

the principal office of CBOE. All submissions should refer to File No. CBOE-97-19 and should be submitted by June 9, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-38622; File No. SR-NSCC-97-04]

### Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing and Order Extending Temporary Approval on an Accelerated Basis of a Proposed Rule Change that Establishes Additional Procedures for Class A Surveillance of Certain Settling Members and Permits the Collection of Clearing Fund and Other Collateral Deposits From These Settling Members

May 13, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on March 27, 1997, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change (File No. SR-NSCC-97-04) as described in Items I and II below, which items have been prepared primarily by NSCC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to extend on an accelerated basis temporary approval of the proposed rule change through May 31, 1998.

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

The proposed rule change seeks to extend the temporary approval of additional procedures which govern the placement of NSCC members on Class A surveillance and the clearing fund deposit and other collateral requirements for such members.<sup>2</sup>

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

In its filing with the Commission, NSCC 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. NSCC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.<sup>3</sup>

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

NSCC seeks to extend the temporary approval of a rule change governing the application of Class A surveillance procedures<sup>4</sup> and the additional collateralization requirements to settling members that engage in certain over-the-counter ("OTC") market making activities.<sup>5</sup> To decrease the risks associated with OTC market makers, NSCC has added Addendum O to its rules and procedures. Addendum O permits NSCC to place settling members on Class A surveillance if they clear for or are themselves OTC market makers and (1) they do not have sufficient capital or access to capital to support either potential increases in market making activity in dominated issues or (2) any additional risk factors are present.<sup>6</sup>

<sup>3</sup> The Commission has modified the text of the summaries submitted by NSCC.

<sup>4</sup> Class A surveillance permits NSCC, among other things, to increase a settling member's clearing fund requirement by an amount equal to (i) up to 5% of the settling member's CNS long fail positions plus (ii) up to 5% of the settling member's short fail positions plus (iii) 2.5% or at NSCC's discretion up to 5% of the settling member's average non-CNS and non-mutual fund service credits. NSCC Rules and Procedures, Addendum B, IV (C).

<sup>5</sup> NSCC's Board of Directors has determined that under certain circumstances settling members which clear securities transactions for OTC market makers or which themselves engage in OTC market making, can have their financial viability materially impacted by such business (e.g., if a market maker takes net positions that are a disproportionately large percentage of one side of the market (i.e., dominates the issue)). Furthermore, if these market makers have insufficient capital or insufficient access to capital and engage in market domination with regard to a particular issue either directly by participating in OTC market making or indirectly by clearing transactions for OTC market makers, NSCC believes that the risk of default by the settling member increases. In turn, this could potentially increase NSCC's exposure because NSCC is obligated to complete defaulting settling members' unsettled trades once NSCC's trade guarantee attaches.

<sup>6</sup> These risk factors include, without limitation:

(1) concentrated short selling in dominated issues;

To further reduce its potential exposure to OTC market making activities, NSCC also has adopted an interim collateralization policy which permits NSCC in its discretion to require settling members placed on Class A surveillance that clear for or are themselves OTC market makers to deposit special collateral in amounts based upon the settling member's OTC activities relative to its amount of excess net capital.<sup>7</sup> The special collateralization requirements are interim measures for settling members on Class A surveillance to be in effect until NSCC has gained enough experience in surveillance of OTC market maker trading activities to impose permanent special collateralization requirements.

Because NSCC believes that its settling members on Class A surveillance present a higher than normal risk of default and insolvency, NSCC now bases such settling members' clearing fund deposits on the close-out risk presented by their unsettled positions in NSCC's systems. Under the temporary rule change, NSCC has the discretion to compute the Continuous Net Settlement ("CNS") component of the clearing fund requirements for any settling member on Class A surveillance according to an alternative formula based upon such close-out risk.<sup>8</sup>

The Commission approved the proposed rule change on a temporary basis so that NSCC could gain additional experience in the surveillance of OTC market makers and the risks posed by clearing such activity. The Commission also noted in its May approval order that NSCC would be able to gain experience with the additional collateralization requirements and alternative clearing fund formula for settling members subject to Class A surveillance. NSCC believes that additional experience with respect to these matters is desirable before seeking permanent approval of these requirements.

