are expected to convert to general collateral repos on a certain date will be the same as the factor for general collateral repos. The repo volatility factor for all other specific repos will be the spread between the system rate for the repo and the system rate for general collateral repos with a minimum factor of fifty basis points.

Each member is required to add to its clearing fund requirement the greater of (1) the product of the repo volatility factors and the market value of the member's repo transactions reduced by offsetting short and long positions based on maturity date and par amount <sup>21</sup> ("offset repo volatility amount") or (2) the average of a member's ten highest offset repo volatility amounts over the most recent seventy five business days. Participants may submit requests for the return of excess collateral on a monthly basis instead of on a quarterly basis.

## (9) Obligation To Submit Trades

GSCC Rule 11, Section 3, which requires a netting member to submit all eligible trades to GSCC for comparison and netting, is not applicable to a netting member's repo transactions. Rule 18, Section 4 requires a repo netting member to submit for comparison and netting all repo trades eligible for netting to either GSCC, to another Commission registered clearing agency, or a clearing agency exempted by the Commission from Clearing agency registration.

## II. Comments

The Commission received one comment letter opposing the proposal.22 This commenter argues that: (1) GSCC's system does not novate trades, and therefore, its members may not offset repo trades on their books in reliance on Interpretation 41 of the Financial Accounting Standards Board ("FASB"); 23 (2) GSCC's repo volatility factor provides inadequate protection in a volatile market; 24 (3) GSCC does not have a third party credit line to pay for customer defaults; and (4) GSCC has not imposed trading limits on its members. In its response to the commenter, GSCC states that the commenter's arguments are based on misrepresentations and

misstatements regarding GSCC and its processes.  $^{25}$ 

## III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder and particularly with the requirements of Section 17A(b)(3)(F).26 Section 17A(b)(3)(F) requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes GSCC's rule change meets these goals because the implementation of a netting system for repos continues the process whereby GSCC provides the benefits of centralized automated settlement to a broader segment of government securities transactions and because the netting system is being implemented with safeguards adequately designed to limit the risks to GSCC and its participants associated with the netting of repo transactions.

In addition to centralizing and automating the settlement process, repo netting provides several benefits to participants. Among others, these include: (1) guaranteed settlement, (2) reduction in FedWire transfer activity through the netting of a member's repo transactions with its cash transactions and auction purchases, (3) automated coupon tracking, and (4) automated output.

The proposed rule change also is consistent with the recommendations of the Joint Report on the Government Securities Market.<sup>27</sup> The Joint Report recommended, among other things, that GSCC include more trades in its netting system. The Joint Report noted that the benefits of netting are greater as more trades are included in the net and that as more trades are included in GSCC's net a larger percentage of market trades become guaranteed trades.

The Commission also believes that GSCC has put in place adequate safeguards to limit the settlement risk associated with repo transactions. For example, GSCC does not novate or guarantee the start leg of a repo until the scheduled settlement date. In addition, GSCC's guarantee is limited to repos that are schedule to settle within 195 days of submission to GSCC. The Commission believes that these measures provide additional risk protection. As GSCC becomes more experienced in the netting of repos, it may decide that it can eliminate or modify these limitations consistent with its responsibility to safeguard securities and funds.28

The Commission further believes that GSCC's forward margin and clearing fund calculations provide adequate risk management. GSCC's margining system takes into account changes in the price of the underlying collateral and the risk that GSCC may need to replace the underlying collateral if a participant defaults. The clearing fund calculation is based on both a member's funds settlement amount and securities settlement amount. With respect to repos, GSCC also will collect clearing fund contributions based on changes in the financing rate which will reflect possible changes in repo rates. The Commission believes that the margin and clearing fund contributions appropriately take into account the risks posed to GSCC by the settlement of

The Commission also notes that GSCC's rules require that netting

 $<sup>^{21}\,\</sup>mathrm{A}$  twenty-five percent disallowance will be imposed an all offsets.

<sup>&</sup>lt;sup>1</sup> Supra note 4.

<sup>&</sup>lt;sup>23</sup>The commenter asserts that nothing in GSCC's rules or procedures prevents it from assigning a guaranteed obligation to a system participant having an equal obligation and stepping out as a counterparty.

<sup>&</sup>lt;sup>24</sup> Specifically, the commenter asserts that GSCC's repo volatility factor is based upon two standard deviations from the mean rate over the historical period instead of the three standard deviations used by the commenter.

<sup>&</sup>lt;sup>25</sup> In its letter, GSCC addressed each of the commenter's points. (1) Regarding novation of trades, GSCC asserts that its rules clearly set forth the novation process whereby GSCC stands in the middle of all net settlement positions as a counterparty to each member for settlement purposes, and with regard to repos, as counterparty it ensures the return of the underlying collateral to the funds borrower and both the return of principal and the payment of interest to the term of the repo to the funds lender. (2) Regarding the protection given by GSCC's repo volatility factor in a volatile market, GSCC asserts that it does not plan to use a two standard deviation measure for the repo volatility component of its clearing fund calculation as asserted by the commenter and states that the factor will reflect the interest rate exposure incurred by GSCC in guaranteeing payment to the funds lender in a repo transaction. (3) Regarding thirdparty credit support, GSCC asserts that it uses a dynamic margining process whereby margin is recalculated and collected daily and increases or decreases daily based on the level of members' net activity. GSCC states that the dynamic nature of the margining process provides a high level of assurance that GSCC's overall settlement process for the Government securities industry never fails. (4) Regarding system limits and risk assessment, GSCC asserts that it has a comprehensive and highly automated management reporting system that allows it to assess the risks presented by members' activities and changing market conditions. GSCC asserts that the clearing fund and forward margin requirements imposed on members act as limits on system-wide exposure because a member can only increase its trading activity to the extent that it can meet its daily margin obligations. Letter from Jeffrey F. Ingber, General Counsel and Secretary, GSCC, to Jerry W. Carpenter, Assistant Director, Division of Market Regulation, Commission (October 27, 1995). <sup>26</sup> 15 U.S.C. 78q-1(b)(3)(F) (1988).

<sup>&</sup>lt;sup>27</sup>Joint Report on the Government Securities Market (January 1992) at 31 ("Joint Report"), prepared by the Department of the Treasury, the Securities and Exchange Commission, and the Board of Governors of the Federal Reserve System.

<sup>&</sup>lt;sup>28</sup> Should GSCC decide that it can modify or eliminate the limitations in a manner consistent with its statutory safeguarding obligations, it will file for Commission approval a proposed rule change.