SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34–49809, File No. S7–24–04]

RIN 3235–AJ26

Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is proposing a new rule under the Securities Exchange Act of 1934 (''Exchange Act'') that would prohibit registered transfer agents from effecting any transfer of any equity security registered under section 12 or any equity security that subjects an issuer to reporting under 15(d) of the Exchange Act if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary, such as clearing agencies, banks, or broker-dealers, is restricted or prohibited. The primary purpose of the proposed rule is to promote the integrity and efficiency of the U.S. clearance and settlement system.

DATES: Comments should be received on or before July 12, 2004.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov.* Please include File Number S7–24–04 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

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 S7–24–04. This file number should be included on the subject line if e-mail is used. To help us 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/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Jerry Carpenter, Assistant Director, or Susan M. Petersen, Special Counsel, Office of Risk Management, 202/942–4187, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–1001.

SUPPLEMENTARY INFORMATION: Recently, a number of issuers of equity securities trading in the public markets have imposed restrictions on their securities to limit or to prohibit ownership of the securities by securities intermediaries such as depositories, broker-dealers, and banks. Such restrictions require these securities to be certificated and transactions in these securities to be manually cleared, settled, and transferred on a transaction-by-transaction basis.

To facilitate the clearance and settlement of securities transactions, securities held by a securities intermediary on behalf of its customers or another securities intermediary are commonly registered in the name of the securities intermediary or in its nominee name, which makes the securities intermediary the registered owner.[1] This is often referred to as holding a security in ''street name.''[2] Holding securities in street name at a securities depository facilitates the transfer of negotiable certificates and obviates the need for investor signatures and delivery of certificates. Registered clearing agencies acting as securities depositories help to centralize and automate the settlement of securities, in part by reducing the physical movement of securities traded in the U.S. markets through the use of book-entry movements. On occasion, other securities intermediaries, such as broker-dealers or banks, may perform similar functions for securities by holding a certificate registered in the name of securities intermediary but held on behalf of its customers and internally adjust its books to reflect customers' purchases and sales of that security.

The use of securities depositories in order to minimize the physical movement in connection with the settlement for securities traded in the public market is essential to the prompt and accurate clearance and settlement of securities transactions.[3] The effort by some issuers to restrict ownership of publicly traded securities by securities intermediaries can result in many of the inefficiencies and risks Congress sought to avoid when promulgating Section 17A of the Exchange Act.[4] Restrictions on intermediary ownership deny investors the ability to use a securities intermediary to hold their securities and to efficiently and safely clear and settle their securities transactions by book-entry movements.

The Commission is proposing Rule 17Ad–20 that would prohibit registered transfer agents[5] from effecting any transfer of any equity security registered under section 12 or any equity security that subjects an issuer to reporting under 15(d) of the Exchange Act[6] if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary.[7] Under the proposed rule, the term

[1] The registered owner is the name of the individual shareholder recorded on the official records of the issuer (sometimes referred to as the record owner or legal owner of the securities).

[2] In the case of securities held in street name, generally the securities are held by a securities depository (*e.g.,* The Depository Trust Company) who as the registered owner holds the securities on behalf of another securities intermediary (*e.g.,* a broker-dealer or bank) who in turn holds the securities for its customers, the beneficial owners. All the rights and obligations of the securities are passed through the registered holder to the beneficial owners. For more information on the relationship between securities intermediaries and beneficial owners, *see infra* note 23.

[3] Section 17A of the Exchange Act directs the Commission to use its authority to end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transaction in securities. 15 U.S.C. 78q–1(e).

[4] 15 U.S.C. 78q–1 *et seq.*

[5] The Exchange Act defines transfer agent as any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance; (C) registering the transfer of such securities; (D) exchanging or converting such securities; or (E) transferring record ownership of securities by book-entry without the physical issuance of securities certificates. 15 U.S.C. 78c(a)(25). Accordingly, issuers acting as their own transfer agent would be subject to the rule.

[6] Pursuant to section 12(g) of the Exchange Act and the rules thereunder, a company must generally register a class of equity securities if on the last day of its fiscal year it has total assets of more than $10 million and the class is held of record by more than 500 persons. 15 U.S.C. 78*l*(g). Under section 12 (b), all securities registered on a securities exchange must also be registered with the Commission. 15 U.S.C. 78*l*(b). Section 15(d) of the Exchange Act generally requires a company with an effective Securities Act registration statement to file the same periodic reports as a company that has a section 12 registered class of securities. 15 U.S.C. 78o(d).

[7] Section 17A(c)(1) makes it unlawful for any transfer agent, unless registered with the Commission, to directly or indirectly perform the function of a transfer agent with respect to any security registered under Section 12 of the Act or which would be required to be registered except for the exemption from registration proved by section 12(g)(2)(B) (investment companies) or section 12(g)(2)(G) (certain securities issued by insurance companies). 15 U.S.C. 78q–1(c)(1).

''securities intermediary'' would be defined as a clearing agency registered under Section 17A of the Exchange Act or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others. The Commission is proposing to exclude from proposed Rule 17Ad–20 any equity security issued by a partnership, as defined in Item 901 of Regulation S–K.[8] For tax or other reasons,[9] partnerships may have an appropriate need to restrict ownership and issue a securities certificate. The Commission invites comment on the proposed rule, the proposed timetable for implementation, and the costs and benefits of such a rule.

I. Background

A. Legislative History of the National System for Clearance and Settlement of Securities Transactions

In the late 1960s and early 1970s, the securities industry experienced a ''paperwork crisis'' that nearly brought the industry to a standstill and that directly or indirectly caused the failure of a large number of broker-dealers.[10] This crisis primarily resulted from drastically increasing trade volume coupled with inefficient, duplicative, and extensively manual clearance and settlement systems; the extensive use of securities certificates; poor records; and insufficient controls over funds and securities.[11] To address the concerns raised by the paperwork crisis, Congress amended the Exchange Act to add, among other things, section 17A.[12]

In section 17A(a), Congress made findings that (1) the prompt and accurate clearance and settlement of securities transactions, including the transfer of registered ownership and safeguarding of securities and funds related to clearance and settlement activities, are necessary for the protection of investors and those acting on behalf of investors,[13] and (2) inefficient clearance and settlement procedures impose unnecessary costs on investors and those acting on their behalf.[14] To address these concerns, Congress gave the Commission the authority and responsibility to regulate, coordinate, and direct the processing of securities transactions in order to establish a national system for the prompt and accurate clearance and settlement of transactions in securities.[15] The basic purpose of Section 17A is to promote the development of a modern, nationwide system for the safe and efficient processing of securities transactions that serves the interests of the financial community and the investing public.[16] Congress expressly provided the Commission with jurisdiction over clearing agencies and transfer agents, as well as other participants in the national system for clearance and settlement.[17] Furthermore, specifically recognizing that the use of securities certificates to transfer registered ownership decreases efficiency and safety in the capital markets, Congress also directed the Commission to end the physical movement of securities certificates in connection with the settlement among brokers and dealers.[18]

