

during this period, the specialist must allow the order to interact with other orders received by the specialist at the post, using the same priority and precedence rules that apply to other orders received at the post.

Finally, during the one minute window, the specialist must notify the order sending firm's MAX floor broker representative if the specialist determines to cancel the order. The reduction of the three minute window to one minute is appropriate because it will reduce the time period in which the order sending firm will be uncertain as to the ultimate status of the order. The imposition of specific duties on the specialist during the one minute window is appropriate in order to both make sure that the order is not disadvantaged during the one minute period and to give the specialist an opportunity to verify with the MAX floor broker representative that the order is accurate and correct.

2. Statutory Basis

The proposed rule change is consistent with Section 6(b)(5) of the Act⁸ in that it is designed to promote just and equitable principles of trade, to remove impediments and to perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The Exchange does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or received.

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

Within 35 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 90 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 the 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, including whether the proposed rule change is consistent with the Act. 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 at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-CHX-97-32 and should be submitted by March 4, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁹

Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 98-3370 Filed 2-10-98; 8:45 am]

BILLING CODE 8010-01-M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39623; File No. SR-DCC-97-10]

Self-Regulatory Organizations; Delta Clearing Corp.; Notice of Filing of Proposed Rule Change Relating to the Clearing of Repurchase Agreement Instrument Transactions

February 5, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on December 31, 1997, Delta Clearing Corp. ("DCC") 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 DCC. The Commission is publishing this notice to solicit comments from

interested persons on the proposed rule change.

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

The proposed rule change will revise DCC's rules to authorize DCC to clear and to settle repurchase agreement instrument transactions ("RAIT").

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

In its filing with the Commission, DCC 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. DCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.²

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

A RAIT is a transaction pursuant to which the counterparties agree to pay each other interest on an agreed upon amount ("notional amount")³ for the agreed term of the RAIT. One counterparty ("selling member") will pay interest that is based on the market rate of interest for a repurchase agreement ("repo") with treasury securities as the underlying collateral and that is adjusted on a daily basis throughout the term of the transaction ("floating rate"). The other counterparty ("purchasing member") will pay interest based on a rate of interest that remains constant throughout the term of the transaction ("fixed rate"). This proposed rule change will permit DCC to clear and to settle RAITs.

1. Structure of the Transaction

The parties will negotiate between themselves: (1) The notional amount, (2) the type of repo to be referenced for the floating rate, (3) the fixed rate, (4) the date the RAIT will start ("commencement date"), (5) the date the RAIT will end ("expiration date"), and (6) any premium that may be paid to one counterparty as consideration for entering into the transaction.

² The Commission has modified the text of the summaries prepared by DCC.

³ The notional amount must be \$1 million or a multiple thereof. The notional amount is used solely as reference and is not exchanged between the parties.

⁸ 15 U.S.C. 78f(b)(5).

⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

On the trade date,⁴ the parties will report the agreed upon transaction terms to DCC either directly or through a broker authorized by DCC.⁵

The parties' payment obligations will begin on the commencement date and will end on the day before the expiration date. The commencement date may be prior to or after the trade date. However, RAITs with a commencement date which is prior to the trade date will only be permitted to allow one party to enter into a RAIT with a new counterparty to close out its existing RAIT position.⁶ Any premium will be paid on the later of the first business day following the commencement date or the first business day following the trade date.⁷

The expiration date (also referred to as the settlement sum payment date) may not be earlier than the later of the second business day following the trade date or the second business day following the commencement date.⁸ In addition, the expiration date may not be later than the earlier of the first anniversary of the trade date or the first anniversary of the commencement date.

Prior to 8:00 a.m. on the expiration date, DCC will notify each member of any amount required to be paid by or to such member with respect to RAITs expiring on such date ("settlement sum").⁹ This information will be included on the daily RAIT activity reports sent to members. Members will be required to make any payment indicated on the daily reports prior to the settlement time on the expiration date.¹⁰

The failure of a member to pay any premium or any settlement sum will constitute a violation of the procedures. The defaulting member will be suspended in accordance with Article 4 of DCC's procedures (subject to deferral for up to two hours) and may be sanctioned in accordance with Article 5.

