

based fee structure and work with market participants to address the issues raised by this concept. In developing its fees the Commission encourages the MSRB to continue to build a consensus among market participants on how best to allocate the burden of funding the MSRB operations.

#### V. Conclusion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the Municipal Securities Rulemaking Board and, in particular, with the requirements of Section 15B of the Act.<sup>20</sup> Specifically, the Commission believes the proposal is consistent with the requirements of Section 15B(b)(2)(J) that the MSRB's rules be designed, among other things, to provide that each municipal securities broker and each municipal securities dealer shall pay to the MSRB such reasonable fees and charges as may be necessary or appropriate to defray the costs and expenses of operating and administering the Board.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (SR-MSRB-95-13) is approved.

By the Commission.

Dated: May 10, 1996.

Margaret H. McFarland,  
Deputy Secretary.

[FR Doc. 96-12384 Filed 5-16-96; 8:45 am]

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[Release No. 34-37202; File No. SR-NSCC-95-17]

**Self-Regulatory Organizations;  
National Securities Clearing  
Corporation; Order Temporarily  
Approving a Proposed Rule Change to  
Establish Additional Procedures for  
Placing Settling Members on Class A  
Surveillance and Collecting Clearing  
Fund and Other Collateral Deposits  
From Settling Members**

May 10, 1996.

On December 20, 1995, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-NSCC-95-17) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") to establish additional procedures for placing settling members on Class A Surveillance and collecting clearing fund and other collateral deposits from settling members.<sup>1</sup> Notice

of the proposal was published in the Federal Register on March 12, 1996.<sup>2</sup> No comment letter were received. For the reasons discussed below, the Commission is temporarily approving the proposed rule change through May 31, 1997.

#### I. Description of the Proposal

NSCC's Board of Directors has determined that under certain circumstances settling members who clear securities transactions for over-the-counter ("OTC") market makers or who themselves engage in OTC market making can have their financial viability materially impacted by such business.<sup>3</sup> Furthermore, if these settling members dominate one side of the market in their street-side trading positions, either directly by participating in OTC market making or indirectly by clearing transactions for OTC market makers, NSCC believes that the risk of default by the settling member increases.<sup>4</sup> In turn, this could potentially increase NSCC's exposure because NSCC is obligated to complete defaulting settling members' unsettled trades once NSCC's trade guarantee attaches.

The problem is magnified if one or more additional risk factors are present. These additional risk factors can include, without limitation:

- (1) Concentrated short selling in dominated issues;
- (2) Undue concentration of securities held in inventory by market maker(s) for dominated issues;
- (3) Dominated issues also being IPOs less than six months past initial issuance particularly when the current value of the issue is significantly different from its initial sales price or there is undue concentration of inventory in the managing underwriter(s); and
- (4) Clearing positions of market makers in dominated issues away from their primary clearing brokers.

<sup>2</sup> Securities Exchange Act Release No. 36930 (March 6, 1996), 61 FR 10051.

<sup>3</sup> When a market maker, either alone or acting in concert with other market makers, takes net street-side trading positions (i.e., non-retail trading with other broker-dealers) that constitute a disproportionately large percentage of the total net street-side buys or net street-side sells in any issue (i.e., the market maker dominates one side of the market in the issue), the risk of default by that market maker can increase.

<sup>4</sup> However, to the extent that market makers' net street-side trading positions in dominated issues result from legitimate customer orders, the potential adverse impact on the financial viability of a settling member and the potential for increased exposure to NSCC could be mitigated. So long as the customer orders are legitimate, the risks associated with such positions are borne among the individual accounts of the market maker's customers and not concentrated solely in the proprietary accounts of the market maker.

Rule 15, Section 3 of NSCC's rules currently provides that any settling member<sup>5</sup> shall furnish to NSCC such adequate assurances of its financial responsibility and operational capability as NSCC may at any time or from time to time deem necessary or advisable in order to protect NSCC. Section 4 of Rule 15 states that such adequate assurances may include, but are not be limited to, increased clearing fund deposits of settling members. Furthermore, Section III.B.1.o. of Addendum B to NSCC's rules sets forth the guidelines for determining when NSCC may place a broker-dealer settling member on Class A surveillance status.<sup>6</sup> Pursuant to these guidelines, NSCC may place a broker-dealer settling member on Class A surveillance if there is any condition which could materially impact the operational or financial viability of the settling member which increases or potentially may increase exposure to NSCC.

