

directors/trustees of such Price Fund, including a majority of the directors/trustees who are not "interested persons," as defined in section 2(a)(19), shall consider to what extent, if any, the advisory fees charged to the Price Fund by the Adviser should be reduced to account for the fee indirectly paid by the Price Fund because of the advisory fee paid by the Central Fund. The minute books of the Price Fund will record fully the directors/trustees' consideration in approving the advisory contract, including the considerations relating to fees referred to above.

3. Each Participating Fund, each Central Fund, and any future fund that may rely on the order shall be advised by or, in the case of a 3(c)(11) Entity, shall have as its trustee, T. Rowe Price or Price-Fleming or a person controlling, controlled by, or under common control with T. Rowe Price or Price-Fleming.

4. Investment in shares of the Central Funds will be in accordance with each Price Fund's respective investment restrictions, if any, and will be consistent with each Price Fund's policies as set forth in its prospectuses and statements of additional information.

5. No Central Fund shall acquire securities of any other investment company in excess of the limits contained in section 12(d)(1) (A) of the Act.

6. A majority of the directors/trustees of each Price Fund will not be "interested persons," as defined in section 2(a)(19) of the Act.

7. Each of the Price Funds will invest uninvested cash in, and hold shares of, the Central Funds only to the extent that the Price Fund's aggregate investment in the Central Funds at the time the investment is made does not exceed 25% of the Price Fund's total net assets. For purposes of this limitation, each Price Fund or series thereof will be treated as a separate investment company.

8. To engage in Interfund Transactions, the Funds will comply with rule 17a-7 under the Act in all respects other than the requirement that the parties to the transaction be affiliated persons (or affiliated persons of affiliated persons) of each other solely be reason of having a common investment adviser or investment advisers which are affiliated person of each other, common officers, and/or common directors.

Applicants also agree that condition number 2 to the Spectrum Fund Order would be modified as follows:

No Underlying Fund shall acquire securities of any other investment company in excess of the limits

contained in section 12(d)(1)(A) of the Act, except to the extent such Underlying Fund acquires securities of another investment company pursuant to exemptive relief from the SEC permitting such Underlying Fund to acquire securities of one or more affiliated investment companies for short-term cash management purposes.

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

Jonathan G. Katz,
Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38810; International Series Release No. 1090; File No. 600-30]

Self-Regulatory Organizations; Emerging Markets Clearing Corporation; Notice of Filing of Application for Registration as a Clearing Agency

July 1, 1997.

I. Introduction

On May 30, 1997, the Emerging Markets Clearing Corporation ("EMCC") filed with the Securities and Exchange Commission ("Commission") an application on Form CA-1 for registration as a clearing agency pursuant to Section 17A of the Securities Exchange Act of 1934 ("Exchange Act")¹ and Rule 17Ab2-1 thereunder² in order to perform the functions of a clearing agency with respect to transactions in U.S. dollar-denominated Brady bonds.³ The Commission is publishing this notice to solicit comments from interested persons.⁴ Comments are solicited on all aspects of the EMCC application, and in particular the matters discussed in Section IV of this notice.

II. Structure of the EMCC System

EMCC is a corporation organized under the laws of the State of New York. EMCC was formed by the Emerging Markets Traders Association ("EMTA") and the International Securities Clearing

Corporation ("ISCC") in response to an industry initiative to reduce risk in the clearance and settlement of emerging markets debt instruments.

Initially, EMCC will be owned by EMTA, the National Securities Clearing Corporation ("NSCC"), and the International Securities Markets Association ("ISMA"). EMTA will be issued 300 shares (37.5% of the outstanding shares), NSCC will be issued 300 shares (37.5% of the outstanding shares), and ISMA will be issued 200 shares (25% of the outstanding shares).⁵

EMTA is a trade association organized as a New York not-for-profit corporation in 1990 by financial institutions to promote the orderly development of trading markets in emerging market instruments. As of the end of 1996, EMTA had 154 members, which were mainly broker-dealers and banks. EMTA had 154 members, which were mainly broker-dealers and bankers. 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 services in May 1995.

ISMA is an industry association composed of member 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. U.K. broker-dealers can use TRAX to fulfill their U.K. reporting requirements. ISMA's wholly-owned subsidiary, International Securities Market Association Limited ("ISMA Ltd."), operates TRAX.

NSCC is a clearing agency registered under Section 17A of the Exchange Act.⁶ NSCC is owned by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National

¹ 15 U.S.C. 78q-1.

² 17 CFR 240.17Ab2-1.

³ On June 2, 1997, and June 17, 1997, EMCC filed amendments to its application. Copies of the application are available for inspection and copying at the Commission's Public Reference Room.

⁴ The description set forth in this notice regarding the structure and operations of EMCC have been largely derived from information contained in EMCC's Form CA-1 application and publicly available sources.

⁵ After the initial issuance of shares to EMTA, NSCC, and ISMA, 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 time as determined by EMCC. EMCC intends to issue shares no later than June 30, 1998. EMCC will file a proposed rule change prior to any such issuances.

⁶ See Securities Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (order approving full registration of NSCC as a clearing agency).