⁴ Trade date will be defined as the date on which members or their broker report a RAIT to DCC.

⁵ Section 3 of this notice contains a description of the trade reporting requirements.

⁶ Such transaction is referred to as a closing transaction and is discussed below in Section 4 of this notice.

⁷ Premium payments must be made to DCC by the later of 11:00 a.m. or the opening of FedWire and will be paid by DCC six hours later. Members' obligations to pay premiums will be netted with their right to receive premiums.

⁸ This time period will give DCC an opportunity to collect margin on all RAITs on the day after the RAIT is accepted by DCC for clearance.

⁹ Section 2 of this notice sets forth the formula that will be used to determine the settlement sum.

¹⁰ Settlement time is defined as the later of 11:00 a.m. or the opening of FedWire.

2. Calculation of Payment

The members must select as the floating rate one of the five special collateral rates or the general collateral rate. The special collateral rates will equal the rate of interest for repos in which the treasury securities underlying such agreements are the most recently issued treasury security with an original maturity of two years, three years, five years, ten years, or thirty years. The general collateral rate will be the rate of interest for repos in which the treasury securities underlying such agreements are any securities other than the most recently issued treasury securities with an original maturity of two, three, five, ten, or thirty years.¹¹

Each special collateral rate and the general collateral rate will be determined by DCC at the close of business on each business day upon a reputable pricing source selected by DCC.¹² DCC will then multiply the applicable floating rate by the notional amount and divide by 360 to determine the floating rate amount. Any daily floating rate amount determined for a business day will apply to any following nonbusiness day.¹³

The fixed rate will be a fixed percentage carried out to three decimal points. As a result, the fixed rate amount will remain constant each day during the term of a transaction. The daily fixed rate amount will be obtained by multiplying the fixed rate by the notional amount and dividing that amount by 360.

At the end of a RAIT, DCC will calculate the sum of the daily floating rate amounts and the sum of the daily fixed rate amounts in each case

¹¹ Participants in the treasury repo market finance other treasury securities at a rate (*i.e.*, the general collateral rate) which does not otherwise distinguish the maturity date of the collateral underlying such treasury repos. For example, market participants finance a treasury security with a remaining term to maturity of 8.5 years and a treasury security with a remaining term to maturity of 1.5 years at the same overnight repo rate unless either of these treasury securities is the most recently issued treasury security of the applicable maturity in which event participants would finance that treasury security at the applicable special collateral rate for newly-issued treasury securities of that maturity.

¹² Prior to the commencement of clearing RAITs, DCC will notify its members of the pricing source to be used. (DCC initially intends to contract with GovPX, Inc. ["GovPX"] as its pricing source for determining the special and general collateral rates.) DCC will also notify members of any change in the pricing source. Any change in DCC's pricing source will not be applicable to RAITs entered into based upon a previous pricing source unless otherwise agreed to by the members to any such transaction.

¹³ For example, the daily floating rate amount calculated for each Friday during the term of the transaction also will apply for the immediately following weekend days.

calculated from and including the commencement date through and excluding the expiration date. The difference between these amounts is the settlement sum. If the sum of the daily floating rate amount is in excess of the sum of the daily fixed rate amount, the selling member will be required to pay the settlement sum to DCC for payment to the purchasing member. If the sum of the daily fixed rate amounts is in excess of the sum of the daily floating rate amounts, the purchasing member will be required to pay the settlement sum to DCC for payment to the selling member.

3. Trade Reporting and Acceptance

The trade reporting procedure for RAITs will be similar to the trade reporting procedures for option transactions cleared by DCC.¹⁴ The transactions may be reported to DCC by the member counterparties or by the broker for the transaction. Members will be required to report RAITs to DCC on the date upon which the members agree to the trades. RAITs made between 9:00 a.m. and 12:00 p.m. on any business day will have to be reported to DCC by telephone prior to 12:30 p.m. of that business day.¹⁵ RAITs agreed to between 12:00 noon and 5:00 p.m. on any business day will have to be reported to DCC by telephone prior to 5:30 p.m. of that business day. Members or their broker will have to submit written trade reports for all trades by 5:30 p.m. of that business day.

