

taken into account in the calculation of the calculated margin requirement or calculated margin credit and would be reflected in OCC's regular morning settlement on the morning of E+2. Information reported back to OCC by NSCC on the evening of E+2 would be taken into account in any calculation of the calculated margin requirement or calculated margin credit and would be reflected in OCC's regular morning settlement on the morning of E+3.

Although NSCC will provide OCC with reports of offsetting deliver and receive obligations in its system on a daily basis and although OCC will monitor these reports for unusual position concentrations, OCC will not actually use the information in the reports in its margin calculations for its members.¹⁸

OCC's guarantee is the Third Restated Agreement is similar to its guarantee in the Second Restated Agreement in that the guarantee does not cover the exposure of NSCC to loss from exercise settlements that would result if a participating member transfers settlements from its account at NSCC to the account of any other member of NSCC (even another participating member or another member that is an affiliate of the participating member) and that second member defaults on its obligations to NSCC with respect to those settlements.

C. Delivery of Stock Held in Escrow

The Second Restated Agreement between NSCC and OCC contemplated that OCC would, if necessary, deliver to NSCC stock held in lieu of margin to cover a suspended clearing member's short call positions against payment by NSCC of the exercise price for the positions and that the value of any such covered short position would not be taken into account in determining the amount guaranteed by OCC to NSCC. In contrast, the Third Restated Agreement does not contemplate that OCC will deliver stock held to cover short call positions because, as described above, the Third Restated Agreement provides for taking the value of offsetting deliver and receive obligations at NSCC into account in the calculation of the calculated margin requirement or calculated margin credit.

¹⁸ Unlike NSCC, OCC employs three types of accounts for its members: customer accounts, market-maker accounts, and firm accounts. Separate margin calculations are made with respect to each type of member account. Therefore, in order to use the information in NSCC's reports in OCC's margin calculations, OCC would have to disaggregate the information received from NSCC on an account-by-account basis. This disaggregation, even if possible, could not be done without major changes in both OCC's and NSCC's systems.

D. Amendments to OCC Rule 601

Because of the guarantee extended by NSCC to OCC, OCC proposes to amend Rule 601 to enable OCC to give margin credit for long option positions in firm and market-maker accounts that have been reported to NSCC for settlement. As a result, OCC will be able to calculate margin for equity options in one product group. The amendments to Rule 601 essentially reverse changes which were proposed in File No. SR-OCC-92-5.¹⁹

E. Amendment to OCC Rule 1107

OCC proposes to amend Rule 1107 to provide that OCC will liquidate securities deposited to cover assigned short call positions and will use the proceeds to reimburse itself for the incremental amount, if any, which OCC is obligated to pay to the designated clearing corporation by reason of the covered short positions as well as for the exercise price of the covered options and for any costs associated with the liquidation.

F. Amendment to NSCC's Clearing Fund Formula

NSCC proposes to amend its clearing fund formula in order to exclude from the calculation trades for which NSCC has protection under the terms of the Third Restated Agreement.²⁰

OCC and NSCC believe the proposed rule changes are consistent with the purposes and requirements of Section 17A of the Act because the proposals (i) will enhance the system used by OCC to effect settlement of exercises and assignments of equity options by providing for a two-way guarantee between OCC and NSCC thereby permitting OCC to return to a one product group margin system and (ii) will enhance NSCC's ability to protect itself and its members against loss.

II. Discussion

Section 17A(b)(3)(F)²¹ requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible and to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions. As set forth below, the Commission believes OCC's and NSCC's proposed

rule changes are consistent with their obligations under Section 17A(b)(3)(F).

The Commission believes the proposals are consistent with OCC's and NSCC's obligations to assure the safeguarding of securities and funds in their custody or control because the proposed rule changes should further reduce OCC's and NSCC's risk exposure by including cross-guarantees for transactions effected through NSCC's and OCC's settlement link. The guarantees, among other things, should reduce the risk of loss to OCC and NSCC resulting from a failed common member's equity options exercise and assignment activity.

