

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40810; International Series  
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10]

### Self-Regulatory Organizations; Emerging Markets Clearing Corporation; Notice of a Proposed Rule Change Relating to Netting Services

December 18, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on November 2, 1998, Emerging Markets Clearing Corporation ("EMCC") 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 EMCC. 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

Under the proposed rule change, EMCC will offer netting services to its 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, EMCC 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. EMCC 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

Currently, EMCC processes its members' transactions on a trade for basis. Under the proposed rule change, EMCC will offer its members the ability to have their transactions processed on a netted basis through EMCC's netting services.

Under the proposal, transactions that are between two netting members<sup>4</sup> and that have been reported on EMCC's "accepted trade report" made available to members no later than two days prior to settlement date ("SD-2") will be eligible for settlement netting. The accepted trade report will indicate those trades that are to be processed on a netted basis.

Both trade for trade transactions and netted transactions will be novated and guaranteed at the same time. As with trade for trade transactions, receive and deliver obligations with respect to netting trades would be established at the time the "accepted trade report" is made available to members. On the scheduled settlement date, these receive and deliver obligations will be extinguished and replaced with new receive obligations or deliver obligations relating to the net position. In order to meet the delivery parameters of the applicable qualified securities depository ("QSD"), EMCC may establish one or more receive and deliver obligations with respect to any one net position.

The value at which receive and deliver obligations will be settled at a QSD will be fixed by EMCC based on an average of the prices of all transactions in the ISIN<sup>5</sup> underlying such receive and deliver obligations. In order to compensate netting members for the difference between the value at which the netted receive and deliver obligations will be settled and the actual consideration for the transactions underlying the receive and deliver obligations, EMCC will debit or credit members with the difference between the value at which such obligations settle and the actual consideration. These credits and debits will be referred to as the "transaction adjustment payment."

The following paragraphs describe the particular changes that EMCC will make to its rules to accommodate netting services.

##### Rule 1—Definitions

EMCC will add definitions of "netting member," "netting services," and "netting trade" to Rule 1. The definition of "netting trade" will set forth the requirements that must be met in order for a trade to be eligible as a netting trade. The requirements are that the

trade must (a) be a compared trade between two netting members and (b) have been reported on an accepted trade report made available to members no later than SD-2. The definition also will state that EMCC may treat any trade or trades, whether by netting member or by ISIN, as ineligible to be a netting trade(s). EMCC will also modify the definition of "final net settlement obligation" to include any unpaid transaction adjustment payment.

EMCC will make technical corrections to the definitions of "fail long position," "fail short position," and "net settlement obligation," all of which incorrectly refer to the "settlement day" rather than the "scheduled settlement date." In addition, EMCC will modify the definition of "contract value" to clarify that this value is calculated by EMCC.

##### Rule 4—Clearing Fund, Margin, and Loss Allocation

EMCC's risk system currently calculates members' margin requirements on a netted basis. Therefore, EMCC will not amend Rule 4 other than with respect to the expiration date of the paragraph in Rule 4 Section 10 that permits EMCC to use clearing fund deposits for intraday financing. The proposed change will postpone the automatic expiration of this ability to the earlier of (i) the first anniversary of the date on which EMCC commenced operation as a registered clearing agency<sup>6</sup> or (ii) the date on which all members are netting members (as opposed to the date on which netting services are available).

In addition, EMCC proposes to make a correction with respect to the use of the term "value of position" in Section 5 of Rule 4. Although the term "value of position" is currently employed with respect to the calculations of both the mark to market amount and volatility amount, its meaning is not the same for both calculations. The current definition applies only to the mark to market calculation. To clarify this, EMCC will move that definition from the text of Section 5 to a footnote to the mark to market formula. In addition, EMCC will insert a different definition of "value of position" as a footnote to the volatility amount formula.

##### Rule 6—Receipt of Data

With the introduction of netting services, the "accepted trade report" will indicate whether a transaction is a

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

<sup>2</sup> The complete text of the proposed amendments to EMCC's Rules is attached as an exhibit to EMCC's filing, which is available for inspection and copying at the Commission's public reference room and through EMCC.

<sup>3</sup> The Commission has modified the text of the summaries prepared by EMCC.

<sup>4</sup> The term "netting member" will be defined in EMCC Rule 1 as a member that is a participant in the netting services.

<sup>5</sup> EMCC's Rules define ISIN to mean the International Securities Identification Number as defined by International Number as defined by International Organization for Standardization 6166.

