

copy of the request, personally or by mail. Hearing requests should be received by the SEC by 5:30 p.m. on March 9, 1998, and should be accompanied by proof of service on applicant, in the form of an affidavit or, for lawyers, a certificate of service. Hearing requests should state the nature of the writer's interest, the reason for the request, and the issues contested. Persons may request notification of a hearing by writing to the SEC's Secretary.

**ADDRESSES:** Secretary, SEC, 450 5th Street, N.W., Washington, D.C. 20549. Applicant, Moreland Management Company, Suite 550 at Cambridge Court, 28601 Chagrin Boulevard, Cleveland, Ohio 44122-4531.

**FOR FURTHER INFORMATION CONTACT:** Catherine M. Saadeh, Staff Attorney, at (202) 942-0650, Jennifer S. Choi, Special Counsel, at (202) 942-0725 (Division of Investment Management, Task Force on Investment Adviser Regulation).

**SUPPLEMENTARY INFORMATION:** The following is a summary of the application. The complete application may be obtained for a fee at the SEC's Public Reference Branch.

#### Applicant's Representations

1. Applicant was organized as an Ohio corporation in 1987 by LJR Trust (the "Trust"), which owns all of applicant's outstanding stock. The Trust exists for the benefit of Mr. Leonard C. Horvitz and his descendants (the "Horvitz Family").

2. Applicant was formed to serve as the "family office" for the Horvitz Family. In addition to the Trust, applicant's other clients consist of (i) The immediate members of Mr. Horvitz's family and (ii) the trusts, foundations, partnerships, and other entities created by them, or by the Trust, to serve as vehicles for investments.

3. Applicant provides asset allocation, record-keeping, investment due diligence, federal and state tax advice, coordination of professional relationships with accountants and attorneys, and other services to the Trust and applicant's other clients. Applicant currently has 14 employees. Applicant is paid for its services by the Trust and applicant's other clients.

#### Applicant's Legal Analysis

1. Section 202(a)(11) of the Advisers Act defines the term "investment adviser" to mean "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the

advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities \* \* \*." Section 202(a)(11)(F) of the Advisers Act authorizes the SEC to exclude from the definition of "investment adviser" persons that are not within the intent of section 202(a)(11).

2. Section 203(a) of the Advisers Act requires investment advisers to register with the SEC. Section 203(b) of the Advisers Act provides exemptions from this registration requirement.

3. Applicant asserts that it does not appear to qualify for any of the exemptions provided by section 203(b). Applicant states that it is not prohibited from registering with the SEC under section 203A of the Advisers Act because its principal office and place of business is located in Ohio.<sup>1</sup> Applicant requests that the SEC declare it to be a person not within the intent of section 202(a)(11).

4. Applicant asserts that there is no public interest in requiring it to be registered under the Advisers Act. Applicant states that it is a private organization that was formed to be the "family office" for the Horvitz Family. Applicant represents that all of its clients have a close relationship with the Horvitz Family in that they are all either immediate members of Mr. Horvitz's family or are entities created by and for the Horvitz Family. Applicant states that it has no public clients in the sense of retail investors, and that it has no plans, now or in the future, to solicit clients from the retail public. Applicant asserts that serving as the "family office" for the Horvitz Family will be its exclusive mission.

5. Applicant states that it does not hold itself out to the public as an investment adviser. Applicant states that only its name, which does not itself have any suggestive connotations, is listed in the Cleveland-area telephone book and on the index of residents located in the lobby of its building. Applicant represents that it does not engage in any advertising, attend investment management-related conferences as a vendor, or conduct any marketing activities.

6. Applicant states that its investment advisory activities constitute a very small portion of its overall activities. Applicant represents that of its 14 employees, only three have any involvement in applicant's investment advisory activities. Applicant states that these three employees estimate that

<sup>1</sup> Ohio does not currently regulate investment advisers.

investment advisory activities make up less than 25 percent of their responsibilities. Applicant states that its principal activities are not investment advisory in nature, and that the largest portion of its activities involve providing services that do not involve investment advice of any kind.

For the SEC, by the Division of Investment Management, under delegated authority.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-4256 Filed 2-19-98; 8:45 am]

BILLING CODE 8010-01-M

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39661; International Series Release No. 1117; File No. 600-30]

### Self-Regulatory Organizations; Emerging Markets Clearing Corporation; Order Granting Temporary Registration as a Clearing Agency

February 13, 1998.

On May 30, 1997, the Emerging Markets Clearing Corporation ("EMCC") filed with the Securities and Exchange Commission ("Commission") an application on Form CA-1<sup>1</sup> for registration as a clearing agency pursuant to Sections 17A and 19 of the Securities Exchange Act of 1934 ("Exchange Act")<sup>2</sup> and Rule 17Ab2-1 thereunder.<sup>3</sup> Notice of EMCC's application was published in the **Federal Register** on July 10, 1997.<sup>4</sup> Eight comment letters were received in response to the notice of filing of the EMCC application.<sup>5</sup> This order grants EMCC registration as a clearing agency for a period not to exceed eighteen months and exempts EMCC from certain provisions of the Exchange Act.

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<sup>1</sup> On June 2, 1997, June 17, 1997, August 7, 1997, October 14, 1997, October 21, 1997, and October 28, 1997, EMCC filed amendments to its application. Copies of the application are available for inspection and copying at the Commission's Public Reference Room.

<sup>2</sup> 15 U.S.C. 78q-1 and 78s.

<sup>3</sup> 17 CFR 240.17Ab2-1.

<sup>4</sup> Securities Exchange Act Release No. 38810 (July 1, 1997), 62 FR 37093 ("EMCC Notice").

<sup>5</sup> Letters from Jonathan Kord Lagemann, attorney for Asialuck Limited (July 15, 1997); JP Morgan (July 30, 1997); Emerging Markets Traders Association (August 8, 1997); UBS Limited (August 7, 1997); Euro Brokers Maxcor Inc. (undated); EMCC European Operations Committee (August 8, 1997); Salomon Brothers Inc. (August 8, 1997); and Merrill Lynch, Pierce, Fenner & Smith Incorporated (August 6, 1997).

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### I. Description of EMCC

#### A. EMCC Organization

EMCC is a corporation organized under the laws of the State of New York. EMCC was formed by the Emerging Markets Traders Association ("EMTA")<sup>6</sup> and the International Securities Clearing Corporation ("ISCC")<sup>7</sup> in response to an industry initiative to reduce risk in the clearance and settlement of emerging markets debt instruments. Currently, the International Securities Markets Association

<sup>6</sup>EMTA is a trade association organized in 1990 as a New York not-for-profit corporation by financial institutions to promote the development of trading markets in emerging market instruments. At the end of 1996, EMTA had 154 members, which were mainly broker-dealers and banks. EMTA owns 100% of the outstanding voting securities of EMTA Black, Inc. EMTA Black, Inc. in turn owns 100% of the outstanding voting securities of each of Clear-EM, Inc.; match-EM, Inc.; and Net-EM, Inc. Match-EM, Inc. is the owner of Match-EM, which is an electronic post-trade confirmation and matching system for Brady bonds and sovereign loans operated by GE Information Services, Inc. ("GE"). Match-EM also enables EMTA to disseminate daily market volume and price data. Match-EM began operations in May 1995.

<sup>7</sup>ISCC is the wholly owned subsidiary of the National Securities Clearing Corporation and is registered as a clearing agency under the Exchange Act. Securities Exchange Act Release No. 26812 (May 12, 1989), 54 FR 21691 (order approving temporary registration of ISCC as a clearing agency). ISCC continues to operate under its temporary registration. Securities Exchange Act Release No. 38703 (May 30, 1997), 62 FR 31183.

("ISMA"),<sup>8</sup> the National Securities Clearing Corporation ("NSCC"),<sup>9</sup> and EMTA are the owners of EMCC.<sup>10</sup>

#### B. Eligible Securities

EMCC has been established as a clearing agency to facilitate the clearance and settlement of transactions in U.S. dollar-denominated Brady bonds at Cedel and Euroclear (collectively referred to as "depositories").<sup>11</sup> Currently, Brady bonds<sup>12</sup> are settled through the facilities of Cedel Bank, Société anonyme ("Cedel") and the Euroclear system, which is operated by the Brussels Office of Morgan Guaranty Trust Company of New York ("Euroclear").<sup>13</sup> In the future, EMCC may expand its clearance and settlement

<sup>8</sup>ISMA is an industry association composed of broker-dealer firms. ISMA has approximately 820 members in 48 countries. ISMA is organized under the laws of Switzerland and is registered in the United Kingdom ("U.K.") as a designated investment exchange. ISMA owns TRAX, a trade matching and reporting system started in 1989. ISMA's wholly-owned subsidiary, International Securities Market Association Limited ("ISMA Ltd."), operates TRAX. U.K. broker-dealers can use TRAX to fulfill their U.K. reporting requirements.

<sup>9</sup>NSCC is a clearing agency registered under Section 17A of the Exchange Act. Securities Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (order approving full registration of NSCC as a clearing agency). NSCC is owned by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc.

<sup>10</sup>EMTA owns 300 shares (37.5% of the outstanding shares), NSCC owns 300 shares (37.5% of the outstanding shares), and ISMA owns 200 shares (25% of the outstanding shares). No later than June 30, 1998, EMCC intends to issue shares to persons that have contributed to the EMCC development fund and to finance EMCC's initial operations in such amounts and at such times as determined by EMCC. EMCC will file a proposed rule change prior to any such issuances.

<sup>11</sup>Initially, only Brady bonds will be eligible for processing at EMCC. As defined in EMCC's rules, Brady bonds are: (i) any bond or note issued in connection with the restructuring of indebtedness by a sovereign or an agency or entity thereof under the auspices of the Brady plan or under any similar restructuring or financing plan whether or not collateralized and including bonds or notes issued in exchange thereof or (ii) any warrant or similar right originally issued attached to a Brady bond. The term does not include securities offered by a sovereign debtor to investors through normal underwriting syndication channels.

<sup>12</sup>Pursuant to a plan developed by then U.S. Treasury Secretary Nicholas Brady, certain countries have issued collateralized debt securities (i.e., Brady bonds) in exchange for outstanding bank loans as part of an internationally supported sovereign debt restructuring. Typically, the collateral would be U.S. Treasury securities. More recently, some issues of Brady bonds have been issued without collateral.