B. The Role of Securities Intermediaries

The process for delivering and transferring certificated securities is almost entirely manual and as such, is labor-intensive, expensive, and time-consuming.[19] The use of securities certificates can result in significant delays and expense in processing securities transactions. Moreover, as negotiable instruments, certificates also can be lost, stolen, or forged.[20] All this adversely affects the national system for clearance and settlement. The concern associated with lost certificates was dramatically demonstrated after September 11, 2001, when thousands of certificates at broker-dealers or banks (either being held in custody in vaults or being processed for transfer) either were destroyed or were unavailable for transfer. Certificates have also been identified by the financial services industry as an obstacle to achieving streamlined processing (*i.e.*, straight-through-processing) and shorter settlement cycles.[21]

Securities intermediaries hold securities on behalf of others in order to facilitate more efficient clearance and settlement of securities transactions by reducing the need to transfer certificates. Investors' securities generally are held in the name of a securities intermediary, such as a securities depository, broker-dealer, or

[8] Item 901(b)(1) defines the term partnership to mean any: (i) finite-life limited partnership or (ii) other finite-life entity. 17 CFR 229.901(b)(1). The Commission has the authority under section 36 of the Exchange Act to conditionally or unconditionally exempt any security or class of securities from the provisions of the Exchange Act to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. 15 U.S.C. 78mm(a)(1).

[9] A ''publicly traded partnership'' as defined in Section 7704 of the Internal Revenue Code is subject to treatment as a corporation rather than a partnership for tax purposes. 26 CFR 1.7704–1.

[10] Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92nd Cong., 1st Sess. 13 (1971). Congress held hearings to investigate the problems and ultimately enacted the Securities Acts Amendments of 1975. Securities Acts Amendments of 1975: Hearings on S. 3412, S. 3297, S. 2551 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 92nd Cong., 2nd Sess. (1972).

[11] S. Rep. No. 75, 94th Cong., 1st Sess. at 4 (1975).

[12] 15 U.S.C. 78q–1 *et seq.*

[13] 15 U.S.C. 78q–1(a)(1)(A).

[14] 15 U.S.C. 78q–1(a)(1)(B).

[15] 15 U.S.C. 78q–1(a)(2)(A)(i). Congress expressly envisioned the Commission's authority to extend to every facet of the securities handling process involving securities transactions within the United States, including activities by clearing agencies, depositories, corporate issuers, and transfer agents. *See* S. Rep. No. 75, 94th Cong., 1st Sess. at 55 (1975).

[16] *See* S. Rep. No. 75, 94th Cong., 1st Sess. at 122 (1975).

[17] *See e.g.*, section 17A(c)(1) of the Exchange Act, which makes it unlawful for any transfer agent, unless registered with the Commission, to directly or indirectly perform the function of a transfer agent with respect to any security registered under section 12 of the Act or which would be required to be registered except for the exemption from registration proved by section 12(g)(2)(B) (investment companies) or section 12(g)(2)(G) (certain securities issued by insurance companies). 15 U.S.C. 78q–1(c)(1) and 15 U.S.C. 78*l*(a) respectively. Exchange Act Section 17A(d)(1) prohibits any registered clearing agency or registered transfer agent from engaging in any activity as a clearing agency or transfer agent in contravention of rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act. 15 U.S.C. 78q–1(d)(1).

[18] Section 17A(e) directs the Commission to use its authority ''to end the physical movement of the securities certificates in connection with the settlement among brokers and dealers of transactions in securities consummated by means of the mails or other means or instrumentalities of interstate commerce.'' 15 U.S.C. 78q–1(e).

[19] For more information on the costs and risks associated with processing certificates, *see* Exchange Act Release No. 49405 (March 11, 2004), 69 FR 12922 (March 18, 2004), [File No. S7–13–04] (concept release regarding securities transaction settlement concept).

[20] In an effort to identify lost, counterfeit, and stolen securities, Exchange Act Rule 17f–1 requires, among other entities, every exchange, the securities association, broker, dealer, transfer agent, registered clearing agency, and many banks to report to the Securities Information Center (''SIC'') missing, lost, counterfeit, or stolen securities certificates. *See* 17 CFR 240.17f–1. SIC operates a centralized database that records lost and stolen securities. When a broker-dealer receives a security certificate to sell, the broker-dealer will submit information about the certificate to SIC so that SIC may search its database to see if the certification has been reported as missing, lost, stolen, or counterfeited. (For more information about SIC, see *www.secic.com*.) If a broker-dealer is unable to have the security reregistered into the name of the buyer or the buyer's securities intermediary after trade date, the rejection of the transfer after trade date exposes the customer to the costs and risks that she may have to buy in the security and exposes the broker-dealer to the costs and risks associated with buy-ins. Investors bear direct costs as well. Transfer agents require investors to obtain a surety bond before the transfer agent will issue a replacement certificate for lost and stolen certificates. We understand that generally most transfer agents charge investors between 2%–4% of the current market value of the securities to obtain a surety bond.

[21] *See* Exchange Act Release No. 49405 (March 11, 2004), 69 FR 12922 (March 18, 2004), [File No. S7–13–04].

bank, or its nominee, for the benefit of the security intermediary's customers. The securities intermediary or its nominee is generally the registered owner of the securities while the securities intermediary's customer typically is the beneficial owner.[22] Securities registered in the name of the securities intermediary or its nominee allows the securities to be immobilized[23] and held in fungible bulk[24] thereby significantly reducing the number of certificates that need to be delivered and transferred. This in turn reduces the risk and cost associated with transferring the securities. Transfers in ownership of securities held in the name of a securities intermediary are accomplished by making book-entry adjustments to the accounts on the securities intermediary's records.

Consistent with Congress' directive to establish a national system for clearance and settlement and to decrease the inefficiencies and risks associated with processing securities certificates, the Commission has long encouraged the use of alternatives to holding securities in certificated form. The Commission's approval of the registration of securities depositories as clearing agencies in 1983 constituted an important step in achieving the mandates established by Congress by immobilizing securities in a registered clearing agency and settling transactions by book-entry movements.[25] The Commission also has approved the rule filings of self-regulatory organizations that require their members to use the facilities of a securities depository for the book-entry settlement of all transactions in depository-eligible securities[26] and that require securities to be made depository eligible if possible before they can be listed for trading.[27]

Registered clearing agencies acting as securities depositories immobilize securities and centralize and automate securities settlements.[28] Holding securities positions in book-entry form at securities depositories reduces the physical movement of publicly traded securities in the U.S. markets and significantly improves efficiencies and safeguards in processing securities certificates, which in turn reduces the costs of those transactions to investors and market professionals alike.

