

bonus credits, the amount of such gains would always be computed at a price determined on the basis of net asset value. Because neither of the harms that Rule 22c-1 was intended to address arise in connection with the proposed bonus credit provisions, the provisions do not conflict with the Rule. Nonetheless, in order to avoid any uncertainty as to hill compliance with the Act, Applicants seek exemptions from Rule 22c-1.

10. The bonus credit recapture provisions are necessary for RLNY or Golden American to offer the bonus credits. It would be unfair to RLNY or Golden American to permit owners to keep their bonus credits upon their exercise of the Contracts' "free look" provision. Because no CDSC applies to the exercise of the "free look" provision, the owner could obtain a quick profit in the amount of the bonus credit at RLNY's or Golden American's expense by exercising that right. Similarly, the owner could take advantage of the bonus credit by taking withdrawals within the recapture period, because the cost of providing the bonus credit is recouped through charges imposed over a period of years. Likewise, because no additional CDSC applies upon death of an owner (or annuitant), a death shortly after the award of bonus credits would afford an owner or a beneficiary a similar profit at RLNY's or Golden American's expense. In the event of such profits to owners or beneficiaries, RLNY or Golden American could not recover the cost of granting the bonus credits. This is because RLNY and Golden American intend to recoup the costs of providing the bonus credits through the charges under the Contract, particularly the daily mortality and expense risk charge and the daily administrative charge. If the profits described above are permitted, certain owners could take advantage of them, reducing the base from which the daily charges are deducted and greatly increasing the amount of bonus credits that RLNY or Golden American must provide. Therefore, the recapture provisions are a price of offering the bonus credits. RLNY and Golden American simply cannot offer the proposed bonus credits without the ability to recapture those credits in the limited circumstances described herein.

11. Applicants state that the Commission's authority under Section 6(c) of the Act to grant exemptions from various provisions of the Act and rules thereunder is broad enough to permit orders of exemption that cover classes of unidentified persons. Applicants request an order of the Commission that would exempt them, RLNY's successors

in interest, Future Accounts and Future Underwriters from the provisions of Sections 2(a)(32) and 27(i)(2)(A) of the Act and Rule 22c-1 thereunder. The exemption of these classes of persons is appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act because all of the potential members of the class could obtain the foregoing exemptions for themselves on the same basis as the Applicants, but only at a cost to each of them that is not justified by any public policy purpose. As discussed below, the requested exemptions would only extend to persons that in all material respects are the same as the Applicants. The Commission has previously granted exemptions to classes of similarly situated persons in various contexts and in a wide variety of circumstances, including class exemptions for recapturing bonus credits under variable annuity contracts.

12. Applicants represent that Future Contracts will be substantially similar in all material respects to the Contracts and that each factual statement and representation about the bonus credit provisions of the Contracts will be equally true of Future Contracts. Applicants also represent that each material representation made by them about Account B and DSI will be equally true of Future Accounts and Future Underwriters, to the extent that such representations relate to the issues discussed in this application. In particular, each Future Underwriter will be registered as a broker-dealer under the Securities Exchange Act of 1934 and be a NASD member.

#### *Conclusion*

Applicants submit that the requested relief therefrom is consistent with the exemptive relief provided under the Existing Order.

Based on the grounds summarized above, Applicants submit that their exemptive request meets the standards set out in Section 6(c) of the Act, namely, that the exemptions requested are necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act, and that, therefore, the Commission should grant the requested order.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Jill M. Peterson,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48201; File No. SR-GSCC-2002-10]

### Self-Regulatory Organizations; Government Securities Clearing Corporation; Order Approving Proposed Rule Change To Establish a Comprehensive Standard of Care and Limitation of Liability to its Members

July 21, 2003.

#### I. Introduction

On October 10, 2002, the Government Securities Clearing Corporation ("GSCC")<sup>1</sup> filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-GSCC-2002-10 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>2</sup> Notice of the proposal was published in the **Federal Register** on January 14, 2003.<sup>3</sup> The Commission received two comment letters in response to the proposed rule change.<sup>4</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

#### II. Description

The purpose of GSCC's rule change is to establish a comprehensive standard of care and limitation of liability with respect to its members. Historically, the Commission has left to user-governed clearing agencies the question of how to

<sup>1</sup> On January 1, 2003, MBS Clearing Corporation ("MBSCC") was merged into the Government Securities Clearing Corporation ("GSCC") under New York law, and GSCC was renamed the Fixed Income Clearing Corporation ("FICC"). The functions previously performed by GSCC are now performed by the Government Securities Division ("GSD") of FICC, and the functions previously performed by MBSCC are now performed by the Mortgage-Backed Securities Division ("MBSD") of FICC. The GSD succeeded to the GSCC proposed rule change upon the merger of MBSCC and GSCC. To avoid confusion and maintain consistency with the Notice, in this Order, we will continue to refer to GSCC instead of the GSD of FICC. Securities Exchange Act Release No. 47015 (December 17, 2002), 67 FR 78531 [File Nos. SR-GSCC-2002-09 and SR-MBSCC-2002-01].

