

provide that calculations of exposure limit and MPSE are to be determined on an aggregate system-wide basis and that liquidation of a participant's positions will be conducted through one account. By ensuring that Delta has access to all of a participant's assets held at Delta, the proposed rule change assists Delta in the safeguarding of securities and funds which are in Delta's control or for which it is responsible.

### III. Conclusion

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

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, the proposed rule change (File No. SR-DCC-97-04) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>14</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39241; File No. SR-DCC-97-06]

### Self-Regulatory Organizations; Delta Clearing Corp.; Order Approving a Proposed Rule Change Relating to the Clearance and Settlement of Mortgage-Backed Securities Repurchase Agreements

October 14, 1997.

On April 7, 1997, the Delta Clearing Corp. ("DCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change (File No. SR-DCC-97-06) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> On May 12, May 29, June 18, and July 9, 1997, DCC amended the proposed rule change. Notice of the proposal was published in the **Federal Register** on July 30, 1997.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

### I. Description

The proposal amends DCC's Procedures for the Clearing of Securities

and Financial Instrument Transactions ("Procedures") to allow DCC to clear and settle repurchase agreements and reverse repurchase agreements ("repos") in which the underlying collateral is book-entry, mortgage-based securities issued by the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). Currently, DCC provides clearance and settlement services for repos in which the underlying collateral is a U.S. Treasury security.<sup>3</sup>

#### A. Definition of Mortgage-Backed Security

Under the rule change, a mortgage-backed security<sup>4</sup> is defined as a book-entry security which is directly issued by FNMA or FHLMC and whose underlying value is represented by a pool of mortgages accumulated by FNMA or FHLMC through its mortgage origination program and which is designed to receive principal payments using a predetermined principal balance schedule. In addition, the following securities are excluded from the definition of mortgage-backed securities: (i) Securities which are issued in registered or bearer form and therefore cannot be transferred through the Board of Governors of the Federal Reserve System's FedWire communication system, (ii) securities which are not issued or guaranteed directly by FNMA or FHLMC, (iii) securities for which the underlying assets are mortgage-backed securities rather than a pool of mortgages, and (iv) notional, interest only, principal only, accrual, and partial accrual securities and floaters and inverse floaters.<sup>5</sup>

A mortgage-backed security may be either a fixed rate mortgage-backed security or an adjustable rate mortgage-backed security. A fixed rate mortgage-backed security is defined as a mortgage-backed security whose coupon rate is a fixed rate of interest. An adjustable rate mortgage-based security

("ARMS") is defined as a mortgage-backed security whose coupon rate is a variable rate of interest consisting of an index and a spread to such index and whose underlying collateral consists of adjustable rate mortgages with indices and spreads that parallel those of the ARMS.<sup>6</sup>

#### B. The Clearing Process

Mortgage-backed securities repo transactions involve two settlement dates. The first settlement date ("on-date") is the date on which one participant ("selling participant") delivers participant") in exchange for the delivery of cash ("delivery money") by the purchasing participants to the selling participant. The second settlement date ("off-date") is the date on which the purchasing participant returns to the selling participant the mortgage-backed securities delivered on the on-date in exchange for the return by the selling participant of the delivery money together with interest based upon a rate agreed to by the participants ("repo rate"). DCC generally clears both the on-date and off-date portion of a repo transaction. However, there may be certain repo transactions where DCC clears only the off-date portion of the transaction.<sup>7</sup>

#### 1. Execution and Reporting of Trades

Mortgage-backed securities repo transactions to be cleared by DCC may be entered into directly between the two participants to a transaction and reported to DCC by the participants, or they may be entered into between two participants through the facilities of an authorized broker and reported to DCC by the authorized broker. The terms of the mortgage-backed securities repo transactions will be agreed to by the participants prior to the submission of

<sup>3</sup> According to DCC, the market for repo transactions in mortgage-backed securities is estimated to be approximately 25% to 40% of the size of the market for repo transactions in Treasury securities. DCC also states that this estimate suggests that the outstanding notional size of the market is between \$250 billion to \$400 billion with daily turnover at 10% of the notional size. For a description of DCC's procedures regarding the clearance and settlement of repos on Treasury securities, refer to Securities Exchange Act Release No. 36367 (October 13, 1997), 60 FR 54095 [File No. SR-DGOC-94-06] (order approving implementation of new procedures allowing for the clearance and settlement of repos on Treasury Securities).

<sup>4</sup> The Procedures refer to mortgage-backed securities as "mortgage securities."