The Commission also believes because the Third Restated Agreement establishes a two-way guarantee to better protect both OCC and NSCC against the risk of loss resulting from the default of a common member, the proposals are consistent with OCC's and NSCC's obligation to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposals are consistent with the requirements of Section 17A(b)(3)(F) 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 changes (File Nos. SR-OCC-96-04 and SR-NSCC-96-11) be, and hereby are, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.²²

Margaret H. McFarland,
Deputy Secretary.

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[Release No. 34-37736; File No. SR-PSE-96-07]

Self-Regulatory Organizations; Pacific Stock Exchange Incorporated; Order Granting Approval To Proposed Rule Change and Notice of Filing of, and Order Granting Accelerated Approval to, Amendment No. 1 to the Proposed Rule Change Relating to the General Reorganization and Revision of the Exchange's Membership Rules

September 26, 1996.

I. Introduction

On March 5, 1996, the Pacific Stock Exchange Incorporated ("PSE" or "Exchange") submitted to the Securities

¹⁹ *Supra* note 6.

²⁰ The complete text of the amendments to NSCC's clearing fund formula is set forth in NSCC's filing. A copy of the filing is available for copying and inspection in the Commission's Public Reference Room or through NSCC.

²¹ 15 U.S.C. § 78q-1(b)(3)(F) (1988).

²² 17 CFR 200.30-3(a)(12) (1996).

and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to reorganize and revise PSE Rule 1, *Membership*, and to make conforming changes to PSE rules 2, 4, 5, and 9.

The proposed rule change was published for comment in the Federal Register on April 11, 1996.³ No comments were received concerning the proposal. On September 23, 1996, the Exchange submitted Amendment No. 1 to the proposed rule change.⁴ This order approves the proposed rule change, including Amendment No. 1 on an accelerated basis.

II. Description of the Proposal

PSE Rule 1 is being revised because much of its language is outdated, inapplicable, or both. Revised PSE Rule 1 more accurately reflects the current procedures and requirements of the Exchange's membership department. While many of the provisions of existing PSE Rule 1 have been kept, they have been reorganized so that the provisions concerning Exchange membership are presented in a more logical and chronological order to enable readers to quickly identify the provisions related to a particular membership issue. In addition, much of PSE Rule 1's language has been rephrased to enhance the readers' comprehension.

As part of its review of the existing provisions of PSE Rule 1, the Exchange's staff also reviewed the membership rules of other exchanges. As described more particularly below, certain provisions from the New York Stock Exchange, Inc. ("NYSE"), the Chicago Board Options Exchange, Incorporated ("CBOE"), and the Chicago Stock Exchange, Incorporated ("CHX") are incorporated in Revised Rule 1.

The Exchange also is proposing to make conforming changes to certain provisions in PSE Rules 2, 4, 5, and 9.

A summary of the most significant changes, organized by reference to the proposed section numbers, is set forth below.⁵

Rule 1.1: Definitions

A "Definitions" section was added to Revised Rule 1 to provide an explanation of the terms used by the PSE in relation to its membership rules. Many of the definitions already were contained in the PSE Constitution and PSE Rule 4, but the Exchange determined that it would be more practical to place these definitions in alphabetical order at the beginning of Revised Rule 1. In addition, the Exchange added a definition of "wholly owned subsidiary" that is based on a Commission definition of that term.⁶

Rule 1.2: Public Securities Business

Revised Rule 1.2, *Public Securities Business*, is new to the PSE. This new language was included to require members to use their memberships for trading, either directly or indirectly through the execution of lease agreement. This provision is designed to assist the Exchange in addressing problems associated with unassigned memberships.