Association of Securities Dealers, Inc. NSCC is the parent corporation of ISCC, which is also registered as a clearing agency under the Exchange Act.⁷

III. Description of EMCC Operations

EMCC is being established as a clearing agency initially to facilitate the clearance and settlement of transactions in U.S. dollar-denominated Brady bonds.⁸ Currently, Brady bonds 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").⁹ As more fully described below, EMCC will facilitate the settlement of Brady bonds at Cedel and Euroclear ("depositories").

A. Clearance Services

Brady bonds are traded in an over-the-counter market composed of dealers and interdealer brokers where trading is either directly between dealers or between dealers through interdealer brokers. Generally, Brady bonds that

have warrants associated with them are traded to include the warrants. In order to participate in EMCC, dealers and interdealer brokers will need to submit transaction data to a locked-in trade source which will match such data using its own criteria. Initially, the locked-in trade sources designated by EMCC will be Match-EM and TRAX.

Upon completion of the matching process, each locked-in trade source will submit all of its transaction data to EMCC regardless of whether the counterparties are EMCC members. EMCC will then segregate all data on trades between two EMCC members to input into EMCC system. As a result, all EMCC members that decide to use Match-EM or TRAX as a part of their normal trading process will be locked into settlement at EMCC and will be unable to select an alternative settlement process. While EMCC members will be able to delete their trades from EMCC's clearance system by submitting cancellation instructions through the locked-in trade source, such action may result in the trade legally being considered cancelled (*i.e.*, the members would be required to reconfirm such trades outside of TRAX or Match-EM and therefore would not receive the benefit of using TRAX's or Match-EM's automated confirmation system).

EMCC will receive data from the locked-in trade sources three times each business day: (1) At approximately 8:30 a.m. eastern time ("ET") ("early morning transmission"), (2) at approximately 11:30 a.m. ET ("early midmorning transmission"), and (3) at approximately 9:30 p.m. ET ("evening transmission"). EMCC will review such data to determine whether it meets EMCC's and the depositories' operational parameters and will reject trades that do not meet such parameters.¹⁰ At approximately 10:30 a.m. ET and 11:30 p.m. ET, EMCC will send out to its members and to the locked-in trade sources a report of data that was rejected because it did not meet the operational parameters. Any correction or cancellation of data must be done through the locked-in trade sources.¹¹

EMCC will report to each member on its "accepted trade report" data on all trades: (a) that are eligible for processing by EMCC (*i.e.*, U.S. dollar denominated

Brady bonds), (b) that are matched by the locked-in trade sources, (c) that are received by EMCC on trade date ("T"), on T+1, and in the early morning transmission on T+2, and (d) that are not rejected by EMCC based on the operational parameters. 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."¹² Transaction data received by EMCC in the evening transmission on T+2 and thereafter will not be accepted by EMCC because it will be unable to submit timely settlement instructions to the depository.

EMCC may also receive uncomparated transaction data from the locked-in trade sources. If EMCC does not receive by the early morning transmission on T+2 updated data from a locked-in trade source indicating that an uncomparated trade has been cancelled or compared, EMCC will include data on the uncomparated trade on the settlement instructions only report if the submitting member has requested EMCC to do so pursuant to the member's standing instructions.

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 transmission. The settlement instructions only report will contain data on matched trades received in the midmorning transmission on T+2 and data on unmatched trades received by the midmorning transmission on T+2. 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 settlement instructions only report.

B. Risk Management Services

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 ("novation") unless EMCC notifies or has made information available to its members that trades listed on the accepted trade report are not assumed and guaranteed because EMCC has ceased to act for the original

⁷ See 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.

⁸ Brady bonds were first issued pursuant to a plan developed by then U.S. Treasury Secretary Nicholas Brady to assist debt-ridden countries restructure their sovereign debt into commercially marketable securities. The plan provided for the exchange of bank loans for collateralized debt securities as part of an internationally supported sovereign debt restructuring. Typically, the collateral would be U.S. Treasury securities. The first Brady bonds were issued in 1990 for Mexico. Later securities that did not strictly adhere to the terms of the plan (*e.g.*, such securities may not have been collateralized) were also referred to as Brady bonds.

The definition of Brady bonds used to denote securities that will be eligible for processing by EMCC will be somewhat broader than the traditional usage of the term. 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.

EMCC intends to offer clearance and settlement services for other emerging markets debt instruments in the future. EMCC will file proposed rule changes with the Commission prior to expanding the categories of securities eligible for processing at EMCC.

⁹ 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 application for limited exemption from registration as a clearing agency).

¹⁰ Such parameters include complete information and valid characters. In addition, EMCC has established a maximum delivery size of \$20 million.

¹¹ Any cancellation or correction must be received by EMCC no later than the early morning transmission two business days after trade date ("T+2").

¹² EMCC provides settlement instructions on behalf of its members with respect to trades listed on the settlement instructions only report to the depositories for settlement directly between the members.

counterparty.¹³ EMCC's guarantee will be effective with respect to: (a) trades reported on the evening accepted trade report at the later of (i) midnight ET or (ii) one half hour after the issuance of the preliminary margin report¹⁴ and (b) trades reported on the morning accepted trade report at the later of (i) 1:00 p.m. ET or (ii) two and one half hours after issuance of the final margin report.¹⁵ The result is a novation of the original contract between the counterparties, creating an obligation on the part of the seller to deliver the securities to EMCC and on the part of the purchaser to receive and pay for the securities delivered by EMCC.