<sup>5</sup> For the definitions of these terms, refer to Schedule A of DCC's filing which is attached as Exhibit A.

<sup>6</sup> Sample indices include: (1) The CD rate, which is the weekly average of secondary market interest rates on six month negotiable certificates of deposit as published by the Federal Reserve Board in its Statistical Release H. 15 (519), Selected Interest Rates; (ii) the LIBOR rate, which is a rate which banks charge others banks for U.S. dollar deposits outside the United States for a specified period; (iii) the 11th District cost of funds index, which is the index made available monthly by the Federal Home Loan Bank Board of the cost of funds to members of the Federal Home Loan Bank 11th District; and (iv) the Treasury index, which is the weekly average yield of the benchmark Treasury securities as published by the Federal Reserve Bank. A sample ARMS could bear interest at LIBOR plus 50 basis points with LIBOR adjusting periodically as specified by the terms of the security.

<sup>7</sup> These transactions are referred to the Procedures as novated repos. Securities Exchange Act Release No. 39065 (September 12, 1997), 62 FR 49547 [File No. SR-DCC-97-03] (order approving proposed rule change).

<sup>14</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> Securities Exchange Act Release No. 38868 (July 23, 1997), 62 FR 40872.

trade reports to DCC.<sup>8</sup> There is an existing practice among mortgage-backed security traders in which the parties to a transaction may agree to a trade amount subject to the right of the delivering party to adjust the amount of the trade by over-delivering mortgage-backed security collateral within a specified percentage of the amount initially agreed to by the parties (*i.e.*, variance). DCC requires that such adjustments be made prior to the submission of trade reports to DCC and be reflected in the trade reports submitted to DCC.

Mortgage-backed securities repo transactions with an on-date later than the trade date will need to be reported to DCC prior to 6:00 p.m. on the trade date. Mortgage-backed securities repo transactions with an on-date on the trade date will need to be reported to DCC: (i) Within one-half hour after the transaction occurs if the transaction occurs prior to 1:30 p.m.; (ii) within five minutes after the transaction occurs if the transaction occurs between 1:30 p.m. and 2:15 p.m.; and (iii) as soon as possible but in no event later than five minutes after the transaction if the transaction occurs after 2:15 p.m.

With respect to mortgage-backed securities repo transactions entered into directly between two participants, each participant will forward a trade report to DCC. If DCC does not receive a trade report from one of the participants to the transaction, DCC will contact that participant within one half-hour of receipt of the trade report to confirm the terms of the trade reported by the other participant. When DCC receives trade reports from both participants, it will match the two trade reports. In order for a transaction to be accepted for clearance, the details of the trade reports for the transaction must agree. If the details of the trade reports do not match, DCC will contact the parties regarding the transaction. Matching of mortgage-backed securities repo transactions will be done continuously throughout the day and at the close of each trading day at 2:30 p.m. All trade reports received through an authorized broker will be confirmed by DCC either orally or via

facsimile with the participants to the transaction.

## 2. Acceptance of Trades

DCC will be deemed to have accepted a transaction for clearance when DCC has matched and verified all the information on the trade reports. However, DCC may reject any transaction if it causes a participant to exceed its exposure limit<sup>9</sup> or if the participant has been suspended from DCC's clearing system. If a transaction is accepted by DCC, DCC will interpose itself as the counterparty to both sides of the transaction. Therefore, for any mortgage-backed securities repo transactions, DCC will assume the position of the purchasing participant with respect to the selling participant and assume the position of the selling participant with respect to the purchasing participant. Prior to 8:00 a.m. each business day, participants will receive a written activity report indicating such participant's transactions which were accepted by DCC the previous business day and indicating all transactions due to settle that day.

## 3. Clearing and Failures to Deliver or Receive

The details of each transaction accepted by DCC will be sent to DCC's clearing bank. Each participant will need to maintain a bank account in one or more correspondent banks for margin and trade settlements. Because the mortgage-backed securities which DCC proposes to clear repos must be maintained in book-entry accounts at Federal Reserve Banks and will be delivered through the FedWire, the selected correspondent bank must be a depository institution with access to the FedWire.

DCC has established delivery cut-off times. For example, the selling participant on the on-date of a mortgage-backed securities repo transactions and the purchasing participant on the off-date of a mortgage-backed securities repo transaction must deliver mortgage-backed securities to the clearing bank against payment no later than one minute prior to the close of the FedWire system for delivery of securities on the settlement date. The clearing bank will redeliver such securities to the purchasing participant on the on-date or the selling participant on the off-date.

