

for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and (b) Michael E. Bartell, Associate Executive Director, Office of Information Technology, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Comments must be submitted to the Office of Management and Budget within 30 days of this notice.

Dated: May 15, 2001.

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44301; File No. SR-GSCC-00-13]

### Self-Regulatory Organizations; Government Securities Clearing Corporation; Order Approving a Proposed Rule Change Relating to Establishment of a Cross-Margining Agreement With the Chicago Mercantile Exchange and a Clarification of the Government Securities Clearing Corporation's Cross-Margining Rules

May 11, 2001.

On October 13, 2000, the Government Securities Clearing Corporation ("GSCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-GSCC-00-13) 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 January 23, 2001.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

#### I. Description

On August 19, 1999, the Commission approved GSCC's proposed rule change to establish a cross-margining program with other clearing organizations and to begin its program with the New York Clearing Corporation ("NYCC").<sup>3</sup> GSCC is now establishing a cross-margining arrangement with the Chicago Mercantile Exchange ("CME") similar to

the one GSCC already has in place with NYCC. With the GSCC-CME cross-margining arrangement, GSCC will implement its "hub-and-spoke" method of cross-margining, which was introduced in the rule filing establishing the GSCC-NYCC cross-margining arrangement and which applies when more than one clearing organization is involved in cross-margining with GSCC.

#### (i) GSCC's Cross-Margining Program

GSCC believes that the most efficient and appropriate approach for establishing cross-margining links for fixed-income and other interest rate products is to do so on a multilateral basis with GSCC as the "hub." Each clearing organization that participates in a cross-margining arrangement with GSCC (hereinafter a "Participating CO") will enter into a separate cross-margining agreement between itself and GSCC, as NYCC did and now CME will do. Each of the agreements will have similar terms,<sup>4</sup> and no preference will be given by GSCC to one Participating CO over another.

Cross-margining is available to any GSCC netting member (with the exception of inter-dealer broker netting members) that is, or that has an affiliate that is, a member of a Participating CO. Any such member (or pair of affiliated members) may elect to have its margin requirements at both clearing organizations calculated based upon the net risk of its cash and repo positions at GSCC and its offsetting and correlated positions in related contracts carried at the Participating CO. Cross-margining is intended to lower the cross-margining participant's (or pair of affiliated members') overall margin requirement.

The GSCC member (and its affiliate, if applicable) signs an agreement under which it (or they) agrees to be bound by the cross-margining agreement between GSCC and the Participating CO and which allows GSCC or the Participating CO to apply the member's (or its affiliate's) margin collateral to satisfy any obligation of GSCC to the Participating CO (or vice versa) that results from a default of the member (or its affiliate).

Margining based on the net combined risk of correlated positions is based on an arrangement under which GSCC and each Participating CO agree to accept the correlated positions in lieu of supporting collateral. Under this arrangement, each clearing organizations holds and manages its

own positions and collateral and independently determines the amount of margin that it will make available for cross-margining (referred to as the "residual margin amount").

GSCC computes the amount by which the cross-margining participant's margin requirement can be reduced at each clearing organization (*i.e.*, the "cross-margin reduction") by comparing the participant's positions and the related margin requirements at GSCC against those at each Participating CO.<sup>5</sup> GSCC offsets each cross-margining participant's residual margin amount (based on related position) at GSCC against the offsetting residual margin amounts of the participant (or its affiliate) at each Participating CO. If the residual margin that GSCC has available for a participant is greater than the combined residual margin submitted by the Participating COs, GSCC will allocate a portion of its residual margin equal to the combined residual margin at the Participating COs. If the combined residual margin submitted by the Participating COs is greater than the residual margin that GSCC has available for that participant, GSCC will first allocate its residual margin to the Participating CO with the most highly correlated position.<sup>6</sup> If the positions are equally correlated, GSCC will allocate pro rata based upon the residual margin amount available at each Participating CO. GSCC and each Participating CO may then reduce the amount of collateral they collect to reflect the offsets between the cross-margining participant's positions at GSCC and its (or its affiliate's) position at the Participating CO.<sup>7</sup> In the event of the default and liquidation of a cross-margining participant, the loss sharing between GSCC and each of the Participating COs will be based upon the foregoing allocations and the cross-margin reduction.