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> Securities Exchange Act Release No. 47135 (January 7, 2003), 68 FR 1876.

<sup>4</sup> Letters from Dan W. Schneider, Counsel to the Association of Global Custodians ("AGC") (March 24, 2003) and Jeffrey F. Ingber, Managing Director, General Counsel, and Secretary, Fixed Income Clearing Corporation (June 12, 2003).

allocate losses associated with, among other things, clearing agency functions.<sup>5</sup> In determining the appropriate standard of care, the Commission has reviewed clearing agency services on a case-by-case basis in order to balance the need for a high degree of care at clearing agencies with the effects that liabilities may have on clearing agency operations, costs, and safekeeping of securities and funds.<sup>6</sup> Because standards of care represent an allocation of rights and liabilities between a clearing agency and its members or participants, which are sophisticated financial entities, the Commission has refrained from establishing a unique federal standard of care and has allowed clearing agencies and other self-regulatory organizations and their participants to establish their own standards of care.<sup>7</sup>

GSCC believes that adopting a rule<sup>8</sup> limiting GSCC's liability to its members to direct losses caused by GSCC's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action: (1) Memorializes an appropriate commercial standard of care that will protect GSCC from undue liability; (2) permits the resources of GSCC to be appropriately utilized for promoting the prompt and accurate clearance and settlement of securities; and (3) is consistent with similar rules adopted by

other self-regulatory organizations and approved by the Commission.<sup>9</sup>

### III. Comment Letters

The Commission received a comment letter from Dan W. Schneider, Counsel to AGC, and a response comment letter from GSCC. The AGC letter asserted that registered clearing agencies should be subject to a negligence standard of care in safeguarding funds and securities and in performing processing obligations relating to custody functions. In addition, registered clearing agencies like GSCC that provide the securities markets and the securities processing community with centralized essential utility services and that become focal points for concentrated risk should meet at least the same standard of care that is required of commercial custodians under Commission rules designed to protect investors. Finally, AGC opined that permitting registered clearing agencies that are central facilities in the national clearance and settlement system to conform their conduct to gross negligence while requiring bank custodians to adhere to a higher standard of care creates a liability differential for which no appropriate statutory or policy basis exists.

GSCC responded that the proposed rule change would not affect GSCC's standard of performance because registered clearing agencies such as GSCC are subject to rigorous regulatory standards for their operations under Section 17A of the Act. The proposed rule change only relates to GSCC's standard of liability and not to the Commission's regulatory operational standards for GSCC. Also, GSCC has operated for 15 years with a gross negligence standard of liability under SEC temporary registration orders without any financial loss to its members or third parties arising from a failure of performance by GSCC. Neither the Act nor prior Commission orders require that a particular level of liability for private rights of action be assumed by registered clearing agencies, as distinguished from the high regulatory standards imposed by the Commission for clearing agency operations under Section 17A. In addition, GSCC members are sophisticated parties who can best determine the allocation of GSCC risk for unintentional loss. GSCC pointed out that adoption of a universal simple negligence standard of liability for GSCC would likely result in a gap between the liability limitation of GSCC

and the gross negligence liability limitation of clearing banks and other service providers to which GSCC is dependent for certain key operational services.

### IV. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>10</sup> The Commission believes that approval of GSCC's rule change is consistent with this Section because it will permit the resources of GSCC to be appropriately utilized for promoting the prompt and accurate clearance and settlement of securities.