DTC, the largest securities depository in the world, provides custody and book-entry transfer services for the vast majority of securities transactions in the U.S. market involving equities, corporate and municipal debt, money market instruments, American depositary receipts, and exchange-traded funds.[29] In accordance with its rules, DTC accepts deposits of securities from its participants (*i.e.*, broker-dealers and banks),[30] credits those securities to the depositing participants' accounts, and effects book-entry movements of those securities.[31] The securities deposited with DTC are registered in DTC's nominee name[32] and are held in fungible bulk for the benefit of its participants and their customers.[33] Each participant having an interest in securities of a given issue credited to its account has a pro rata interest in the securities of that issue held by DTC.[34]

Some securities trading in the public market are not deposited at a securities depository because either the securities are not eligible for deposit[35] or the securities intermediary chooses not to deposit the securities.[36] To clear and settle securities transactions without the use of a securities depository, broker-dealers must make independent arrangements to provide for delivery of securities (in certificated form) and payment on a trade-by-trade basis. In

[22] The relationship between various levels of securities intermediaries and beneficial owners is complex. There may be many layers of beneficial owners (some of which may also be securities intermediaries) with all ultimately holding securities on behalf of a single beneficial owner, who is sometimes referred to as the ultimate beneficial owner. For example, an introducing broker-dealer may hold its customer's securities in its account at a clearing broker-dealer, that in turn holds the introducing broker-dealer's securities in an account at The Depository Trust Company (DTC). In this context, DTC or its nominee is the registered owner and DTC's participants (*i.e.,* broker-dealers and banks) are beneficial owners, as are the participants' customers. However, DTC, the clearing broker-dealer (the DTC participant), and the introducing broker-dealer are all securities intermediaries. These distinctions may be important under both federal and state law when determining the rights and obligations of the parties holding securities on behalf of others.

[23] Immobilization of securities occurs where a securities depository holds the underlying certificate and transfers of ownership are recorded through book-entry movements between the depository's participants' accounts. An issue is partially immobilized (as is the case with most equity securities traded on an exchange or at the NASD) when the street name positions are immobilized (*i.e.,* those held through broker-dealers that are participants of a depository), but certificates are still available to individual shareholders upon request. For more information about immobilization and dematerialization, *see* Exchange Act Release No. 49405 (March 11, 2004), 69 FR 12922 (March 18, 2004), [File No. S7–13–04].

[24] Fungible bulk means that no participant or customer of a participant has any claim or ownership rights to any particular certificate held by DTC. Rather, participants have a securities entitlement to obtain a certificate representing securities held in their DTC accounts.

[25] Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (October 3, 1983), [File Nos. SR–600–5 and 600–19] (order approving the clearing agency registration of four depositories and four clearing corporations).

[26] Exchange Act Release No. 32455 (June 11, 1993), 58 FR 33679 (June 18, 1993), [File Nos. SR–Amex–93–07; SR–BSE–93–08; SR–MSE–93–03; SR–NASD–93–11; SR–NYSE–93–13; SR–PSE–93–04; and SR–Phix–93–09)] (order approving rules requiring members, member organizations, and affiliated members of the New York Stock Exchange, National Association of Securities Dealers, American Stock Exchange, Midwest Stock Exchange, Boston Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange to use the facilities of a securities depository for the book-entry settlement of all transactions in depository-eligible securities with another financial intermediary). In rare circumstances, DTC will be unable to accept a deposit of a security because it is unable to process it. In those cases, the rules of the self-regulatory organizations do not require the security to be depository eligible.

[27] Exchange Act Release No. 35798 (June 1, 1995), 60 FR 30909 (June 12, 1995), [File Nos. SR–Amex–95–17; SR–BSE–95–09; SR–CHX–95–12; SR–NASD–95–24; SR–NYSE–95–19; SR–PSE–95–14; SR–PHLX–95–34] (order approving rules setting forth depository eligibility requirements for issuers seeking to have their shares listed on the American Stock Exchange, Boston Stock Exchange, Chicago Stock Exchange, National Association of Securities Dealers, New York Stock Exchange, Pacific Stock Exchange, and the Philadelphia Stock Exchange).

[28] Securities depositories work in conjunction with securities clearing corporations. Both types of entities must be registered as clearing agencies under section 17A of the Exchange Act. Clearing corporations, such as the National Securities Clearing Corporation, serve to compare trades submitted to it by its participants and net those trades to a single position at the end of the day. The trade position data is then submitted to the depository in order to effectuate settlement by debiting or crediting the participants' book-entry securities position at DTC and facilitating the payments to or from the participants.

[29] Of the four depositories registered as clearing agencies in 1983, DTC is the only one still operating. DTC estimates that as of December 31, 2002, approximately 84% of the shares issued by domestic companies listed on the NYSE and 88% of the domestic companies listed on the Nasdaq are deposited at DTC. (These statistics do not include ADRs.) E-mail from Joseph Trezza, Senior Product Manager, DTCC, to the Commission staff (November 14, 2003).

[30] In the case of ''book-entry-only'' securities (*e.g.*, no securities certificates are available), the issuer will authorize DTC to credit the account or accounts of participants with all of the issuer's outstanding shares.

[31] *See, e.g.*, Rules 5 and 6 of DTC's Rules.

[32] DTC registers securities in the name of its nominee, Cede & Co., which makes it the registered owner of the securities.

[33] Securities deposited at DTC by its participants or the issuers in the case of book-entry-only securities are legally or beneficially owned by the participants or their customers at the time of the deposit and are subsequently transferred into DTC's nominee name.

[34] While DTC is the registered owner, the participants and their customers are the beneficial owners. At no time does an issuer have an ownership interest in the securities deposited at DTC. *See* supra note 22.

[35] A securities depository determines whether a security is eligible for deposit. Certain securities may not be eligible for a variety of reasons such as the security cannot conform to the depository's processing systems or ownership of the security is restricted in such a manner that it cannot be freely transferred.

[36] For example, DTC participants may choose to not deposit the securities in the depository if the security is not widely traded and instead hold certificated securities registered in the name of either the participant's nominee or its customer.

cases where an issuer has prohibited ownership of their securities by certain securities intermediaries, such as DTC, some broker-dealers register their customers' positions in the name of the broker-dealer so that certificates do not need to be issued for each customer and transferred on each trade. However, securities transactions between broker-dealers would still have to be manually processed. Thus, clearing and settling securities transactions outside of a depository raises greater risks and inefficiencies, including credit risk issues and risk of defaults, than transfers within a depository. Furthermore, the payment of dividends and proceeds from corporate actions for securities held outside a depository typically are slower and more costly because issuers must send a check to each shareholder rather than make a single deposit of the funds at DTC.[37]

In addition to encouraging the use of securities depositories, the Commission has also long supported industry efforts to develop other alternatives to securities certificates, particularly for those investors who want to retain the registration of the securities in their own names.[38] The Commission issued a concept release in 1994 seeking public comment on the policy implications and the regulatory issues raised by use of a system that would allow individual investors to register securities in their own names but hold their positions in book-entry form on the books of the issuers or its transfer agent. Such a system, known as the Direct Registration System (''DRS'') began operating in mid 1990s. DRS provides investors with the ability to register their securities in their own names directly on the issuer's records in book-entry form and to electronically transfer by book-entry movements the securities positions between the issuer or its transfer agent and the investors' broker-dealers.[39] In place of a certificate, issuers send a periodic statement to reflect the number of shares registered in the name of and held in DRS by the shareholder. Today over 750 issuers have made their securities eligible for DRS and nearly 40 million investors hold their shares in DRS.[40]

II. Need for the Proposed Rule

A small but growing number of issuers whose securities are registered under section 12 or are reporting under section 15(d) of the Exchange Act[41] recently have restricted, or indicated their intention to restrict, ownership of their securities by prohibiting their transfer agents from acknowledging ownership of shares registered in the name of DTC or by prohibiting transfer of their securities to DTC or in some cases to any securities intermediary.[42] Most, if not all, of the issuers restricting ownership of their securities have also required that the shares be represented in certificated form.[43] In several cases, the issuer has required the broker-dealer to disclose the name of the ultimate beneficial owner before reregistering any securities held by the broker-dealer either in the name of the broker-dealer or in the name of DTC.[44] Some brokers refused because they believed disclosure of the customer's name would violate federal securities laws[45] or contractual obligations to the customer. Other broker-dealers could not disclose the name of the ultimate beneficial owner because they knew only the identity of their customer and not necessarily for whom their customer was holding the securities.