If the delivering participant fails to deliver mortgage-backed securities on the settlement date by one minute prior

to the close of the FedWire system or the receiving participant does not accept all of the mortgage-backed securities on the settlement date by one half-hour after the close of the FedWire system, DCC has the option to buy-in or sell-out the securities with the cost of buy-in or sell-out being charged to the defaulting participant. If DCC effects a buy-in or sell-out, DCC will give the defaulting participant written notice of the buy-in or sell-out which will describe the security, quantity, and price.

## 4. Netting

As a general rule, repo transactions in mortgage-backed securities will be cleared on a delivery versus payment basis. Therefore, the delivery of mortgage-backed securities will be required on settlement date. However, if a participant has a repo and reverse repo agreement with the same underlying collateral and the same on-date or off-date, as applicable, the participant's payment and delivery obligations with respect to such agreements will be netted. Payment obligations for such transactions including repo interest will also be netted.

Section 2207 of DCC's Procedures requires the purchasing participant to forward coupon interest with respect to U.S. Treasury securities or mortgage-backed securities to DCC absent an agreement of the parties to the contrary, and upon receipt, DCC will forward the coupon interest to the selling participant. In the event that repo interest on a repo transaction is due from the selling participant on the same day that coupon interest with respect to the same transaction is required to be paid by the purchasing participant, such payments will be netted. If repo interest has accrued but is not yet due with respect to a transaction, payments of coupon interest which are received by the purchasing participant will not be netted against repo interest; instead, the coupon interest will be forwarded to DCC and then to the selling participant.

Unlike U.S. Treasury securities, mortgage-backed securities involve principal payments as well as payments of coupon interest. DCC's Procedures provide that principal payments, like coupon payments, will be forwarded by the purchasing participant upon receipt to DCC and then forward by DCC to the selling participant. In the event that a principal payment on a mortgage-backed security is received by the purchasing participant on the same date on which a payment of repo interest is due from the selling participant with respect to a repo transaction on such mortgage-backed security, the principal

<sup>8</sup>The trade reports for each mortgage-backed securities repo transaction must set forth the identity of the parties to the transaction, including which party is the selling participant and which party is the purchasing participant; the CUSIP number or numbers for the mortgage-backed securities being delivered in connection with the repo transaction; the par amount of the securities being delivered; the delivery money being delivered by the purchasing participant; the trade date and time; the on-date and off-date for the transaction; and any details relating to any rights of substitution, including the number of rights of substitution to be permitted and any restrictions on rights of substitution.

<sup>9</sup>A participant's exposure limit is the limit prescribed for each participant by DCC based on the incremental margin due to DCC by the participant.

payment and the repo interest payments will be netted.

#### C. Margin

DCC has adapted its existing margining methodology for U.S. Treasury security repos to incorporate exposures from mortgage-backed securities repo transactions. Under DCC's current margin system,<sup>10</sup> every participant is obligated to maintain a margin account for the benefit of DCC at DCC's clearing bank. Margin will be calculated every business day using a generally available source of mortgage-backed security prices. With respect to term repos, margin will be based on a mark-to-market amount and an amount based on an estimated shortfall from the liquidation of positions on the next day. For overnight repos, margin will be based on an intraday mark-to-market amount.

#### D. Exposure Limits and MPSE for Mortgage-Backed Securities

The definition of maximum potential system exposure ("MPSE") is revised to provide that with respect to positions in repo transactions, the MPSE for the DCC's clearance and settlement system shall include net exposure in mortgage-backed securities adjusted to reflect a hypothetical adverse movement in the aggregate of six standard deviations in market prices of mortgage-backed securities.<sup>11</sup> The standard deviation is based upon the volatility represented by the greatest of the following three amounts: (i) The standard deviation of equivalent U.S. Treasury securities for the period of 100 consecutive trading days ending on February 19, 1980, (ii) the standard deviation of equivalent U.S. Treasury securities for any subsequent period of 100 consecutive trading days, and (iii) the standard deviation of mortgage-backed securities during any period of 100 consecutive trading days subsequent to January 1, 1990.<sup>12</sup>

For purposes of clauses (i) and (ii) above, DCC will look to U.S. Treasury securities which are generally accepted equivalents to the applicable mortgage-

backed securities. For example, DCC will treat repo transaction in mortgage-backed securities where the underlying collateral are FNMA and FHLMC securities with original stated maturities of thirty years as equivalent to ten year U.S. Treasury securities. When the underlying collateral are FNMA and FHLMC securities with original stated maturities of fifteen years, DCC will treat these repo transactions as equivalent to five year U.S. Treasury securities. Finally, DCC will treat repo transaction in ARMS as equivalent to one year U.S. Treasury securities.<sup>13</sup>