Although the Act does not specify the standard of care that must be exercised by registered clearing agencies, the Commission has determined that a gross-negligence standard of care is acceptable for non-custodial functions where the parties contractually agree to limit liability.<sup>11</sup> GSCC's functions are

<sup>10</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>11</sup> In the release setting forth standards to be used by the Division of Market Regulation in evaluating clearing agency registration applications, the Division of Market Regulation urged clearing agencies to embrace a strict standard of care in safeguarding participants' funds and securities. Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 4192. In the release granting permanent registration to The Depository Trust Company, the National Securities Clearing Corporation, and several other clearing agencies, however, the Commission indicated that it did not believe that sufficient justification existed at that time to require a unique federal standard of care for registered clearing agencies. Securities Exchange Act Release No. 20221 (October 3, 1983), 48 FR 45167. In a subsequent release, the Commission stated that the clearing agency standard of care and the allocation of rights and liabilities between a clearing agency and its participants applicable to clearing agency services generally may be set by the clearing agency and its participants. In the same release, the Commission stated that it should review clearing agency proposed rule changes in this area on a case-by-case basis and balance the need for a high degree of clearing agency care with the effect resulting liabilities may have on clearing agency operations, costs, and safeguarding of securities and funds. Securities Exchange Act Release No. 22940 (February 24, 1986), 51 FR 7169. Subsequently, in a release granting temporary registration as a clearing agency to The Intermarket Clearing Corporation, the Commission stated that a gross negligence standard of care may be appropriate for certain noncustodial functions that, consistent with minimizing risk mutualization, a clearing agency, its board of directors, and its members determine to allocate to individual service users. Securities Exchange Act release No. 26154 (October 3, 1988), 53 FR 39556. Finally, in a release granting the

Continued

<sup>5</sup> Securities Exchange Act Release Nos. 20221 (September 23, 1983), 48 FR 45167 and 22940 (February 24, 1986), 51 FR 7169.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> The language of new Section 3 to Rule 39 is as follows: Section 3—Limitation on Liability of the Corporation Notwithstanding any other provision in the Rules:

(a) The Corporation will not be liable for any action taken, or any delay or failure to take any action, hereunder or otherwise to fulfill the Corporation's obligations to its Members, other than for losses caused directly by the Corporation's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action. Under no circumstances will the Corporation be liable for the acts, delays, omissions, bankruptcy, or insolvency, of any third party, including, without limitation, any depository, custodian, sub-custodian, clearing or settlement system, transfer agent, registrar, data communication service or delivery service ("Third Party"), unless the Corporation was grossly negligent, engaged in willful misconduct, or in violation of Federal securities laws for which there is a private right of action in selecting such Third Party; and

(b) Under no circumstances will the Corporation be liable for any indirect, consequential, incidental, special, punitive or exemplary loss or damage (including, but not limited to, loss of business, loss of profits, trading losses, loss of opportunity and loss of use) howsoever suffered or incurred, regardless of whether the Corporation has been advised of the possibility of such damages or whether such damages otherwise could have been foreseen or prevented.

<sup>9</sup> See, e.g., Securities Exchange Act Release Nos. 37421 (July 11, 1996), 61 FR 37513 [SR-CBOE-96-02] and 37563 (August 14, 1996), 61 FR 43285 [SR-PSE-96-21].

non-custodial in that it does not hold its members funds or securities. GSCC relies on clearing banks to perform custodial services for Government securities, which are uncertificated, and for funds. It is reasonable for GSCC, which is member-owned and governed, and its members to agree among themselves through board approval of the proposed rule change and through the proposed rule change notice and approval process to agree and to contract with one another in a cooperative arrangement as to how to allocate GSCC's liability among GSCC and themselves.

In its order granting temporary registration as a clearing agency, the Commission expressed concern that GSCC's failure to perform accurately and timely the comparison service could adversely affect the ability of GSCC members to deliver securities and effect trade settlements. Considering the size of the Government securities market and the next-day time frame for trade settlements, the Commission deemed it appropriate that GSCC amend its standard of care to an ordinary negligence standard of care in performing all functions affecting member settlements of Government securities.<sup>12</sup> The Commission, recognizing that GSCC's members are best suited to allocate GSCC's rights and liabilities, has determined and finds that, given the non-custodial nature of GSCC's services, the extensive and rigorous financial and operational regulatory oversight to which GSCC is subject,<sup>13</sup> and GSCC's exemplary level of performance,<sup>14</sup> a gross negligence standard of care is appropriate for GSCC.

The Commission has given thoughtful and careful consideration to the

approval of temporary registration as a clearing agency to the International Securities Clearing Corporation, the Commission indicated that historically it has left to user-governed clearing agencies the question of how to allocate losses associated with noncustodial, data processing, clearing agency functions and has approved clearing agency services embodying a gross-negligence standard of care. Securities Exchange Act Release No. 26812 (May 12, 1989), 54 FR 21691.