C. Settlement Services

EMCC will be a member of both Euroclear and Cedel. EMCC will transmit settlement instructions to the appropriate depository on behalf of members with EMCC as the counterparty to each side of the trade. With respect to each transaction reported on an accepted trade report which has not been deleted, EMCC will send receive and deliver instructions to the depository at 12:30 p.m. on T+2. If the accepted trade report indicates that a member has a securities receive obligation, EMCC will notify the depository to deliver the bonds from EMCC's account into the member's account against payment on the next day ("T+3"). If the member had a securities deliver obligation reflected on the accepted trade report, EMCC will instruct the depository to deliver the specified quantity of bonds from the member's account into EMCC's account against the receipt of the corresponding payment price on T+3.¹⁶

Settlement will occur in accordance with the rules of Euroclear or Cedel. Essentially, the receiver must have sufficient cash or line of credit to pay for the delivery, and the deliverer must have sufficient securities to make full delivery.¹⁷ The depositories will notify

EMCC and its members each day at midnight ET of the status of trades indicating which have settled and which are still pending. EMCC will not provide settling trade reports or fail reports to its members.

If a member cannot accept delivery of securities because of insufficient funds, EMCC will generate a fail compensation instruction and will transmit it to the appropriate depository. Pursuant to that instruction, 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 matched transactions reflected on the settlement instructions only report, EMCC will send instructions on the afternoon of T+2 to the depository on behalf of the members listed as counterparties. The depository will be advised to deliver on T+3 bonds from the account of the member with the deliver obligation to the account of the member with the receive obligation against payment. EMCC will not monitor the settlement of these transactions.

With respect to uncomparated transactions reflected on the settlement instructions only report, EMCC will send instructions on the afternoon of T+2 to the depository on behalf of the member submitting the data naming the other member as the counterparty to the instruction. EMCC will not monitor the settlement of these transactions.

transactions are sent through its bridge connection with Euroclear. EMCC has informed the Commission that its members currently do not intend to use Cedel as a depository. If this changes, EMCC intends to maintain a line of credit at Cedel of approximately \$40 million to allow the receipt and delivery of securities across the bridge.

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 review to see if 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, if EMCC inserts itself as a common counterparty without sufficient funds to accept deliveries, Euroclear's system will only look to EMCC's member to determine if sufficient funds exist. Therefore, EMCC will maintain a line of credit between \$60 and \$100 million at Euroclear to reduce settlement inefficiencies. 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.

D. Buy-ins/Sell-Outs

EMCC's rules will permit a buy-in or a sell-out in the event that a transaction has not been completed by five days after settlement date ("SD+5") as described below. A buy-in or sell-out may be initiated by the member with the receive or deliver obligation, respectively, by submitting a pre-advice notice to EMCC. Upon receipt of the pre-advice notice, EMCC will transmit the pre-advice notice to the corresponding 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 will need to 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. EMCC also may 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.

EMCC will also use the buy-in or sell-out procedures for deliver and receive obligations for warrants. However, if EMCC has ceased to act for a member with fail obligation prior to the execution of the buy-in or sell-out, EMCC will undertake the buy-in or sell-out only at the expense of the member that submitted the pre-advice notice. 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 first confirm with the requesting firm that it wants to proceed with the buy-in at the requesting firm's expense.

E. Release of Clearing Data

Pursuant to EMCC's rules, EMCC may release transaction data of its members 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 release of information relating to the aggregate and per trade

¹³ EMCC does not interpose itself as the counterparty and guarantor for transactions reported on the settlement instructions only report.

¹⁴ See *infra* Section IV.C.1.a for a description of the preliminary margin report.

¹⁵ See *infra* Section IV.C.1.a for a description of the final margin report.

¹⁶ Consistent with industry conventions, EMCC assumes that the bonds will be delivered with attached warrants unless otherwise specified.

¹⁷ 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. However, Cedel's chaining program is limited when

transaction volumes and prices of trades processed by EMCC.

IV. EMCC's Request for Registration

A. Introduction

Brady bonds are the most actively traded emerging market debt instrument. In the first quarter of 1997, Brady bonds represented \$671 billion of the \$1.6 trillion traded in emerging markets instruments. Brady bonds constitute approximately 12% of the total \$1.2 trillion issued of emerging market instruments.¹⁸

While Brady bonds currently are cleared and settled either through Euroclear or Cedel, neither guarantees settlement of these transactions. Furthermore, dealers have exposure to brokers until the assumption of risk by clearing firms on the afternoon of T+1. As a result, parties to a transaction retain a high degree of settlement risk. EMCC was developed in response to an industry initiative to reduce risk in the clearance and settlement of emerging market debt instruments. Therefore, in order to provide the benefits of guaranteed settlement to the Brady bond market, EMCC seeks registration as a clearing agency pursuant to Section 17A of the Exchange Act and Rule 17Ab2-1.

B. Goals of Clearing Agency Registration

Section 17A of the Exchange Act directs the Commission to promote Congressional objectives to facilitate the development of a national clearance and settlement system for securities transactions.¹⁹ Registration and

regulation of clearing agencies is a key element in promoting these statutory objectives. 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 the clearing agency's organization, capacity, and rules.²⁰ The Commission has published standards developed by its Division of Market Regulation which are used in evaluating applications for clearing agency registration.²¹

C. Safety and Soundness Protections

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.²² In the Standards Release, the Division enumerated certain requirements that should be met to comply with this standard.