<sup>13</sup>For a description of Cedel, see Securities Exchange Act Release No. 38328 (February 24, 1997), 62 FR 9225 (order approving application for limited exemption from registration as a clearing agency). For a description of Euroclear, see Securities Exchange Act Release No. 38589 (May 9, 1997) 62 FR 26833 (notice of filing of application for exemption from registration as a clearing agency).

services to include other emerging markets debt instruments.<sup>14</sup>

#### C. Clearance Services

Dealers and interdealer brokers ("broker") will submit transaction data relating to trades to be settled at EMCC to a locked-in trade source which will match such data using its own criteria. Initially, the locked-in trade sources designated by EMCC are Match-EM and TRAX.<sup>15</sup> Upon completion of the matching process, each locked-in trade source will submit transaction data to EMCC.<sup>16</sup>

EMCC will receive data from the locked-in trade sources three times each business day: (1) Between 8:00 a.m. and 8:30 a.m. eastern time ("ET") ("early morning transmission"); (2) between 11:00 a.m. and 11:30 a.m. ET ("midmorning transmission"); and (3) between 9:00 p.m. and 9:30 p.m. ET ("evening transmission"). At approximately 10:30 a.m. ET and 11:30 p.m. ET, EMCC will send to its members and to the locked-in trade sources a report of data that was rejected because it did not meet EMCC's or the depositories' operational parameters.<sup>17</sup> Any correction or cancellation of data must be done through the locked-in trade sources.<sup>18</sup>

EMCC will report to each member on its "accepted trade report" data on all trades: (a) That are matched by the locked-in trade sources; (b) that are received by EMCC by the early morning transmission two days after trade date ("T+2"); (c) that are eligible for processing by EMCC (i.e., U.S. dollar denominated Brady bonds); and (d) that are not rejected by EMCC based on the operational parameters. EMCC will interpose itself as the counterparty and guarantor on a trade-for-trade basis with respect to the trades it reports on its accepted trade report unless EMCC notifies or has made information available to its members that trades

<sup>14</sup>EMCC will file proposed rule changes with the Commission prior to expanding the categories of securities eligible for processing at EMCC.

<sup>15</sup>See *supra* notes 6 and 8.

<sup>16</sup>TRAX will only submit data to EMCC on matched trades that members have designated as EMCC trades. Match-EM will submit data to EMCC on all trades submitted to it. EMCC will segregate out for processing all data on trades between two EMCC members. However, if an EMCC member maintains two accounts with Match-EM, EMCC will only process trades in the EMCC designated account.

<sup>17</sup>Such parameters include complete information and valid characters. In addition, EMCC has established a maximum delivery size of \$20 million.

<sup>18</sup>Any cancellation or correction must be received by EMCC no later than the early morning transmission two business days after trade date ("T+2").

listed on the accepted trade report are not assumed and guaranteed because EMCC has ceased to act for the original counterparty.<sup>19</sup> EMCC's guarantee will be effective with respect to: (a) Trades reported on the evening accepted trade report at the later of midnight ET or one half hour after the issuance of the preliminary margin report<sup>20</sup> and (b) trades reported on the morning accepted trade report at the later of 1:00 p.m. ET or two and one-half hours after issuance of the final margin report.<sup>21</sup>

Matched trades that are eligible for processing and that are received on T+2 in the midmorning transmission will be listed on a settlement instructions only report ("SIO report"). For trades listed on this report, EMCC will provide settlement instructions on behalf of its members to the depositories but will not novate or guarantee the trade. EMCC will not accept transaction data sent after the midmorning transmission on T+2.

Upon standing instructions of a member, EMCC will also include on the SIO report uncompleted transaction on T+2. If EMCC receives by the early morning transmission on T+2 updated data from Match-EM indicating that an uncompleted trade has been cancelled or compared, EMCC will not include data on the trade on the SIO report. If submitted in time, these trades will be reported on the accepted trade report. If not, they will be processed by the depositories, but will not be guaranteed by EMCC.

Accepted trade reports will be made available to members at approximately 10:30 a.m. ET and 11:30 p.m. ET. The morning report will contain data on matched trades received in the early morning transmission. The evening report will contain data on matched trades received in the midmorning and evening transmissions. The SIO report will be issued at approximately 12:00 p.m. ET. At approximately 12:30 p.m. on T+2, EMCC will send settlement instructions to the depositories based on trade data contained in the accepted trade reports and in the SIO reports.

#### D. Settlement Services

EMCC is a member of both Euroclear and Cedel. For trades listed on the accepted trade report, EMCC will transmit settlement instructions to the appropriate depository on behalf of members with EMCC as the

<sup>19</sup> EMCC does not interpose itself as the counterparty and guarantor for transactions reported on the settlement instructions only report.

<sup>20</sup> See *Infra* Section III.D.1.a for a description of the preliminary margin report.

<sup>21</sup> See *infra* Section III.D.1.a for a description of the final margin report.

counterparty to each side of the trade. EMCC will send instructions to the depository at 12:30 p.m. on T+2 for settlement the next day ("T+3"). The settlements will be made on a delivery against payment/receive against payment basis through EMCC's account at each depository.<sup>22</sup>

In accordance with the depositories' rules, settlement will occur only if the receiver has sufficient cash or line of credit to pay for the delivery and the deliverer has sufficient securities to make full delivery.<sup>23</sup> The depositories will notify EMCC and its members each day at midnight ET of the status of trades indicating which have settled and which were scheduled to settlement but are still pending. EMCC will not provide settling trade reports or fail reports to its members.

If a member fails to accept delivery of securities from EMCC because it has insufficient funds, EMCC will send a fail compensation instruction to the appropriate depository. The next day (presuming that the member is not insolvent), the depository will debit the account of the member that had insufficient funds and credit its counterparty's account an amount of money based on the depository's overnight borrowing interest rate multiplied by the amount of funds which were not paid.

With respect to transactions reflected on a member's SIO report, EMCC will send instructions on the afternoon of

<sup>22</sup> Unless otherwise specified, EMCC assumes that bonds will be delivered with attached warrants.

<sup>23</sup> Both Cedel and Euroclear employ mechanisms that can look beyond the initial counterparties' obligations. Cedel has a "chaining" program which scans open transactions until all cash and securities resulting from same day settlements are reemployed to settle further transactions for same day value. Therefore, for back-to-back transfers for equivalent funds, customers may not need to pay because proceeds from sales are used to settle purchases.

Euroclear's chaining program operates somewhat differently. In scanning open transactions, the Euroclear program will only look to the next settlement. For example, if a member does not have sufficient funds to receive securities, Euroclear will ascertain whether that member has a corresponding securities deliver obligation to another member. In such case, Euroclear will complete both transactions if the counterparty to the deliver obligation has sufficient funds to pay for the securities. But if the counterparty to the securities deliver obligation did not have sufficient funds to settle the transaction, Euroclear, unlike Cedel, would not look to subsequent settlements for funds and securities. Accordingly, where EMCC as the counterparty to EMCC member trades has insufficient funds to accept deliveries, Euroclear's system will only look to EMCC's member to determine if sufficient funds exist. In order to permit Euroclear to "look through" EMCC for settlement and deliveries, EMCC will maintain a line of credit of at least \$50 million at Euroclear. EMCC's line of credit will permit Euroclear to review not only the available funds of EMCC's member but also such member's subsequent counterparty, if any.

T+2 to the depository on behalf of that member for T+3 settlement. EMCC will not monitor the settlement of these transactions.

#### E. Buy-ins/Sell-outs

EMCC's rules permit a member to buy-in or a sell-out of Brady bonds in the event that a transaction has not been completed by five days after settlement date ("SD+5").<sup>24</sup> EMCC may also initiate a buy-in or sell-out if it determines that such action is necessary to protect EMCC, its members, its creditors, or its investors; to safeguard securities or funds in EMCC's custody or control; or to promote the prompt and accurate clearance and settlement of securities transactions.

While a member may request a buy-in or sell-out for deliver and receive obligations for warrants, EMCC will only complete the buy-in or sell-out of warrants at the requesting member's expense in the event that EMCC ceases to act for the member's counterparty. In addition, if EMCC ceases to act for the defaulting member after the pre-advice notice has been submitted but before the execution of the buy-in or sell-out, EMCC will only proceed with the buy-in or sell-out after confirming with the requesting firm that it wants to proceed at its expense.

#### F. Release of Clearing Data

Pursuant to EMCC's rules, EMCC may release its members' transaction data to EMTA in accordance with a written agreement between EMCC and EMTA. Such data may be used only for the purpose of promoting market transparency on a noncommercial basis. On June 9, 1997, EMCC and EMTA entered into a letter agreement that provides for the public dissemination of information relating to the aggregate and per trade transaction volumes and prices of trades processed by EMCC.

## II. Comment Letters

The Commission received eight comment letters in response to the

<sup>24</sup> A buy-in or sell-out may be initiated by submitting a "pre-advice" notice to EMCC. Upon receipt of the pre-advice notice, EMCC will transmit the notice to the member with the fail obligation. If the instruments or money covered by the pre-advice notice are not received within two business days after the date of the pre-advice notice, then the member that requested the buy-in or sell-out must deliver to EMCC a buy-in or sell-out notice between two to five business days after issuance of the pre-advice notice in order to proceed with the buy-in or sell-out. Upon receipt of the buy-in or sell-out notice, EMCC will transmit a buy-in or sell-out notice to the member with the fail obligation. Execution of the buy-in or sell-out will take place through an agent selected by EMCC on the fifth business day following the issuance of the buy-in or sell-out notice.

notice of filing of EMCC's application.<sup>25</sup> Seven were in favor of granting EMCC's application for registration. These commenters stated that EMCC would be effective in reducing the risks, particularly counterparty risk, involved in settling Brady bonds. In addition, many of these commenters thought that EMCC would provide a cost-effective means of settling Brady bond trades.