Issuers imposing these restrictions, sometimes referred to as ''custody-only trading,'' frequently state that they are imposing ownership or transfer restrictions on their securities to protect their shareholders and their share price from ''naked'' short selling.[46] These issuers believe that requiring all securities to be in certificated form and precluding ownership by certain securities intermediaries forces broker-dealers to deliver certificates on each transaction, thereby eliminating the ability of naked short sellers to maintain a naked short sale position.[47]

A number of issuers imposing ownership or transfer restrictions sought to withdraw from DTC all securities issued by them and indicated that they would not allow their securities to be reregistered in the name of DTC.[48] In June 2003, the Commission approved a DTC rule change clarifying that DTC's rules and procedures provide only for participants (*i.e.*, broker-dealers and banks) to submit withdrawal instructions for securities deposited at DTC and do not require DTC to comply with withdrawal requests from issuers.[49]

[37] Payments from issuers submitted to DTC are immediately distributed to DTC participants (generally the same day) who then pay the dividends to their investor clients.

[38] *See* ''Progress and Prospects: Depository Immobilization of Securities and the Use of Book-Entry Systems,'' Staff Report, Division of Market Regulation, U.S. Securities and Exchange Commission (June 14, 1985). In 1990, the Commission held a Roundtable on Clearance and Settlement to discuss the implementation of the Group of Thirty's U.S. Working Committee regarding clearance and settlement. ''Clearance and Settlement in the World's Securities Markets,'' Group of Thirty (March 1989). The Committee noted in its report that the pressure to have securities available for settlement in shorter settlement timeframes would increase the need for immobilizing securities certificates and the use of book-entry transfer at the retail level. The roundtable participants envisioned a transfer agent operated book-entry registration system that would allow investors to be ''directly registered'' in electronic form on the books of the issuer and receive a periodic statement reflecting their ownership interest. ''Providing Alternatives to Certificates For the Retail Investor,'' Group of Thirty, U.S. Working Committee, Clearance and Settlement Project (August 1991).

[39] Prior to full implementation of DRS's electronic transfer capability (the ''Profile Modification System''), shareholders wanting to sell shares held in DRS had to certificate and physically deliver the securities to the broker-dealer. With DTC's Profile Modification System, DRS shares can be electronically transferred between DTC participants and transfer agents. Exchange Act Release Nos: 37931 (November 7, 1996), 61 FR 58600 (November 15, 1996), [File No. SR–DTC–96–15] (order granting approval to establish DRS); 41862 (September 10, 1999), 64 FR 51162 (September 21, 1999), [File No. SR–DTC–99–16] (order approving implementation of the Profile Modification System); 42704 (April 19, 2000), 65 FR 24242 (April 25, 2000), [File No. SR–00–04] (order approving changes to the Profile Modification System); 43586 (November 17, 2000), 65 FR 70745 (November 27, 2000), [File No. SR–00–09] (order approving the Profile Surety Program in DRS); 44696 (August 14, 2001), 66 FR 43939 (August 21, 2001), [File No. SR–DTC–2001–07] (order approving movement of DRS issues into the Profile Modification System and the establishment of the ''S'' position as the default in DRS). DRS also can be used as a means for issuers to dematerialize their securities (*i.e.*, so that certificates are no longer issued to evidence security ownership).

[40] DRS statistics are as of April 5, 2004. E-mail to industry participants from Joseph Trezza, DTC, May 5, 2004.

[41] *See supra* note 6.

[42] *See e.g., www.jagnotes.com* or *www.nutk.com.* Also *see* ''Intergold Corporation Announces Custody Only CommonShare Transfer System,'' PRNewswire-First Call (January 30, 2003).

[43] *Id.* The certification requirement does not in and of itself preclude securities from being deposited at DTC. In fact, DTC's nominee owns most securities deposited at DTC in certificated form, generally by a global or balance certificate.

[44] *See supra note 42.* Registration of a transfer is necessary to change registered ownership of a security.

[45] For example, some broker-dealers have expressed concern that such disclosure may cause them to violate Exchange Act Rule 14b–1 that requires a broker to provide a requesting issuer only with the identities of beneficial owners who have not objected to disclosures of this information to issuers. 17 CFR 240.14b–1.

[46] *See* Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003). A short sale is a sale of a security that the seller does not own or is effectuated by the delivery of borrowed securities. Although a ''naked short sale'' is not a defined term under federal securities laws, it generally refers to situations where a seller sells a security without owning or borrowing the security and does not deliver when delivery is due.

[47] *Id.*

[48] *Id.*

[49] Exchange Act Release Nos. 47365 (February 13, 2003), 68 FR 8535 (February 21, 2003), [File No. SR–DTC–2003–02] (notice of proposed rule change); 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003), [File No. SR–DTC–2003–02] (order approving proposed rule change concerning requests for withdrawal of certificates by issuers). DTC noted in a response letter to commenters on File No. SR–DTC–2003–02 that DTC, on behalf of

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In response, a number of issuers indicated that they had adopted or would adopt restrictions, assertedly pursuant to state corporation laws, to prohibit ownership of their securities by a depository, securities intermediaries, or both.[50] Issuers' actions to implement the restrictions caused numerous clearance and settlement problems. Some of these issuers refused to recognize positions that had been registered in the name of DTC's nominee or in the name of broker-dealers before the adoption of the restriction and refused to transfer (or allow their transfer agent to transfer) stock to the name of any entity or person that the issuer believed was not the ultimate beneficial owner.[51] Where issuers refused to recognize ownership positions registered in the name of securities intermediaries, the broker-dealers and banks were forced individually to negotiate a solution directly with the issuer.

In order to compel securities intermediaries to register stock only in the names of the ultimate beneficial owners, some issuers initiated corporate actions or ''reorganizations.'' These corporate actions or reorganizations, such as stock dividends, exchanges, reverse splits, or name changes, were intended to force the intermediaries to either comply with the issuers' instructions to deliver securities to the issuer or its agent for exchange and reregistration into the name of the ultimate beneficial owner or exclude their customers from participating in a corporate action or dividend.[52] In situations where broker-dealers refused to comply with the issuer demands to disclose the name of customers so that new restricted shares may be issued, the new securities remain unissued.