#### E. Substitution of Mortgage-Backed Securities as Underlying Collateral

The proposed rule change establishes rights of substitution for both repos on U.S. Treasury securities and for mortgage-backed securities. The right of a selling participant to substitute underlying collateral is subject to various conditions and restrictions. For repo transactions in U.S. Treasury securities, the following requirements apply: (i) A Treasury note or a Treasury bond may be substituted for another Treasury note or Treasury bond; (ii) a Treasury bill may be substituted for a Treasury bill; and (iii) a Treasury note or Treasury bond may not be substituted for a Treasury bill, and a Treasury bill may not be substituted for a Treasury note or Treasury bond. For mortgage-backed securities repo transactions, the following requirements apply: a fixed rate mortgage-backed security may be substituted for a fixed or floating rate mortgage-backed security, but a floating rate mortgage-backed security may only be substituted for a floating rate mortgage-backed security.

In addition to the foregoing requirements, substitution is subject to any restrictions on substitution which have been agreed to by the parties at the time of the trade, including restrictions on the number of rights of substitution. The right of substitution is also subject to the agreement of DCC and the purchasing participant that the fair market value of the collateral which the selling participant proposes to provide in place of the existing underlying collateral for a transaction is at least equal to the fair market value of the existing underlying collateral for such transaction. In order to obtain the consent of the purchasing participant, DCC will notify the purchasing participant of all details of the proposed substitution prior to 12:15 p.m. New

York time on the day of the proposed substitution.

#### II. Discussion

Section 17A(b)(3)(F) of the Act and the rules and regulations thereunder require that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions. The Commission believes that DCC's proposed clearance system will assist in the development of the national clearance and settlement system by providing a clearance mechanism for transactions that are currently settled outside the facilities of a registered clearing agency. These trades may benefit from DCC's margining and other risk reduction procedures which should decrease the likelihood of failure to settle. Furthermore, the number of securities movements may be reduced because of DCC's netting of transactions. This should result in increased efficiency and promote the prompt and accurate clearance and settlement of mortgage-backed repo transactions. The Commission therefore believes that the proposed rule change is consistent with the Act.

Because of the novelty and complexity of clearing repos on U.S. Treasury securities, the Commission initially limited the average principal amount of outstanding repos on U.S. Treasury securities in DCC's system over a ten day moving period to \$45 billion.<sup>14</sup> With this limitation, the Commission found that DCC has the capacity to facilitate the prompt and accurate clearance and settlement of repo transactions in U.S. Treasury securities in a safe and sound manner. Since the Commission's approval, DCC has implemented several enhancements to its clearance and settlement procedures.<sup>15</sup> Nevertheless, the Commission believes that due to the novelty and complexity of mortgage-backed repo transactions that, initially, the average principal amount of outstanding repos and reverse repos in mortgage-backed securities in DCC's system over a ten day moving period may reach but not exceed \$45 billion. If, as the volume of DCC's clearance and settlement of mortgage-backed repo transactions nears \$45 billion, DCC desires to exceed the \$45 billion limitation, it must file a proposed a rule

<sup>10</sup> Section 2201 of DCC's Procedures.

<sup>11</sup> The MPSE is designed to limit the amount of liability that DCC is exposed to from the positions of all of its participants. Pursuant to DCC's rules, MPSE cannot exceed one third of the amount of DCC's credit enhancement facility. For a complete discussion of MPSE, refer to Securities Exchange Act Release No. 38646 (May 15, 1997), 62 FR 28085 (order granting approval of proposed rule change relating to definitions of trading limits and MPSE).

<sup>12</sup> For U.S. Treasury securities, the standard deviation is based upon the volatility during the 100 day period ending February 19, 1980, or any subsequent period of 100 days in which volatility was higher than the 100 day period ending February 19, 1980.

<sup>13</sup> Letter from Stephen K. Lynner, President, DCC (July 16, 1997).

<sup>14</sup> See supra note 4.

<sup>15</sup> See Letter from Stephen K. Lynner, President, DCC (September 15, 1997).

change pursuant to Section 19(b)(2) of the Act. The proposed rule change may request either an increase in the volume limitation or removal of all volume limitations.

### III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder.

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-DCC-97-06) be and hereby is approved.