Both the verbal and written trade report for each transaction will need to report (a) The identities of the purchasing member and the selling member, (b) the trade date, (c) the commencement date, (d) whether any party is required to pay a premium and if so the party required to pay such premium and the amount, (e) the notional amount, (f) the fixed rate, (g) the floating rate, (h) the expiration date, (i) whether a selling or purchasing transaction, (j) whether an opening or closing transaction,¹⁶ and (k) such other information as may be prescribed.¹⁷

DCC will orally confirm that submitted trade reports contain the required information and that the parties agreed as to the terms of the

¹⁴ Trade reporting for options transactions is described in Article 23 of DCC's procedures.

¹⁵ All references to time are Eastern Time ("ET").

¹⁶ An opening transaction creates or increases a member's short or long position. A closing transaction decreases a member's short or long position.

¹⁷ Records maintained by members with respect to RAITs will need to show the trade date, any premium, the party required to pay the premium, the notional amount, the fixed rate, the floating rate, the expiration date, and whether an opening or closing transaction.

transaction. As with option and repo transactions, DCC may reject a RAIT for various reasons, including if the RAIT causes a member to exceed its exposure limit established by DCC.¹⁸ If DCC rejects a RAIT for any reason, it will promptly notify the members by telephone. If DCC rejects a RAIT because the members' trade reports do not match, the members are required to cooperate with DCC to reconcile any differences. When DCC accepts a RAIT for clearance, DCC will enter into matching transactions with each member so that DCC will act as the counterparty to the purchasing and selling members with respect to their rights and obligations under the RAIT.

4. Netting

A long position with respect to RAITs will be defined as the aggregate rights and obligations of a member as the purchaser of one or more RAITs. A short position with respect to RAITs will be defined as the aggregate rights and obligations of a member as the seller of one or more RAITs. A member's long position or short position will be determined by reference to the applicable notional amount.¹⁹

Transactions entered into by a member with the same commencement date, floating rate, fixed rate, and expiration date will be defined in the procedures as being part of the same "series of instruments." To the extent that a member is the seller of one RAIT and the purchaser of another RAIT in the same series of instruments, such member's long and short positions in such RAITs will be netted.²⁰

If a member wants to close out an existing position, it must enter into a RAIT that has the same commencement date as that existing position (*i.e.*, a date that is prior to the trade date). If the RAIT is the same series of instruments as the earlier RAIT and the member's position is on the opposite side (*e.g.*, the member was the selling member and is now the purchasing member), the new RAIT will be netted against the old RAIT. If the notional amount of the two

RAITs is the same, the member will no longer have a position with DCC in this series of instruments. Such a transaction will be referred to as a closing transaction.

5. Margin

At present, DCC has established exposure limits for each member.²¹ These exposure limits apply to exposure for option transactions and term repos on an aggregate basis. DCC also calculates a member's margin requirements for options transactions and term repos on an aggregate basis,²² and members are required to maintain such margin with DCC's clearing bank in the form required by DCC.²³

Under the proposed rule, a member's exposure for options transactions, term repos, and RAITs will be determined by aggregating a member's exposure with respect to each transaction type. The member's margin requirement will be reduced by a net positive position with respect to a transaction type and will be increased by a net negative position with respect to a transaction type.

Under the proposed rule change, margin provisions now applicable to options and repo positions will become applicable to RAIT positions. For example, DCC will have the right to collect intraday margin if DCC determines such action is appropriate to reflect the change of the value of a member's positions in RAITs during the day. In addition, members will be able to borrow from DCC up to 35% of their net positive exposure, if any, aggregating all their transactions in DCC's clearing system.²⁴

Margin will be collected on a daily basis prior to the settlement time on each business day. Margin for RAITs will be collected for the first time on the first business day following the trade date. This is true even in the case of transactions with a future commencement date ("forward-start") where margin will be collected prior to the commencement date based on mark-to-market and performance margin exposure. During this period prior to the commencement date, margin will also

be collected to cover any premium payments which may be required to be made on the premium settlement date.