<sup>6</sup> The Commission granted EMCC temporary registration as a clearing agency on February 13, 1998. Securities Exchange Act Release No. 39661, International Series Release No. 1117 (February 13, 1998), 63 FR 8711.

netting trade or whether it will be settled on a trade for trade basis. EMCC will modify Rule 6 to reflect this. EMCC members will receive a "netting detail report" from EMCC with respect to netting trades scheduled to settle on the following business day. The "netting detail report" will indicate with respect to each ISIN in which a netting member has a netting trade a net settlement position for a given settlement date. The net settlement position will equal the net amount of EMCC eligible instruments in a particular ISIN that a netting member has purchased from or sold to all other netting members. In addition, EMCC will add language to Rule 6 to clearly indicate that cutoff times for submission of data to EMCC may be different for netting trades and trades to be settled on a trade for trade basis.

#### Rule 7—Novation and Guaranty of Obligations and Receive, Deliver and Settlement Obligations and Rule 8—Settlement Instructions Only Report

EMCC will amend Section 1 of Rule 7 so that it pertains to the guaranty and novation of all trades submitted to EMCC. No change is proposed with respect to the timing of the guaranty and novation.

EMCC will amend Section 2(a) of Rule 7 so that it pertains to the creation of a member's receive and deliver obligations. EMCC proposes no change with respect to the point in time at which receive and deliver obligations are created by EMCC. However, with respect only to netting trades on the scheduled settlement date, the receive and deliver obligations that are established in accordance with Section 2(a) will be extinguished and replaced with one or more new receive and deliver obligations with respect to each net position. In addition, subsection (c) of Section 2 will state that deliver and receive obligations are to be settled at the settlement value set forth on the "accepted trade report" for trades to be settled on a trade for trade basis and as set forth on the "netting detail report" with respect to netting trades.

EMCC will amend Section 3 of Rule 7 so that it pertains to the transaction adjustment payment. Because EMCC will calculate a settlement value for netted trades, EMCC will be required to credit or debit netting members with an amount equal to the difference between the net consideration of the transactions underlying each net settlement position and the net settlement value of such netting member's receive and deliver obligations for each net settlement position. This payment will be referred

to as the transaction adjustment payment.

In addition, EMCC will make the following technical changes so that (i) all rules pertaining to receive, deliver, and settlement obligations appear under one rule and (ii) Rule 8 pertains solely to EMCC's settlement instructions only report:

"Fail settlement positions"—moved from Section 2 of Rule 8 to Section 12 of Rule 7.

"Partial deliveries"—moved from Section 3 of Rule 8 to Section 13 of Rule 7.

"Financing costs/obligation to receive securities"—moved from Section 4 of Rule 8 to Section 14 of Rule 7. A paragraph will be added to this section which will enable EMCC to charge interest to and/or fine a member for failure to make a transaction adjustment payment.

"Obligation to facilitate financing"—moved from Section 5 of Rule 8 to Section 15 of Rule 7.

"Relationship with qualified securities depository"—moved from Section 6 of Rule 8 to Rule 25.

#### Rule 25—Qualified Securities Depositories

In addition to moving Section 6 of Rule 8 to Section 2 of Rule 25, EMCC will add a section to Rule 25 prohibiting a member from canceling or otherwise modifying instructions previously transmitted by EMCC to a QSD.

#### Addendum C—Statements of Policy with Respect to Additional Clearing Fund Deposits

Addendum C will be corrected to refer to contract values rather than settlement values.

#### Addendum F—Fee Schedule

In order to be consistent with the timetables contained elsewhere in its Rules which key off of settlement day ("SD") and because members may submit trades that were done on a forward basis so long as such trades are submitted to EMCC no earlier than SD-3, EMCC proposes to change the references to Trade Date (T) in its fee schedule to SD.

EMCC believes that the ability to offer the netting services would facilitate the prompt and accurate clearance and settlement of emerging market securities transactions and is therefore consistent with the requirements of Section 17A of the Act<sup>7</sup> and the rules and regulations thereunder.

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

EMCC 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. EMCC will notify the Commission of any written comments received by EMCC.

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

Within thirty-five days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which EMCC consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. 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 provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing also will be available for inspection and copying at the principal office of EMCC. All submissions should refer to File No. SR-EMCC-98-10 and should be submitted by January 20, 1999.

<sup>7</sup> 15 U.S.C. 78q-1.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>8</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40814; File No. SR-NASD-98-78]

### Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Equity Option Hedge Exemption

December 21, 1998.

#### I. Introduction

On October 15, 1998, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary NASD Regulation ("NASD Regulation"), filed with the Securities and Exchange Commission ("Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act"),<sup>1</sup> and Rule 19b-4 thereunder.<sup>2</sup> In its proposal, NASD Regulation seeks to make permanent the Equity Option Hedge Exemption, which has been operating as a pilot program since 1990. Notice of the proposal was published in the **Federal Register** on November 16, 1998 ("Notice").<sup>3</sup> No comments were received. This order approves the proposal.