In order for NSCC to reduce its potential exposure from the OTC market making activity described above, NSCC is adding Addendum O to its rules and procedures. Addendum O will permit NSCC to place settling members on Class A surveillance if they clear for or are themselves OTC market makers and (i) they do not have sufficient capital or access to capital to support either potential increases in market making activity in dominated OTC issues or (ii) there is the presence of the additional risk factors described above. At its discretion, NSCC may elect not to place settling members on Class A surveillance if it has obtained sufficient assurances that a high degree of mitigating circumstances exist.<sup>7</sup>

Furthermore, NSCC is adopting an interim collateralization policy which will allow NSCC in its discretion to require settling members placed on Class A surveillance that clear for or are themselves OTC market makers to meet

<sup>5</sup> NSCC Rule 1 defines a "settling member" to include any NSCC member, non-clearing member and, except where a contrary intent is expressed in NSCC's rules, a special representative.

<sup>6</sup> Class A Surveillance permits NSCC, among other things, to increase a settling members clearing fund requirement by an amount equal to (i) up to 5% of the settling member's CNS long fail positions, plus (ii) up to 5% of the settling member's short fail positions, plus (iii) 2.5% or at NSCC's discretion up to 5% of the settling member's average non-CNS and non-mutual fund services debits, plus (iv) 2.5% of the settling member's average non-CNS and non-mutual fund services credits. NSCC Rules and Procedures, Addendum B, IV(C).

<sup>7</sup> However, the mere fact that a market maker has a large customer base may not necessarily constitute the necessary mitigating circumstances especially if the customers are retail and/or the market maker has a history of customer complaints or other adverse regulatory or disciplinary actions. Refer also to note 4.

<sup>20</sup> 15 U.S.C. § 78o-4.

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988).

the following special collateralization requirements:

(1) To the extent that the sum of the absolute dollar values of any such settling members' net unsettled trading positions in all securities dominated<sup>8</sup> by a market maker exceeds such market maker's excess net capital, NSCC can require the settling member to deposit with NSCC at such times and in such manner as NSCC may designate, including an immediate deposit of same-day funds the amount by which the value of the net unsettled trading positions exceed the market maker's excess net capital.<sup>9</sup> In determining the size of net unsettled trading positions, NSCC may take into account offsetting pending (*i.e.*, non-fail) institutional delivery ("ID") transactions that have been confirmed and when NSCC deems appropriate, affirmed,<sup>10</sup> through the ID system of a clearing agency registered under Section 17A of the Act ("registered clearing agency").<sup>11</sup> In addition, if a market maker's net unsettled trading positions in dominated issues are cleared by one or more other settling members, including any settling member on Class A surveillance, NSCC will have the discretion for purposes of calculating the special collateral deposit of treating those positions as if they were all cleared by a settling member on Class A surveillance.

(2) To the extent that the unsettled positions referred to in paragraph (1) above are short (*i.e.*, net sells), NSCC in its discretion may collect more than 100 percent of the amount by which the sum of the absolute dollar values of the net unsettled trading positions of any such settling member in all the securities dominated by a market maker exceeds the market maker's excess net capital.<sup>12</sup> In lieu of cash collateral, NSCC may require or accept a book-entry delivery

of securities to NSCC sufficient to cover such short position.

(3) NSCC will reserve the right at all times to accept alternative arrangements for its protection in any of the above situations. NSCC may require special collateral deposits with respect to trading positions in issues dominated by a market maker even when the value of those positions do not exceed the market maker's excess net capital. NSCC also may choose to forego collecting such special collateral even when the value of those positions exceed the market maker's excess net capital but do not exceed some higher threshold.<sup>13</sup> NSCC will make these determinations based on the specific situation and depending upon, among other things, the presence or absence of additional risk factors or mitigating circumstances.

The special collateralization requirements described above are interim measures for settling members on Class A surveillance which will be in effect until NSCC has gained enough experience in surveillance of OTC market maker trading activities to impose permanent special collateralization requirements. Additionally, if there is concentrated short selling in dominated issues, NSCC will maintain its right to collect special collateral deposits from the settling members clearing the short sales without regard to their surveillance status. Special collateral collected from any settling member pursuant to the above procedures will be in addition to the settling member's clearing fund deposit computed in accordance with the formulae set forth in NSCC Procedure XV or in accordance with the alternative method set forth below.