1. Clearing Fund

The Standards Release stated that a clearing agency should have a clearing fund which is based on a formula applicable to all users and is comprised 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 (a) from defaults of participants and (b) 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 stated 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.²³ The clearing agency should provide for the maximum assessment to which any participant is subject. Comment is requested on whether EMCC meets these standards as described below.

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 would fail to perform its obligations to EMCC. Each member will be obligated to make deposits to EMCC's clearing fund. The initial required clearing fund deposit for each member will be set by EMCC based on the expected nature and level of the member's activity. The minimum required clearing fund deposit for each member will be US \$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. EMCC will generally calculate the margin amount as follows: (mark to market amount + volatility amount) × event risk factor.²⁴ The mark to market

²³ The Standards Release also stated 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.

²⁴ EMCC has represented that it performed 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 (*i.e.*, 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.

However, the test did not attempt to take into account any spillover effect (*i.e.*, where the sudden drop of prices in a country's bond market resulted in a similar drop in the bond markets of other countries with similar risk profiles). EMCC states that it is difficult to quantify any spillover effects. EMCC believes that spillover effects are addressed because the test assumes that for each firm the stressed event occurred in the country in which the firm was most concentrated and therefore would most adversely effect the value of the firm's position and also assumes a degree of deviation from the mean that was substantially higher than was the case in the Mexican debt crisis.

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.

¹⁸ Broward Daily Business Review, May 20, 1997, at A3.

¹⁹ 15 U.S.C. 78q-1. Section 17A(a)(1) provides:

(1) The Congress finds that—

(A) The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors.

(B) Inefficient procedures for clearance and settlement impose unnecessary costs on investors and persons facilitating transactions by and acting on behalf of investors.

(C) New data processing and communications techniques create the opportunity for more efficient, effective, and safe procedures for clearance and settlement.

(D) The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.

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).

²⁰ 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.

²¹ 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).

²² 15 U.S.C. 78q-1(b)(3) (A) and (F).

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.²⁵ 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.

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. 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 have not settled.²⁶ 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, which will determine which volatility formula will be applied to that security.²⁷ The sum of the volatility

amounts for each security will be the clearing member's volatility amount.²⁸

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 a member or for all members without prior notice to the member(s). EMCC also will increase margin requirements by multiplying a global holiday risk factor to the formula to take into account days on which U.S. banks are closed but securities markets are open.

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 will not be 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. A member's required margin deposit will be equal to the largest single final daily margin amount computed for that member for the month during which such margin calculation is being performed and for the previous calendar month. 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 be considered to be a margin deficit. Payment must be made through the U.S. Fedwire system.

EMCC also will have the authority to collect additional 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.²⁹ EMCC also may collect additional margin if a member has been placed on surveillance status.³⁰

b. Margin Composition and Investment. Members will be required to pay margin in cash, U.S. Treasury

²⁹ 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 position in L1, L2, and L3 securities plus the sum of the absolute settlement values of the member's 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 the net country position exceeds 20% of net worth or the net geographical position exceeds 30% of net worth. An undue concentration will be deemed to exist for a broker-dealer when the net country position exceeds 50% of excess regulatory capital or the 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. If EMCC is not satisfied with the answers to these questions, EMCC may request additional clearing fund deposits.

³⁰ 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 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.

²⁵ 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 the 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). Some trades will settle Friday at the depository. Some trades will settle later, but EMCC will receive notice of them before it begins its processing day. 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.

²⁶ The reason for including transactions in the morning volatility calculation whether or not they have settled is to insure that data on three days of pending trades is included. EMCC believes that because it is guaranteeing three days of trades, it is appropriate that data on three days of trading activity is included in the volatility calculation. 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 calculate fails as of the prior day because fails calculated as of the current day would include trades due to settle that day (*i.e.*, these trades would be doubled 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. Thus, it is no longer necessary to include trades that have settled that day.

²⁷ The four classes and spreads are as follows: L1—3/8% or less; L2—3/4% or less; L3—2% or less; L4—greater than 2% or no trading activity for a certain period of days.

²⁸ 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 short or long L1+L2) \times 2 Std \times CC, PLUS
4. (value of short or long 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 a 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.

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.

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., repurchase agreements related to EMCC, or otherwise pursuant to the investment policy adopted by EMCC. 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. Comment is requested as to whether such investments are consistent with the standard that investments should be limited to safe and liquid investments such as government securities.

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 upon whether the insolvent member has exceeded its overnight exposure cap.

When the failed member is not an interdealer broker, EMCC will classify trades as brokered or direct.³¹ 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 days³² and (b) losses 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 issue of securities. 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.³³ EMCC then will segregate the smallest remaining losses up to an amount that equals the amount of the defaulting member's overnight exposure cap ("under the cap losses").³⁴ The under the cap losses 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 the 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 thirty 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 the member's trades and (b) losses attributable to brokered transactions will be allocated first to the interdealer broker member

that was a contraparty to such trade to the extent of the loss attributable to such trade up to a maximum allocation of \$3 million per interdealer broker and then pro rata among members that were counterparties to interdealer brokers that reach their maximum allocation and that were on the opposite side of the market in the same issue of securities creating a loss with the same settlement date and at approximately the same price.

