

The General Counsel of the Commission, or his designee, has certified that, in his opinion, one or more of the exemptions set forth in 5 U.S.C. 552b(c) (4), (8), (9)(A) and (10) and 17 CFR 200.402(a) (4), (8), (9)(i) and (10), permit consideration of the scheduled matters at the closed meeting.

Commissioner Wallman, as duty officer, voted to consider the items listed for the closed meeting in a closed session.

The subject matter of the closed meeting scheduled for Thursday, August 22, 1996, at 10:00 a.m., will be:

Institution of injunctive actions.
Institution and settlement of administrative proceedings of an enforcement nature.
Opinions.

At times, changes in Commission priorities require alterations in the scheduling of meeting items. For further information and to ascertain what, if any, matters have been added, deleted or postponed, please contact: The Office of the Secretary at (202) 942-7070.

Dated: August 16, 1996.

Jonathan G. Katz,

Secretary.

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[Release No. 34-37565; File No. SR-GSCC-96-07]

Self-Regulatory Organizations; Government Securities Clearing Corporation; Notice of Proposed Rule Change Modifying the Rights and Responsibilities of Interdealer Broker Netting Members

August 14, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on July 2, 1996, the Government Securities Clearing Corporation ("GSCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which items have been prepared primarily by GSCC. On July 22, 1996, GSCC amended the filing.² The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

¹ 15 U.S.C. § 78s(b)(1) (1988).

² Letter from Karen Walraven, Vice President and Associate Counsel, GSCC, to Jerry W. Carpenter, Assistant Director, Division of Market Regulation, Commission (July 18, 1996).

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

GSCC proposes to modify its rules governing the rights and responsibilities of interdealer broker ("IDB") netting members.

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

In its filing with the Commission, GSCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. GSCC has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.³

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

At the time of the implementation of GSCC's netting system in 1989, IDBs were given distinct rights and obligations with regard to loss allocation, clearing fund margin, and funds-only settlement as a result of their status as agents for partially disclosed principals that do not take positions for their own accounts. Since 1989, the volume and types of transactions submitted by IDBs to GSCC have increased significantly.

As a result of the continuing changes in the government securities marketplace, various revisions have been proposed or have been made regarding the status of IDBs under GSCC's rules. These changes include: (i) The creation of a second category of IDB membership designed to allow IDBs with higher levels of net worth and excess net or liquid capital to do a limited amount of business away from GSCC members,⁴ (ii) the establishment of a \$10 million minimum net/liquid capital requirement for Category 1

³ The Commission has modified the text of the summaries prepared by GSCC.

⁴ Securities Exchange Act Release No. 32722 (August 1, 1993), 58 FR 42993 [SR-GSCC-93-01] (order approving proposed rule change modifying participation standards). Unless otherwise indicated, the term IDB refers to both Category 1 and Category 2 IDBs. Under current rules, Category 1 IDBs act exclusively as brokers and trade with GSCC netting members and certain grandfathered nonmember firms and must maintain \$10 million in net or liquid capital. Category 2 IDBs may transact up to 10% of their trading volume with nonmembers and must maintain \$25 million in net worth and \$10 million in excess net or liquid capital.

IDB's,⁵ (iii) the imposition of strict limitations on Category 1 IDB's scope of business allowing them to do business in eligible securities with other netting members and grandfathered firms, and (iv) in conjunction with the next planned phase of repo netting, which will include repos done on a blind brokered basis, the determination to allow IDBs to submit to GSCC eligible repo business but only with netting members on both sides of the transaction.⁶ GSCC has reviewed its rules governing loss allocation and clearing fund requirements for IDBs in relation to the risks posed by IDBs to determine what amendments are appropriate.

1. Loss Allocation

Currently, if a loss or liability is incurred due to the failure of a GSCC netting member to meet its obligations, GSCC looks first to the clearing fund and forward margin collateral that the failed member maintains with GSCC. If the collateral is insufficient to cover the entire loss, GSCC looks back the number of days needed to capture an amount of trading that is equal to the amount of the liquidated positions of the failed member.⁷ The loss is then allocated based on the counterparties to the trading activity captured.