The one commenter that opposed EMCC's application stated that EMTA has failed to respond to a New York Stock Exchange subpoena and that such conduct was inconsistent with the conduct expected of a registered clearing agency. EMCC responded to this commenter by stating that EMTA had in fact responded to the subpoena and that EMTA's actions were irrelevant to EMCC's application because EMTA's involvement is limited to an ownership interest in EMCC pursuant to which it may elect only one director out of the 21 directors on EMCC's board.

### III. Discussion

#### A. Statutory Standards

Section 17A of the Exchange Act directs the Commission, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition, to use its authority to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions.<sup>26</sup> Registration of clearing agencies is a key element of the statutory objectives set forth in Section 17A.<sup>27</sup> Before granting registration to a clearing agency, Section 17A(b)(3) of the Exchange Act requires that the Commission make a number of determinations with respect to, among other things, a clearing agency's organization, rules, and ability to provide safe and accurate clearance and settlement.<sup>28</sup> Additionally, the Division of Market Regulation has published the standards it applies in evaluating

applications for clearing agency registration.<sup>29</sup>

Section 17A(b)(1) provides that the Commission:

May conditionally or unconditionally exempt any clearing agency or security or any class of clearing agencies or securities from any provisions of [Section 17A] or the rules or regulations thereunder, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of [Section 17A], including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds.<sup>30</sup> As a result, in granting exemptions from portions of Section 17A, the Commission requires substantial compliance with Section 17A and the rules and regulations thereunder based on a review of the standards.<sup>31</sup>

#### B. Participant Standards

##### 1. Eligible Categories of Members

Section 17A(b)(3)(B) of the Exchange Act enumerates certain categories of persons that a clearing agency's rules must authorize as potentially eligible for access to clearing agency membership and services.<sup>32</sup> As discussed in the Standards Release, a clearing agency may also accept specific categories of persons other than those enumerated but must be cognizant of the impact that any additional category of members may have on the clearing agency and must take steps to address any such risk. While entities falling into the specified categories are eligible for membership, applicants must also satisfy the other criteria established by EMCC and discussed later in this release.

A partnership, corporation, limited liability company, or other organization, entity, or individual will be qualified to

<sup>29</sup> Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 ("Standards Release"). See also, Securities Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (omnibus order granting registration as clearing agencies to The Depository Trust Company, Stock Clearing Corporation of Philadelphia, Midwest Securities Trust Company, The Options Clearing Corporation, Midwest Clearing Corporation, Pacific Securities Depository, National Securities Clearing Corporation, and Philadelphia Depository Trust Company).

<sup>30</sup> 15 U.S.C. 78q-1(b)(1)

<sup>31</sup> The Commission has granted temporary registrations that included exemptions from specific statutory requirements of Sections 17A. In granting these temporary registrations, the subject clearing agencies were expected to become registered on a permanent basis. See, e.g., Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19839 (order approving Government Securities Clearing Corporation's temporary registration as a clearing agency with a temporary exemption from compliance with Section 17A(b)(3)(C)).

<sup>32</sup> The classes are registered brokers or dealers, registered clearing agencies, registered investment companies, banks, and insurance companies.

become a member of EMCC if it satisfies at least one of the following qualifications: (a) It is a broker or dealer registered under the Exchange Act; (b) it is a broker or dealer registered or regulated under the laws of another jurisdiction;<sup>33</sup> (c) it is a bank or trust company, including a trust company having limited power, which is a member of the Federal Reserve System or is supervised and examined by state or federal authorities in the U.S. having supervision over banks; (d) it is a bank or trust company, which is supervised and examined by the banking regulator in another jurisdiction; or (e) if it does not qualify under (a) through (d) but is the successor or assign of any member and has demonstrated to the board of directors that its business and capabilities are such that it could use EMCC's services without undue risk to EMCC, then such successor or assign may become a member for the limited purpose of winding up its business with EMCC in an orderly manner.

After the issuance of shares to persons which have contributed to the development fund for the organization and initial operation of EMCC,<sup>34</sup> all applicants that EMCC accepts for membership will be required to be either a shareholder of EMCC or an affiliate or subsidiary of a shareholder of EMCC. EMCC may deny an application to become a member or to use one or more services of EMCC upon a determination by EMCC that EMCC does not have adequate personnel, space, data processing capacity, or other operational capability at such time to perform its services for the applicant or member without impairing the ability of EMCC to provide services for its existing members, to assure the prompt, accurate, and orderly processing and settlement of securities transactions, or to otherwise carry out its functions. However, any such applications which are denied will be approved as promptly as the capabilities of EMCC permit. Further Section 17A(b)(3)(F) of the Exchange Act requires that the rules of a clearing agency should not be designed to discriminate in the admission of members.

##### 2. Examination of Applicants

The Standards Release notes that a registered clearing agency is empowered by the Exchange Act to examine and verify the qualifications of an applicant in accordance with the procedures

<sup>33</sup> Initially, only broker-dealers that are organized under the laws of the U.K. will be eligible for admission. EMCC will file a proposed rule change setting forth membership criteria prior to admission of other categories of non-U.S. broker-dealers.

<sup>34</sup> See *supra* note 10.

<sup>25</sup> *Supra* note 5.

<sup>26</sup> 15 U.S.C. 78q-1. For legislative history concerning Section 17A, see, e.g., Report of Senate Comm. on Housing and Urban Affairs, Securities Acts Amendments of 1975: Report to Accompany S. 249, S. Rep. No. 75, 94th Cong., 1st Sess. 4 (1975); Conference Comm. Report to Accompany S. 249, Joint Explanatory Statement of Comm. of Conference, H.R. Rep. No. 229, 94th Cong., 1st Sess., 102 (1975).

<sup>27</sup> "Clearing agency" is defined in Section 3(a)(23) of the Exchange Act. 15 U.S.C. 78c(a)(23).

<sup>28</sup> 15 U.S.C. 78q-1(b)(3). See also Section 19 of the Exchange Act, 15 U.S.C. 78s, and Rule 19b-4, 17 CFR 240.19b-4, setting forth procedural requirements for registration and continuing Commission oversight of clearing agencies and other self-regulatory organizations.

established by the rules of the clearing agency. However, the Standards Release also states that such authority could be used only subject to a clearing agency's responsibility not to discriminate in the admission of participants and not to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Each applicant for admission to EMCC must provide a copy of its financial statements for the two most recent fiscal years certified by the applicant's independent certified public accountants. To the extent that such audited financial statements are not prepared in accordance with U.S. generally accepted accounting principles ("GAAP"), the applicant must provide EMCC with a discussion of the material variations of such accounting principles from U.S. GAAP.

A U.S. broker-dealer applicant must provide copies of its Form X-17A-5 FOCUS Reports or Form G-405 FOGS Reports for the last two years and any supplemental reports required to be filed with the Commission pursuant to Exchange Act Rule 17a-11<sup>35</sup> or 17 CFR 405.3. If the applicant is a U.K. broker-dealer subject to regulation by the Securities and Futures Authority ("SFA") or any successor organization, it must provide EMCC with its SFA monthly reports and returns for the prior 24 months and if necessary and feasible, financial statements prepared in accordance with U.S. GAAP.

A bank applicant must provide all quarterly financial statements covered by the last audited financial statement plus all subsequent quarterly financial statements. A U.S. bank applicant also must provide copies of its three most recent Consolidated Reports of Condition and Income ("Call Reports") and information as to its capital levels and ratios. A non-U.S. bank applicant also must provide all material regulatory filings made with its primary regulator in its home country over the prior two years.

If required by EMCC, an applicant must provide a certificate of the chief executive or chief financial officer of the applicant that no material adverse changes have occurred in the financial condition of the applicant since the date of the most recent financial statements or reports filed with EMCC; that the applicant has not guaranteed the obligations of any other person; and that the applicant is not subject to any other contingent liabilities except as set forth in such financial statements, reports, or the certificate.

All applicants must fill out a questionnaire that elicits information on any liabilities of the applicant, the types of business conducted by the applicant, and the applicant's operational capabilities. All applicants must provide to EMCC an opinion of outside counsel as to the member's organization, the validity and enforceability of the member's agreement, and the need for regulatory approvals. In addition, the opinion of non-U.S. applicants must also opine as to jurisdictional and conflict-of-law issues. A non-U.S. applicant must represent that it is in good standing with its home country's financial regulatory authority.

### 3. Membership Standards

Section 17A(b)(4)(B) of the Exchange Act contemplates that a registered clearing agency have financial responsibility, operational capability, experience, and competency standards that are used to accept, deny, or condition participation of any participant or any category of participants, but that these criteria may not be used to unfairly discriminate among participants. The Standards Release states that a clearing agency may discriminate among persons in the admission to or the use of the clearing agency if such discrimination is based on standards of financial responsibility, operational capability, experience, and competence.

EMCC's board or the membership and risk committee of the board may approve an application to become a member upon a determination that such applicant meets the applicable admission criteria. The applicant must have adequate personnel, physical facilities, books and records, accounting systems, and internal procedures to enable it to satisfactorily handle transactions and communicate with EMCC, to fulfill anticipated commitments to and meet the operational requirements of EMCC with necessary promptness and accuracy, and to conform to any condition and requirement that EMCC reasonably deems necessary for its protection or that of its members.

The applicant must have an established business history of a minimum of three years or personnel with sufficient operational background and experience to ensure, in the judgment of the board, the ability of the firm to conduct its business. The applicant must agree to make and have sufficient financial ability to make all anticipated payments required to be made to EMCC. The applicant must be in compliance with the capital requirements imposed by its designated

examining authority or appropriate regulatory agency, any other self-regulatory organizations, and any other regulatory authority or self-regulatory authority to which it is subject by statute, regulation, or agreement. The applicant cannot be subject to a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act<sup>36</sup> or similar order. EMCC may deny an application if it has reasonable grounds to believe that the applicant or any associated person meets a disqualification criteria specified in EMCC's rules.<sup>37</sup>

If the applicant is a U.S. broker or dealer, its aggregate indebtedness/excess net capital ratio must be less than 950%, or its excess net capital/aggregate debit items ratio must be in excess of 5.25% and its excess net capital must equal at least \$100 million. If the applicant is a U.K. broker or dealer, its financial resources must be at least 120% of its financial resources requirement and its excess financial resources must equal at least \$100 million. However, a broker or dealer applicant may have excess regulatory capital of at least \$50 million if the membership and risk committee of EMCC's board of directors makes a written finding that other credit factors of the applicant compensate for the lower financial resources.<sup>38</sup>

In addition, if the applicant is a bank, it must have net worth as of the end of the quarter prior to the effective date of its membership determined in accordance with U.S. GAAP of at least \$500 million. However, an applicant bank may be accepted if it has a net worth of at least \$200 million if the membership and risk committee of EMCC's board of directors makes a written finding that other credit factors of the applicant compensate for the lower net worth.<sup>39</sup>

<sup>36</sup> 15 U.S.C. 78c(a)(39).

