributors will be able to determine through AIP whether the AIP Manufacturer Representations and Assurances have been provided by reference to an indicator on a security profile that is included on a data file provided to the AIP Distributor.

NSCC also proposes to amend the AIP Membership Agreement with regard to AIP Manufacturers to provide that each time the AIP Manufacturer accepts an AIP order and designates the securities with respect to that order as “broker-controlled,” such AIP Manufacturer will be making the AIP Manufacturers Representations and Assurances on a continual and ongoing basis to the applicable AIP Distributor, so long as the “broker-controlled” designation remains in place.

Additionally, Rule 53, as amended, will provide that each AIP Distributor that is a registered broker-dealer and that is relying on a specified AIP Manufacturer’s Representations and Assurances with respect to a customer account shall for so long as the applicable “broker-controlled” designation remains in place be continually stating that such AIP Distributor:

1. carries those Eligible AIP Product securities “long” in each respective customer account;
2. reflects all share positions of the applicable Eligible AIP Product separately in its securities records or ledgers maintained pursuant to Rule 17a-3 of the Act;
3. maintains in a separate file a current list of all AIP Manufacturers of which Eligible AIP Product securities are carried on that AIP Distributor’s books and records, including the name, telephone number, and address of a contact person at each AIP Manufacturer; and
4. is not aware of any substantial problems of an operational nature which AIP or the applicable AIP Manufacturer or issuer (if different) may be experiencing and which may endanger the interests of the customer.

The above AIP Distributor statements (collectively the “AIP Distributor Statements”) would be recorded by way of an electronic indicator within AIP.

NSCC proposes to amend the AIP Membership Agreement with regard to AIP Distributors to set forth that each AIP Distributor who shall be relying on an AIP Manufacturer's Representations and Assurances understands that such AIP Distributor will continually and on an ongoing basis be making the AIP Distributor Statements so long as the applicable "broker-controlled" designation remains in place.

The above AIP Manufacturer Representations and Assurances and AIP Distributor Statements conform to the No-Action Letters developed by the Commission staff and described herein, including the 2012 No-Action Letter addressing the use AIP for establishing good control locations. As noted above, registered broker-dealers currently establish their Commission Rule 15c3-3(c)(7) obligations by way of manual processes. Automating this process through AIP will standardize and centralize the process will assist the parties in establishing compliance with legal requirements and will provide a better audit trail for AIP Members and their regulators to verify compliance after the fact.

Further, if an AIP Manufacturer or AIP Distributor at any time elects to change the customer account designation from "broker-controlled" to "customer-controlled," the above AIP Manufacturer Representations and Assurances and AIP Distributor Statements from that point forward would no longer apply to the relevant AIP Members, and each relevant AIP Distributor and AIP Manufacturer, as the case may be, would be put on notice that the designation with regard to the customer account has changed. As a condition set forth in the 2012 No-Action Letter, each AIP Distributor relying on the AIP Manufacturer Representations and Assurances is required to monitor AIP on a regular basis for any changes to the "broker-controlled" account

designations for which the AIP Distributor maintains custody.<sup>20</sup>

The proposed rule change is consistent with the requirements of the Act and the rules and regulations issued thereunder because it promotes the prompt and accurate clearance and settlement of transactions in securities by automating, standardizing, and centralizing the communication of information between persons engaged in the clearance and settlement of securities transactions. In addition, the proposed rule change fosters cooperation and coordination between broker-dealers and issuers of securities and removes impediments to the prompt and accurate clearance and settlement of securities transactions.

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

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

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

Written comments relating to the proposed rule change have not 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

The foregoing proposed rule change has become effective upon filing pursuant to Section

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<sup>20</sup> See the 2012 No-Action Letter, Condition #7. Where an AIP Distributor learns that the designation for an Eligible AIP Product has been changed from “broker-controlled” to “customer-controlled,” the AIP Distributor should contact the AIP Manufacturer to confirm whether the position was intended to be returned to the customer. If the Eligible AIP Product is not re-designated as “broker-controlled,” the AIP Distributor should remove the position from the customer’s brokerage account.

19(b)(3)(A)(iii)<sup>21</sup> of the Act and Rule 19b-4 (f)(4)(i)<sup>22</sup> thereunder because it effects a change in NSCC's existing AIP services that does not adversely affect the safeguarding of securities or funds in the custody or control of NSCC or for which it is responsible and does not significantly affect the respective rights or obligations of NSCC or the persons using the service. The proposed rule change affects a service of NSCC which is not guaranteed (i.e., to which NSCC is not a central counter-party) and which does not provide for the movement of securities or for the application of credits or debits to cash balances of members. Accordingly, the proposed rule change does not adversely affect the safeguarding of securities or funds in the custody or control of NSCC or for which NSCC is responsible. Additionally, designation of an account as "broker-controlled" or "customer-controlled" within AIP is wholly voluntary meaning that an AIP Manufacturer may choose to decline an order request with a broker-controlled designation and therefore may not be required to make the above stated assurances and representations. This is effectively what happens in the market today outside of AIP when a registered broker-dealer attempts to designate an account as broker-controlled but the applicable alternative investment product record keeper refuses to provide the requisite representations and assurances. A registered broker-dealers' failure to obtain such assurances and representations would preclude the registered broker-dealer from continuing to identify the customer account in such alternative investment product as "broker-controlled." Under the proposed rule change, the rights and obligations of the parties would not change, but each relevant party would know the status of the customer account designation in a far less time-consuming manner. Further, if a "customer controlled" designation is made with respect to an AIP order, the above rule changes would not

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<sup>21</sup> 15 U.S.C. 78s(b)(3)(A)(iii).

<sup>22</sup> 17 CFR 240.19b-4(f)(4)(i).

apply to either the AIP Manufacturer making the designation or to the applicable AIP Distributor. At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### 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-2012-04 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NSCC-2012-04. 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 website (<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 website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filings also will be available for inspection and copying at the principal office of NSCC and on NSCC's website at [http://www.dtcc.com/downloads/legal/rule\\_filings/2012/nsc/2012-04.pdf](http://www.dtcc.com/downloads/legal/rule_filings/2012/nsc/2012-04.pdf)

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-2012-04 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.<sup>23</sup>

Kevin O'Neill  
Deputy Secretary

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<sup>23</sup> 17 CFR 200.30-3(a)(12).