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 issue of securities. 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. Any remaining loss after application of clearing fund will be allocated back 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 will provide that the use of clearing fund deposits is limited to satisfaction of losses or liabilities of EMCC arising from the failure of a member to satisfy an obligation to EMCC or as an incident to the clearance and settlement by EMCC and to provide EMCC with a source of collateral to meet its temporary financing needs. 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. Comment is requested whether EMCC's proposed uses of its clearing fund are consistent with the requirement that temporary applications of the clearing fund should be used only in limited amounts to meet unexpected and unusual requirements for funds and that the regular or substantial use of a clearing fund for operational purposes would be inappropriate.

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 (i) the negligence or misconduct of the clearing agency, the clearing agency's

³¹ 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.

³² A member that is assessed pursuant to this provision may limit its assessment to its current margin requirement if it chooses to terminate its membership.

³³ For example, after netting new trades in each issue of securities, EMCC may determine that there are losses of \$2 million, \$4 million, \$3 million, and \$10 million in four issues and EMCC has collateral of the defaulting member of \$8 million. EMCC will satisfy the \$2 million loss first, then the \$3 million loss, then a portion of the \$4 million loss.

³⁴ For example, if after netting there are losses of \$5 million, \$7 million, and \$3 million in four issues and the defaulting member had an overnight exposure cap of \$10 million, EMCC will segregate out the \$3 million loss, the \$5 million loss, and \$2 million of the \$7 million loss.

subcustodian or agent, or any of their respective employees, (ii) the placement of 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, (iii) larceny, (iv) mysterious disappearance, or (v) any other cause for which the clearing agency has assumed responsibility. Since the date of the Standards Release, the Commission has further clarified its position on clearing agency liability, stating that clearing agencies should perform their functions under a high standard of care and at a minimum custody services should be performed under an ordinary negligence standard.³⁵ The Commission also has stated that custody functions include all functions related to transaction processing and the safekeeping of customer funds and securities.³⁶

As proposed, EMCC's member's agreement, executed between EMCC and each member, will provide 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. The agreement further will provide 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.

EMCC's rules will provide that EMCC will have no responsibility for errors which may occur in any transmission of data to EMCC except in the case of EMCC's gross negligence. EMCC's rules also will provide that EMCC will have no liability for errors made by it in the conversion of data from a yield basis to a price basis or vice versa or from the comparison of such converted data if EMCC has acted in good faith and takes prompt action to correct any error.

The Commission preliminarily believes that EMCC's proposed standard of care is inconsistent with the Exchange Act and prior Commission positions. Because EMCC's actions bear directly upon the safeguarding of securities and funds, the Commission believes that EMCC's activities

constitute custodial functions for which a negligence standard is appropriate. Furthermore, the Commission has never approved a gross negligence standard as a blanket standard of liability for a fully functioning clearing agency.³⁷ The Commission invites comment upon the appropriateness of EMCC's proposed standard of liability.

3. Processing Capacity

ISCC has agreed pursuant to a service agreement to perform services for EMCC with respect to EMCC's clearing agency activities. ISCC will furnish the services necessary to conduct EMCC's operations 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 has seven employees. Such employees' duties are generally limited to operational functions. ISCC currently provides limited clearing agency services. Many of ISCC's functions are performed by NSCC or by the International Depository & Clearing, L.L.C. ("IDC"). IDC is a company equally owned by NSCC and The Depository Trust Company, both registered clearing agencies. However, IDC is not regulated in any manner. The Commission invites comments as to whether ISCC has sufficient capacity to act as the facilities manager and operate another clearing agency.

ISCC may use outside parties to fulfill its commitments to EMCC. 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 Corporation ("SIAC"), through ISCC and NSCC, also will provide EMCC with managerial, clerical, and data processing services. In addition, ISCC will rely on employees of IDC for product development, marketing and sales, planning, participant services, and executive (*i.e.*, decision making) functions. The Commission asks for comment as to whether these service arrangements are appropriate,

and particularly whether it is appropriate that an unregulated entity such as IDC perform the above functions for a clearing agency.

In addition, as discussed above, EMCC has no independent capacity to match trades. Instead, it relies on Match-EM and TRAX for such services, neither of which is regulated in the U.S. EMCC has represented that it has no contractual agreement with either GE (the operator of Match-EM) or ISMA Ltd. (the operator of TRAX) that would permit it to review their operational capabilities. Because the failure of Match-EM or TRAX could result in EMCC being unable to fulfill its clearance and settlement functions with respect to those trades which either Match-EM or TRAX should have matched and reported to EMCC, the Commission requests comment on whether the current arrangement is consistent with EMCC's obligations to ensure that it has sufficient operational capability. Specifically, the Commission believes that at a minimum, EMCC should obtain sufficient information to be able to make a determination that Match-EM and TRAX are operating in a manner that ensures that they will be able to accurately match and to report trades on a timely basis to EMCC. Furthermore, the Commission believes that it should have access to the materials that EMCC has relied on to make this determination. Comment is requested as to whether other conditions should be applied.

4. Audit Committee and Internal Audit Department

The Standards Release stated that clearing agencies 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 will provide that the board of directors may appoint an audit committee consisting of three or more directors other than officers of EMCC. The audit committee will have responsibility for reviewing with the independent certified public accountants the scope of their auditing procedures and the financial statements of EMCC to be certified by the accountants. The Commission notes that EMCC's bylaws do not prohibit the directors that are representatives of

³⁵ 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).

