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DIVISION OF MARKET REGULATION

Jeffrey F. Ingber
Managing Director
General Counsel and Secretary

August 15, 1997

Michael Macchiaroli, Esq.
Associate Director
Division of Market Regulation
Securities and Exchange Commission
450 5th Street, N.W.
Washington, DC 20549

Dear Mr. Macchiaroli:

I am writing on behalf of Government Securities Clearing Corporation ("GSCC") and members of its Netting System ("Netting Members") to request a no-action position, or other appropriate relief consistent with the facts recounted below, with respect to Securities and Exchange Commission ("Commission") Rule 15c3-1(c)(2)(F) (the "Rule"), to the effect that registered broker-dealers that are Netting Members be permitted to disregard deficit charges on repurchase and reverse-repurchase agreement transactions ("Repos") as part of their net capital computation for Repo contracts entered into GSCC's netting system.

A. Background

GSCC is an industry service organization, designed to operate on a not-for-profit basis, whose primary purpose is to ensure orderly settlement in the Government securities marketplace; it effectively is the primary settlement vehicle for that marketplace. Its mission, broadly stated, is to bring both operational and risk management benefits to the clearance and settlement of Government securities through the provision of automated trade comparison, netting, and settlement services for the U.S. Government securities marketplace. GSCC's automated system is designed to provide real-time interactive communication facilities for the clearance and settlement of Government debt products.

GSCC is also a securities clearing agency registered with and regulated by the Commission. Over 80 percent of the shares of GSCC are owned by industry participants, and GSCC is governed by a board of directors composed primarily of its members.

GSCC's Netting System is a system for aggregating and matching, on a multilateral basis among all Netting System members, offsetting deliver and receive obligations resulting from trades submitted by Netting Members, in order to establish a single net settlement position for a member's activity in each security with a separate security. Each day, a Netting Member's buy-sell cash activity, Treasury auction purchases, and Repos in a security are totaled and netted to establish a single net position - long, short, or flat. For netting purposes, the settlements associated with Repo start legs and reverse close legs are treated as short positions, while the settlements associated with Repo close legs and reverse start legs are treated as long positions.

After net settlement positions have been determined, resultant receive and deliver obligations are established. GSCC interposes itself between all receive and deliver obligations so that a long position represents securities that the member will receive from GSCC, while a short position represents securities that must be delivered to GSCC by the member. For example, in the case of a Repo return leg, GSCC would interpose itself between the participant that submitted the Repo (the long participant for the return leg) and the participant that submitted the corresponding reverse (the short participant for the return leg). In doing so, GSCC assumes contra party responsibility and guarantees settlement of all Repos that enter its netting system. Thus, GSCC's guarantee for netted Repos includes the: return of Repo collateral to the Repo participant, return of principal (Repo start amount) to the reverse participant, and payment of Repo interest to the full term of the Repo to the reverse participant.

<u>In sum, GSCC's repo netting process provides an absolute, comprehensive guarantee of settlement for all repos that it encompasses.</u>

B. <u>No-Action Request</u>

The Net Capital Rule in general is designed to ensure that every registered broker-dealer maintains adequate liquid assets to meet its obligations to investors and creditors. Because of the Net Capital Rule's emphasis on ensuring liquidity, it requires a registered broker-dealer to deduct from net worth most "unsecured" receivables.

One such type of deduction may be said to arise in connection with Repos. Under the Rule, the difference between the contract price for resale or repurchase of securities and the market value of the securities subject to the Repo contract is termed a "deficit" ("Deficit") and must be included in the Rule's formula for calculating net capital deductions. The Rule provides, for example, that, as regards a Treasury Repo, the deduction shall be the excess of the difference in market value of the underlying collateral and, if less, 105% of the close price. The Rule also provides, if the registered broker-dealer is on the reverse Repo side, that the deduction is equal to the difference between the close price and, if less, the market value of the underlying collateral.

GSCC believes that Repo Deficits and Reverse Repo deficits should not be applied to any Repos that are netted and guaranteed by GSCC, for two reasons.

First, Repos for which settlement is guaranteed by GSCC do not present a risk of default to Netting Member parties to those transactions. In this regard, we note that

Subparagraph (iv) of Paragraph (1) of the Rule permits broker-dealers to exclude from their Deficit computations Repos where the Federal Reserve Bank of New York is counterparty. Although the Commission releases are silent about the reasons for this exclusion, it is likely predicated on the strength and performance integrity of the New York Fed. We believe that, given the demonstrated strength of GSCC's risk management and operating systems for Repos, comparable logic -- and a comparable exclusion -- should apply to Repos to which GSCC is the counterparty through its netting by novation process.

Also, the formula in the Rule for calculating a Deficit includes factors that may be used to offset the Deficit, including calls for marks-to-market or margin payments on the Repo contract that are outstanding one business day or less. GSCC, through its daily mark-to-market process, in effect calculates, collects and pays Deficits through to and from Netting Members each settlement day. This mark and settlement process ensures that Deficits, as that term should be used in respect of net Repo positions at GSCC, are always covered by "marks-to-the-market;" and these marks are never "outstanding" more than one business day, consistent with paragraphs (2)(ii)(d) and (3)(ii)(c) of the Rule. As a result, on GSCC netted Repo positions, there is no differential between market price and contract price that is not currently settled; and every daily price move is fully and finally resolved at GSCC the following settlement day.