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

**Margaret H. McFarland,**  
*Deputy Secretary.*

### **Exhibit A—Schedule A to Delta Clearing Corp; Procedures for the Clearing of Securities and Financial Instrument Transactions**

#### **Excluded Classes of Mortgage Securities**

**Notional**—A class having no principal balance and bearing interest on the related notional principal balance.

**Interest Only**—A class that receives some or all of the interest payments made on the underlying mortgage or other assets of a series trust and little or no principal. Interest only classes have either a nominal or a notional principal balance.

**Principal Only**—A class that does not bear interest and is entitled to receive only payments of principal.

**Accrual**—A class that accretes the amount of accrued interest otherwise distributable on such class, which amount will be added as principal to the principal balance of such class on each applicable distribution date. Such accretion may continue until some specified event has occurred or until such accrual class is retired.

**Partial Accrual**—A class that accretes a portion of the amount of accrued interest thereon, which amount will be added to the principal balance of such class on each applicable distribution date, with the remainder of such accrued interest to be distributed currently as interest on such class. Such accretion may continue until a specified event has occurred or until such partial accrual class is retired.

**Floater**—A class other than an adjustable rate mortgage security with an interest rate that resets periodically

based upon a designated index and that varies directly with changes in such index.

**Inverse Floater**—A class other than an adjustable rate mortgage security with an interest rate that resets periodically based upon a designated index and that varies inversely with changes in such index.

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### **SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-3932; File No. SR-DTC-97-18]

#### **Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Regarding the Participant Exchange Service**

October 10, 1997.

Pursuant to Section 19(b)(1) <sup>1</sup> of the Securities Exchange Act of 1934 ("Act"), notice is hereby given that on August 15, 1997, The Depository Trust Company ("DTC") 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 primarily by DTC. The Commission is publishing this notice to solicit comments from interested persons on the proposed rule change.

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

The proposed rule change will expand DTC's participant exchange service system ("PEX") to add an additional notice, letters of free funds ("LOFFs"), to the menu of notices currently available.

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

In its filing with the Commission, DTC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DTC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>2</sup>

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

<sup>2</sup> The Commission has modified the text of the summaries prepared by DTC.

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

PEX is an on-line system that enables DTC participants to use DTC's automated network to send and to respond to various notices required by other self-regulatory organizations.<sup>3</sup> The purpose of the proposed rule change is to automate the exchange of LOFFs by adding LOFFs to the menu of notices that can be transmitted through PEX.<sup>4</sup>

LOFFs are notices exchanged between the receiving and delivering brokers of two party customer trades. Currently, LOFFs are sent in hardcopy (*i.e.*, on paper), usually through the mail or by facsimile. The delivering broker sends a LOFF to the receiving broker requesting the receiving broker to verify that the customer has sufficient funds to settle the trade pursuant to Regulation T under the Act.<sup>5</sup> The receiving broker confirms the existence of the funds and returns the LOFF to the delivering broker.

Under the proposed rule change, a delivering broker will be able to send LOFF notices by entering the notice information into DTC's participant terminal system ("PTS").<sup>6</sup> LOFF notices that do not contain any errors will be stored in a DTC database in open status pending a response from the receiving broker. Each LOFF sent using PEX will be assigned a unique control number. Open notices will be available for browsing and reply through PTS.

Receiving brokers will be able to use PEX to respond to each LOFF notice by its control number.<sup>7</sup> Upon receiving a response, DTC will match its control number to that of an open LOFF notice and mark that notice as either (i) having sufficient funds, (ii) not having sufficient funds, (iii) being rejected, or (iv) having a prime broker relationship with the delivery broker.

All open LOFF notices will be kept on a DTC database for ninety days from the

<sup>3</sup> For a complete description of PEX, refer to Securities Exchange Act Release No. 28123 (June 13, 1990), 55 FR 25188 [File No. SR-DTC-89-21] (order approving proposed rule change establishing PEX).

<sup>4</sup> DTC attached a detailed description of the method by which LOFFs will be added to PEX as Exhibit B to its filing, which is available for review and copying at the Commission's Public Reference Room and through DTC.

<sup>5</sup> 12 CFR 220.

<sup>6</sup> DTC has informed the Commission that participants initially will be able to exchange LOFFs through PEX only by way of PTS. At some later point, participants will be able to exchange LOFFs by way of mainframe dual host or computer-to-computer facility.

<sup>7</sup> Although LOFF notices will not generate tickets, receiving brokers will be able to view LOFF notices through PTS.

<sup>16</sup> 17 CFR 200.30-3(a)(12).