Rules 1.4 to 1.9: Qualifications and Application for Membership

The existing provisions relating to qualification and application for membership were completely reorganized to set forth the Membership Department's requirements in a more orderly and chronological manner. The reorganization is designed to make the provisions easier to follow and understand. In addition to the PSE's current membership requirements, the proposal also adds Revised Rules 1.4 1.5, 1.7, and 1.8.

Revised Rule 1.4, *Qualifications of Individual Members*, and Revised Rule 1.5, *Qualification of Member Organizations*, establish some of the basic requirements necessary for Exchange membership. They require that all members and member organizations, except "Inactive Lessors,"⁷ must be registered pursuant to Section 15⁸ of the Act.⁹ In addition, Revised Rule 1.5(b) requires member

firms who own or lease a membership to designate a natural person as its member. When a member confers the privileges of membership on a member firm, Revised Rule 1.5(c) requires that member to be the firm's designated representative and prohibits members from representing more than one member organization.

In addition to the authority contained in Current Rule 1.4, Revised Rule 1.7, *Denial of and Conditions to Membership*, grants the Membership Committee greater discretion when reviewing applications. The proposal contains two new grounds for denying or conditioning membership—an applicant, either directly or indirectly, has engaged in conduct that would bring the Exchange into disrepute or any other reasonable cause the Membership Committee may decide. In addition, the PSE clarified the impact that a current member's comments concerning an applicant will have on the application process in Revised Rule 1.7(b)(6) and in the PSE Membership Application.¹⁰ Finally, the proposal grants the Membership Committee the authority to toll the approval process while an applicant is the subject of an investigation by any self-regulatory organization or government agency and may take action against a member if any of the reasons for denying or conditioning membership comes into existence after a member has been approved and its membership has become effective.

Revised Rule 1.8, *Effectiveness of Membership Applications*, requires all approved applications to be activated by the applicant within six months and requires the Exchange to provide all members with notice of all newly effective memberships.

Rules 1.10 to 1.20: Requirements of Membership

This new section pulls together the obligations of members and member organizations from different locations and describes particular requirements for sole proprietors, corporations, partnerships, and limited liability companies.

Revised Rule 1.11 is designed to give the Exchange greater oversight of allied members and approved persons. Revised Rule 1.11(a) provides that allied members and approved persons are subject to Exchange approval and that the Exchange must receive written notice, all applicable fees, and all necessary information before an allied member or approved person will be admitted. Revised Rule 1.11(b) prohibits

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 37076 (Apr. 5, 1996), 61 FR 16152 [hereinafter Notice].

⁴ See letter from Rosemary A. MacGuinness, Senior Counsel, PSE, to Ivette Lopez, Assistant Director, Division of Market Regulation, SEC, dated Sept. 20, 1996 [hereinafter Amendment No. 1]. Amendment No. 1 made a number of typographical edits; clarified the PSE's policy concerning members giving gifts to employees of other members and employees of the Exchange; clarified that inactive lessors need not register as a broker or dealer to own a membership; added a definition for wholly owned subsidiary; changed the policy concerning changes in documents submitted as part of a membership application from 15 calendar days to 15 business days; and explained the purpose and impact of a member's comments concerning a membership application.

⁵ See Notice, *supra* note 3, and File No. SR-PSE-96-07 for a more complete description of the proposal.

⁶ See Amendment No. 1, *supra* note 4; 17 CFR 230.405.

⁷ Revised PSE Rule 1.1(h) defines an "Inactive Lessor" as a natural person, firm, or other such entity as the PSE Board may approve that owns or inherits a membership for the sole purpose of acting as a lessor.

⁸ 15 U.S.C. 78o.

⁹ See Amendment No. 1, *supra* note 4.

¹⁰ See Amendment No. 1, *supra* note 4.

a firm from remaining a member firm unless all persons required to be approved are, in fact, approved and the member firm continues to meet all of the prescribed membership requirements. Revised Rule 1.11(c) requires that the Exchange promptly receive written notice of the dissolution of a member firm, as well as written notice of the death, retirement, or other termination of any member, allied member, or approved person.