Where securities intermediaries are precluded from having securities registered in their names, the securities intermediaries' ability to hold and move securities is severely limited. As a result, trading and clearance and settlement efficiency suffers, and costs and risks increase. This consequence of issuer restrictions is not compatible with the congressional objective that trades in the securities of publicly traded companies should be settled through the national system for clearance and settlement and benefit from its efficiencies and risk reductions and is a significant step backwards in our progress to develop the national system. Furthermore, forced certification of securities is inconsistent with the industry's goals of streamlining processing of securities transactions.[53]

These types of restrictions have also caused investors increased costs and delays. By forcing securities intermediaries to submit securities as part of an issuer's recapitalization, the transfer agent must transfer the securities by canceling the certificate registered in the name of the securities intermediary and re-register a new certificate in the name of the beneficial owner. Transfer agent registration fees, which may range from $10.00 to $75.00 per transfer, and costs for secure delivery of securities certificates, can be more than the market value of the securities being processed.[54] In some cases, the broker-dealers assume these costs but in many cases the cost is passed along to investors. Broker-dealers that did reregister securities received numerous complaints from investors about the fees, particularly where the investors had not issued instructions to reregister the securities. In addition, broker-dealers had to deliver the securities certificates to an issuer's transfer agent and the transfer agent similarly had to deliver the newly registered certificates. As a result, there were significant costs and delays in obtaining certificates, which could ultimately impede the customers' ability to sell or otherwise negotiate the security in the marketplace.

The Commission understands that some issuers view this mechanism as a means of deterring manipulative naked short selling.[55] These issuers believe that by requiring securities be processed through the national system for clearance and settlement, the securities are subject to manipulative naked short selling, which, they argue, can result in issuers and investors suffering losses due to the diminution in the market value or adverse effects on ownership (*e.g.*, dilution, decrease in market value, or loss of voting rights).[56] The Commission has recently published for comment proposed rules directly relating to issues raised by short selling.[57] The Commission does not believe that naked short selling concerns should or can be addressed by issuers attempting to control the ownership or transferability of their securities that trade in the public market. Restrictions on securities can often make the stock less liquid, causing reduction in the value of the securities, and interfere with efficient processing. Accordingly, we are proposing a rule that would prohibit registered transfer agents from transferring any equity security registered under section 12 or any equity security that subjects an issuer to reporting under section 15(d), other than equity securities issued by partnerships, if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary. The objective of the proposed rule is to prohibit registered transfer agents from effecting transfers in securities of public companies that have restricted their stock in a manner that prevents trades in these securities from being processed through the national clearance and settlement system.

III. Description of Proposed Rule 17Ad–20

A. Rule Text

Proposed Rule 17Ad–20 would provide that a registered transfer agent[58] is prohibited from effecting any transfer of any equity security registered under section 12 or any equity security that subjects an issuer to reporting

its participants or their customers, owned these securities without restrictions at the time of the deposit into the depository. DTC also stated that in the situations where the issuers attempted to restrict transferability of its shares, none of their securities bore any legend, conspicuous or otherwise, noting the restrictions.

[50] *See e.g., www.jagnotes.com* or *www.nutk.com.* Also *see* ''Intergold Corporation Announces Custody Only CommonShare Transfer System,'' PRNewswire-First Call (January 30, 2003).

[51] Telephone conversation between Susan Geigel, Director, Legal and Regulatory Compliance, The Depository Trust Clearing Corporation and Staff, Division of Market Regulation, Commission (August 4, 2003).

[52] In the case of a stock dividend, some issuers would require broker-dealers to remit their shares registered in the name of either DTC's nominee or the broker-dealer and to disclose the names of their customers so that the current shares and the stock dividend could be reregistered in the name of the broker-dealer's customers (*i.e.*, the beneficial owners). In the case of a merger, a new entity would be formed for the sole purpose of requiring that outstanding securities in the old company to be remitted to the issuer and reregistered in the name of the beneficial owner.

[53] *See* Exchange Act Release No. 49405 (March 11, 2004), 69 FR 12922 (March 18, 2004), [File No. S7–13–04] (securities transaction settlement concept release). *See also* ''SIA T+1 Business Case Final Report,'' at 18–21 (August 2000) (''SIA Business Case Report''). The report is available online at *http://www.sia.com/t_plus_one_issue/pdf/BusinessCaseFinal.pdf.*

[54] Securities trading in the non-Nasdaq over-the-counter market are not subject to listing requirements and as such, have no rules governing fees charged for transfers of the issuers' securities.

[55] *See* Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003), [File No. SR–DTC–2003–02].

[56] *Id.*

[57] Exchange Act Release No. 48709 (October 28, 2003), 68 FR 62972 (November 6, 2003), [File No. S7–23–03] (Regulation SHO proposing changes to Commission rules relating to short sales).

[58] *See supra* notes 5 and 7. Transfer agents will not be able to evade compliance with this proposed rule or any other transfer agent rule by failing to register as transfer agents when the Exchange Act requires such registration.

under section 15(d) of the Exchange Act[59] if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary.[60] The term ''securities intermediary'' would be defined as a clearing agency registered under section 17A of the Exchange Act[61] or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others.[62] Any equity security issued by a partnership, as defined in Item 901(b) of Regulation S–K,[63] is excluded from the proposed rule.[64]

The proposed rule will apply only to transfer agents who are registered or should be registered with the Commission pursuant to section 17A of the Exchange Act. Since the Exchange Act only requires registration of entities acting as transfer agents for securities registered under section 12, the proposed rule will not extend to unregistered transfer agents acting solely for securities not registered under section 12. In other words, if an unregistered transfer agent is acting as agent for only section 15(d) securities, the transfer agent would be able to transfer securities that have restrictions on intermediary ownership. But if a transfer agent is required to register, the agent would be required to comply with proposed Rule 17Ad–20 for any equity security registered under section 12 or any equity security that subjects an issuer to reporting under section 15(d) of the Exchange Act.

As agent of the issuer responsible for processing transfers, a transfer agent is in the optimal position to know if the issuer has restricted the stock in a manner covered by the rule. Under the proposed rule, registered transfer agents would be required to make a determination prior to effecting a transfer in an equity security registered under section 12 or an equity security that subjects an issuer to reporting under section 15(d) of the Exchange Act that the securities do not have a restriction or prohibition on transfer to or ownership by a securities intermediary. We understand that many transfer agents already have procedures in place to ascertain whether securities have other restrictions on trading or transfer. In addition, many transfer agents obtain representations from each issuer prior to becoming its transfer agent that the issuer's securities are properly registered under federal securities laws or exempt from registration.

The vast majority of securities trading on exchanges or Nasdaq are already subject to market rules requiring depository eligibility of securities and mandating members' use of depositories.[65] Most securities whose issuers restrict ownership of their securities by securities intermediaries are trading in the non-Nasdaq over-the-counter market. Accordingly, the proposed rule effectively would supplement the market rules to expand the scope of securities covered to include most public company securities (*i.e.*, registered under section 12 or securities of issuers subject to reporting under section 15(d)) that trade in the non-Nasdaq over-the-counter market.