GSCC will guarantee the cross-margining participant's (or its affiliate's) performance to each Participating CO

<sup>5</sup> NYCC uses GSCC's margin rates to determine margin reduction. CME, which utilizes its own rates, and GSCC will compare margin reduction rates and will use the lower of the two in determining margin reduction.

<sup>6</sup> GSCC has computed and tested disallowance factors that will be applicable to each potential pair of positions being offset. "Disallowance factor" means the specified percentage in the cross-margining agreement between GSCC and CME that is applied to reduce the residual margin amount used to calculate the margin offset.

<sup>7</sup> GSCC and each Participating CO unilaterally have the right to not reduce its participant's margin requirement by the cross-margin reduction or to reduce it by less than the cross-margin reduction. However, the clearing organizations may not reduce a participant's margin requirement by more than the cross-margin reduction.

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

<sup>2</sup> Securities Exchange Act Release No. 43849 (January 17, 2001), 66 FR 7522.

<sup>3</sup> Securities Exchange Act Release No. 41766 (August 19, 1999), 64 FR 46737 (August 26, 1999) [File No. SR-GSCC-98-4]. The rule changes necessary for GSCC to engage in cross-margining were made in the NYCC cross-margining rule filing.

<sup>4</sup> It is anticipated that in the interest of conformity NYCC and GSCC will execute a new cross-margining agreement that is substantially the same as the draft agreement with the CME.

up to a specified maximum amount which relates back to the cross-margin reduction. There will always be a specified maximum amount that one clearing organization could be required to pay another clearing organization. Each Participating CO will provide the same guaranty up to the same specified maximum amount to GSCC.

GSCC proposed one additional rule change, to Rule 22, Section 4, in this present rule filing in order to further clarify that before GSCC credits an insolvent member for any profit realized on the liquidation of the member's final net settlement positions, GSCC will fulfill its obligations with respect to that member under the cross-margining agreement.

*(ii) Information Specific to the Current Agreement between GSCC and CME*

(a) *Participation in the cross-margining program:* Any netting member of GSCC other than an inter-dealer broker netting member will be eligible to participate. Any clearing member of CME will be eligible to participate.<sup>8</sup>

(b) *Products subject to cross-margining:* The products that will be eligible for the GSCC-CME cross-margining arrangement will be (1) the Treasury bills, notes, and bonds that are cleared by GSCC and (2) Eurodollar futures contracts with ranges in maturity from 3 months to 10 years and options on such futures contracts cleared by CME.<sup>9</sup> GSCC offset classes will be offset against CME offset classes based on correlation studies and the appropriate disallowance factors will be applied. All eligible positions maintained by a cross-margining participant in its account at GSCC and in its (or its affiliate's) proprietary account at CME will be eligible for cross-margining.<sup>10</sup>

(c) *Margin Rates:* GSCC and CME currently use different margin rates to establish margin requirements for their respective products. Residual margin amounts in the GSCC-CME cross-margining arrangement will always be

computed based on the lower of the applicable margin rates. This methodology results in a potentially lesser benefit to the participant but ensures a more conservative result for both GSCC and CME (*i.e.*, more collateral held at the clearing organizations).

(d) *Daily Procedures:* On each business day, it is expected that CME will inform GSCC of the residual margin amounts it is making available for cross-margining by approximately 10 p.m. New York time. GSCC will inform CME by approximately 12 a.m. New York time how much of these residual margin amounts it will use. Reductions as computed will be reflected in GSCC's daily clearing fund calculation.