PSE members are required to keep current all of the documents submitted in connection with their application. When changes to those documents become necessary (e.g., change in member's home address or Form BD), the member has fifteen calendar days to submit an amendment to the Exchange. Revised Rule 1.17(b) changes this policy to fifteen business days.¹¹

Rules 1.21 to 1.25: Purchase, Sale, Transfer, or Lease of Membership

The provisions relating to the purchase and sale of memberships are essentially unchanged in substance. Of particular note, however, are Revised Rules 1.21(b), 1.22(a), and 1.23 because they either are new to the PSE or modify existing responsibilities.

Revised Rule 1.21(b) requires the Exchange to post the highest bid with the earliest submission date on the Exchange bulletin board for six months. Likewise, Revised Rule 1.22(a) requires the Exchange to post the lowest offer with the earliest submission date on the Exchange bulletin board for six months. When a bid filed in accordance with the provisions of Revised Rule 1.21, *Purchase of Membership*, is matched with an offer filed in accordance with the provisions of Revised Rule 1.22, *Sale of Membership*, neither can be changed or withdrawn.

In addition to the types of transfers already defined in the PSE rules, Revised Rule 1.23, *Transfer of Membership*, adds "Succession of member organization" to the list of permissible interfirm transfers. This would allow a membership to be transferred from a member organization to an organization that succeeds through statutory merger, exchange of stock, or acquisition of assets to the business of the transferring membership organization.

Rules 1.26 to 1.27: Employees of Member Organizations

Currently, the PSE's rules require that the Exchange and, when relevant, the recipient's employer give their consent before a member can give a gift or

gratuity in excess of \$100 to an employee of the Exchange or an employee of another member. Revised Rule 1.26(f) modifies this policy by requiring prior Exchange consent only when a member wants to give a gift to an Exchange employee. The Exchange has not been requiring members to obtain the Exchange's prior consent when members were giving gifts to employees of other members.¹² Therefore, the Exchange proposes to conform its rules to its current practice.

In addition, Revised Rule 1.26(f) eliminates a potential loophole by clarifying that the \$100 minimum is per calendar year. Hence, a member may not avoid the prior consent requirement of this rule by simply granting consecutive \$99 gifts (i.e., when the value of all of the gifts given by a member to an Exchange or another member's employee in one calendar year exceed \$100, prior consent must be obtained).

Revised Rule 1.27, *Floor Employees of Member Organizations*, is new to the Exchange. Revised Rule 1.27(a) clarifies that all employees of member organizations seeking admission to the Floor must first be approved by the Exchange. Revised Rule 1.27(c) requires every member organization to take reasonable care to determine the existence of a statutory disqualification.¹³ To assist member organizations in fulfilling this duty, Revised Rule 1.27(b) requires all floor employees to submit fingerprints and complete an application form that includes those questions from the Form U-4 that would aid member organizations in determining whether an individual is subject to a statutory disqualification. In addition, the application must be signed by the member firm. Revised Rule 1.27(d) codifies the Exchange's policy requiring a member firm with an employee on one of the PSE's trading floors to have at least one member present on the trading floors at all times. The Exchange believes these provisions will help member organizations and the PSE identify persons who are subject to a statutory disqualification and, in addition, enhance the overall security on the PSE's trading floors.¹⁴

Provisions Removed From Existing PSE Rule 1

In updating the PSE's rules, Revised Rule 1 omits certain requirements that presently are contained in Rule 1. The most significant of these deletions involves the PSE's fees and the giving of gifts by members to employees of other members.