B. Scope and Compliance Date

In order to achieve the goals of the national system for clearance and settlement, it is imperative that as many publicly traded securities as practicable be eligible to clear and settle through the national system for clearance and settlement and that investors and securities intermediaries retain the choice as to how to hold their securities in order to avail themselves of the benefits of the national system for clearance and settlement. Therefore the Commission proposes to apply the proposed rule to all covered equity securities that are either currently registered under section 12 or any equity security that subjects an issuer to reporting under section 15(d), not just those that are registered or become reporting companies after the rule's effective date. In order to provide sufficient notice and opportunity for issuers to remove restrictions from securities and for transfer agents to comply with the rule, if it were adopted, the Commission is proposing to require compliance with the rule on and after the ninetieth day after the date the Commission adopts the rule.

IV. Solicitation of Comment

The Commission invites commenters to address the merits of the proposed rule and specifically invites comment on specific costs and benefits of the proposed rule. The Commission seeks comment on the effects of the proposed rule on the national system for clearance and settlement and the national market system, as well as whether the approach and scope of the proposed rule is necessary or appropriate. Interested persons are also invited to comment on whether alternative approaches would address the concerns raised by issuer restrictions on publicly traded securities.

The Commission invites comment on the effect of the proposed rule on registered transfer agents, the entities primarily responsible for compliance with the proposed rule, and whether the transfer agent is the appropriate entity to be responsible for compliance or whether the compliance obligations should be placed on or extended to other market participant. Interested persons may comment on how registered transfer agents will ensure compliance, on the costs to comply, and on any risks, risk reduction, benefits, or savings that may result from the proposed rule. The Commission also seeks comment on what if any difficulties registered transfer agents may have in monitoring whether securities are registered under section 12 or any equity security that subjects an issuer to reporting under section 15(d). Interested persons are invited to comment on how registered transfer agents will address the situations where issuers refuse to remove the restrictions and whether the rule should address this concern.

The Commission invites comment on the effects of the proposed rule on issuers, and in particular, the costs and benefits of prohibiting the issuers' agents from transferring equity securities that are restricted in a manner prohibited by the proposed rule. Given that most of the companies that will be effected by the proposed rule are those currently not trading on a national exchange or Nasdaq, the Commission also seeks comment on the impact of the proposed rule on issuers, particularly small issuers, and its effect on ownership and capital formation.

The Commission invites comment on whether the scope of the proposed rule is appropriate and whether the

[59] 15 U.S.C. 78*l* and 15 U.S.C. 78o(d) respectively.

[60] The term ''transfer'' means (1) delivery of the security (*i.e.*, the certificate, or in the case of book-entry, an instruction); (2) a volitional act by the transferor which manifests an intent to change ownership or convey a security interest; and (3) reregistration of ownership. *See* Egon Guttman, *Modern Securities Transfers* § 6:2, at 6–4 (3d ed. 2002).

[61] 15 U.S.C. 78q–1 *et seq.*

[62] The term ''securities intermediary'' as used for purposes of the proposed rule differs from the definition of securities intermediary as adopted in the Uniform Commercial Code (''UCC'') in that the clearing corporation or person that in the ordinary course of its business maintains securities accounts for others does not need to be acting in that capacity in order for prohibition to apply.

[63] *See supra* notes 8 and 9.

[64] The Commission has the authority under Section 36 of the Exchange Act to conditionally or unconditionally exempt any security or class of securities from the provisions of the Exchange Act to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors. 15 U.S.C. 78mm(a)(1).

[65] *See supra* notes 26 and 27. As a result, most securities trading on exchanges or Nasdaq cannot be restricted in a manner that precludes ownership by or transfer to securities intermediaries.

application of the rule to any particular securities would create difficulties or costs for investors, issuers, transfer agents, or other market participant. The Commission invites comment on whether the exclusion of equity securities issued by partnerships as defined in Item 901 of Regulation S–K is appropriate. The Commission also requests comment on whether there should be other exclusions included in the proposed rule.

As proposed, the rule would apply to equity securities currently registered under section 12 or to equity securities that currently subjects an issuer to reporting under section 15(d) as well as those securities that will be section 12-registered securities or securities of issuers that will be subject to Section reporting in the future. The Commission seeks comment on whether the application of the proposed rule should not extend to those securities already registered or those securities of issuers already subject to reporting and whether by doing so, particular hardships or costs will ensue. Interested persons are invited to comment on whether 90 days is sufficient time for issuers to remove the restrictions and for transfer agents to operationally adjust their procedures.

V. Paperwork Reduction Act

The proposed Rule 17Ad–20 does not contain new ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 (''PRA'').[66] Accordingly, the PRA is not applicable to the proposed amendments because they do not impose any new collection of information requirements that would require approval of the Office of Management and Budget (''OMB'').

VI. Costs and Benefits of Proposed Rule

The Commission is considering the costs and the benefits of proposed Rule 17Ad–20, which would prohibit registered transfer agents from effecting transfers of equity securities (other than those issued by certain partnerships) registered under section 12 or any equity security that subject an issuer to reporting under section 15(d) if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary. The Commission is sensitive to the costs and benefits associated with proposed rule, and encourages commenters to discuss the costs and benefits addressed below, as well any additional costs or benefits that we may have not considered. In particular, the Commission requests comment on the potential costs for any modification to computer systems, operations, or procedures the proposed rule may require, as well as any potential benefits resulting from the proposal for investors, securities intermediaries (including, but not limited to, broker-dealers, depositories, and banks), transfer agents, other securities industry professionals, and others. To assist us in evaluating the costs and benefits that may result from the proposed rule, we encourage commenters to provide analysis and data to support their view.

A. Benefits

By prohibiting registered transfer agents from effecting a transfer in any equity security registered under section 12 or in any equity security that subjects an issuer to reporting under section 15(d) that restricts or prohibits transfers to or from securities intermediaries, proposed Rule 17Ad–20 would allow investors to clear and settle their securities transactions through the national system for clearance and settlement and thereby take advantage of benefits of that system. We believe that the use of the national system, which can only be accessed through securities intermediaries, provides significant benefits to U.S. investors, brokers, dealers, other securities intermediaries, and issuers, by increasing efficiencies and reducing risks associated with processing, transferring, and settling securities certificates. While some of these benefits may not be readily quantifiable in terms of dollar value, particularly those related to risk reduction, we nonetheless believe that investors and broker-dealers who choose to use a securities intermediary will lower their transactions costs and realize a reduction in certain risks related to settlement of securities transactions and transfer of securities to registered ownership.

