



8011-01p
SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-69741; File No. SR-DTC-2013-03)

June 12, 2013

Self-Regulatory Organizations; The Depository Trust Company; Order Approving Proposed Rule Change in Connection with the Implementation of The Foreign Account Tax Compliance Act (FATCA)

On April 22, 2013, The Depository Trust Company (“DTC”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change SR-DTC-2013-03 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder.² The proposed rule change was published for comment in the Federal Register on May 8, 2013.³ The Commission did not receive comments on the proposed rule change. This order approves the proposed rule change.

I. Description

DTC is amending various DTC rules “in connection with the implementation of sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended, which sections were enacted as part of the Foreign Account Tax Compliance Act, and the Treasury Regulations or other official interpretations thereunder (collectively “FATCA”).”⁴ In its filing with the Commission, DTC provided information concerning FATCA background, implementation, and DTC’s proposed rule changes.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 69494 (May 2, 2013), 78 FR 26823 (May 8, 2013) (SR-DTC-2013-03).

⁴ Id. at 26823.

DTCC's Background Statement

FATCA was enacted on March 18, 2010, as part of the Hiring Incentives to Restore Employment Act, and became effective, subject to transition rules, on January 1, 2013. The U.S. Treasury Department finalized and issued various implementing regulations (“FATCA Regulations”) on January 17, 2013. FATCA generally requires foreign financial institutions (“FFIs”)⁵ to become “participating FFIs” by entering into agreements with the Internal Revenue Service (“IRS”). Under these agreements, FFIs are required to report to the IRS information on U.S. persons and entities that have (directly or indirectly) accounts with these FFIs. If an FFI does not enter into such an agreement with the IRS, FATCA will impose a 30% withholding tax on U.S.-source interest, dividends and other periodic amounts paid to such “nonparticipating FFI” (“Income Withholding”), as well as on the payment of gross proceeds arising from the sale, maturity, or redemption of securities or any instrument yielding U.S.-source interest and dividends (“Gross Proceeds Withholding,” and, together with Income Withholding, “FATCA Withholding”). The 30% FATCA Withholding taxes will apply to payments made to a nonparticipating FFI acting in any capacity, including payments made to a nonparticipating FFI that is not the beneficial owner of the amount paid and acting only as a custodian or other intermediary with respect to such payment. To the extent that U.S.-source interest, dividend, and other periodic amount or gross proceeds payments are due to a nonparticipating FFI in any capacity, a U.S. payor,

⁵ According to DTC, non-U.S. financial institutions are referred to as “foreign financial institutions” or “FFIs” in the FATCA Regulations.

such as DTC, transmitting such payments to the nonparticipating FFI will be liable to the IRS for any amounts of FATCA Withholding that the U.S. payor should, but does not, withhold and remit to the IRS with respect to those payments.

According to DTC, as an alternative to FFIs entering into individual agreements with the IRS, the U.S. Treasury Department provided another means of complying with FATCA for FFIs which are resident in jurisdictions that enter into intergovernmental agreements (“IGA”) with the United States.⁶ Generally, such a foreign jurisdiction (“FATCA Partner”) would pass laws to eliminate the conflicts of law issues that would otherwise make it difficult for FFIs in its jurisdiction to collect the information required under FATCA and transfer this information, directly or indirectly, to the United States. An FFI resident in a FATCA Partner jurisdiction would either transmit FATCA reporting to its local competent tax authority, which in turn would transmit the information to the IRS, or the FFI would be authorized/required by FATCA Partner law to enter into an FFI agreement and transmit FATCA reporting directly to the IRS. Under both IGA models, payments to such FFIs would not be subject to FATCA Withholding taxes so long as the FFI complies with the FATCA Partner’s laws mandated in the IGA.

According to DTC, under the FATCA Regulations, (A) beginning January 1, 2014, DTC will be required to do Income Withholding on any payments made to any nonparticipating FFI approved for membership by DTC as of such date or thereafter,

⁶ DTC states that as of the date of this proposed rule change filing, the United Kingdom, Mexico, Ireland, Switzerland, Spain, Norway, Denmark, Italy and Germany have signed or initialed an IGA with the United States. The U.S. Treasury Department has announced that it is engaged in negotiations with more than 50 countries and jurisdictions regarding entering into an IGA.

(B) beginning July 1, 2014, DTC will be required to do Income Withholding on any payments made to any nonparticipating FFI approved for membership by DTC prior to January 1, 2014 and (C) beginning January 1, 2017, DTC will be required to do Gross Proceeds Withholding on all nonparticipating FFIs, regardless when any such FFI's membership was approved.

DTC stated that it already has established tax services that are currently available to its Participants in which DTC, in accordance with sections 1441 through 1446 of the Code, withholds on certain payments of income made to certain of its Participants. Thus, DTC can and intends to support certain FATCA Income Withholding as part of such established tax services.