*(iii) Benefits of Cross-Margining*

GSCC believes that its cross-margining program enhances the safety and soundness of the settlement process for the government securities marketplace by: (1) Providing clearing organizations with more data concerning members' intermarket positions (which is especially valuable during stressed market conditions) to enable the clearing organizations to more accurately make decisions regarding the true risk of such positions to the clearing organization; (2) allowing for enhanced sharing of collateral resources; and (3) encouraging coordinated liquidation processes for a joint participant, or a participant and its affiliate, in the event of an insolvency. GSCC further believes that cross-margining benefits participating clearing members by providing members with the opportunity to more efficiently use their collateral. More important from a regulatory perspective, however, is that cross-margining programs have long been recognized as enhancing the safety and soundness of the clearing system itself. Studies of the October 1987 market break gave support to the concept to the concept of cross-margining. For example, The Report of the President's Task Force on Market Mechanisms (January 1988) noted that the absence of a cross-margining system for futures and securities options markets contributed to payment strains in October 1987. The Interim Report of the President's Working Group on Financial Markets (May 1988) also recommended that the SEC and CFTC facilitate cross-margining programs among clearing organizations. As a result, the first cross-margining arrangement between clearing

organizations was implemented in 1988.<sup>11</sup>

## II. Discussion

Under section 19(b) of the Act, the Commission is directed to approve a proposed rule change of a clearing agency if not finds that the proposed rule change is consistent with the Act and the rules and regulations thereunder.<sup>12</sup> In section 17A(a)(2)(A)(ii) of the Act, Congress directs the Commission to use its authority under the Act to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for further delivery and options thereon, and commodity options.<sup>13</sup> Section 17A(b)(3)(F) 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 for which it is responsible.<sup>14</sup> The Commission believes that the approval of GSCC's proposed rule change is consistent with these sections.

First, the Commission's approval of GSCC's proposed rule change to establish a cross-margining arrangement with the CME and to implement its hub and spoke approach to cross-margining with the CME and NYCC is in line with the Congressional directive to the Commission to facilitate linked and coordinated facilities for the clearance and settlement of securities and futures. Second, approval of GSCC's proposal should result in increased and better information sharing between GSCC and Participating COs regarding the portfolios and financial conditions of participating joint and affiliated members. As a result, GSCC and participating COs will be in a better position to monitor and assess the potential risks of participating joint or affiliated members and will be in a better position to handle the potential losses presented by the insolvent of any joint or affiliated member. Therefore, GSCC's proposal should help GSCC better safeguard the securities and funds in its possession or control or for which it is responsible.

<sup>11</sup> Securities Exchange Act Release No. 26153 (October 3, 1988), 53 FR 39567 (October 7, 1988) [File No. SR-OCC-86-17] (order approving cross-margining program between The Options Clearing Corporations and the Intermarket Clearing Corporation).

<sup>12</sup> 15 U.S.C. 78s(b).

<sup>13</sup> 15 U.S.C. 78q-1(a)(2)(A)(ii).

<sup>14</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>8</sup> The draft GSCC-CME agreement requires ownership of 50 percent or more of the common stock of an entity to indicate control of the entity for purposes of the definition of "affiliate."

<sup>9</sup> Under the GSCC-NYCC cross-margining arrangement are Treasury bills, notes, and bonds cleared by GSCC and Treasury futures cleared by NYCC.

<sup>10</sup> At least initially, the GSCC-CME cross-margining arrangement will be applicable on the futures side only to positions in a proprietary account of a cross-margining participant (or its affiliate) at the CME. The arrangement will not apply to positions in a customer account at CME that would be subject to segregation requirements under the CEA. This is also the case with respect to the GSCC-NYCC cross-margining arrangement.