<sup>37</sup> For example, disqualification criteria will include closer than normal surveillance by the applicant's designated examining authority or appropriate regulatory agency, violations of the federal securities laws, convictions of any criminal offense involving securities transactions, or any injunction against engaging in securities transactions. In addition, if the applicant has been enjoined from engaging in securities related business or has been expelled from a self-regulatory organization, EMCC must deny the application.

<sup>38</sup> EMCC will consider any ratings assigned by a nationally recognized statistical rating organization, any significant adverse off-balance sheet items, and the applicant's significant business lines as compared to its internal risk management controls and short term funding arrangements.

<sup>39</sup> In making such determination, EMCC will consider the applicant's return on average assets, capital to total assets ratio, nonperforming assets to total assets ratio, and liquid assets to total assets ratio. EMCC will also consider the ratings assigned to the applicant by a nationally recognized

<sup>35</sup> 17 CFR 240.17a-11.

If a U.S. broker applicant is applying to become a broker member, it must have excess net capital of at least \$10 million and must agree to submit trading data to EMCC in such instruments as requested by EMCC. EMCC will determine the broker's potential margin calls, and the broker must demonstrate an ability to meet such margin calls and any loss allocation assessments. The broker can demonstrate this ability by agreeing to submit to EMCC only transactions with EMCC members on both sides and by demonstrating a low error rate.<sup>40</sup>

During the first six months of EMCC's operations, EMCC will permit a broker to become an EMCC member which cannot demonstrate its ability to meet potential margin calls if it meets an alternate criterion. Such applicant must maintain a clearing relationship with an EMCC member which is not a broker. Pursuant to the clearing relationship, the clearing firm must take the place of the broker on T+1 for all trades that do not have EMCC members on both sides. The broker will have a fixed clearing fund deposit in lieu of the required margin deposit. However, EMCC will calculate each day for such broker a preliminary and final required fund deposit excluding any positions that resulted from a systems failure of a counterparty resulting in a failure to submit trade data. If the required fund deposit exceeds the broker's fixed deposit, EMCC will not guarantee any transactions to the broker until its required fund deposit is equal to or lower than its fixed deposit.<sup>41</sup> However, EMCC will guarantee completion of the broker's trades to the original EMCC counterparties pursuant to the loss allocation rules relating to a broker's default.<sup>42</sup> In addition, if the broker's

statistical rating organization, any significant off-balance sheet items, and the applicant's risk management controls.

<sup>40</sup> If a broker has a margin obligation because one of its counterparties fails to submit data on a trade prior to 8:00 a.m. ET on T+1, the nonsubmitting counterparty must compensate the broker for the cost of financing the payment obligation and may be subject to fine by EMCC.

<sup>41</sup> The broker could lower its required fund deposit by depositing additional funds with EMCC. If it does not deposit additional funds, its required fund deposit will exceed its fixed deposit until at least the end of the next month (because its required fund deposit is based on the highest margin calculation during the current month and the prior month).

<sup>42</sup> Because EMCC is not guaranteeing trades to the broker, if a dealer counterparty becomes insolvent, the broker is responsible for completing the trade to its counterparty on the other side. As a result, the nondefaulting EMCC dealer member does not receive the benefit of EMCC's guarantee of brokered trades. In such a situation, if the broker is then unable to complete the trade, EMCC will then guarantee the broker's trade to its EMCC member

required fund deposit exceeds its fixed deposit, the broker will not be subject to assessment for loss allocations<sup>43</sup> and the broker will be charged a market rate of interest on the difference between its required fund deposit and its fixed deposit. EMCC will notify all dealer members whenever a broker's required fund deposit exceeds its fixed deposit.

The foregoing financial responsibility standards are minimum requirements, and EMCC's board may impose higher standards based upon the level of the anticipated positions and obligations of an applicant, the anticipated risk associated with the volume and types of transactions an applicant proposes to process through EMCC, and the overall financial condition of an applicant. If an applicant does not itself satisfy its capital requirements, the board may include for such purposes the capital of an affiliate of the applicant if the affiliate has delivered to EMCC a guaranty, satisfactory in form and substance to the board, of the obligations of the applicant to EMCC.

#### 4. Membership Agreement

Each applicant to become a member of EMCC will be required to sign a membership agreement pursuant to which the member's books and records must at all times be open to inspection by EMCC and the member must furnish EMCC with any information with respect to the member's business and transactions as EMCC may require. However, upon ceasing to be a member, EMCC cannot inspect a member's books and records or require information relating to transactions that occurred after the time the member ceased to be a member.

Membership in EMCC and use of EMCC's services are governed by the laws of the state of New York. Each member must agree to submit to the jurisdiction of the courts of the state of New York and the U.S. District Court for the Southern District of New York and to appoint a person acceptable to EMCC as its agent to receive on its behalf service of process. Each member must also agree that any judgment obtained in an action or proceeding may be enforced in the courts of any jurisdiction where the member or any of its property may be found, and the member must irrevocably submit to the jurisdiction of

counterparty. However, the trade is treated as a direct trade between the broker and its counterparty. Thus, under the loss allocation rules, the dealer would be allocated a greater portion of its loss than if the broker had not exceeded its fixed deposit requirement.

<sup>43</sup> Because EMCC is not guaranteeing trades to the broker, there would be no loss from direct trades entered into with the broker.

each such court with respect to any such action or proceeding. To the fullest extent permitted by law, each member must waive all immunity whether on the basis of sovereignty or otherwise from jurisdiction, attachment both before and after judgment, and execution to which it might otherwise be entitled in any action or proceeding in any county or jurisdiction relating in any way to the agreement or to any transaction.

The membership agreement also provides EMCC with an additional source of information for risk control purposes. Upon the request of and at no charge to EMCC, members must provide research that they provide to any of their customers relating to EMCC eligible instruments and events or conditions which might affect the price of EMCC eligible instruments.

#### 5. Compliance With the Statutory Membership Requirements

The Commission notes that EMCC's rules do not provide for the admission of certain of the statutory categories of members (e.g., registered investment companies).<sup>44</sup> The Commission believes that EMCC's provision for limited categories of members is appropriate at least during EMCC's initial phases of operations. The Commission also notes that during the comment period, EMCC did not receive any comments from anyone in the category of entities not covered by EMCC's rules. Therefore, the Commission is granting EMCC a temporary exemption from Section 17A(b)(3)(B) of the Exchange Act with respect to this requirement.

EMCC's rules also make certain categories of entities eligible for EMCC services that are not within the statutory categories (i.e., non-U.S. banks and U.K. broker-dealers).<sup>45</sup> As discussed in the Standards Release, clearing agencies may admit additional categories of members provided that the goals of safety and soundness are met. The Commission believes that the admission criteria EMCC has established for non-U.S. banks and U.K. broker-dealers are consistent with the goals of safety and soundness. As discussed above, EMCC will obtain legal opinions from foreign members to assure that EMCC will be able to enforce its rules and member's agreement. In addition, EMCC will obtain information from the participant regarding its regulatory status in its home country and will obtain copies of all regulatory filings made in its home

<sup>44</sup> *Supra* note 32.

<sup>45</sup> EMCC's admission criteria for non-U.S. entities initially will apply only to non-U.S. banks and U.K. broker-dealers.

country. Thus, the Commission believes that EMCC's current procedures for acceptance of non-U.S. participants are consistent with the goals of the Exchange Act.

### C. Fair Representation

Section 17A(b)(3)(C) of the Exchange Act requires that the rules of a clearing agency provide for fair representation of the clearing agency's shareholders or members and participants in the selection of the clearing agency's directors and administration of the clearing agency's affairs. This section contemplates that users of a clearing agency have a significant voice in the direction of the affairs of the clearing agency.

#### 1. Governance Procedures

EMCC's board has a total of 21 directors, divided into four classes. The first three classes consist of five directors each ("participant directors").<sup>46</sup> The fourth class has six directors, consisting of one director selected by EMTA, one director selected by ISMA, two directors selected by NSCC, and two directors selected by EMCC. The term of office of the participant directors is three years with the term of one class of directors expiring each year.<sup>47</sup> Participant directors may not serve for more than six consecutive years. The term of the fourth class is one year.

A nominating committee selected by the board will select individuals to serve as participant directors. Members may also nominate individuals to serve as participant directors by filing with EMCC's Secretary at least 30 days prior to the date of the annual meeting a petition signed by the lesser of five percent of the participants of ten participants. If any member files a petition for participant director, EMCC's Secretary will mail ballots to all members. Members will then be provided the opportunity to vote for participant directors.<sup>48</sup>

Because members are given an opportunity both to nominate board members and to vote in any contested election, members should have a

<sup>46</sup> A member along with any of its affiliates which are members may only have one representative sitting on the board.

<sup>47</sup> The term of the initial directors in class one will expire in 1998, the term of the initial directors in class two will expire in 1999, and the term of the initial directors in class three will expire in 2000.

<sup>48</sup> Members will have three votes for each \$1.00 of average clearing fund deposits during the twelve month period ending on the last day of the second month prior to the date of determination and two votes for each \$1.00 of the average monthly fee payable or paid by the member to EMCC during the same twelve month period.

meaningful voice in the governance of EMCC. Therefore, the Commission believes that EMCC's election procedures provide fair representation to its members.

#### 2. Provision of Information to Participants

The Standard Release states that participants should have sufficient information concerning a clearing agency's affairs to participate meaningfully in its administration. Clearing agencies should furnish participants with audited annual financial statements, an annual report on internal accounting control prepared by an independent public accountant, and notices of any proposed rule changes.