A member's margin requirement with respect to RAITs will be the sum of accrual margin, mark-to-market margin, and performance margin.²⁵ All payment obligations of accrual margin, mark-to-market margin, and performance margin will be discounted at the then prevailing general collateral rate to calculate the member's margin requirement.²⁶

a. *Accrual Margin.* Accrual margin will take into account the positive or negative interest amounts accrued with respect to a RAIT based upon the daily fixed and floating rate amounts through the date on which margin is calculated discounted at the current general collateral rate. In the case of a forward-start RAIT, accrual margin will not be applied during the period between the trade date and the commencement date.

b. *Mark-to-Market.* Mark-to-market margin involves a mark-to-market valuation of a member's RAIT positions based upon a comparison of the daily fixed rate amount for the transaction and the current interest rates on comparable repos.²⁷ The calculation

²⁵ Accrual margin, mark-to-market margin, and performance margin are explained later in this notice.

²⁶ DCC believes that discounting is appropriate in order to reflect the current value of the payment obligation. DCC believes the general collateral rate accurately reflects the time value of money under circumstances in which the payment obligations are linked to and secured by treasury securities and that discounting by another interest rate such as the overnight rate on federal funds or the London interbank offered rate ("LIBOR") would result in too steep a discount to the future payment obligation thus leaving DCC unnecessarily exposed to a member.

²⁷ DCC intends to solicit members with respect to selecting comparable repos for each of the six indexes. During the course of each business day, the marketplace establishes the applicable interest rates for repos for each of the six indices based upon the number of days from the current business day to the prospective expiration date for each such repo agreement. The number of days between the current business day and prospective expiration date are quoted in standard units of time starting with weekly increments for the most immediate prospective expiration dates and eventually quoted in months for the most distant expiration date structures. For example, market participants will quote fixed rates for repos for each of the following time units: one week, two weeks, three weeks, one month, two months, and three months through to one year, inclusive. Such term structure of interest rates are established and routinely quoted for each of the five special collateral rates and the general collateral rate. Such term structures are supplied by the market on a continuous basis. In identifying such term structures, DCC will be able to establish benchmark pricing. In the event a RAIT's remaining term to maturity falls between two quoted time units, DCC will interpolate between the two time units on a linear basis to derive the appropriate rate for the comparable term structure for such RAIT. For example, the interpolated rate for a RAIT with forty days remaining to its expiration date would be 3.44% assuming the one month rate was 3.40% and the two month rate was 3.52% [(3.52% - 3.40%)

¹⁸ Note 21 contains a definition of exposure limit.

¹⁹ For example, if a member is the purchaser of a RAIT with a notional amount of \$3,000,000, the member will have a long position in that RAIT for a notional amount of \$3,000,000. Similarly, if a member is the seller of a RAIT with a notional amount of \$2,000,000, the member will have a short position in that RAIT for a notional amount of \$2,000,000.

²⁰ For example, if the two transactions described in note 19 involved the same commencement date, floating rate, fixed rate, and expiration date and were entered into by the same member, the members' long and short positions in those RAITs would be netted and the member would have a net long position of \$1,000,000 in that series of instruments.

²¹ Exposure limit currently is defined as the limit prescribed for each member on the aggregate incremental margin due to DCC for that day that the member may incur or carry in respect of its short position in options, the settlement of exercised options, and its positions in repos.

²² Overnight repos are subject to separate margin requirements. Section 2203 of DCC's procedures.

²³ Provisions relating to margin are set forth in Article 22 of DCC's procedures.

²⁴ To the extent that members with negative exposures to DCC have not made required margin payments to DCC, DCC will not permit members with positive exposure to borrow against their positive exposures.

with respect to such mark-to-market value will be: (notional size) times (number of days to end of RAIT/360) times (difference between the fixed rate and current repo rate). The calculation, after discounting the resulting value at the prevailing general collateral rate through the applicable expiration date, produces the mark-to-market value for both members to a RAIT. The payor of the fixed rate will incur an obligation to deposit mark-to-market margin in the event that the comparable interest rates are less than the RAIT's fixed rate. Conversely, the floating rate payor will incur an obligation to deposit mark-to-market margin in the event that the comparable repo rates are greater than the RAIT's fixed rate. In the case of a forward-start RAIT, mark-to-market margin also will take into account the premium required to be paid or received by the member on the premium settlement date for the RAIT.²⁸

c. *Performance Margin.* Performance margin will adjust a member's margin requirement based on a hypothetical three standard deviation movement adverse to the member in the fixed rates on comparable repos.²⁹ For each period to maturity and reference rate, DCC will determine the volatility of the rates on the comparable repos based upon the changes in such rates during the immediately preceding 100-day period. The calculation for performance margin will be (notional size) times (# of days to end of RAIT/360) times (# of basis points representing three standard deviations).