Issuers restricting transfers of their securities to or from securities intermediaries are causing investors to have to certificate their positions, which must be reregistered after every purchase or sale transaction. The Securities Industry Association (''SIA'') recently noted that the annual direct and indirect cost of processing and transferring certificates in the U.S. market, including those related to shipping, signature guarantees,[67] transfer fees, custody, and manual processing, exceeds $234,000,000.[68] Costs and risks associated with missing, lost, counterfeit, or stolen certificates are also significant. Between 1996 and 2000, the SIA estimated that an average of 1.7 million certificates were reported lost or stolen.[69] In 2001, that figure increased to 2.5 million certificates.[70] Reporting missing, lost, stolen, or counterfeit securities certificates to SIC, determining negotiability of these certificates, and paying for surety bonds for lost certificates costs the financial industry and investors millions of dollars each year.[71] In recent years, the fraudulent resale and fraudulent collateralization of cancelled certificates (certificates with no resale value) alone have cost investors and financial institutions millions of dollars.[72]

Furthermore, the process of manually transferring securities transactions on an individual trade basis through the transfer agent causes significant delays in settling securities transactions and registering ownership. These delays may prevent investors from effecting timed transactions in the market. All of these costs and risks are ultimately borne by investors. The Commission believes the costs and risks are substantially reduced or even eliminated through the use of book-entry transfers and automated settlement at a securities depository.

The Commission seeks comments, analysis, and empirical data on the extent to which the proposed rule will benefit investors by reducing costs associated with issuer-imposed restrictions on transferring securities to or from securities intermediaries. In particular, the Commission seeks

[66] 44 U.S.C. 3501 *et seq.*

[67] Every endorsement of a securities certificate requires a signature guarantee by an acceptable guarantor. Securities Transfer Association Rule Book, Section 1.02 (1998). The Uniform Commercial Code that states that a signature guarantee is a warranty by the signature guarantor that, among other things, the endorser is an appropriate person to endorse and thus the transfer the security. UCC 8–312.

[68] Letter to Robert L.D. Colby, Deputy Director, Division of Market Regulation, Commission, from Donald Kittell, Executive Vice President, SIA (August 20, 2003); letter to Annette Nazareth, Director, Division of Market Regulation, Commission, from Donald Kittell, Executive Vice President, SIA (March 24, 2003) (''Nazareth Letter''). These letters advocate the need to dematerialize the U.S. market.

[69] *Id.* The SIA's statistics on securities reported lost and stolen were obtained by the SIA directly from SIC.

[70] *Id.*

[71] Nazareth Letter. Investors who have either lost their certificates or had the certificates stolen generally must obtain a surety bond before the transfer agent will register a transfer of ownership in order to protect the transfer agent from the risk of wrongful transfers in the event that the lost or stolen certificates reappear at a later date. We understand that generally most transfer agent charge investors 2%–4% of the current market value of the securities for such a bond.

[72] *See* Exchange Act Release No. 48931 (December 16, 2003), 68 FR 74390 (December 23, 2003), [File No. S7–18–00] (order adopting rule relating to certificate destruction).

comment and data on the benefits to investors of the proposed rule to the extent it precludes decreased liquidity, increased risk, and increased transaction costs that may be associated with such issuer-imposed restrictions on securities. We also solicit comments and data on the potential benefits that may accrue due to a reduction in production, transfers, and processing of certificates, and the increased use of a depository.

Moreover, the proposed rule may benefit issuers by reducing the number of transfers recorded and the number of certificates produced. Many issuers pay their transfer agent a fee to produce a certificate and transfer securities. Accordingly, the Commission requests data on how many issuers, particularly those affected by the proposed rule, permit their transfer agent to charge a fee for transfers, and if so, whether that fee is paid by the issuer or the investor.

A number of broker-dealers have informed the Commission that they have had to undertake special communications with investors and institute manual processing in order to exit securities positions from DTC (or any other intermediary position) and to accommodate issuers' requests to certificate positions in the name of the ultimate beneficial owner. The Commission seeks comment as to any cost savings that may be realized, as well as any other potential benefits, resulting from not having to undertake these expenses should the proposed rule be adopted.

The Commission does not have data to quantify the value of the benefits described above. We are therefore seeking comment on how we may quantify these benefits and any other benefits not already identified that may result from the adoption of the proposed amendments.

B. Costs

The Commission seeks comment on what costs, if any, could be incurred if a registered transfer agent acted for an issuer that restricted or prohibited transfers, as the rule proposes to prohibit. For example, will there be handling, shipping, or insurance costs associated with the repackaging and returning non-transferable certificates? If so, what are these costs and are these costs incurred on a one-time or ongoing basis?

The proposed Rule 17Ad–20 would require registered transfer agents to determine whether or not securities subject to the proposed rule could be eligible for transfer prior to effecting a transfer and whether the person or class of persons restricted from ownership by the issuer are securities intermediaries. The Commission requests comment and data on what, if any, operational or procedural changes would need to be made to comply with the proposed rule and how much these changes would cost.

Issuers and registered transfer agents might obtain certain representations or indemnifications from each other to remove any current restrictions that would be prohibited by the proposed rule and to assist registered transfer agents in complying with the proposed rule, which might require one-time expenses related to contract revisions or legal fees. Accordingly, we request comment on the potential costs to issuers and registered transfer agents for any removal of restrictions, and developments of or modifications to systems, procedures, or records that might be necessary to determine whether a security is subject to the proposed rule.

The Commission understands that, if it were to adopt the proposed rule, some issuers might believe that the rule removes a mechanism by which they believe they can counter the negative effects of naked short selling in general, and manipulative naked short selling in particular.[73] As has been previously contended in comment letters to the Commission, by requiring these securities to participate in the national system for clearance and settlement, it has been alleged that both issuers and investors will suffer losses due to the diminution in the market value of these securities caused by naked short selling or by adverse effects on ownership (*e.g.,* market value and voting rights) stemming from such short sale transactions.[74] The Commission believes that these issues should be addressed through regulation rather than issuers attempting to control the ownership or transfer of securities that trade in the public market. As stated earlier in this release, we believe issuer-imposed restrictions on securities often make the stock less liquid, causing reduction in the trading volume of the securities. To the extent that there is any diminution of issuers' abilities to counter the perceived negative effects of naked short selling by restricting or prohibiting ownership or transfer by securities intermediaries, we do not believe this cost is significant and is likely justified by the benefits of the national system for clearance and settlement.[75] We request comment on whether this cost exists and the extent of these costs. We also request comment on whether the proposal will result in any other costs for issuers or their transfer agents to facilitate transfers of securities should the securities be held by a securities intermediary.

The Commission also seeks comments, analysis, and empirical data on any costs to investors or other market participants associated with any impact the proposed rule may have on the issuers or their transfer agent. Among other things, the Commission seeks comments and data on the extent to which, if any, investors may incur costs associated with any decrease in the capacity or propensity of the issuer to deter manipulative naked short selling as a result of the proposed rule.

VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[76] a rule is ''major'' if it has resulted or is likely to result in: an annual effect on the economy of $100 million or more;

- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment regarding the potential impact of the proposed rule amendments on the economy on an annual basis. We also request that commenters provide empirical data and other factual support for their views.

VIII. Consideration of Burden on Competition, and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) the of the Exchange Act,[77] as amended by the National Securities Markets Improvement Act of 1996,[78] provides that whenever the Commission is engaged in rulemaking and is required to consider or to determine whether an action is necessary or appropriate in the public interest, it must also consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the anti-competitive effects of any rule it adopts. Exchange Act section 23(a)(2) prohibits

[73] *See* Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003), [File No. SR–DTC–2003–02].