Because NSCC believes that its settling members on Class A surveillance present a higher than normal risk of default and insolvency, NSCC is proposing that such settling members' clearing fund deposits be based on the close-out risk presented by their unsettled positions in NSCC's systems. Therefore, pursuant to Rule 15 as expressed under Addendum O, NSCC will have the discretion to compute the continuous net settlement ("CNS") component of the clearing fund requirement for any settling member on Class A surveillance in accordance with the following alternative method rather than the formulae to calculate clearing fund set forth in NSCC Procedure XV.<sup>14</sup>

(1) NSCC may calculate on a daily or periodic basis the volatility of any such

settling member's net unsettled trading positions in CNS eligible issues ("net CNS trading positions"). Such positions shall be determined after taking into account offsetting pending (*i.e.*, non-fail) ID transactions that have been confirmed and, when NSCC deems appropriate, affirmed<sup>15</sup> through the ID system of a registered clearing agency. Such calculation will be made in accordance with the Capital Asset Pricing Model or any other generally accepted portfolio volatility model, including without limitation, any margining formula employed by any other registered clearing agency provided, however, that not less than two standard deviations' volatility shall be calculated under any model chosen. Such calculation will be made utilizing such assumptions and based on such historical data as NSCC deems reasonable and shall cover such range of historical volatility as NSCC from time to time deems appropriate. If such volatility is calculated on a periodic basis, it may be expressed as a percentage of the sum of the absolute values of the firm's net CNS trading positions. Any such calculations, whether expressed as a dollar value or percentage, may be rounded as NSCC deems appropriate.

(2) NSCC shall have the discretion to exclude from the above calculations net CNS trading positions in classes of securities whose volatility is (i) less amenable to statistical analysis such as OTC bulletin board or pink sheet issues or issues trading below a designated dollar threshold (*e.g.*, five dollars) or (ii) amenable to generally accepted statistical analysis only in a complex manner (*e.g.*, municipal or corporate bonds). The amount of clearing fund required with respect to net CNS trading positions in such issues shall be determined by multiplying the absolute value of such positions by a percentage designated by NSCC, which percentage may vary depending on such factors as NSCC deems relevant.

(3) The amounts calculated in accordance with the immediately preceding two numbered paragraphs will be substituted for the amount calculated in accordance with paragraph (1)(c) of Sections A.I.(a), A.II.(a) and A.II.(b) of NSCC's Procedure XV.<sup>16</sup> In addition, NSCC may in its discretion reduce or eliminate the amount calculated in accordance with paragraph (1)(a) of Procedure XV.

(4) NSCC in its discretion also may calculate the total clearing fund requirement of any settling member on

<sup>8</sup> Domination will be determined according to criteria specified by NSCC from time to time.

<sup>9</sup> The term "same-day funds" refers to payment in funds that are immediately available and generally are transferred by electronic means.

<sup>10</sup> In determining net unsettled trading positions, NSCC in its discretion under certain circumstances may elect to take into account offsetting pending confirmed ID transactions only if such transactions also have been affirmed. Moreover, NSCC may decline to consider any ID transaction if it has reason to believe that the institutional counterparty may not or cannot settle such transaction.

<sup>11</sup> 15 U.S.C. 78q-1 (1988).

<sup>12</sup> For example, if a clearing member's excess net capital is \$100,000 and the value of its OTC market making activities is \$125,000, the rule change permits NSCC to require the clearing member to deposit an additional \$25,000. However, if the clearing member's OTC market making activity includes short positions, the rule change will permit NSCC to collect more than \$25,000.

<sup>13</sup> From time to time, NSCC will determine in its discretion what such higher threshold shall be.

<sup>14</sup> NSCC Procedure XV contains the formulae usually employed to calculate clearing members' clearing fund requirements.

<sup>15</sup> *Supra* note 10.

<sup>16</sup> *Supra* note 14.

a daily basis instead of a twenty-day rolling average basis and may collect deficiencies at such times and in such manner as specified by NSCC from time to time, including immediate collection of same-day funds.

Nothing in the foregoing rule change will limit NSCC's discretion with respect to placing settling members on Class A surveillance or requiring settling members to furnish adequate assurance of financial responsibility or operational capability as set forth in NSCC's rules and procedures.