#### II. Description of the Proposal

The purpose of the proposed rule change is to make permanent the NASD's Equity Option Hedge Exemption program ("Hedge Exemption"), which has been operating on a pilot basis since 1990. NASD Rule 2860(b)(3) provides that the position limits for equity options are determined according to a five-tiered system in which more actively traded stocks with larger public floats are subject to higher position limits. Under the NASD rules, the current basic position limits are as follows. For standardized equity options,<sup>4</sup> the current basic position

limits are: 4,500, 7,500, 10,500, 20,000 and 25,000 contracts. For conventional equity options,<sup>5</sup> the current basic position limits are three times the standardized equity options position limits, *i.e.*, 13,500, 22,500, 31,500, 60,000 and 75,000 contracts. NASD rules do not specifically govern how a particular equity option falls within one of the five position limit tiers. Rather, the NASD's position limit rule provides that the position limit established by an options exchange for a particular equity option is the applicable position limit for purposes of the NASD's rule.<sup>6</sup>

The Hedge Exemption provides for an automatic, limited exemption from position limits<sup>7</sup> and exercise limits<sup>8</sup> for equity options that are hedged using one of the four most commonly used hedge positions: (1) Long stock and short call; (2) long stock and long put; (3) short stock and long call; and (4) short stock and short put. The NASD rules also specify how an options contract must be hedged. To be properly hedged, the options contract must be: (i) hedged by 100 shares of stock, (ii) hedged by securities that are readily convertible into, or economically equivalent to, such stock,<sup>9</sup> or (iii) in the case of an

respect to strike prices, expiration dates and the amount of the underlying security.

<sup>5</sup> A conventional option is any option contract not issued, or subject to issuance by, the OCC.

<sup>6</sup> For equity options that do not trade on an options exchange, the NASD's position limit rule provides that the limit for conventional equity options shall be three times the basic limit of 4,500 contracts, such as 13,500 contracts, unless the member can demonstrate to the Association that the underlying security meets the standards for higher limits and the initial listing standards for standardized options trading.

<sup>7</sup> Position limits impose a ceiling on the number of options contracts of each options class on the same side of the market that can be held or written by an investor or group of investors acting in concert.

<sup>8</sup> Exercise limits restrict the number of options contracts that an investor or group of investors acting in concert can exercise within five consecutive business days. Under NASD Rules, exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set forth as the applicable position limits for those options classes.

<sup>9</sup> The Commission notes that the NASD determines on a case-by-case basis whether an instrument that is being used as the basis for an underlying hedged position is readily and immediately convertible into the security underlying the corresponding option position. In this regard, the NASD generally finds that an instrument which will become convertible into a security at a future date, but which is not presently convertible, is not a "convertible" security for purpose of the equity option position limit hedge exemption until the date it becomes convertible. In addition, if the convertible security used to hedge an options position is called for redemption by the issuer, the security would have to be converted into the underlying security immediately or the corresponding options position reduced accordingly.

adjusted options contract, hedged by the number of shares represented by the adjusted contract. Under the Hedge Exemption, the maximum standardized equity option position (combining hedged and unhedged positions) is three times the basic position limit level for standardized options, *i.e.*, 13,500, 22,500, 31,500, 60,000 or 75,000 contracts. Additionally, the maximum conventional equity option position (combining hedged and unhedged positions) is three times the basic position level for conventional equity options, *i.e.*, 40,500, 67,500, 94,500, 180,000 or 225,000 contracts.

#### III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association, and, in particular, the requirements of Section 15A.<sup>10</sup> Specifically, the Commission believes that the NASD's equity options position limit hedge exemption will accommodate the needs of investors and market participants while at the same time furthering investor protection and the public interest.<sup>11</sup>

The Commission believes that the Hedge Exemption is an important component of the options position limit rules and should be continued on a permanent basis. The Hedge Exemption is a necessary tool for market participants to manage their market exposure by allowing them the flexibility to hold larger options positions in cases where such positions are hedged. The Commission further believes that the Hedge Exemption provides depth and liquidity to the market and will allow investors to hedge their stock portfolios more effectively, without significantly increasing concerns regarding intermarket manipulations or disruptions of either the options market or the underlying stock market.

The Commission notes that the Hedge Exemption has been operating on a pilot basis since 1990. NASD Regulation has had eight years of experience administering and monitoring the program. The Commission believes that NASD Regulation has adequate rules in place to surveil the proposed hedge exemption. Specifically, NASD rules require each member to report options positions of any account which has established an aggregate position of 200

<sup>10</sup> 15 U.S.C. 78o-3(b)(6).

<sup>11</sup> In approving the proposal, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>8</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Exchange Act Release No. 40652 (Nov. 9, 1998), 63 FR 63764 (Nov. 16, 1998) (File No. SR-NASD-98-78).

<sup>4</sup> Standardized equity options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that have standard terms with