[74] *Id.*

[75] As noted above, most securities trading on an exchange or Nasdaq are already subject to SRO rules that require depository eligibility. *See* supra notes 26 and 27.

[76] 5 U.S.C. 801 *et. seq.*

[77] 15 U.S.C. 78c.

[78] Pub. L. 104–290, 110 Stat. 3416 (1996).

the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

The Commission's preliminary view is that the proposed rule would promote the objectives of the national system for clearance and settlement as established in section 17A of the Exchange Act by allowing securities intermediaries and their customers effecting securities transactions in the public market to benefit from the increased efficiencies and risk reduction afforded by the national system for clearance and settlement. By permitting transfers to and from securities depositories and other intermediaries, the proposed rule should promote efficiency by reducing some of the costs and delays associated with the clearance and settlement of securities transactions and promote capital formation by making it easier for the securities to be traded in the marketplace. We solicit comment on whether the proposal would promote both efficiency and capital formation.

The proposed rule could enhance competition. While most companies listed on a national exchange or Nasdaq are already subject to rules that in essence prohibit restrictions on transfers to or from securities intermediaries,[79] those issues trading in the non-national market and not subject to any listing requirements have not been subject to this restriction, such as those securities trading in the Pink Sheets. Proposed Rule 17Ad–20 would help to level the playing field by extending these obligations to all companies issuing equity securities that are registered under section 12 or that subject issuers to reporting under section 15(d) of the Exchange Act and transferred by a registered transfer agent.[80] In doing so, the proposal would also promote liquidity in these securities by removing barriers to ownership of securities and decreasing transaction costs, thereby facilitating increased efficiency and capital formation. We request comment on the other effects on competition of the proposed rule to both issuers and transfer agents. We also request comment on any effects on efficiency or capital formation that may result under the proposed rules.

[79] *See supra* notes 26 and 27.

[80] As noted above, the proposed rule would not apply to equity securities of issuers subject to section 15(d) that are transferred by transfer agents that are not required to be registered under Section 17A of the Exchange Act.

IX. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with the provisions of the Regulatory Flexibility Act[81] regarding proposed Rule 17Ad–20 under the Exchange Act. The IRFA states the purpose of the proposal is to prohibit registered transfer agents from effecting transfers of certain equity securities where the issuer restricts or prohibits the transfer of an equity security to or from a securities intermediary.

The IRFA sets forth the statutory authority for the proposal. The IRFA also discusses the effect of the proposal on registered transfer agents that are small entities pursuant to Rule 0–10 under the Exchange Act.[82] A transfer agent is a small entity if it: (1) Received fewer than 500 items for transfer and fewer than 500 items for processing during the preceding six months (or in the time that it has been in business, if shorter); (2) transferred items only of issuers that would be deemed a ''small business'' or ''small organizations'' as defined in Rule 0–10 under the Exchange Act; (3) maintained master shareholder files that in the aggregate contained less than 1,000 shareholder accounts or was the named transfer agent for less than 1,000 shareholder accounts at all times during the preceding fiscal year (or in the time that it has been in business if shorter); and (4) is not affiliated with any person other than a natural person that is not a small business or small organization under Rule 0–10. The IRFA states that we estimate that 470 transfer agents of approximately 900 registered transfer agents qualify as ''small entities'' for purposes of RFA and would be subject to the requirements of the proposed Rule 17Ad–20.

The IRFA also discusses the effect of the proposal on issuers that are small entities pursuant to Rule 0–10 under the Exchange Act.[83] An issuer is a small entity if it had on the last day of its most recent fiscal year total assets of $5 million or less. The IRFA states that we estimate that 2500 issuers qualify as ''small entities'' for purposes of RFA and could be affected by the requirements of the proposed Rule 17Ad–20.

Proposed Rule 17Ad–20 would prohibit all registered transfer agents from transferring certain equity securities registered under section 12 or any equity security that subjects an issuer to reporting under section 15(d) that restrict or prohibit transfers to or from a securities intermediary. While there are no reporting or recordkeeping obligations associated with the rule, compliance by registered transfer agents will be subject to examination by the transfer agent's appropriate regulatory agency.[84]

The IRFA states that the Commission considered whether viable alternatives to the proposed rulemaking exist that accomplish the stated objectives of applicable statutes that minimize any significant economic impact of the proposed rules on small entities. As explained more fully in the IRFA, the Commission has considered alternatives to the proposed rules that would adequately address the problem posed by issuers imposing restrictions or prohibitions on ownership, and therefore restrictions or prohibitions on the transfer, of securities in the public market. The Commission believes that the establishment of different requirements for small entities is neither necessary nor practical because the proposal is designed to provide general standards that would protect the public and members of the financial community from increased inefficiencies, costs, and risks associated with trading, clearing, and settling securities without the protections afforded by the national system for clearance and settlement. Finally the IRFA addresses each of the other requirements set forth under 5 U.S.C. 603.

The Commission encourages the submission of written comments with respect to any aspect of the IRFA. These comments should specify costs of compliance with the proposed rule, and suggest alternatives that would accomplish the objective of proposed Rule 17Ad–20. A copy of the IRFA may be obtained by contacting Jerry W. Carpenter or Susan M. Petersen, Division of Market Regulation, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–1001.

X. Statutory Authority

The Commission is proposing to add § 240.17Ad–20 of chapter II pursuant to sections 3(b), 17A(a)(1), 17A(a)(2), 17A(d), 17A(e), 23(a), and 36 of the Exchange Act[85] in the manner set forth below.

[81] 5 U.S.C. 603.

[82] 17 CFR 240.0–10.

[83] *Id.*

[84] Registered transfer agents are currently subject to numerous rules under section 17A of Exchange Act and subject to examination by the transfer agents' appropriate regulatory authority. 15 U.S.C. 78q–1(d).

[85] 15 U.S.C. 78q–1(a)(1), 78q–1(a)(2), 78q–1(d), and 78w(a).

List of Subjects in 17 CFR Part 240

Securities, Securities intermediaries, Transfer agents.

Text of Proposed Rule

In accordance with the foregoing, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The general authority citation for part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j–1, 78k, 78k–1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78q–1, 78s, 78u–5, 78w, 78x, 78*ll*, 78mm, 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4, 80b–11, and 7201 *et seq.*; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

2. Section 240.17Ad–20 is added to read as follows:

§ 240.17Ad–20 Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries.

(a) Except as provided in paragraph (c) of this section, no registered transfer agent shall transfer any equity security registered pursuant to section 12 or any equity security that subjects an issuer to reporting under section 15(d) of the Act (15 U.S.C. 78*l* or 15 U.S.C. 78o(d)) if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary.

(b) The term *securities intermediary* means a clearing agency registered under section 17A of the Act (15 U.S.C. 78q–1) or a person, including a bank, broker, or dealer, that in the ordinary course of its business maintains securities accounts for others.

(c) The provisions of this section shall not apply to any equity security issued by a partnership as defined in § 229.901(b) of Regulation S–K.

Dated: June 4, 2004.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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