In order to avoid the confusion caused by having some of the PSE's fees listed in both its rules and in its fee schedule, the Exchange will omit from Rule 1 all references to the fees currently enumerated in Rule 1.10.¹⁵ Also, the fee reductions in Rule 1.10 that pertain to the Options Funding Plan of 1975 are being deleted because they are no longer relevant.¹⁶

Rules 1.17(f) and 1.17(g) pertain to the giving of gifts and gratuities by members to employees of other members and to employees of the Exchange. The rules currently require that the Exchange and, when relevant, the recipient's employer give their prior consent. The proposal modifies this policy by requiring prior Exchange consent only when a member wants to give a gift to an Exchange employee. The Exchange has not been requiring members to obtain the Exchange's prior consent when members were giving gifts to employees of other members.¹⁷ Therefore, the proposal conforms the PSE's rules to its current practice.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 1. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule

¹⁵ Telephone conversation between Rosemary A. MacGuinness, Senior Counsel, PSE, and Anthony P. Pecora, Attorney, Division of Market Regulation, SEC (Mar. 22, 1996). For example, the initial membership fee in PSE Rule 1.10(a)(i)(A) is "5 percent of the average purchase price plus the two preceding seat sales," while the fee schedule sets the initial membership fee at "5 percent of the average price of the last three membership sales, with a minimum of \$1,000 and a maximum of \$4,000." (Emphasis added). See also PSE Rule 1.10(c)(i) (no minimum or maximum); PSE Rule 1.10(c), cmt. 01 (\$350 minimum and \$3,500 maximum).

¹⁶ Telephone conversation between Rosemary A. MacGuinness, Senior Counsel, PSE, and Glen Barrentine, (then) Team Leader, Division of Market Regulation, SEC (Nov. 24, 1995).

¹⁷ Telephone conversation between Rosemary A. MacGuinness, Senior Counsel, PSE, and Anthony P. Pecora, Attorney, Division of Market Regulation, SEC (Mar. 22, 1996).

¹² Telephone conversation between Rosemary A. MacGuinness, Senior Counsel, PSE, and Anthony P. Pecora, Attorney, SEC (Mar. 22, 1996).

¹³ See 15 U.S.C. 78c(a)(39) (listing categories of people that are statutorily disqualified).

¹⁴ See Securities Exchange Act Release No. 33045 (Oct. 14, 1993), 58 FR 54179 (approving File No. SR-NYSE-93-28).

¹¹ See Amendment No. 1, *supra* note 4.

change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the PSE. All submissions should refer to File No. SR-PSE-96-07 and should be submitted by October 24, 1996.

IV. Commission's Findings and Order Granting Approval to the Proposed Rule Change

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange. In particular, the Commission believes the proposal is consistent with the Section 6(b)(5)¹⁸ requirements that the rules of an exchange be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest and the Section 6(d)¹⁹ and Section 6(b)(7)²⁰ requirements that the rules of an exchange provide a fair procedure for the denial of membership to any person seeking membership therein.

The Commission supports the PSE's efforts to continue to review the form and substance of its membership regulations in response to changes in market structure and to eliminate requirements that no longer serve a meaningful regulatory purpose. For example, consolidating the Exchange's fees into a single fee schedule should eliminate a source of confusion among the PSE's members without raising any regulatory concerns. The Commission also believes the proposed rule changes should be helpful in updating the PSE's membership rules, should facilitate transactions in securities, should clarify certain obligations already contained in the rules and, in general, further the purposes of the Act.

The Commission notes that the new rules grant a certain amount of discretion to the PSE in the standards for evaluating an application for membership. For example, Revised PSE Rule 1.6(b) requires the PSE

Membership Department to post the name of an applicant on the bulletin board of the trading floors of the Exchange for ten calendar days. The PSE represents that the purpose of this posting is to provide current members an opportunity to comment on an applicant. Comments may include an objection from a member claiming that the applicant owes the member money. If the applicant agrees with the member's assertion, the Exchange will require the applicant to pay the debt in full or work out a payment schedule with the member before the PSE will take any further steps to process the application. If the applicant disputes the member's claim, the Exchange will continue to process the application without coming to any conclusions concerning this unadjudicated dispute. If the application is approved and activated, however, the newly approved member will become subject to the provisions of PSE Rule 12, *Arbitration*, thereby enabling the objecting member to request that the dispute be submitted to arbitration.²¹