To the extent that the defaulting member's trading activity represents direct transactions with other netting members (*i.e.*, the counterparties to the trade are netting members trading directly with each other without using the services of a broker), a portion of the loss equivalent to such trading activity is allocated on a pro rata basis based on the dollar value of the trading activity of each non-IDB netting member with the defaulting member netted and novated on the day of default as defined in GSCC Rule 4, Section 8(a)(v).⁸

To the extent that the defaulting member's trading activity represents member brokered transactions (*i.e.*, a brokered transaction where both the buy-side and sell-side counterparties to

⁵ Securities Exchange Act Release No. 37343 (June 20, 1996), 61 FR 33564 [SR-GSCC-96-02] (order approving rule change modifying minimum financial criteria for Category 1 IDB netting membership).

⁶ Securities Exchange Act Release No. 37482 (July 25, 1996), 61 FR 40275 [SR-GSCC-96-04] (order approving proposed rule change relating to IDB netting members participating in the netting and settlement services for repos).

⁷ Recently, GSCC proposed modifying the loss allocation procedure to capture a level of trading activity that is at least five times the dollar value amount of the securities of the defaulting member that are liquidated. Securities Exchange Act Release No. 37548 (August 9, 1996) [File No. SR-GSCC-96-05].

⁸ *Supra* note 7.

the IDB are netting members), such loss is allocated as follows: (i) Ten percent of the loss is allocated to the IDBs on an equal basis, up to \$1.6 million per calendar year for each IDB, regardless of the level of trading activity each IDB had with the defaulting member and (ii) the other ninety percent of the loss is allocated among all other netting members pro rata based on the dollar value of each netting member's trading activity with the defaulting member channeled through IDBs.

To the extent that the defaulting member's trading activity represents nonmember brokered transactions (*i.e.*, a brokered transaction where either the buy-side or sell-side counterparty to the IDB is a nonmember), such loss is allocated as follows: (i) Ten percent of the loss is allocated to the IDBs on an equal basis, up to \$1.6 million per calendar year for each IDB, regardless of the level of trading activity each IDB had with the defaulting member and (ii) the other ninety percent of the loss is allocated among Category 2 IDBs pro rata based on the dollar value of each Category 2 IDB's trading activity with the defaulting member.

GSCC is proposing to raise the percentage of a loss arising from member or nonmember brokered transactions allocated collectively to the IDBs to fifty percent with a dollar cap on each IDB's potential liability as discussed below. GSCC believes this change is appropriate because the volume of transactions submitted by IDBs for netting and guaranteed settlement has increased significantly since the netting system became operational in 1989 and is expected to rise significantly with the introduction of netting services for brokered repos. Brokered transactions represent a potential risk to GSCC because the IDBs are principals vis-à-vis GSCC and may have settlement obligations to GSCC as the result of unobligated trades and trades with nonmembers. GSCC also believes that this proposed change will result in a fairer loss allocation methodology because the IDBs will share on a collective basis equally with the dealers any loss allocation arising from brokered transactions. By placing a dollar cap on each IDB's share of a loss, the IDBs will continue to be protected from unusually large loss allocations.

Furthermore, GSCC proposes that each IDB's individual share of the collective broker allocation should be allocated pro rata based on the dollar value of its trading activity with the defaulting member instead of an equal allocation. GSCC believes that the practice of mutualizing losses among the IDBs should be discontinued. By

implementing this change, an IDB will no longer be subject to an allocation of a portion of a loss arising from the default of a firm with which the IDB never traded. This manner of loss allocation provides IDBs with greater incentive to assess the creditworthiness of their counterparties.

Currently, the loss amount allocated to each IDB is capped at \$1.6 million per calendar year for losses attributable to member or nonmember brokered transactions.⁹ The use of a per calendar year cap ignores the possibility that there may be multiple loss events in a calendar year and, thus, may not protect sufficiently GSCC and its members from loss. GSCC proposes that the maximum amount of loss that should be allocated to each IDB should be based on a per loss allocation event as opposed to a calendar year maximum. Although it is unlikely, there is potential for more than one loss event to occur during a calendar year, and a loss allocation cap based on a calendar year maximum would allow an IDB that has hit its calendar year cap to use GSCC's netting system for the remainder of the year on a risk-free basis. A per loss allocation event standard creates a more appropriate economic incentive to IDBs to manage counterparty credit risk.