d. *Application of Margin in Event of Default.* If a DCC member becomes insolvent or otherwise defaults on a payment obligation, DCC will attempt to transfer that member's positions to other DCC members. If DCC cannot locate a third party willing to accept the transaction, DCC will be required to liquidate the transaction based upon the RAITs' values as calculated for accrual and mark-to-market margins. To the extent that DCC would be required to pay a third party to assume a RAIT or would be required to pay the nondefaulting counterparty upon the

liquidation of a RAIT, DCC will pay the third party or the nondefaulting counterparty, as applicable, the equivalent of the accrual and mark-to-market margin for the RAIT.

6. Maximum Potential System Exposure ("MPSE")

DCC is required to ensure that MPSE does not at any time exceed one-third of the coverage provided by DCC's credit enhancement facility.³⁰ To the extent necessary to ensure that MPSE does not exceed the prescribed limit, a member may be restricted from entering into opening transactions, may be required to reduce or eliminate existing positions through closing transactions, and may be required to pay additional margin.

With respect to RAITs, DCC will calculate MPSE by adjusting all member positions by a hypothetical adverse six standard deviation movement in the repo rates for comparable repos.³¹ The standard deviation for MPSE will be determined by reference to the most volatile 100-day period from the earliest date from which repo rate information is available to DCC to the present.³²

7. Operational Implications

DCC believes its current operating environment is sufficiently robust and appropriately configured to accommodate RAITs. DCC's current arrangements with its clearing bank with respect to the payment and the receipt of margin and premium payments and the prospective arrangements with respect to the payment of funds with respect to expired RAITs are within DCC's existing capabilities. DCC's systems will be adapted to incorporate RAIT related exposure management requirements into DCC's established mechanism regarding exposure management. Such other necessary system enhancements will be introduced as DCC consults with the user community during the RAIT development and implementation process.

DCC believes that the proposed rule change is consistent with the

requirements of Section 17A of the Act³³ and the rules and regulations thereunder which require that a clearing agency be organized and its rules be designed to promote the prompt and accurate clearance and settlement of securities transactions, to safeguard funds and securities in DCC's possession and control, and to remove impediments to and to perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions. DCC believes that the amendment contemplated by the proposed rule change will permit wider utilization of the clearing system by members and will provide a clearing service which addresses market needs.

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

DCC does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

No comments on the proposed rule change were solicited or received.

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 periods: (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 the 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

(10/30) + 3.40%]. Such benchmark pricing would be equivalent to "end of day" pricing for outstanding RAITs with respect to calculating DCC's exposures to members and will be utilized in the margining process.

²⁸ On the first business day following the trade date of a forward-start RAIT, the member required to pay premium on the premium settlement date will be required to deposit margin in an amount equal to such premium obligation. Conversely, the member entitled to receive premium will have a net positive value with respect to the premium payment until the premium payment is made on the premium settlement date.

²⁹ Note 27 contains a description of comparable repos.

³⁰ MPSE represents the liability to DCC of its members' positions reduced by margin on hand or to be collected by the next day.

³¹ Note 27 contains a definition of comparable repos.

³² Pricing data for at least a five-year period for each repo rate is available from the dealer community, and DCC intends to obtain such data. DCC intends to file with the Commission a supplemental information report which will show the applicable reference periods and other relevant data for determining volatility for MPSE purposes. DCC acknowledges that the Commission's receipt of the supplemental information report in a form which is acceptable to the Commission will be a condition to the Commission's approval of this filing.

³³ 15 U.S.C. 78q-1.