Although the Commission understands the PSE's need to solicit comment from its members concerning an applicant and the importance of this input in the decision making process, the Commission urges the PSE to be judicious in processing membership applications where claims of debts are raised. In this regard, the Commission believes the existence of an unadjudicated, disputed debt, by itself, may not be a sufficient basis to deny an application. Furthermore, the Commission emphasizes that the Exchange must exercise its discretion in a fair and impartial manner in accordance with the goals of the Act.²²

In addition to these concerns, the Commission expects the PSE to resolve

²¹ PSE Rule 12.1(a) states "Any dispute, claim or controversy between parties who are members, member organizations or associated persons arising in connection with the securities business of such parties shall, at the request of any such party, be submitted for arbitration in accordance with this Rule." (Emphasis added.) The Commission emphasizes that either party to a claim within the scope of PSE Rule 12 may request arbitration of that claim. Although the language in Revised Rule 1.7 and Item 16 of the Exchange's membership application only refers to what action an objecting member may take, this language does not preclude the applicant, once he becomes a member, from requesting that the disputed debt be submitted to arbitration.

²² The Commission has taken appropriate action where it found the membership application process not to conform with the goals set forth in the Act. See, e.g., Securities Exchange Act Release No. 37538 (Aug. 8, 1996) (imposing remedial sanctions on the National Association of Securities Dealers, Inc.); SEC, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Stock Market (Aug. 8, 1996).

the conflict that exists between provisions in the PSE Constitution and in the new rules regarding the membership application process.²³ Due to the potential for confusion among applicants, members, and regulators, the Commission encourages the PSE to rectify this situation before November 1, 1996.²⁴

The Commission finds good cause for approving Amendment No. 1 prior to the thirteenth day after the date of publication of notice thereof in the Federal Register. All of the changes contained in Amendment No. 1 simply correct typographical errors, the PSE's rules, or otherwise do not raise any significant regulatory concerns. Therefore, the Commission believes that granting accelerated approval to Amendment No. 1 is appropriate and consistent with Section 6 and Section 19(b)(2) of the Act.²⁵

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁶ that the proposed rule change (SR-PSE-96-07) is approved, including Amendment No. 1 on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,²⁷

Margaret H. McFarland,
Deputy Secretary.

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²³ Revised Rule 1.8(a) conflicts with Article VI, Section 3, of the PSE Constitution. The new rule states that approved applications must be activated by the applicant within six months, while the PSE Constitution provides that admission to membership automatically becomes effective after an approved application has been posted for 10 days.

In addition, Revised Rule 1.6(b) conflicts with Article VI, Section 2, of the PSE Constitution. The PSE Constitution requires that the name of the applicant be posted after it has been approved. The rule, however, requires the name of all applicants to be posted within a reasonable time after receipt and before being approved.

The Exchange anticipates rectifying this situation by having its members vote to amend the PSE Constitution in September 1996. Telephone conversation between Rosemary A. MacGuinness, Senior Counsel, PSE, and Anthony P. Pecora, Attorney, Division of Market Regulation, SEC (Mar. 22, 1996).

²⁴ The PSE represented that it anticipates submitting a rule filing that conforms the PSE Constitution to the provisions contained in this proposal in October 1996. Telephone conversation between Erin E. Cosgrove, Vice President, Membership and Corporate Secretary, PSE, and Ivette López, Assistant Director, Division of Market Regulation, SEC (Sept. 12, 1996).

²⁵ 15 U.S.C. 78f and 78s(b)(2).

²⁶ 15 U.S.C. 78s(b)(2).

²⁷ 17 CFR 200.30-3(a)(12).

¹⁸ 15 U.S.C. 78f(b)(5).

¹⁹ 15 U.S.C. 78f(d).

²⁰ 15 U.S.C. 78f(b)(7).