<sup>12</sup> Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19639.

<sup>13</sup> GSCC must have its rule changes approved by the Commission and is the subject of frequent Commission examinations for compliance with its rules and those of the Commission. As directed by Congress, the Commission cannot approve GSCC's proposed rule changes if they are inconsistent with Section 17A of the Act, including being inimical to the public interest or the protection of investors.

<sup>14</sup> Over the past 15 years, GSCC has demonstrated a high level of responsibility in performing its non-custodial functions and has had appropriate standards in place to ensure adequate performance. As a result, GSCC has operated without financial loss to its members or third parties arising from its failure to perform.

comment letter of AGC and finds that AGC's concerns about the performance level of GSCC operating under a gross negligence standard of care and limitation of liability are addressed by the extensive regulatory oversight to which GSCC is subject as a registered clearing agency and the fact GSCC is not changing its financial and operational standards with the adoption of a gross negligence standard of care and limitation of liability.<sup>15</sup>

## V. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular section 17A of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR-GSCC-2002-10) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48200; File No. SR-GSCC-2002-11]

### Self-Regulatory Organizations; Government Securities Clearing Corporation; Order Approving Proposed Rule Change To Reduce the Permitted Use of Letters of Credit to Twenty-Five Percent of a Member's Required Clearing Fund Deposit

July 21, 2003.

#### I. Introduction

On October 10, 2002, the Government Securities Clearing Corporation ("GSCC")<sup>1</sup> filed with the Securities and

<sup>15</sup> The Commission notes that the rule change does not alleviate GSCC from liability for violation of the Federal securities laws where there exists a private right of action and therefore is not designed to adversely affect GSCC's compliance with the Federal securities laws and private rights of action that exist for violations of the Federal securities laws.

<sup>16</sup> 17 CFR 200.30-30(a)(12).

<sup>1</sup> On January 1, 2003, MBS Clearing Corporation ("MBSCC") was merged into GSCC under New York law, and GSCC was renamed the Fixed Income Clearing Corporation ("FICC"). The functions previously performed by GSCC are now performed by the Government Securities Division ("GSD") of FICC, and the functions previously performed by MBSCC are now performed by the Mortgage-Backed Securities Division ("MBSD") of FICC. The GSD

Exchange Commission ("Commission") proposed rule change SR-GSCC-2002-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>2</sup> Notice of the proposal was published in the **Federal Register** on June 17, 2003.<sup>3</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

## II. Description

The purpose of the proposed rule change is to reduce the permitted use of letters of credit ("LCs") to twenty-five percent of a member's required clearing fund deposit. One of GSCC's most important risk management tools is its maintenance of clearing fund collateral. GSCC's clearing fund is comprised of cash, certain netting-eligible securities, and eligible LCs. The purposes served by the clearing fund are (1) to have on deposit from each netting member assets sufficient to satisfy any losses that may be incurred by GSCC as the result of the default by the member and the resultant close-out of that member's settlement positions and (2) to ensure that GSCC has sufficient liquidity at all times to meet its payment and delivery obligations.

Currently, GSCC's rules permit up to 70 percent of a member's required clearing fund deposit to be in the form of LCs. Although GSCC believes that it will always receive funds from the presentation of an LC for payment, GSCC has recognized that in a period of market crisis there is the potential that GSCC might not receive the funds on a timely basis. To ensure that GSCC can always meet its liquidity needs on a timely basis in the unlikely event of a member default and in times of market crisis, GSCC is reducing the permitted use of LCs to 25 percent of a member's required clearing fund deposit. Thus, the minimum level of cash and securities required to be maintained on deposit will increase from 30 percent to 75 percent of a member's required clearing fund deposit.<sup>4</sup>

succeeded to the GSCC proposed rule change upon the merger of MBSCC and GSCC. To avoid confusion and maintain consistency with the Notice, in this Order we will continue to refer to GSCC as such. Securities Exchange Act Release No. 47015 (December 17, 2002), 67 FR 78531 [File Nos. SR-GSCC-2002-09 and SR-MBSCC-2002-01].

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> Securities Exchange Act Release No. 48016 (June 11, 2003), 68 FR 35925.

<sup>4</sup> The new LC limitation will not affect the requirement that certain non-US GSCC members post additional collateral in the form of LCs to protect GSCC against legal risk presented by the insolvency laws in those members' home countries. These members will not be required to increase the amount of their deposit that is in the form of cash and securities from 30 percent to 75 percent of their required clearing fund deposit.