³⁶ See, *e.g.*, ICC registration order, *supra* note 35.

³⁷ While the Commission approved the temporary registration of the Government Securities Clearing Corporation ("GSCC") under a gross negligence standard, such clearing agency's functions at the time were limited to comparison of data. In addition, the Commission urged GSCC to adopt a negligence standard for all functions affecting member settlements, including comparison of data. Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19839. GSCC continues to operate under its temporary registration. Securities Exchange Act Release No. 38698 (May 30, 1997), 62 FR 30911.

NSCC, ISMA, and EMTA from serving on the audit committee. Comment is requested as to whether the relationship and the services provided by NSCC, ISMA, and EMTA are such that the individuals representing these entities on EMCC's board should not serve on the audit committee.

The Standards Release stated that a clearing agency should have an internal audit department which is adequately staffed with qualified personnel. NSCC's internal audit department will perform EMCC's internal auditing functions.

5. Securities, Funds, and Data Controls

The Standards Release provides that a clearing agency should have off-site storage of up-to-date files, 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.

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 participant 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.

D. 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 will have a total of 21 directors, divided into four classes. The first three classes will consist of five directors each ("participant directors"). The fourth class will have six directors, consisting of one director selected by EMTA, one director selected by ISMA, two directors selected by NSCC, and two directors selected by the EMCC board. The term of office of the participant directors will be three years, with the term of one class of directors

expiring each year.³⁸ Participant directors may not serve for more than six consecutive years. The term of the fourth class will be one year.

Members may nominate individuals to serve as participant directors by filing with EMCC's Secretary at least thirty days prior to the date of the annual meeting a petition signed by the lesser of five percent of the participants or ten participants.³⁹ A nominating committee selected by the board will also select individuals to serve as participant directors. 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.⁴⁰

2. Provision of Information to Participants

The Standards Release stated 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 stated that the annual financial statements should be provided within 60 days following the close of the clearing agency's fiscal year prepared in accordance with generally accepted accounting principles. EMCC's rules will provide that EMCC will undertake to provide to all members audited financial statements and a report prepared by independent public accountants within 60 days following the close of its fiscal year. EMCC also will undertake to provide unaudited financial statements to its members within 30 days following the close of each of EMCC's fiscal quarters.

The Standards Release stated 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

³⁸ 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.

³⁹ Only one director may be selected which is an officer of any single participant or its affiliate.

⁴⁰ 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.

accounting control. The report should disclose any material weaknesses discovered and any corrective action taken or proposed to be taken. The report should be furnished to all participants promptly after it becomes available and no later than 60 days after the period covered by the report. EMCC indicated in its Form CA-1 that it intends to prepare an annual internal accounting control report. However, EMCC does not provide that such report will be given to its participants.

As discussed in the Standards Release, the notice of proposed rule changes 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. EMCC's rules will provide that it will immediately notify all members and registered clearing agencies of all proposals it has made to change, revise, add, or repeal any rule, including a brief description of the proposal, its purpose, and its effect.

E. Participant Standards

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.⁴¹ In addition, a clearing agency may accept specific categories of persons other than those enumerated, but a clearing agency should be cognizant of the impact that participation may have on the safety of the clearing agency and should provide safeguards to protect against that risk. 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 participants or any category of participants enumerated in Section 17A(b)(3)(B), but that these criteria may not be used to unfairly discriminate among participants. In addition, the Exchange Act recognizes 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.

1. Members

EMCC will provide services to those organizations, entities, or persons that

⁴¹ The classes are registered brokers or dealers, registered clearing agencies, registered investment companies, banks, and insurance companies.

qualify as members under EMCC's rules, that apply to EMCC to act for them, whose applications are approved by EMCC, and that have contributed to EMCC's clearing fund. A partnership, corporation, limited liability company, or other organization, entity, or individual will be qualified to 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 the jurisdiction other than the U.S. in which it is organized or established; (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 and examined by the banking regulator in the jurisdiction other than the U.S. in which it is organized or established; or (e) if it does not qualify under (a) through (d) but is the successor or assigns 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, then such successor or assigns may become a member for the limited purpose of winding up its business with EMCC in an orderly manner. Initially, only broker-dealers that are organized under the laws of the U.K. will be eligible for admission under (b) above. Comment is requested as to the advisability of admission of non-U.S. participants and whether the proposed admission standards provide sufficient protection to EMCC and the national clearance and settlement system.

After the issuance of shares to persons which have contributed to the development fund for the organization and initial operation of EMCC,⁴² 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.

2. Financial Reports

All applicants for admission to EMCC will need to provide a copy of the applicant's financial statements for the two fiscal years ending immediately preceding the year in which application is made, certified without qualification 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 will be required to provide EMCC with a discussion of the material variations of such accounting principles from U.S. GAAP.