DTC's Statement on FATCA Implementation

According to DTC, in preparation for FATCA's implementation, FFIs are being asked to identify their expected FATCA status as a condition of continuing to do business. Customary legal agreements in the financial services industry already contain provisions allocating the risk of any FATCA Withholding tax that will need to be collected, and requiring that, upon FATCA's effectiveness, foreign counterparties must certify (and periodically recertify) their FATCA status using the relevant tax forms that the IRS has announced it will provide.⁷ Advance disclosure by an FFI client or counterparty would permit a withholding agent to readily determine whether it must, under FATCA, withhold on payments it makes to the FFI. If an FFI fails to provide appropriate compliance documentation to a withholding

⁷ For example, credit agreements now routinely require foreign lenders to agree to provide certifications of their FATCA status under approved IRS forms to U.S. borrowers, and subscription agreements for alternative investment funds that are anticipated to earn U.S.-source income are routinely requiring similar covenants.

agent, such FFI would be presumed to be a nonparticipating FFI and the withholding agent will be obligated to withhold on certain payments.

DTC states that FATCA will require DTC to deduct FATCA Withholding on payments to certain of its Participants arising from certain transactions processed by DTC on behalf of such Participants.⁸ Because FATCA treats any entity holding financial assets for the account of others as a “financial institution,” and almost all Participants hold financial assets for the account of others, new and existing Participants which are treated as non-U.S. entities for federal income tax purposes, including those members and limited members that are U.S. branches of non-U.S. entities (collectively, “FFI Participants”)⁹ will likely be FFIs under FATCA. DTC says that as a result, it will be liable to the IRS for the amounts associated with any failures to withhold correctly under FATCA on payments made to its FFI Participants.

In light of this, DTC has evaluated its existing systems and services to determine whether and how it may comply with its FATCA obligations. As a result of this evaluation, DTC has determined that its existing systems are incapable of processing and accounting for Gross Proceeds Withholding with regard to the securities transactions processed by it, as no similar withholding obligation of this magnitude has ever been imposed on it to date and DTC has therefore not built systems to support such an obligation.

⁸ According to DTC, FFI participants resident in IGA countries, that are compliant with the terms of applicable IGAs, should not be subject to FATCA Withholding.

⁹ Currently, only a small percentage of DTC’s Participants are treated as non-U.S. entities for federal income tax purposes.

Additionally, DTC nets credits and debits per Participant for end of day net funds settlement. There is further netting with DTC's affiliated central counterparty, National Securities Clearing Corporation and further netting on a settling bank basis; the effect of this netting is to significantly reduce the number and magnitude of payments made via the NSS System of the Federal Reserve. Gross Proceeds Withholding would foreclose such netting, greatly reducing liquidity available to the system and Participants, increasing systemic risk.

Furthermore, DTC believes that, given DTC's netting, undertaking Gross Proceeds Withholding could require DTC in certain circumstances to apply its Participants Fund in order to fund FATCA Withholding taxes with regard to nonparticipating FFI Participants in non-FATCA Partner jurisdictions whenever the net credit owed to such FFI Participant is less than the 30% FATCA tax. In the view of DTC, this would not be the best application of such funds which are required to support liquidity and satisfy losses attributable to the settlement activities of DTC, *inter alia*. For example, if a nonparticipating FFI is owed a \$100M gross payment from the sale or maturity of U.S. securities, but such nonparticipating FFI is in a net debit settlement position at the end of that day because of DTC's end of day net crediting and debiting, and the other netting described above, there would be no payment to this FFI Participant from which DTC could withhold. In this example, DTC would likely need to fund the \$30M FATCA Withholding tax until such time as the FFI Participant can reimburse DTC.⁶ In that case, DTC would need to consider an increase in the amount of cash required to be deposited into the Participants Fund, either by FFI Participants or all Participants, which would reduce liquidity resources

of Participants and could have significant systemic effects. The amount of the FATCA Gross Proceeds Withholding taxes would be removed from market liquidity, which could lead to increased risk of Participant failure and increased financial instability.

For the reasons explained above and the following additional reasons, DTC is amending its rules to implement preventive measures that would generally require all of DTC's FFI Participants not to cause a Gross Proceeds Withholding obligation on DTC because DTC believes that:

- Undertaking Gross Proceeds Withholding by DTC (even if possible) would make it economically discouraging for affected FFI Participants to engage in transactions involving U.S. securities. It would likely also quickly cause a significant negative impact on liquidity because such withholding taxes would be imposed on the very large gross amounts due to such FFI Participants. Furthermore, Participants would be burdened with extra costs and the negative impact on liquidity caused by the likely need to substantially increase the amount of cash required to be deposited into the Participants Fund.
- The cost of implementing a Gross Proceeds Withholding system for a small number of nonparticipating FFI Participants would be substantial and disproportionate to the related benefit. Under the Model I IGA form and its executed versions with various FATCA Partners, DTC would not be required to withhold with regard to FFI residents in such FATCA Partner jurisdictions. Accordingly, DTC's withholding obligations under FATCA would effectively be limited to nonparticipating FFI Participants in non-FATCA Partner jurisdictions. Since the cost

of developing and maintaining a complex Gross Proceeds Withholding system would be passed on to DTC's Participants at large, it may burden Participants that otherwise comply with, or are not subject to, FATCA Withholding.