## II. Discussion

Section 17A(b)(3)(F) of the Act<sup>17</sup> requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency and generally to protect investors and the public interest. The Commission believes the proposed rule change is consistent with NSCC's obligations under the Act because it will allow NSCC to take particular action to protect itself, its members, and investors in situations where settling members pose an increased risk because of their involvement in OTC market making.

Under the proposal, NSCC will have the authority with respect to settling members who participate in OTC market making activities or clear for correspondents that engage in such activity (1) to place such members on Class A surveillance, (2) to require such members to post additional collateral with NSCC, and (3) to calculate an alternative clearing fund requirement for such members when additional risk factors are present. Collectively, the higher level of surveillance, the additional level of collateralization, and the alternative clearing fund requirements should help to ameliorate NSCC's exposure which in turn should assist NSCC in fulfilling its obligations under the Act to safeguard securities and funds for which it has control of, is responsible for and, generally, to protect investors and the public interest.

The Commission is temporarily approving the proposed rule change through May 31, 1997, so that NSCC can gain additional experience in the surveillance of OTC market makers and the risks posed by clearing such activity. NSCC also will be able to gain experience with the additional collateralization requirements and alternative clearing formula requirements for settling members subject to Class A surveillance prior to permanent imposition of these requirements. Temporary approval also

will afford both the Commission and NSCC an opportunity to observe whether the additional collateralization and alternative clearing fund requirements adequately protect NSCC, its members, and investors from the expected risks of participating in and clearing OTC market maker activity and whether adjustments to the procedures are necessary. Prior to filing a proposed rule change seeking permanent approval of the procedures set forth in this temporary approval order, NSCC shall present to the Commission a more detailed report of its findings regarding the adequacy of the controls and discussing any changes to be made to the procedures. During the temporary approval period, NSCC will from time to time apprise the Commission on the operation of the additional collateralization requirements to enable the Commission to monitor the implementation of such requirements.

## III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the 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-NSCC-95-17) be, and hereby is, approved on a temporary basis through May 31, 1997.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

Margaret H. McFarland,

*Deputy Secretary.*

[FR Doc. 96-12471 Filed 5-16-96; 8:45 am]

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[Release No. 34-37203; File No. SR-OCC-95-20]

### **Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of an Amendment to a Proposed Rule Change Relating to the Issuance, Clearance, and Settlement of Buy-Write Options Unitary Derivatives**

May 10, 1996.

On December 27, 1995, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-OCC-95-20) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act") relating to the issuance,

clearance, and settlement of Buy-Write Options Unitary Derivatives ("BOUND").<sup>1</sup> On February 5, 1996, OCC filed Amendment No. 1 to the proposed rule change.<sup>2</sup> Notice of the proposed rule change, as amended, was published in the Federal Register on March 20, 1996.<sup>3</sup> On March 20, 1996, OCC filed Amendment No. 2.<sup>4</sup> Amendment No. 2 is described in Items I, II, and III below, which items have been prepared primarily by OCC. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

The purpose of Amendment No. 2 to the proposed rule change is to add a provision to Article XXIV, Section 6 of OCC's By-Laws to specify that the closing price for the underlying security of a BOUND is conclusively presumed to be accurate and shall be final for purposes of determining settlement rights and obligations with respect to that BOUND.

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

In its filing with the Commission, OCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments that it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. OCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>5</sup>

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

The purpose of Amendment No. 2 to the proposed rule change is to add a provision to Article XXIV, Section 6 of OCC's By-Laws to specify that the

<sup>1</sup> 15 U.S.C. 78s(b)(1) (1988).

<sup>2</sup> Letter from James C. Yong, First Vice President and General Counsel, OCC, to Jerry W. Carpenter, Assistant Director, Division of Market Regulation ("Division"), Commission (February 5, 1996).

<sup>3</sup> Securities Exchange Act Release No. 36960 (March 13, 1996), 61 FR 11458.

<sup>4</sup> Letter from James C. Yong, First Vice President and General Counsel, OCC, to Jerry W. Carpenter, Assistant Director, Division, Commission (March 19, 1996).

<sup>5</sup> The Commission has modified the text of the summaries submitted by OCC.

<sup>17</sup> 15 U.S.C. § 78q-1(b)(3)(F) (1988).

<sup>18</sup> 17 CFR 200.30-3(a)(12) (1995).