The Standards Release states that the annual financial statements should be provided to participants within 60 days following the close of the clearing agency's fiscal year and should be prepared in accordance with generally accepted accounting principles. The Standards Release also states that the report on internal accounting control should be furnished to all participants promptly after it becomes available and no later than 60 days after the period covered by the report.<sup>49</sup> The Standards Release also states that a notice of a proposed rule change should be provided to participants prior to or as soon as possible after filing with the Commission and should provide a description of the rule change, its purpose, and its effect. After review of EMCC's rules and procedures, the Commission finds that such rules and procedures are consistent with EMCC's obligations to provide information to its participants.

### D. Safety and Soundness Considerations

Sections 17A(b)(3)(A) and (F) of the Exchange Act require that a clearing agency be organized and its rules be designed to facilitate the prompt and accurate clearance and settlement of securities transactions for which it is responsible and to safeguard securities and funds in its custody or control or for which it is responsible.<sup>50</sup> In the Standards Release, the Division enumerated certain requirements that

<sup>49</sup> The Standards Release also states that the report on internal accounting control should be based on a study and an evaluation which was made for the purpose of reporting on the clearing agency's overall system of internal accounting control and should disclose any material weaknesses discovered and any corrective action taken or proposed to be taken. The Commission expects EMCC to prepare its reports in accordance with these principles.

<sup>50</sup> 15 U.S.C. 78q-1(b)(3)(A) and (F).

should be met to comply with this standard.

#### 1. Clearing Fund

The Standards Release states that a clearing agency should have a clearing fund which is based on a formula applicable to all users and is composed of cash or highly liquid securities. The rules of a clearing agency should limit the investments that can be made with the cash portion of its clearing fund to government securities or other safe and liquid investments. The clearing fund should only be used to protect participants and the clearing agency from defaults of participants and from clearing agency losses not resulting from day to day expenses and not covered by insurance or other resources of the clearing agency. While the Standards Release states that a clearing agency could use temporary applications of the clearing fund in limited amounts to meet unexpected and unusual requirements for funds, the regular or substantial use of a clearing fund for operational purposes would be inappropriate.<sup>51</sup>

##### a. Clearing Fund Formula

EMCC will maintain and will manage a clearing fund for the purpose of limiting or eliminating EMCC's exposure to loss in the event a member fails to perform its obligations to EMCC. Each member will be obligated to make deposits to EMCC's clearing fund. EMCC will set the initial required clearing fund deposit for each member based on the expected nature and level of the member's activity. A member's required margin deposit will be equal to the largest single final daily margin amount computed, as described below, for that member for the month during which such margin calculation is being performed and for the previous calendar month. The minimum required clearing fund deposit for each member will be U.S. \$1,000,000.

Every day, EMCC will calculate margin in the morning and in the evening but will only collect margin based on the morning calculation.<sup>52</sup> EMCC will generally calculate the margin amount as follows: (mark-to-

<sup>51</sup> The Standards Release also states that there may be legitimate purposes for which a clearing fund may be used for a longer period of time so long as (a) the funds are properly protected, (b) the funds are used to facilitate the process of clearance and settlement, and (c) the participants and the Commission approve such use during the registration proceedings.

<sup>52</sup> EMCC refers to the amount that each member must contribute to the clearing fund as its margin requirement.



market amount + volatility amount)  $\times$  event risk factor.<sup>53</sup>

The mark-to-market amount will be based on all trades due to settle on or after that day and all fails, unless EMCC has received notice from the depository that such trade or fail has settled.<sup>54</sup> The mark-to-market amount will be based on the difference between the market price and the contract value of the trade. If the net mark-to-market is a credit, the firm will have a zero mark-to-market charge.

The volatility amount for the evening calculation will be based on all trades due to settle on or after that day and all fails, unless EMCC has received notice from the depository that such trade or fail has settled.<sup>55</sup> The volatility amount for the morning calculation will be based on all trades due to settle on or after the current day and all fails calculated as of the prior day whether or not EMCC has received notice of the settlement of such trades or fails. Thus, the morning volatility amount will include trades that have already settled that day while the evening volatility amount will only include trades that

<sup>53</sup> EMCC has provided the results of a stress test in which the proposed formula was applied using three months of data on EMCC eligible transactions obtained from Match-EM. The test assumed for each member that the market in which such member had its highest concentration of positions experienced an abnormal negative market move (*i.e.*, the "stressed market"). All securities positions for that member in other countries were run under the baseline assumptions of no unusual market movements. The tests assumed first a 10 standard deviation market drop in the stressed market and second a 4 standard deviation market gain in the stressed market. The test assumed that bonds on the opposite sides of the stressed market had correlations of 80% while bonds on the same side of the stressed market had 100% correlation.

Under this test, EMCC had no exposure 73.64% of the time. EMCC had exposure between \$1 and \$1 million 9.18% of the time. EMCC had exposure of greater than \$10 million 1.7% of the time. The highest exposures were four occurrences of an exposure of approximately \$15 million and one exposure of approximately \$50 million. EMCC has represented that it will continue to conduct periodic stress testing on a quarterly basis. Results of the stress tests will be reviewed with the membership and risk committee of EMCC's board of directors, and EMCC will reconsider the event risk factor if warranted by the results of the stress tests. The Commission directs EMCC to make the results available to Commission staff periodically. For example, EMCC is currently conducting stress testing based on data from trading during the week of October 27, 1997, a volatile period for the Brady bond markets. EMCC has stated that it will provide the Commission with the results of this testing.

<sup>54</sup> EMCC will receive notice at midnight ET (or 6:00 a.m. in Brussels and Luxembourg) from Euroclear and Cedel of all trades that have settled. At that time, Euroclear and Cedel have already completed most of their settlements of that day (*i.e.*, the notice issued at midnight ET on Friday morning will indicate trades that will settle Friday at the depository). Thus, when EMCC calculates the margin in the morning and the evening, it will have received notice of which trades have settled or failed for the day.

<sup>55</sup> *Supra* note 54.

have not settled.<sup>56</sup> In order to calculate the volatility amount, each security will be placed into one of four liquidity categories based on the average bid/offer spread. The liquidity category into which a security is placed will determine the volatility formula to be applied to that security.<sup>57</sup> The sum of the volatility amounts for each security will be the clearing member's volatility amount.<sup>58</sup>

The event risk factor, which is designed to give EMCC an additional cushion against events in countries not covered by two standard deviations, will initially be set at 1.25. EMCC may adjust the event risk factor for an individual member or for all members without prior notice to the member(s). EMCC also will increase margin requirements by use of a global holiday risk factor to take into account days on which U.S. banks are closed but securities markets are open.

<sup>56</sup> By including transactions in the morning volatility calculation whether or not they have settled, EMCC insures that data on three days of pending trades (*i.e.*, the number of days that EMCC is guaranteeing) is included. At the time of the morning volatility calculation, the trades entered into three days before will have settled, but EMCC will not have received data for the trades entered into on the current day. Thus, by including data for trades settling that day, EMCC will be using three days of data. EMCC will use fails as of the prior day because fails as of the current day would include trades due to settle that day (*i.e.*, these trades would be double counted as trades due to settle that day and fail trades). With respect to the evening volatility calculation, EMCC will have received data on trades entered into on that day and therefore will have data on three days of pending trades on which to base its calculation.

<sup>57</sup> The four liquidity classes and their bid/offer spreads are as follows: L1— $\frac{3}{8}$  of a point or less; L2— $\frac{3}{4}$  of a point or less; L3—2 points or less; L4—greater than 2 points or no trading activity for a certain period of days.

<sup>58</sup> For each L4 security, the volatility amount is the value of the position  $\times 30\%$ . For L1, L2, and L3 securities of each issuer, EMCC will take the larger of the following formula with: (a) the member's long positions in lines 1 and 2 and short positions in lines 3 and 4; and (b) the member's short positions in lines 1 and 2 and long positions in lines 3 and 4.

1. (value of long or short L1+L2) $\times 2$  Std plus
2. (value of long or short L3) $\times 4$  Std plus
3. (value of long or short L1+L2) $\times 2$  Std  $\times$  CC plus
4. (value of long or short L3) $\times 1$  Std  $\times$  CC

Std is equal to a one standard deviation move over a five day holding period based on the higher of a calculation using price data for one year and three months. CC is the smallest correlation coefficient between any security of that issuer in which the member has short position and any security of that issuer in which the member has a long position. The correlation coefficient will be based on one year's pricing data and will be updated daily.

EMCC may adjust the fixed percentage applied to L4 securities or the number of standard deviations applied to L1, L2, and L3 securities without prior notice in order to increase the volatility calculations when warranted by circumstances. These adjustments may be made on a country by country basis or a bond by bond basis either for all members or for members unduly concentrated.

The preliminary margin amount will be calculated each evening and will be reported to members at approximately 11:30 p.m. on a preliminary margin report. The report will show the member's current deposit, preliminary margin amount, and preliminary amount due, if any. However, members are not required to make any payment to EMCC based on the preliminary margin report.

The final margin amount will be calculated each morning and will be reported to members at approximately 10:30 a.m. on a final margin report. The final margin report will indicate each member's current deposit, final margin amount, and final amount due, if any. A member will be required to pay any obligation with respect to its margin obligation reflected on the final margin report no later than the later of 11:30 a.m. ET or one hour after the final margin report is made available. Margin deficits of less than \$100,000 will not have to be paid by members. Payment must be made through the U.S. Fedwire system.

EMCC also has the authority to collect amounts over and above the daily margin requirement in order to obtain adequate assurances of the financial responsibility or operational capability of a member. EMCC has created a policy statement on procedures to follow in determining whether additional clearing fund deposits are needed.<sup>59</sup> EMCC also may collect additional margin if a member has been placed on surveillance status.<sup>60</sup>

<sup>59</sup> Each day, EMCC will calculate a net country position and a net geographical position for each member. The net country position will be the sum of the settlement values of the member's positions in L1, L2, and L3 securities plus the sum of the absolute settlement values of the member's net position in L4 securities of each country. The net geographical position will be the sum of the net country positions in Latin America, Eastern Europe, Asia, and Africa. An undue concentration will be deemed to exist for a bank when its net country position exceeds 20% of net worth or its net geographical position exceeds 30% of net worth. An undue concentration will be deemed to exist for a broker-dealer when its net country position exceeds 50% of excess regulatory capital or its net geographical position exceeds 80% of excess regulatory capital. Under such circumstances, EMCC will contact the member to request information on the nature and magnitude of non-Brady bond exposure and on any hedging positions. After analyzing a member's responses, EMCC may request additional clearing fund deposits if it determines an additional deposit is necessary.