### 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-GSCC-00-13) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

**Jonathan G. Katz,**  
Secretary.

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### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44307; File No. SR-NASD-2001-37]

#### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Trading Halt Authority

May 15, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 11, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq" or "Association"), 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 Nasdaq. 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

Nasdaq is proposing to amend NASD Rule 4120, Trading Halts, to clarify the extent of Nasdaq's authority to halt trading in a security in response to extraordinary market activity that Nasdaq believes may be caused by the misuse or malfunction of an electronic system that is operated by, or linked to, Nasdaq. The text of the proposed rule

change is below. Proposed new language is in *italics*; proposed deletions are in *brackets*.

\* \* \* \* \*

#### 4120. Trading Halts

(a) No change.

(1)-(5) No change.

(6) *Halt trading in a security listed on Nasdaq when:*

(i) *extraordinary market activity in the security is occurring, such as the execution of a series of transactions for a significant dollar value at prices substantially unrelated to the current market for the security, as measured by the national best bid and offer, and*

(ii) *Nasdaq believes that such extraordinary market activity may be caused by the misuse or malfunction of an electronic quotation, communication, reporting, or execution system operated by, or linked to, Nasdaq.*

(b)(1)-(3) No change.

(4) Should Nasdaq determine that a basis exists under Rule 4120(a)(1), (a)(2), (a)(3), (a)(4), or (a)(5) for initiating a trading halt, the commencement of the trading halt will be effective simultaneously with appropriate notice in the Nasdaq "NEWS" frame.

(5) No change.

(6) *A trading halt initiated under Rule 4120(a)(6) shall be terminated as soon as Nasdaq determines either that the system misuse or malfunction that caused the extraordinary market activity has been corrected or that system misuse or malfunction is not the cause of the extraordinary market activity.*

\* \* \* \* \*

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

In its filing with the Commission, Nasdaq 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. Nasdaq 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

##### 1. Purpose

The purpose of the proposed rule change is clarify Nasdaq's authority to initiate and continue trading halts in circumstances where Nasdaq believes that extraordinary market activity in a security listed on Nasdaq may be caused by the misuse or malfunction of an electronic quotation, communication, reporting, or execution system operated

by, or linked to, Nasdaq. NASD Rule 4120 provides Nasdaq with authority to halt trading in securities in a number of circumstances in which Nasdaq deems a trading halt necessary to protect investors and the public interest. The specific bases for initiating a trade halt that are currently listed in Rule 4120 focus primarily on ensuring that investors have access to material news about an issuer. Thus, trading may be halted to allow the issuer to disseminate material news or to allow Nasdaq to request from the issuer information relating to material news or other information that is necessary to protect investors and the public interest. Trading of a security may also be halted in certain circumstances to ensure coordination with a halt of the same or a related security imposed by another market. The decision to halt trading and to resume trading in a particular security are communicated to market participants via the Nasdaq "NEWS" frame of the Nasdaq Workstation.

As a result of the decentralized and electronic nature of the market operated by Nasdaq, the price and volume of transactions in a Nasdaq-listed security may be affected by the misuse or malfunction of electronic systems, including systems that are linked to, but not operated by, Nasdaq. In circumstances where misuse or malfunction results in extraordinary market activity, Nasdaq believes that it may be appropriate to halt trading until the system problem can be rectified. As is true for all trading halts initiated under Rule 4120, a decision to halt trading would require a determination that the action is necessary to protect investors and the public interest. Thus, a misuse or malfunction that has a limited effect on a particular security may not warrant a trading halt. In extraordinary circumstances, however, the system misuse or malfunction may generate significant misinformation about the demand for a particular security in a manner that distorts prices to the detriment of investors.

Under the proposed rule change, Nasdaq would be authorized to initiate a halt if it believes that a particular instance of extraordinary market activity may be caused by system misuse or malfunction. However, the trading halt would continue only until Nasdaq determines either that the system misuse or malfunction that caused the extraordinary market activity has been corrected or that system misuse or malfunction is not the cause of the extraordinary market activity. Thus, the existence of extraordinary market activity, unrelated to an instance of system misuse or malfunction, would

<sup>15</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.