Despite those characteristics of GSCC's Repo netting program, it is not clear to GSCC and Netting Members that the Rule expressly recognizes GSCC mark-to-market amounts as factors Netting Members may use to eliminate Deficit charges under the Rule.[1] We therefore seek a statement of relief from the Staff that would enable broker-dealers to disregard from their net capital computation Repo position Deficits related to Repo contracts netted at GSCC.

A summary of GSCC's Repo netting operation and safeguarding mechanisms is set forth below.

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1 Technically, the offsets available under Paragraphs (2)(ii)(D) and (3)(ii)(C) of the Rule may be said to not apply to net Repo positions carried at GSCC, since Repos submitted to the netting operation at GSCC in a given security are included with cash trades and auction purchases for that security, and the resulting net position is not strictly a Repo position.

C. GSCC's Repo Netting Operation

GSCC provides its members with a comprehensive set of Repo comparison, netting, settlement, and risk management services, each of which has been reviewed and approved by Commission staff. Pursuant to these services, GSCC Netting Members submit Repo contracts to GSCC which, following comparison, are included in GSCC's netting by novation operation. As noted above, Netting Members continuously carry a single net settlement position in each eligible security in which the member has activity. Netting by novation places GSCC in the position of counterparty and guarantor to each GSCC Netting Member with respect to each of that member's net settlement positions at GSCC.[2] While netting results in the creation of a single net position for each participant in each of its active securities, GSCC provides each participant with a breakdown of its net positions per security by Reporting: (1) the net buy-sell position; (2) the net Repo position; and (3) the total net position.

GSCC's Repo netting operation provides GSCC Netting Members with a wide variety of benefits. In addition to centralizing, automating and guaranteeing the settlement process, Repo netting substantially lowers the total daily settlement obligations of participants and reduces participants' costs for Fedwire securities transfers and exposure to daylight overdraft charges. Further, GSCC passes coupon payments from the holder of securities (reverse Repo/short participant) to the funds borrower (Repo/long participant) whenever the Repo term crosses a coupon payment date. Finally, because GSCC marks netted positions to the market and settles differences on a daily basis, GSCC is able to substantially reduce the risks associated with market movements.

D. GSCC's Risk Management Process for Netted Repo Positions

In order to enable it to provide its guarantee of settlement of all net settlement positions, GSCC employs a number of risk management measures (each of which have been reviewed and approved by the Commission), including the: margining and marking-to-market of all net settlement positions; imposition of minimum financial requirements that must be maintained on a continuous basis; ongoing monitoring of every Netting Member's financial condition and trading activity; sharing of information on common members with other self-regulatory entities; maintenance of liquidation procedures; and creation of a centralized loss allocation process. These risk management controls have

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[2] Both start legs and close legs on Repo transactions, except same day-settling legs, are eligible for GSCC netting services. At the present time, forward starting Repos (that is, Repos with start legs settling one or more business days in the future) are not eligible for netting or guaranteed settlement until they reach their scheduled start date. GSCC has filed a proposed rule change with the Commission, however, seeking authority to make forward-starting Repos eligible for netting and guaranteed settlement once they are compared by GSCC.

been rigorously tested,[3] and ensure that GSCC faces no significant risk as the result of a Netting Member's insolvency.

Of particular importance are GSCC's margining and marking mechanisms. Netting Members are required to maintain deposits in a Clearing Fund account. Each member's required deposit is calculated daily to ensure that enough funds are on hand to collateralize the risks associated with that member's activities.

The Clearing Fund is designed to provide GSCC with assets of each Netting Member sufficient to satisfy losses to GSCC in the event of the default by the member and the resultant close out of that member's open positions. It also enables GSCC to maintain a total asset amount that should be sufficient to satisfy potential losses to GSCC and its members resulting from the failure of more than one member (and the failure of such members' counterparties to pay their pro-rata allocation of loss). Further, it ensures GSCC that it has sufficient liquidity at all times to meet its payment and delivery obligations.

The Clearing Fund margining process is separate from the daily mark-to-market mechanism that applies to forward net settlement positions. The daily mark-to-market process, described further below, effectively brings net settlement positions from contract value to current market value, while the Clearing Fund is designed to protect GSCC, in the event of a member's failure, from the exposure presented by sudden fluctuations in the value of a net settlement position that could occur between the time of the latest mark-to-market operation and liquidation.

Clearing Fund margining is a dynamic process. The Clearing Fund level is not set, or capped, at a specific point, but is recalculated daily. Thus, the Clearing Fund increases or decreases daily based on the level of members' net activity, both historical and current. The dynamic nature of GSCC's margining process provides a very high level of assurance that GSCC will be able to perform its most significant function -- ensuring that the overall settlement process for the Government securities industry operates smoothly in all circumstances.[4]

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3. In late 1996, GSCC conducted a detailed assessment of its exposure in a variety of circumstances to any risk of loss that might be associated with Netting Member default. The assessment included Repo activity in times of projected market stress and confirmed that GSCC's safeguarding systems enable GSCC and its members to operate with no material risk of loss.