<sup>60</sup> EMCC will put a member on surveillance status if any of the following factors are present: (a) the member fails to meet any financial standard for admission or continuance as a member; (b) the member's capital position falls below the standards for admission; (c) the member experiences an inability to meet its money or securities settlement obligations to EMCC; (d) EMCC's board determines that a significant reorganization, change in control, or management of the member is likely to impair



The Commission preliminarily believes that EMCC's method of calculating clearing fund requirements is consistent with its obligations to safeguard securities and funds. The Commission will review the results from EMCC's future stress tests. Prior to any grant of permanent registration as a clearing agency, the Commission will reevaluate EMCC's clearing fund formula.

#### b. Margin Composition and Investment

Members will be required to pay margin in cash, U.S. Treasury securities, or letters of credit from banks that have been approved by EMCC. If letters of credit are used as margin, no more than 70% of a member's requirement may be satisfied with letters of credit, and as a minimum, the greater of \$100,000 or 10% of the member's margin requirement (up to a maximum of \$1,000,000) must be in cash. Furthermore, no more than 20% of EMCC's total clearing fund may be letters of credit from any one issuer. If letters of credit are not used, the greater of \$100,000 or 5% of the member's margin requirement (up to a maximum of \$1,000,000) must be in cash. A haircut of 5% will be applied to letters of credit and treasury securities.

Pursuant to EMCC's rules, EMCC may invest any cash deposited as margin in securities issued or guaranteed as to principal or interest by the U.S. or agencies or instrumentalities of the U.S. ("government securities"), repurchase agreements related to such securities, or otherwise pursuant to the investment policy adopted by EMCC. As part of its application, EMCC has filed a copy of its investment policy.<sup>61</sup> EMCC's investment policy provides that EMCC clearing fund cash may be invested only in government securities with terms of one year or less or in overnight repurchase agreements with government

the member's ability to meet its money or securities settlement obligations to EMCC; or (e) the member has been placed on surveillance status by another self-regulatory organization or comparable regulatory organization. EMCC also will have the discretion to put a member on surveillance status if any of the following factors are present: (a) it experiences a significant operational problem; (b) the member's positions are significantly disproportionate to its usual activity in light of current industry conditions; (c) EMCC receives notification from the member's designated examining authority or appropriate regulatory agency or comparable regulatory organization of a pending investigation or administrative action that could call into question the member's ability to meet its obligations to EMCC; or (d) the member experiences any condition that could materially affect its financial or operational capability so as to potentially increase EMCC's exposure to loss or liability.

<sup>61</sup> If EMCC amends its investment policy, it will file a proposed rule change with the Commission.

securities as underlying collateral. The repurchase agreements must conform to certain standards set forth in the investment policy regarding custody and market value of the collateral and eligible counterparty. If not invested, cash funds will be deposited by EMCC in its name in a depository institution selected by EMCC. EMCC will retain all investment income from cash deposits.

The Commission believes that EMCC's investment policy and required margin composition are consistent with EMCC's obligations under the Exchange Act as explained in the Standards Release because they require that EMCC's clearing fund is composed of liquid securities and that the cash portion of the clearing fund is invested appropriately.

#### c. Loss Allocation

EMCC will establish an overnight exposure cap for each member. This cap will be set at the lesser of: (a) 5% of excess net capital for U.S. broker-dealers, 5% of excess financial resources for U.K. broker-dealers, and 1% of shareholders' equity for banks; or (b) \$20 million. If a member's preliminary margin calculation is in excess of its overnight exposure cap, the member will be subject to fines. The loss allocation method applied to trades of an insolvent member will be dependent on whether a defaulting member has exceeded its overnight exposure cap.

When a failed member is not a broker, EMCC will classify trades as brokered or direct.<sup>62</sup> If there was an overnight exposure cap violation, EMCC will further classify such trades as trades received by EMCC before the violation ("old trades") or trades received by EMCC after the violation ("new trades"). Any collateral of the defaulting member will be divided between direct trades and brokered trades in proportion to the amount of losses attributable to old trades in each category. If there is insufficient collateral to cover all of the losses attributable to old trades: (a) Losses attributable to brokered transactions that are old trades will be allocated pro rata among all members based upon each member's average final daily margin amount for the prior 30 calendar days;<sup>63</sup> and (b) losses

<sup>62</sup> If the failed member's counterparty was an interdealer broker, but the interdealer broker's counterparty on the other side was not an EMCC member, EMCC will consider the trade to be a direct trade between the insolvent and the interdealer broker. In other words, "brokered trades" are trades where the interdealer broker is an EMCC member and EMCC members are on both sides.

<sup>63</sup> A member that is assessed pursuant to this provision may limit its assessment to its current

attributable to direct transactions that are old trades will be allocated among all the original counterparties in proportion to the amount of losses created by each member's transactions.

After the losses from old trades have been satisfied, EMCC will determine if any clearing fund collateral of the defaulting member remains. EMCC will net new trades to obtain a net loss per security issue. Any remaining clearing fund of the defaulting member will be applied to the smallest loss, then the next remaining smallest loss until there is no remaining clearing fund of the defaulting member. Next, EMCC will take the smallest remaining losses up to an amount that equals the amount of the defaulting member's overnight exposure cap ("under the cap losses") and will allocate the under the cap losses as follows: (a) Losses attributable to direct transactions will be allocated back to the original counterparties in an amount equal to the losses attributable to each member's trades; and (b) losses attributable to brokered transactions will be allocated pro rata among all EMCC members based upon each member's final daily margin amount calculated with respect to the prior 30 calendar days. Any remaining losses attributable to new trades will be allocated as follows: (a) Losses attributable to direct transactions will be allocated back to the original counterparties in an amount equal to the losses attributable to each member's trades; and (b) losses attributable to brokered transactions will be allocated first to the broker members that were counterparties to the trades to the extent of the loss attributable to each trade up to a maximum allocation of \$3 million per broker and then pro rata among members that were counterparties to brokers that reach their maximum allocation and that were on the opposite side of the market in the same security issues creating a loss with the same settlement dates and approximately the same prices.

Different loss allocation rules will apply when the defaulting member is a broker. In such cases, any collateral of the defaulting member will be applied first to losses resulting from old trades. If there are remaining losses from old trades, such losses will be allocated among all the original counterparties in proportion to the amount of loss created by each member's transactions. EMCC then will net new trades to obtain a net loss per security issue. Any remaining clearing fund of the defaulting member will be applied to the smallest loss, then margin requirement if it chooses to terminate its membership.

the next remaining smallest loss until there is no remaining clearing fund. Any remaining loss after application of clearing fund will be allocated to the counterparties to the transactions giving rise to such loss to the extent of the loss attributable to such transactions.

#### d. Use of Clearing Fund

EMCC's rules provide that the use of clearing fund deposits is limited to: (a) Satisfaction of losses or liabilities of EMCC arising from the failure of a member to satisfy an obligation to EMCC, or (b) providing EMCC with a source of collateral: (i) To finance the temporary receipt by EMCC of EMCC eligible instruments that cannot be redelivered to a member due to the inability of the member to pay for the receipt but only if such inability constitutes the failure by the member to meet its securities settlement obligations to EMCC; (ii) to finance only on an intraday basis the receipt of EMCC eligible instruments that will be redelivered to another member at a depository, provided that no more than 10% of the total clearing fund may be used for this purpose and that eligible letters of credit will be used to the maximum extent practicable prior to the use of treasury securities, and that cash will not be used;<sup>64</sup> and (iii) to temporarily finance the amount of any loss or liability allocated to a member prior to such time as such member's actual clearing fund is applied to the loss. If EMCC pledges any part of the clearing fund deposits for more than 60 days as a source of temporary financing, EMCC will by the 74th day consider such amount to be a loss and will allocate such loss in accordance with the loss allocation rules.

The Commission believes that EMCC's uses of clearing fund to satisfy losses or to finance settlements related to the failure of a member is consistent with the Exchange Act and the Standards Release. As a general rule, the Commission believes that procedures permitting the routine use of clearing fund assets to finance on a daily basis the receipt of instruments in the normal settlement process is not consistent with the Exchange Act or the guidelines set forth in the Standards Release. However, the Commission believes that the limitations EMCC has established on its use of assets for the routine, daily financing of security receipts (*i.e.*, intraday financing, 10% limitation, and use of letters of credit first to the extent

possible) and the limited purpose for which EMCC intends to use the clearing fund collateral (*i.e.*, to collateralize a line of credit at Euroclear to permit "chaining"<sup>65</sup>), are reasonably designed and should not cause undue risk to EMCC. The intraday financing procedures will allow EMCC to collateralize its line of credit at Euroclear, which is needed to allow EMCC to conduct its business effectively and efficiently, while still providing adequate protection to the assets of its clearing fund. Therefore, the Commission is granting EMCC a temporary exemption from Sections 17A(b)(3)(A) and 17A(b)(3)(F) of the Exchange Act to permit EMCC to use a portion of its clearing fund as described in (ii) above until the earlier of one year after EMCC has commenced operations or the date on which EMCC begins its netting service.<sup>66</sup>

#### 2. Standard of Care

The Division stated in the Standards Release that the rules of a clearing agency should provide that it is liable to a participant for failure to deliver the participant's securities resulting from: (1) The negligence or misconduct of the clearing agency, the clearing agency's subcustodian or agent, or any of their respective employees; (2) the placement on fully-paid participant securities of a lien or charge of any kind in favor of the clearing agency, the clearing agency's subcustodian or agent, or any person claiming through any one or more of them; (3) larceny; (4) mysterious disappearance; or (5) any other cause for which the clearing agency has assumed responsibility. Subsequent to issuance of the Standards Release, the Commission has stated that clearing agencies should perform their functions under a high standard of care and that at a minimum custody functions should be performed under an ordinary negligence standard.<sup>67</sup> The Commission has also stated that custody functions include all functions related to transaction processing and the safekeeping of customer funds and securities.<sup>68</sup>

<sup>65</sup> See *supra* note 23.