In order to protect sufficiently GSCC and its members from loss, it is necessary that any loss allocation cap sufficiently reflect the exposure posed to GSCC by an IDB and provide an adequate incentive for IDBs to manage effectively their counterparty credit risk. GSCC proposes that the maximum amount of loss that should be allocated to an individual IDB should be raised to \$5 million per loss allocation event. GSCC believes that an increase in the maximum loss that can be allocated to an IDB is reasonable in that IDBs pose an increased risk to the netting system. However, a balance should be maintained between protecting GSCC and its members from a loss and applying a loss allocation methodology that may be so onerous as to disable an IDB from meeting GSCC's standards. A cap of \$5 million per loss allocation event would seem to strike that appropriate balance. Furthermore, the \$4.2 million excess net/liquid capital requirement that was applied for many years to Category 1 IDBs was linked to the \$1.6 million maximum loss allocation figure. With the recent increase in the excess capital requirements to \$10 million, an increase

in the maximum amount of loss that can be allocated to an IDB seems reasonable. The proposed increase will protect more effectively GSCC and its members from losses, while setting the maximum amount of loss that could be allocated to each IDB at less than the IDB's full capital requirement will ensure that the IDB's excess capital would not be depleted entirely in one loss allocation event.

2. Clearing Fund and Funds Settlement

Currently, Category 1 IDBs have a fixed clearing fund obligation of \$1.6 million. Category 2 IDBs must maintain a clearing fund deposit of at least \$1.6 million. Category 1 and Category 2 IDBs also have different clearing fund deposit composition requirements. For Category 1 IDBs, \$100,000 of the deposit must be in cash (while other netting members must maintain ten percent of the total deposit required in cash), and the remaining portion of the deposit can be made up of eligible letters of credit or eligible securities. Category 2 IDBs must maintain at least \$100,000 of their clearing fund in cash or ten percent if their clearing fund deposit exceeds \$1.6 million, and no more than seventy percent of the deposit can consist of eligible letters of credit.

GSCC believes that if the maximum loss allocation for the IDBs is raised to \$5 million per loss allocation event, the required clearing fund deposit should also be raised. GSCC proposes that Category 1 IDBs should have a fixed \$5 million clearing fund requirement while Category 2 IDBs should have a minimum \$5 million clearing fund requirement. The cash component of the clearing fund requirements for Category 1 IDBs should remain at a fixed \$100,000 amount, and they should continue to be permitted to meet the remainder of their clearing fund requirement (now \$4.9 million) all or in part by the pledge of letters of credit. Category 1 IDBs will be subject to all of the surveillance requirements of Section 3 of GSCC Rule 4, with GSCC having the authority to increase the amount of clearing fund deposit for any IDB on surveillance status. Category 2 IDBs will be subject to the same clearing fund deposit composition requirements as other non-Category 1 IDB netting members: ten percent of their required fund deposit (\$500,000) must be in cash, and no more than seventy percent of the remaining total can consist of eligible letters of credit.

By aligning an IDB's required clearing fund deposit with the maximum per loss allocation event, GSCC will have access to the funds necessary to cover a member's default. Continuing to waive

⁹ As noted above, Category 2 IDBs are subject to an unlimited loss allocation, based on trading volume, for losses related to nonmember brokered transactions. GSCC is not proposing any changes to this position of the loss allocation provisions.

the general limitations placed on netting members posting cash and letters of credit collateral for Category 1 IDBs should reduce the hardship of raising the clearing fund deposit requirement. However, because Category 2 IDBs represent a higher risk of loss for GSCC, they should be subject to the more stringent standards applied to non-Category 1 IDB netting members.