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 also will be available for inspection and copying at the principal office of DCC. All submissions should refer to File No. SR-DCC-97-10 and should be submitted by March 4, 1998.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.³⁴

Margaret H. McFarland, Deputy Secretary.

[FR Doc. 98-3367 Filed 2-10-98; 8:45 am]

BILLING CODE 8010-01-M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39620; File No. SR-NASD-97-95]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Amendment to the Free-Riding and Withholding Interpretation

February 4, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on December 23, 1997, NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASD Regulation is proposing to amend National Association of Securities Dealers, Inc. ("NASD" or "Association") Interpretative Material IM-2110-1 and Rule 2720, to revise certain aspects of the Free-Riding and Withholding Interpretation. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

IM-2110-1. "Free-Riding and Withholding"

(a) Introduction

(1) No change. (2) As in the case of any other interpretation issued by the [Board of Governors of the] Association, the implementation thereof is a function of the NASD Regulation staff [District Business Conduct Committee] and the [Board of Governors] NASD Regulation Board of Directors. Thus, the interpretation will be applied to a given factual situation by NASD Regulation staff, subject to oversight by the Board, with staff soliciting input from individuals active in the investment banking and securities business [who are serving on these committees or on the Board. They] In making such interpretations, staff and the Board will construe this interpretation to effectuate its overall purpose to assure a public distribution of securities for which there is a public demand.

* * * * *

(5) The NASD Regulation staff, upon written request, may, taking into consideration all relevant factors, provide an exemption either unconditionally or on specified terms from any or all of the provisions of this interpretation upon a determination that such exemption is consistent with the purposes of the interpretation, the protection of investors, and the public interest. A member may appeal a decision issued by NASD Regulation staff to the National Adjudicatory Council pursuant to the Code of Procedure.

* * * * *

(b) Violations of Rule 2110

(9) Sell any of the securities to any person, or to a member of the immediate family of such person, who owns or has contributed capital to a broker/dealer, other than solely a limited business broker/dealer as defined in paragraph (c) of the interpretation, or the account in which any such person has a beneficial interest, provided, however, that:

(A) The prohibition shall not apply to any person who directly or indirectly owns any class of equity securities of, or who has made a contribution of capital to, a member, and whose ownership or capital interest is passive and is less than 10% of the equity or capital of a member, as long as:

(i) such person purchases hot issues from a person other than the member in which it has such passive ownership and such person is not in a position by virtue of its passive ownership interest to direct the allocation of hot issues, or

(ii) such member's shares are publicly traded on an exchange or Nasdaq.

(B) This prohibition shall not apply to sales to the account of any person restricted under this subparagraph established for the benefit of bona fide public customers, including an insurance company general or separate account.

(C) For purposes of this paragraph, any person with an equity ownership or capital interest in an entity that maintains an investment in a member shall be deemed to have a percentage interest of the entity in the member multiplied by the percentage interest of such person in such entity.

* * * * *

(d) Issuer-Directed Securities

[(1) This interpretation shall apply to securities which are part of a public offering notwithstanding that some or all of those securities are specifically directed by the issuer to accounts which are included within the scope of paragraph (b)(3) through (8) above.

Therefore, if a person within the scope of those subparagraphs to whom securities were directed did not have the required investment history, the member would not be permitted to sell him such securities. Also, the "disproportionate" and "insubstantial" test would apply as in all other situations. Thus, the directing of a substantial number of securities to any one person would be prohibited as would the directing of securities to such accounts in amounts which would be disproportionate as compared to sales to members of the public. If such issuer-directed securities are sold to the issuer's employees or directors or potential employees or directors resulting from an intended merger, acquisition, or other business combination, such securities may be sold without limitation as to amount and regardless of whether such employees have an investment history as required by the interpretation; provided, however, that in the case of an offering of securities for which a bona fide independent market does not exist, such securities shall not be sold, transferred, assigned, pledged, or hypothecated for a period of three months following the effective date of the offering. This interpretation shall also apply to securities which are part of a public offering notwithstanding that some of those securities are specifically directed by the issuer on a non-underwritten basis. In such cases, the managing underwriter of the offering shall be responsible for issuing compliance with this interpretation in respect to those securities.]

³⁴ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).