<sup>66</sup> When EMCC institutes netting, the need for repeated use of the clearing fund to facilitate chaining will be greatly reduced.

<sup>67</sup> Securities Exchange Act Release Nos. 26154 (October 3, 1988), 53 FR 39556 (registration order of The Intermarket Clearing Corporation ["ICC"]); 26450 (January 12, 1989), 54 FR 2010 (registration order of the Delta Government Options Corp. ["DGOC"]); 26812 (May 12, 1989), 54 FR 21691 (registration order of ISCC); and 27611 (January 12, 1990), 55 FR 1890 (second registration order of DGOC).

<sup>68</sup> See, *e.g.*, ICC registration order, *supra* note 67.

The member's agreement between EMCC and each member provides that EMCC is not subject to any liability under the agreement, including any liability with respect to EMCC's failure to provide any services under the agreement or EMCC's rules, except for losses resulting from EMCC's gross negligence, criminal act, or willful misconduct in connection with its duties. However, with respect to the safeguarding of securities or funds within its custody or control, the member's agreement provides that EMCC is not be subject to any liability for any act or omission in connection with the safeguarding of securities or funds within its custody or control except for losses, costs, or expenses resulting from EMCC's negligence, criminal act, or willful misconduct. The agreement further provides that EMCC will not be liable for any consequential or special damages which may result from EMCC's failure to perform its obligations under the agreement.

The Commission believes that EMCC's standard of care is consistent with the Exchange Act and prior Commission positions. However, the Commission preliminarily believes that a clearing agency should accept some responsibility for damages that are foreseeable and related to securities settlement (*e.g.*, damages resulting from a buy-in or sell-out conducted as a result of EMCC's negligence in delivering or not delivering funds or securities). At this time, the Commission is temporarily registering EMCC as a clearing agency but intends to review this issue further.

#### 3. Operational Capacity

Pursuant to a service agreement, ISCC has agreed to perform services for EMCC with respect to EMCC's clearing agency activities. ISCC will furnish the services for a fee designed to cover ISCC's costs. ISCC will provide EMCC with technical services in the following areas: data processing, operations, planning and development, communications, and research and development. Currently, ISCC provides limited clearing agency services and has seven employees whose duties are generally limited to operational functions.

Pursuant to its service agreement, ISCC may use outside parties to fulfill its commitments to EMCC. Many of ISCC's functions will be performed by NSCC. Specifically, NSCC through ISCC will provide EMCC with management and administrative services in the following areas: financial, personnel, corporate communications, marketing, regulatory or compliance, and legal. The Securities Industry Automation

<sup>64</sup> This provision will automatically expire the earlier of the first anniversary of EMCC's commencement of operations or the date on which EMCC begins its netting service.

Corporation ("SIAC"),<sup>69</sup> through ISCC and NSCC, also will provide EMCC with clerical and data processing services. In addition, ISCC will rely on International Depository & Clearing, L.L.C. ("IDC")<sup>70</sup> for product development, marketing and sales, and planning functions.

As discussed above, EMCC has no independent capacity to match trades. Instead, it will rely on Match-EM and TRAX for such services. EMCC has verified that its board of directors has authorized the selection of Match-EM and TRAX after review of information describing these entities' operations and capacity testing.<sup>71</sup> Furthermore, EMCC has represented that Match-EM and TRAX have procedures in place relating to capacity planning and systems testing, and that EMCC will receive and will furnish to the Commission documentation relating to such areas.

While EMCC's operational structure will be unusual for a clearing agency, the Commission believes that its structure and operational arrangements will provide an adequate level of service. The Commission notes in particular that EMCC's core functions, such as its managerial functions, will not be performed by an unregistered entity. The Commission will monitor EMCC's operation during the term of its temporary registration and will review its structure and outsourcing arrangements prior to granting permanent registration.

#### 4. Audit Committee and Internal Audit Department

The Standards Release states that each clearing agency should have an audit committee composed of nonmanagement directors. A nonmanagement director is a director who is not associated with the clearing agency other than in a user capacity or with any entity which furnishes securities processing services to the clearing agency. The audit committee should have responsibility for reviewing the work performed by the clearing agency's independent public accountant.

EMCC's bylaws provide that the board of directors may appoint an audit committee consisting of three or more directors other than directors that are members of Class IV (*i.e.*, directors elected by EMTA, ISMA, or NSCC), or

<sup>69</sup> SIAC is owned by the New York Stock Exchange and the American Stock Exchange.

<sup>70</sup> IDC is a company equally owned by NSCC and The Depository Trust Company, both registered clearing agencies. However, IDC is not a regulated entity.

<sup>71</sup> Copies of the materials that EMCC's board of directors relied on were filed with the Commission as part of EMCC's application.

are officers of EMCC. The audit committee has responsibility for reviewing with the independent certified public accountant the scope of its auditing procedures and the financial statements of EMCC to be certified by the accountant.

The Standards Release also states that a clearing agency should have an internal audit department which is adequately staffed with qualified personnel. The internal audit committee should report periodically to the audit committee. NSCC's internal audit department will perform EMCC's internal auditing functions. The audit department reports directly to EMCC's audit committee. Accordingly, with regard to internal audits, the Commission believes that EMCC fulfills the Exchange Act's requirements.

#### 5. Securities, Funds, and Data Controls

The Standards Release provides that a clearing agency should have, among other things, off-site storage of back-up data, written procedures detailing steps involved in handling funds and securities, and emergency mechanisms for establishing and maintaining communications with participants and other entities. In addition, clearing agencies should have adequate insurance coverage.

EMCC has represented that through its facilities manager, SIAC, it has access to two computer sites in different locations, both of which are capable of being operated independently and are capable of handling total member activity. Data received will be automatically written to both sites. EMCC has provided a detailed written statement of security measures that will be used to prevent unauthorized access to EMCC's processing facilities. EMCC maintains blanket bond insurance and all risk insurance.

The Standards Release emphasizes that a clearing agency should assure the integrity and accuracy of its automatic data processing operations. More recently, the Commission has issued automation review guidelines for clearing agencies that provide a more specific outline of clearing agencies' obligations with respect to such things as capacity planning, contingency planning, data security, telecommunications, systems development, and internal/external audit.<sup>72</sup> EMCC has acknowledged that it

<sup>72</sup> Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 and 29185 (May 9, 1991), 56 FR 22490; and Memorandum from Division of Market Regulation to all registered clearing agencies regarding Development of an Automation Review Policy Statement For Clearing Agencies (April 25, 1994). Available for copying

has obligations with respect to capacity planning and systems testing under these guidelines and has represented that it will fulfill its responsibilities with respect to these obligations.<sup>73</sup>

The Commission has also been monitoring efforts within the industry to prepare computer systems for the Year 2000 date change.<sup>74</sup> EMCC has represented that it is Year 2000 compliant and will take appropriate actions to ensure that the parties with which it conducts business (*e.g.*, vendors, and members) will be Year 2000 compliant on a timely basis.<sup>75</sup> Based on the foregoing, the Commission believes that EMCC has adequate controls with respect to securities, funds, and data processing.

#### E. Capacity To Enforce Rules

Section 17A(b)(3)(A) of the Exchange Act provides that a clearing agency must be organized and have the capacity to enforce (subject to any rule or order of the Commission pursuant to Section 17(d) or 19(g)(2) of the Exchange Act) compliance by its participants with the rules of the clearing agency. Sections 17A(b)(3)(G) and (H) require that the rules of a clearing agency provide that its participants shall be appropriately disciplined for violations of any provision of those rules and provide fair procedures for disciplining participants, denying participation in the clearing agency to any person, prohibiting or limiting access to the clearing agency's services, and reviewing summary suspensions.

##### 1. Participant Monitoring

EMCC's Rule 13 authorizes EMCC to examine the financial responsibility and operational capability of any member or applicant to become a member. Pursuant to Rule 13, EMCC may require a member to furnish EMCC with adequate assurances of its financial responsibility and operational capability, including additional reporting by a member of its financial or operational condition; increased clearing fund deposits; and other assurances as may be required by EMCC.

and inspection in the Commission's Public Reference Room.

<sup>73</sup> As discussed above in Section III.D.3., EMCC has represented to the Commission that Match-EM and TRAX will provide to EMCC information in these areas and that EMCC will provide the information to the Commission.

<sup>74</sup> See *Report to the Congress on the Readiness of the United States Securities Industry and Public Companies To Meet the Information Processing Challenges of the Year 2000*, U.S. Securities and Exchange Commission (June 1997).

<sup>75</sup> Letter from EMCC (October 8, 1997).

EMCC also has general continuance standards that require a member to promptly inform EMCC in the event that it is no longer in compliance with any of the relevant standards for membership or has had any materially adverse change. The board may require additional financial reporting if a member no longer meets the standards for admission to membership; if it has violated any rule to EMCC; if it fails to satisfy in a timely manner any obligation to EMCC; if there is a material change in control or financial condition of such member; or if the board determines that it is necessary or advisable to protect EMCC, its other members, or its creditors or investors; to safeguard securities and funds in the custody or control of EMCC; or to promote the prompt and accurate processing, clearance, or settlement of securities transactions. The board must also make a determination as to whether the member should be placed on surveillance status consistent with its rules.<sup>76</sup>

## 2. Ceasing to Act

Section 17A(b)(5)(C) of the Exchange Act provides that a clearing agency may summarily suspend and close the accounts of a participant that is expelled or suspended from any self-regulatory organization; that is in default of any delivery of funds or securities to the clearing agency; or that is in such financial or operational difficulty that the clearing agency determines and so notifies the appropriate regulatory agency for such participant that such suspension and closing of accounts are necessary for the protection of the clearing agency, its participants, creditors, or investors.

Upon providing notice to a member, EMCC may at any time cease to act for such member if the board of directors determines that adequate cause exists to do so.<sup>77</sup> EMCC may cease to act either

with regard to a particular transaction or with regard to transactions generally. EMCC will promptly notify all members when it ceases to act for a member. A member for which EMCC has ceased to act may request a hearing to review EMCC's decision.