Category 1 IDBs are not required under GSCC's current rules to participate in the daily funds-only settlement process.¹⁰ GSCC believes that requiring all IDBs to participate in the morning funds-only settlement process is necessary at this time because of the required pass-through of forward margin credits, which became effective with the 1995 implementation of the first phase of netting services for repurchase agreements ("repos").¹¹ If the forward margin debits are not submitted to GSCC in the morning funds-only settlement, GSCC will be unable to pass through the forward margin credits. Thus, all netting members must participate in the morning funds-only settlement process. This rule change should not result in any major changes for the IDBs, as the single Category 1 IDB and all Category 2 IDBs already participate in the funds-only settlement process as a matter of practice.

In addition, the proposed rule change will eliminate the exception in Section 3 of GSCC Rule 11 that permits IDBs to exclude trades from GSCC's netting system if the inclusion of such trade will result in the IDB having a net settlement position other than zero. GSCC Rule 11, Section 3 will continue to permit netting members to exclude repo transactions from the netting system in accordance with GSCC Rule 18.

GSCC believes the proposed rule changes are consistent with the requirements of Section 17A of the Act and the rules and regulations thereunder, because they will result in a more fair and appropriate loss allocation methodology and a higher level of margin protection for GSCC and thereby will promote the safeguarding of securities and funds in GSCC's custody or control or for which GSCC is responsible.

¹⁰ Until recently, Tullett & Tokyo Securities was the only Category 1 IDB, and they participate in the morning funds-only settlement.

¹¹ Securities Exchange Act Release No. 36941 (November 17, 1995), 60 FR 61577 [SR-GSCC-95-02] (order approving a proposed rule change relating to the netting and risk management services for non-same-day-settling aspects of next-day and forward-settling repo transactions).

B. Self-Regulatory Organization's Statement on Burden on Competition

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

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

Comments on the proposed rule change have not yet been solicited or received. Members will be notified of the rule filing, and comments will be solicited by an important notice. GSCC will notify the Commission of any written comments received by GSCC.

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

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

- (A) By order approve such proposed rule change or
- (B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of GSCC. All submissions should refer to File No. SR-GSCC-96-07 and should be submitted by September 10, 1996.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹²

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-37555; File Nos. SR-MCC-96-04; SR-MSTC-96-04]

Self-Regulatory Organizations; Midwest Clearing Corporation; Midwest Securities Trust Company; Notice of Filing of Proposed Rule Changes Relating to Nominations for Board Membership, the Risk Assessment Committee, the Appeals Process, Audits and Financial Reports, and Temporary Sponsored Participants and Accounts

August 9, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that the Midwest Clearing Corporation ("MCC") and Midwest Securities Trust Company ("MSTC") filed with the Securities and Exchange Commission ("Commission") on June 26, 1996, the proposed rule changes as described in Items I and II below, which items have been prepared primarily by MCC and MSTC, respectively. The Commission is publishing this notice to solicit comments on the proposed rule changes from interested persons.

I. Self-Regulatory Organizations' Statement of the Terms of Substance of the Proposed Rule Changes

MCC and MSTC respectively propose to (i) eliminate the sections of their by-laws that require the corporate secretary to mail copies of the list of nominees for the respective boards of directors to each participant of MSTC and MCC;² (ii) amend their respective rules to remove any reference to their risk assessment committees;³ (iii) adjust some of the appeal time periods, the composition of the appeal panels, and eliminate a second level of internal appeals;⁴ (iv) eliminate their respective

¹² 17 CFR 200.30-3(a)(12) (1995).

¹ 15 U.S.C. 78s(b)(1) (1995).

² MSTC proposes to amend Article III, Section 2 of its By-Laws and MCC proposes to amend Article 3, Section 3.2 of its By-Laws. The specific proposed amendments to MSTC's and MCC's respective rules are attached as exhibit A to MSTC's and MCC's respective proposed rule changes, which are available for inspection at the places specified in Item IV below.

³ MSTC proposes to delete Article I, Rule 4 and to amend Article V, Rule 2. MCC proposes to delete Article I, Rule 4 and to amend Article VIII, Rule 2.