A U.S. broker-dealer applicant will need to provide copies of the its Form X-17A-5 FOCUS Reports ("FOCUS Reports") or Form G-405 Reports on Finances and Operations ("FOGS Reports") for the last 24 months if a monthly filer or the last eight quarters if a quarterly filer submitted to its designated examining authority and any supplemental reports required to be filed with the Commission pursuant to Exchange Act Rule 17a-11⁴³ or 17 C.F.R. Section 405.3. A bank applicant will need to provide all quarterly financial statements covered by the last audited financial statement plus all subsequent quarterly financial statements. A U.S. bank applicant also will need to provide copies of its three most recent Consolidated Reports of Condition and Income ("Call Reports") submitted to its appropriate regulatory agency and, to the extent not contained within such Call Reports or to the extent that the applicant does not have Call Reports, information containing each of the applicant's capital levels and ratios, as such levels and ratios are required to be provided to its appropriate regulatory agency. A non-U.S. bank applicant also will need to provide all material regulatory filings made with its primary regulator in its home country over the prior two years. If the applicant is a U.K. broker-dealer subject to regulation by the Securities Futures Association ("SFA"), it will need to provide EMCC with its SFA monthly reports and returns for the prior twenty-four months and if necessary and feasible, financial statements prepared in accordance with U.S. GAAP.

If required by EMCC, an applicant will need to 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, FOCUS Report, FOGS Report, Call Report, or comparable reports to regulatory authorities, as applicable, 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, FOCUS Report, FOGS Report, Call Report, comparable reports to regulatory authorities, or the certificate.

3. Admission Criteria for Members

The 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 an order of statutory disqualification as defined in Section 3(a)(39) of the Exchange Act⁴⁴ or an order of similar effect issued by a federal or state banking authority in the U.S. or any non-U.S. regulator.

EMCC must have received no substantial information that would reasonably and adversely reflect on the applicant or any associated person to such an extent that the applicant should be denied membership in EMCC. However, no application will be denied on such basis unless the board has

⁴² See *supra* note 5.

⁴³ 17 CFR 240.17a-11.

⁴⁴ 15 U.S.C. 78c(a)(39).

reasonable grounds to believe that the applicant or any associated person meets a disqualification criteria specified in EMCC's rules.⁴⁵

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 formal findings that will become part of EMCC's books and records to the effect that other credit factors of the applicant compensate for the lower net worth.⁴⁶

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. However, a U.S. broker-dealer applicant may have excess net capital of at least \$50 million if the membership and risk committee of EMCC's board of directors makes a formal findings that will become part of EMCC's books and records to the effect that other credit factors of the applicant compensate for the lower excess net capital.⁴⁷

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, the applicant may have excess financial resources of at least \$50 million if the membership and risk committee of EMCC's board of directors makes a formal finding that will become part of EMCC's books and records to the effect that other credit factors of the applicant compensate for the lower excess financial resources.⁴⁸

⁴⁵ 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.

⁴⁶ In making such determination, EMCC will consider the applicant's return on average assets, capital to total assets ratio, non-performing assets to total assets ratio, and liquid assets to total assets ratio. EMCC also will consider the ratings assigned to the applicant by a nationally recognized statistical rating organization, any significant off balance sheet items, and the applicant's risk management controls.

⁴⁷ 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.

⁴⁸ EMCC will consider any rating assigned by a nationally recognized statistical rating organization,

If a U.S. broker applicant is applying to become an interdealer 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 interdealer broker's potential margin calls, and the interdealer broker must demonstrate an ability to meet such margin calls and loss allocation assessments. The interdealer 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.⁴⁹

During the first six months of EMCC's operations, EMCC will permit an interdealer broker to become an EMCC member which does not meet the \$10 million excess net capital requirement if it meets an alternate criterion. Such applicant must maintain a clearing relationship with an EMCC member which is not an interdealer broker. Pursuant to the clearing relationship, the clearing firm must take the place of the interdealer broker on T+1 on all trades which do not have EMCC members on both sides. The interdealer broker will have a fixed clearing fund deposit in lieu of the required margin deposit. However, EMCC will calculate each day for such interdealer broker a preliminary and final required fund deposit excluding any positions that resulted from a systems failure of a contraparty 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.⁵⁰ However, EMCC will guarantee completion of the interdealer broker's trades to the original EMCC counterparties.⁵¹ In

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.

⁴⁹ If an interdealer broker has a margin payment because one of its counterparties fails to submit data on a trade prior to 8:00 a.m. ET on T+1, the contraparty must compensate the interdealer broker for the cost of financing the payment obligation and may be subject to fine by EMCC.

⁵⁰ The interdealer 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).

⁵¹ Because EMCC is not guaranteeing trades to the broker, if a dealer contraparty becomes insolvent, the broker is responsible for completing the trade to its contraparty on the other side. As a result, the nondefaulting EMCC dealer member does not receive the benefit of EMCC's guarantee of brokered trades. If the broker is unable to complete the trade,

in addition, if the interdealer broker's required fund deposit exceeds its fixed deposit, the interdealer broker will not be subject to assessment for loss allocations⁵² and the interdealer 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 an interdealer broker's required fund deposit exceeds its fixed deposit. Comment is requested as to whether this alternative standard provides sufficient protection to EMCC. Specifically, EMCC will be guaranteeing trades to EMCC members in the event that an interdealer broker becomes insolvent even though it will not have collected margin from the broker to cover the loss. Furthermore, this provision does not set forth any minimum excess net capital requirements for brokers to meet before becoming EMCC members. Comment is requested as to whether such provisions are consistent with a clearing agency's obligations to have appropriate membership standards.