If certain factors are present, EMCC will treat a member as insolvent.<sup>78</sup> EMCC will notify all members of the treatment of the member as insolvent. Upon a determination of insolvency, EMCC will immediately cease to act for such member. EMCC will delete all trades of that member to which EMCC's guaranty has not attached except trades that the board determines will promote an orderly market. EMCC will then close out the guaranteed trades and the trades that the board has determined to accept. EMCC will close out by buying in or selling out securities deliverable by or to the insolvent. The close out procedure will be completed by EMCC as promptly as practicable after EMCC has given notice of the treatment of the member as insolvent.

## 3. Hearing Procedures

Section 17A(b)(5) of the Exchange Act provides that in any proceeding to determine whether a participant should be denied participation, prohibited or limited with respect to access to the clearing agency's services, or disciplined, the clearing agency must notify the participant of the specific ground of the denial of services of the charges brought against the member. The clearing agency must provide the member with an opportunity to be heard on the grounds of the denial or to defend against any charges. The clearing agency must keep a record of the proceeding.

A member may request a hearing by filing with EMCC a written request setting forth the contested action of EMCC. Within seven business days after filing the request or three business days in the case of summary action, the objecting member must provide EMCC with a detailed written statement setting forth the contested action and the basis

its contracts with EMCC; or the board has reasonable grounds to believe that ceasing to act is necessary either for the protection of EMCC or for any of the other members or to facilitate the orderly and continuous performance of EMCC's services. EMCC Rule 15, Section 1.

<sup>78</sup> Such circumstances include: the member provides notice to EMCC that it is insolvent; the board or any regulatory body determines that the member is insolvent; a court order is entered adjudging the member to be insolvent; the member files or consents to the filing of a petition seeking bankruptcy relief, the member makes a general assignment to its creditors; the member is dissolved; or a resolution is passed by the member that it be wound up, liquidated, or dissolved. EMCC Rule 17, Section 1.

for objection. EMCC will notify the member in writing of the date and place of the hearing at least five business days prior to the hearing.

The hearing will be before a panel drawn from participant directors on the membership committee unless the contested action was taken by the membership committee. In such a case, the panel will be drawn from participant directors on the executive committee. The committee will select the members of the panel. The objecting members will have an opportunity to be heard and may be represented by counsel. The panel will make a decision within ten business days after conclusion of the hearing. Although the panel's decision is considered final, the board may overturn any decision adverse to the member.

The Commission believes that EMCC has the capacity to enforce its rules. EMCC has criteria to determine when it has cause to cease to act for a member or when it must treat a member as insolvent. A member for which EMCC has ceased to act or for which EMCC has limited its access to EMCC services may request a hearing pursuant to EMCC's rules. The hearing procedures are consistent with the guidelines discussed in the Standards Release. Therefore, the Commission believes that EMCC's rules in this are consistent with the Exchange Act.

## F. Dues, Fees, and Charges

Sections 17A(b)(3)(D) and (E) of the Exchange Act require that the rules of the clearing agency provide for the equitable allocation of reasonable dues, fees, and other charges among its participants and prohibits a clearing agency from imposing or fixing prices for services rendered by its participants. EMCC's proposed fee schedule is generally usage based. EMCC does not impose any schedule of prices or fix rates or other fees for services rendered by its customers. Accordingly, the Commission is satisfied that the method by which EMCC provides for the equitable allocation of reasonable dues, fees, and other charges among its customers and its prohibitions regarding the fixing of prices of its customers substantially satisfies the Exchange Act requirements.

## IV. Conclusion

The Commission finds that EMCC's application for registration as a clearing agency meets the standards and requirements deemed appropriate except as otherwise discussed in this order for which EMCC has received temporary exemptions.

<sup>76</sup> See, *supra* note 60.

<sup>77</sup> Such cause may exist if one or more factors are found, including: the member has failed to perform any of its obligations or has failed to make any required payment to EMCC; the member is no longer in compliance with the admissions standards or continuance standards; the board has reasonable grounds to believe the member has been responsible for any fraudulent or dishonest conduct or breach of fiduciary duty or has made any material misstatement to EMCC in connection with its application to be a member of any EMCC service; the board has reasonable grounds to believe the member is in financial or operation difficulty; the member is in breach of any requirement imposed by an appropriate regulatory agency, self-regulatory organization, or any regulatory body; the member is not paying its debts as they become due or is otherwise involved in a bankruptcy proceeding; the member is dissolved or ceases to carry on its business; the member contests the validity of any agreement with EMCC; the member fails to perform

The Commission has granted EMCC partial exemptions from Section 17A(b)(3)(B) of the Exchange Act to permit EMCC to limit the eligible categories of members and from Sections 17A(b)(3)(A) and 17A(b)(3)(F) of the Exchange Act to permit EMCC to use a portion of its clearing fund to collateralize a line of credit at Euroclear subject to the limitations discussed above. The Commission finds that granting the above exemptions is consistent with the public interest, the protection of investors, and the purposes of Section 17A, including the prompt and accurate clearance and settlement of securities transactions as well as the safeguarding of securities and funds. The Commission reserves the right to modify, by order (including such orders as the Commission may issue under Section 19(b) of the Exchange Act in connection with changes to EMCC's rules), the terms, scope, or conditions of the exemptions from the Exchange Act, if it determines such modification is appropriate for the protection of investors or in the public interest.

*It is therefore ordered*, pursuant to Section 19(a)(1) of the Exchange Act, that the applications for registration as a clearing agency filed by EMCC (File No. 600-30) be and hereby is approved until August 20, 1999 and that EMCC be granted the exemptions described above subject to the terms, exemptions, and other qualification contained in this order.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 98-4255 Filed 2-19-98; 8:45 am]

BILLING CODE 8010-01-M

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39464; File No. SR-Amex-97-44]

### Self-Regulatory Organizations; American Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change Relating to Institutional Index Option Position Limits

February 11, 1998.

#### I. Introduction

On November 4, 1997, the American Stock Exchange, Inc. ("Amex" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities and Exchange Act of 1934 ("Exchange Act" or "Act")<sup>1</sup>

and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to increase both position and exercise limits, as well as the firm facilitation exemption, for its Institutional Index Options ("XII").

The proposed rule change was published for comment in the **Federal Register** on November 17, 1997.<sup>3</sup> No comments were received on the proposal. This order approves the proposal, as amended.

#### II. Description

##### A. Increase XII Position and Exercise Limits

The Amex is proposing to increase XII position and exercise limits to 100,000 contracts on the same side of the market. Existing Exchange rules provide for XII position and exercise<sup>4</sup> limits of 45,000 contracts on the same side of the market of which no more than 25,000 contracts may be used for purposes of realizing any differential in price between XII and the securities underlying XII. In July of 1992, the Exchange increased position and exercise limits for XII to their current levels.<sup>5</sup> Since that time, options on XII continue to be traded primarily by institutional and professional investors and member firms, each often needing to hedge large asset quantities.

The Exchange believes that increasing the position and exercise limits for XII options to 100,000 contracts will allow increased institutional use of XII and allow it to be more competitive with alternative products. In addition, the Exchange believes that an increase in XII position and exercise limits will benefit not only the beneficiaries of assets managed by various institutions, but also the marketplace in general through increased liquidity.

These proposed changes are intended to result in little or no attendant risk to the marketplace as XII is composed of seventy-five of the most widely-held stocks in institutional portfolios that have a market value of more than one hundred million in investment funds.<sup>6</sup> Thus the component issues are extremely liquid and the overall index less volatile than individual stocks. Lastly, XII options are European-style

and therefore can only be exercised at expiration.

To enhance its ability to monitor unhedged positions, the Amex will add a reporting requirement (new Commentary .03 to Exchange Rule 904(C) for accounts having a position in excess of 45,000 a.m.-settled, European-style XII option contracts on the same-side of the market. Specifically, new Commentary .03 to Exchange Rule 904C states that if a member or member organization, other than an Exchange Specialist or Registered Options Trader, maintains a position in excess of 45,000 a.m.-settled, European-style XII option contracts on the same-side of the market on behalf of its own account or for the account of a customer, it must report information as to whether those positions are hedged and provide documentation as to how such contracts are hedged, in the manner and form required by the Exchange. In addition, to address the Commission's concerns with respect to the ability of the Exchange to monitor customer accounts that maintain large unhedged positions, the Amex will add a margin and clearing firm requirement. Pursuant to new Commentary .04 to Exchange Rule 904C, whenever the Exchange determines that additional margin is warranted in light of the risks associated with an under-hedged option position in excess of 45,000 contracts, the Exchange may impose additional margin upon the account maintaining such under-hedged position, or assess capital charges upon the clearing firm carrying the account to the extent of any margin deficiency resulting from the higher margin requirement.

##### B. Increase XII Firm Facilitation Exemption

The Exchange is proposing to increase the XII firm facilitation exemption<sup>7</sup> from 100,000 contracts to 400,000 contracts in order to accommodate the needs of investors as well as market participants. The Exchange believes that this increase should not substantially increase concerns regarding the potential for manipulation and other trading abuses.<sup>8</sup> Furthermore, the Exchange believes that proposed rule change will further enhance the potential depth and liquidity of the options market as well as the underlying

<sup>2</sup> 17 CFR 240.19b-4

<sup>3</sup> Exchange Act Release No. 39313 (November 7, 1997), 62 FR 61418 (November 17, 1997).

<sup>4</sup> The exercise limit for XII, which is equal to XII's position limit, is determined under Exchange Rules 905C and 905.

<sup>5</sup> See Exchange Act Release No. 31330 (Oct. 16, 1992) 57 FR 30516 (Oct. 23, 1992).

<sup>6</sup> To qualify for inclusion in XII, stocks must be held by a minimum of 200 of the reporting institutions filing Section 13(f) reports and must have traded at least 7 million shares in each of the two preceding calendar quarters.

<sup>7</sup> The Amex defines a facilitation order as an order which is only executed in whole or in part, in a cross transaction with an order for a public customer of the member organization. See Amex Rule 950 (e)(iv).

<sup>8</sup> The Exchange notes that the XII firm facilitation exemption is in addition to the standard limit and other exemptions under Exchange rules, commentaries and policies.

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