NSCC believes that the proposed rule change is consistent with the

(2) undue concentration of securities held in inventory by market maker(s) for dominated issues;

(3) dominated issues also being IPOs less than six months past initial issuance particularly when the current value of the issue is significantly different from its initial sales price or there is undue concentration of inventory in the managing underwriter(s); and

(4) clearing positions of market makers in dominated issues away from their primary clearing brokers.

<sup>7</sup> For a complete description of the special collateralization requirements, refer to the May approval order, *supra* note 2.

<sup>8</sup> For a complete description of the alternative CNS clearing fund formula, refer to the May approval order, *supra* note 2.

<sup>5</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. 37202 (May 10, 1996), 61 FR 24993 [File No. SR-NSCC-95-17] (temporary approval of proposed rule change) ("May approval order").

requirements of Section 17A(b)(3)(F)<sup>9</sup> of the Act and the rules and regulations thereunder since it will facilitate the prompt and accurate clearance and settlement of securities transactions and, in general, will protect investors and the public interest.

*(B) Self-Regulatory Organization's Statement on Burden on Competition*

NSCC does not believe that the proposed rule change will have an impact on or impose a burden on competition.

*(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

No written comments relating to the proposed rule change have been solicited or received. NSCC will notify the Commission of any written comments received by NSCC.

**III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Section 17A(b)(3)(F)<sup>10</sup> of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency and generally to protect investors and the public interest. The Commission believes the proposed rule change is consistent with NSCC's obligations under the Act because it will allow NSCC to take particular action to protect itself, its members, and investors in situations where settling members pose an increased risk because of their involvement in OTC market making.

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

At NSCC's request, the Commission is extending temporary approval of the proposed rule change through May 31, 1998, so that NSCC can gain additional experience in the surveillance of OTC market makers and the risks posed by clearing such activity prior to permanent imposition of the new Class A surveillance procedures, collateralization requirements, and alternative clearing fund formula. Temporary approval also will allow both the Commission and NSCC to continue to observe whether the additional collateralization and alternative clearing fund requirements adequately protect NSCC, its members, and investors from the expected risks of participating in and clearing OTC market maker activity and whether adjustments to the procedures are necessary.<sup>11</sup>

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing because accelerated approval will allow NSCC to continue to utilize its Class A surveillance procedures, the interim collateralization policy, and the alternative clearing fund formula without interruption and therefore to continue to protect itself, its participants, and investors in general from the potential risks of OTC market making activities.

**IV. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the

<sup>11</sup> As noted in the May approval order, prior to filing a proposed rule change seeking permanent approval of the procedures set forth in this temporary approval order, NSCC shall present to the Commission a more detailed report on its findings regarding the adequacy of the controls and discussing any changes to be made to the procedures. During the temporary approval period, NSCC will continue to apprise the Commission from time to time on the operation of the Class A surveillance procedures, additional collateralization requirements, and alternative clearing fund formula to enable the Commission to monitor the implementation of such requirements.

provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of NSCC. All submissions should refer to the file number SR-NSCC-97-04 and should be submitted by June 9, 1997.

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

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

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

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**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-38624; File No. SR-NSCC-96-20]

**Self-Regulatory Organizations; National Securities Clearing Corporation; Order Granting Approval of a Proposed Rule Change to Revise Rules Relating to Clearing Agency Cross-Guaranty Agreements**

May 13, 1997.

On November 14, 1996, the National Securities Clearing Corporation ("NSCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change (File No. SR-NSCC-96-20) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on March 6, 1997.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

**I. Description**

The purpose of the proposed rule change is to modify the definition of "Clearing Agency Cross-Guaranty Agreement." In 1993, the Commission approved a proposed rule change filed by NSCC to establish a Netting Contract and Limited Cross-Guaranty Agreement between it and the Depository Trust

<sup>12</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. 38350 (February 27, 1997), 62 FR 10601.

<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>10</sup> *Id.*