4. Clearing Fund margin includes a special component designed to accommodate the peculiar nature of Repos. This Repo Volatility Component reflects the interest rate exposure incurred by GSCC in guaranteeing payment to the funds lender of the full amount of interest due on the Repo transaction. The need for this component of the

As noted above, the daily mark-to-market process for all settlement positions is separate from the Clearing Fund margining process and is designed to effectively bring non-settling net positions from contract value to current market value as of every settlement day, thereby ensuring that potential losses associated with market price changes do not reach dangerous levels. GSCC collects and passes through mark-to-market amounts (the "forward mark adjustment payments") on a daily basis as part of the morning funds-only settlement. These marks in the aggregate are equivalent to GSCC's ongoing exposure on forward net settlement positions.

This mark-to-market payment requirement, which applies to GSCC-netted Repo obligations, has the following characteristics:

> It reflects the daily net mark-to-market obligation associated with a member's ongoing forward net settlement position in each distinct security from the time of novation of the trades that underlie such position.
>
> The payment is collected from those Netting Members that are in a debit mark position on a particular business day with regard to a particular security, and paid through to Members that are in a credit mark position with regard to such security.
>
> For cash trades, the forward mark adjustment is calculated by comparing the trade's current market value to its contract value. The forward mark calculation for Repos contains an additional financing mark component, which reflects the fact that, if GSCC replaced, for example, the reverse (short) side of the Repo by buying securities and putting them out on Repo, a financing cost would be incurred. The financing mark is always debited to the reverse (short) side, and credited to the Repo (long) side.
>
> Credit marks are used to offset debit marks 100 percent across securities.
>
> A member's total forward mark is the mathematical sum of the individual debit and credit marks calculated across all securities and across all settlement dates.

Clearing Fund arises as a result of the replacement contract/liquidation process, and associated interest rate gains or losses, that GSCC would undergo should a member with an outstanding term Repo fail.

> A member's required payment is re-calculated daily; therefore, each day the previous day's debit/credit (if any) is reversed and a new forward mark adjustment obligation established.
>
> Because credits are paid through, only cash may be used to pay marks to market.

In sum, GSCC's margining and marking programs in effect eliminate on a daily basis Netting Members' Deficits on Repo contracts netted at GSCC. In addition to their theoretical integrity, GSCC's experience demonstrates the practical effectiveness of GSCC's aggregate safeguards. Since the first day of operation, GSCC has never had occasion to declare a member insolvent or to apply Clearing Fund assets in a liquidation. Its early warning systems enable GSCC effectively to identify a troubled firm in advance of a default situation and to work with the firm to reduce and gradually eliminate its processing activity at GSCC before it withdraws from membership; its netting and marking operations limit GSCC's exposure to market risk to a one-day movement. Since GSCC has never needed to use its close out and liquidation procedures, it has never applied the Clearing Fund deposits of any solvent Netting Member to satisfy another Netting Member's obligations to GSCC. We believe that, in the event of a Netting Member's insolvency, the operative effect of GSCC's netting program, supplemented by the insolvent Netting Member's Clearing Fund deposits, would be sufficient in virtually every circumstance to permit GSCC to close out the insolvent Netting Member's obligations without loss to GSCC (i.e. without a loss that would require the use of solvent Netting Members' Clearing Fund deposits).

E. <u>Summary</u>

GSCC's netting and risk management processes for Repo obligations have been developed with reference to the special features, variables and risks associated with those transactions. Those processes have been reviewed and approved by the Commission. In granting approval to GSCC's Repo netting program, the Commission stated its view that the netting operation -- supplemented by daily calculation and settlement of marks-to-market and daily adjusted Clearing Fund contributions -- appropriately safeguards GSCC and its Netting Members against the risks posed by Repo netting and settlement.[5]

GSCC's netting, marking and collateralization operations -- particularly when considered in combination with other GSCC safeguards -- enable GSCC to appropriately protect its members against counterparty settlement and default risks. Accordingly, GSCC believes that GSCC Netting Members should be able to disregard from net capital

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5 Securities Exchange Act Release No. 96491 (Nov. 13, 1995).

computation Deficits relating to Repo obligations that are netted and subject to marks-to-market (and other supplemental safeguarding processes) at GSCC.

GSCC therefore requests the Commission Staff to confirm that it would not recommend enforcement action against any GSCC member broker-dealer that, in computing the firm's net capital, does not include Deficit charges identified in the Rule on Repo contracts that are entered into GSCC's Repo Netting system.

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If you have any questions regarding this letter, or require additional information, please contact myself, at (212) 412-8637 or jingber@gscc.com, or either Dan W. Schneider or Jeffrey T. Brown of Smith, Lodge & Schneider, at (312) 853-3230.

Respectfully submitted,

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General Counsel