- As briefly noted above, absent this current action and in order to avoid counterparty credit risk, DTC would likely require each of the nonparticipating FFI Participants in non-FATCA Partner jurisdictions to make initial or additional cash deposits to the Participants Fund as liquidity for the approximate potential FATCA tax liability of such nonparticipating FFI Participant or otherwise adjust required deposits to the Participants Fund. The amount of such deposits, which could amount to billions of dollars, would be removed from market liquidity.

- From the nonparticipating FFI Participant's perspective, having 30% of its payments withheld and sent to the IRS would have a severe negative impact on such nonparticipating FFI Participants' financial stability. In most cases, the gross receipts are for client accounts, and the nonparticipating FFI Participant would need to make such accounts whole. Without receipt of full payment for its dispositions, the nonparticipating FFI Participant would not have sufficient assets to fund its client accounts.

- These rule changes should not create an undue burden for Participants because requiring FFIs to certify (and to periodically recertify) their FATCA status, and imposing the costs of non-compliance on them, are becoming standard market practice in the United States, separate and apart from being a Participant of DTC.

Rule Changes

In line with its risk management focus, DTC has determined that compliance with FATCA, so that DTC shall not be responsible for Gross Proceeds Withholding, should be a general membership requirement (A) for all applicants that are treated as non-U.S. entities for U.S. federal income tax purposes, and (B) for all existing FFI Participants.¹⁰ DTC is amending its rules as follows:

- Amending Rule 1: adding “FATCA,” “FATCA Certification,” “FATCA Compliance Date,”¹¹ “FATCA Compliant,” and “FFI Participant” to Section 2 as terms cross-referenced from Rule 2, Section 9;
- Amending Section 1 of Rule 2: adding the requirements that, (i) with regard to any applicant that shall be an FFI Participant, such applicant must be FATCA Compliant, and (ii) as a qualification for activation of its membership that each applicant approved by DTC complete and deliver to DTC a FATCA Certification; and
- Adding new Section 9 of Rule 2: (i) requiring all FFI Participants (both new and existing) to agree not to conduct any transaction or activity through DTC if such Participant is not FATCA Compliant, (ii) requiring all FFI Participants to certify and, as required under the timelines set forth under FATCA, periodically

¹⁰ DTC may grant a waiver under certain circumstances, provided, however, that DTC will not grant a waiver if it causes DTC to be obligated to withhold under FATCA on gross proceeds from the sale or other disposition of any property.

¹¹ Although FATCA Withholding with regard to FFI Participants approved for membership by DTC prior to January 1, 2014 is first required under FATCA beginning July 1, 2014, the proposed amendments to DTC rules would require such existing FFI Participants to be FATCA compliant approximately 60 days prior to July 1, 2014 in order for DTC to comply with its disciplinary and notice processes as set forth in DTC rules.

recertify, to DTC, in accordance with the timelines set out under FATCA, that they are FATCA Compliant, (iii) specifying that failure to be FATCA Compliant creates a duty upon an FFI Member (both new and existing) to inform DTC, (iv) providing that Participants that violate the provisions of Section 9 are subject to disciplinary sanction or other applicable actions by DTC in accordance with DTC rules, including, but not limited to, a fine, as well as restrictions of services to the Participant and/or ceasing to act for the Participant in accordance with Rule 10, and (v) requiring all FFI Participants to indemnify DTC for any losses sustained by DTC resulting from such FFI Participants' failure to be FATCA Compliant. In addition, Rule 2, Section 9 will include the definitions for "FATCA," "FATCA Certification," "FATCA Compliance Date," "FATCA Compliant," and "FFI Participant".

- In addition, DTC will modify its *Policy Statement on the Admission of Non-U.S. Entities as Direct Depository Participants* to reference DTC rules requirements of foreign entities which are treated as non-U.S. entities for tax purposes.

II. Discussion

Section 19(b)(2)(C) of the Act¹² directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act¹³ requires the rules of a clearing agency to be designed to, among other things, promote the prompt and accurate

¹² 15 U.S.C. 78s(b)(2)(C).

¹³ 12 U.S.C. 78q-1(b)(3)(F).

clearance and settlement of securities transactions, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, and protect investors and the public interest. The Commission finds that DTC's proposed rule change is consistent with these requirements because it is designed to comply with FATCA while eliminating uncertainty in funds settlement. Specifically, based on DTC's representations, the Commission understands that the proposed rule change is designed codify DTC's rules in a way that will allow DTC to comply with FACTA without developing and maintaining a complex Gross Proceeds Withholding system under FATCA and, as a result, it will eliminate uncertainty in funds settlement that DTC believes will arise if DTC is subject to FATCA Withholding.¹⁴

¹⁴ In approving this proposed rule change, the Commission is mindful of the IRS's jurisdiction respecting FATCA. This Order does not interpret FATCA. The Commission's approval of the proposed rule change in no way constitutes a determination or finding by the Commission that the proposed rule change complies with FATCA, which is under the purview of the IRS.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁵ and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-DTC-2013-03) be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁶

Kevin M. O'Neill
Deputy Secretary

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¹⁵ In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁶ 17 CFR 200.30-3(a)(12).