The foregoing financial responsibility standards are minimum requirements, and the board may impose greater 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 the above minimum 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 applicant agrees to abide by the rules of EMCC. Under the agreement, the member's books and records must at all times be open to inspection by EMCC, and EMCC must be furnished with all such information in respect of the member's business and

EMCC will then guarantee the broker's trade to its EMCC member contraparty. However, the trade is treated as a direct trade between the broker and its contraparty. 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.

⁵² Because EMCC is not guaranteeing trades to the interdealer broker, there would be no loss from direct trades entered into with the broker. Therefore, there would be no reason to assess the broker for such loss.

transactions as EMCC may require. However, upon ceasing to be a member, EMCC cannot inspect such member's books and records or require information relating to transactions that occurred after the time when it ceased to be a member.

The 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. Under the agreement, membership in EMCC and use of EMCC's services is governed by the laws of the state of New York. The member must agree that any judgment obtained in an action or proceeding may be enforced in the courts of any jurisdiction where the applicant or any of its property may be found, and the applicant must irrevocably submit to the jurisdiction of each such court in respect of any such action or proceeding. To the fullest extent permitted by law, members 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.

F. 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. In order to do so, a clearing agency must have procedures for determining whether a participant is experiencing financial or operational difficulties. 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. Financial Standards

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

EMCC also will have general continuance standards that require a member to promptly inform EMCC in the event that it no longer is in compliance with any of the relevant standards for membership or any materially adverse change. The board may require additional financial reporting if the member no longer meets the standards for admission to membership, it has violated any rule of EMCC, it fails to satisfy in a timely manner any obligation to EMCC, there is a material change in control or financial condition of such member, or 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.⁵³

2. Ceasing to Act

Section 17A(b)(5)(C) provides that a clearing agency may summarily suspend and close the accounts of a participant that has been and 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.

⁵³ See *supra* note 30.

Upon providing notice to the member, EMCC may at any time cease to act for a member if the board of directors determines that adequate cause exists to do so.⁵⁴ 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.⁵⁵ 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 accepted. 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

⁵⁴ Such cause may exist if one or more of certain 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 or 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 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.

⁵⁵ 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.

clearing agency's services, or disciplined, the clearing agency must notify the participant of the specific grounds of the denial of services or the changes 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 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 member 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.

G. Equitable Allocation of Dues, Fees, and Charges

Section 17A(b)(3)(D) of the Exchange Act requires that the rules of the clearing agency provide for the equitable allocation of reasonable dues, fees, and other charges among its participants. EMCC's proposed fee schedule provides that it will charge \$5 for input, \$7.50 for late instructions after 9:00 p.m. on T, \$25 for late instructions after 11:00 a.m. on T+1, and \$7.50 for net settlement.⁵⁶

H. Burden on Competition

Section 17A(b)(3)(I) of the Exchange Act requires that the rules of a clearing agency not impose any burden on competition not necessary or appropriate in furtherance of the purpose of the Exchange Act. As discussed in Section III.A., EMCC will automatically receive data on all trades

of EMCC members that have been submitted to TRAX or Match-EM. EMCC members do not have the ability to exclude trades from the EMCC clearance system unless they confirm trades without using TRAX's and Match-EM's automated confirmation system. Although EMCC's rules do not require that EMCC members submit all of their eligible trades to EMCC, as a practical matter EMCC members that want to obtain the benefit of Match-EM or TRAX must settle at EMCC. The Commission is concerned that this aspect of EMCC's operations could either force EMCC members to settle all their eligible trades at EMCC or result in trades being excluded from automated processing.⁵⁷ In addition, EMCC's arrangements with the locked-in trade sources could result in inhibiting future clearing agencies from beginning operations. Comment is requested as to whether this aspect of EMCC's operations is consistent with the Exchange Act.

V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing application by August 11, 1997. Such written data, views, and arguments will be considered by the Commission in deciding whether to grant Euroclear's request for exemption from registration. Persons desiring to make written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Reference should be made to File No. 600-30. Copies of the application and all written comments will be available for inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁵⁸

Jonathan G. Katz,

Secretary.

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⁵⁷ To exclude trades from EMCC settlement, EMCC members would be forced to use manual processes to confirm trades. Members may want to exclude trades from EMCC's system for various reasons. For example, if the trade would cause a member to exceed its overnight exposure cap, it may want to process the trade through other means. In addition, brokers may have agreed to only submit trades to EMCC with EMCC members on both sides. Information on such trades would then be generally unavailable which would reduce market transparency.

⁵⁸ 17 CFR 200.30-3(a)(16).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38811; File No. SR-BSE-97-3]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Boston Stock Exchange, Incorporated Relating to the Authority and Responsibility of Floor Officials

July 2, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on June 18, 1997, the Boston Stock Exchange, Incorporated ("BSE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

The Exchange seeks to supplement its rule regarding the authority and responsibilities of Floor Officials, and the appeal of Floor Official rulings. The text of the proposed rule change is available at the Office of the Secretary, the Exchange, and at the Commission.

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

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

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

The purpose of the proposed rule change is to more clearly define the authority and responsibilities of Floor Officials set forth in the Supplementary Material to Chapter I, Section 1 of the Rules of the Board of Governors, as well as to provide a mechanism for members

⁵⁶ The Commission understands that EMCC may adjust its fee schedule soon after being registered (providing that the Commission grants EMCC registration).

¹ 15 U.S.C. § 78s(b)(1).

² 17 CFR 240.19b-4.