

margin for option securities held in customers' accounts.¹⁶

ProTrade states that it will treat all of its customers as margin customers and will require margin collateral for all short positions. ProTrade indicates that its in-house initial margin requirements will be higher than the NASD's maintenance margin requirements to insure that customers have sufficient funds to cover immediate price moves after they open positions. ProTrade further states that it may reject customer applicants and that it may suspend active customers if they are found not to meet margin standards. ProTrade reports that it has programmed its System to reject any order that would open an option position if the subject account does not have the necessary funds or margin and if an existing account were to become undermargined. ProTrade also states that it may choose to vary customer trading limits, margin requirements, and position limits according to the qualifications of each customer.

ProTrade represents that its System is designed to calculate intraday the margin requirements for each account based upon changes in any bid or asked prices that affect an account. The System reportedly will provide ProTrade with real-time reports of under-margined accounts that will allow prompt margin calls and an enhanced ability to prevent account defaults.

4. Default

In the event that a customer's default becomes imminent, ProTrade states that at its discretion it may choose to prevent the default by assuming the customer's positions itself and by creating a hedged position in the cash market. However, ProTrade does not guarantee that it would undertake such bail-out procedures in the face of an imminent default and states that any such efforts would depend upon the circumstances.

In the event of the actual occurrence of a customer default, ProTrade states that it will guarantee full performance to the contraparties. ProTrade does not plan to create a clearing fund in support of this guarantee.¹⁷ ProTrade reports

that it is contemplating the formation of the other risk management facilities such as: (1) A blanket surety bond to be purchased by ProTrade from an insurance company or (2) a transactional insurance fee in the form of a refundable deposit that would be included in the cost of each trade.¹⁸

III. Public Interest Statement

ProTrade believes that exemption from clearing agency registration is critical to its entering the option securities business. ProTrade maintains that its business plan will provide investors with increased access to over-the-counter options through an integrated electronic transaction and margin system, which ProTrade claims will lower trading costs, create processing efficiencies, ensure more fairness and price transparency, and provide a complete audit trail.

ProTrade asserts that these efficiencies will eliminate the need for paperwork, will reduce the time required for order entry and for post-trade processing, and will shorten settlement cycles. Thus, ProTrade believes that its System will improve the option marketplace.

IV. Specific Request for Comments

A. Statutory Standards

Section 17A of the Exchange Act directs the Commission to develop a national clearance and settlement system through, among other things, the registration and regulation of clearing

the clearing agency from participant defaults and from unusual, significant clearing agency losses. Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (order approving standards for clearing agency registration).

However, on one occasion the Commission permitted a clearing agency, Delta Government Options Corp. ("Delta") to register and to operate as a clearing agency without a clearing fund. In Delta's case, the clearing agency's risk management system was deemed adequate, despite the lack of a clearing fund, because Delta had the financial backing of an affiliated corporation and had a substantial credit facility. Securities Exchange Act Release No. 26450 (January 12, 1989), 54 FR 2010 (order approving Delta's registration as a clearing agency).

¹⁸ A transactional insurance fee differs from margin in several ways. In brief, margin is collateral deposited by a customer with a broker in connection with the specific purchase of specific securities, and margin requirements are governed by the Exchange Act and the rules and regulations thereunder as well as certain rules of the Federal Reserve Board and the appropriate self-regulatory organization. Under ProTrade's contemplated transactional insurance fee program, ProTrade would debit a customer's account a certain amount in connection with each transaction and later credit that amount back to the customer's account upon normal settlement of the transaction. Currently, ProTrade is considering a debit in the vicinity of 5% of the value of each transaction. As stated above, ProTrade has not yet decided if it will implement such a program.

agencies.¹⁹ This statutory scheme contemplates that (1) Clearing agencies will provide clearance and settlement functions consistent with statutory goals and (2) as self-regulatory organizations, clearing agencies will exercise certain regulatory functions in furtherance of other statutory goals.

In fostering the development of a national clearance and settlement system generally and in overseeing clearing agencies in particular, Section 17A authorizes and directs the Commission to promote and facilitate certain goals with due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers, dealers, clearing agencies, and transfer agents.²⁰ Furthermore, Section 17A, as amended by the Market Reform Act of 1990, directs the Commission to use its authority to facilitate the establishment of linked or coordinated facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options.²¹

Section 17A(b)(1) of the Exchange Act²² authorizes the Commission to exempt applicants from some or all of the requirements of Section 17A if it finds such exemptions are consistent with the public interest, the protection of investors, and the purposes of Section 17A including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds. Historically, the Commission has granted newly registered clearing agencies temporary exemptions from specific statutory requirements imposed by Section 17A in a manner that achieves statutory goals.²³

The Commission recognizes that clearing agencies pose some safety and soundness concerns to the marketplace. Accordingly, the Division has published standards for clearing agency

¹⁹ 15 U.S.C. 78q-1 (1988).

²⁰ For the legislative history of Section 17A of the Exchange Act, refer to Report of Senate Committee on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, Report to Accompany S. 249, S. Rep. NO. 75, 94th Cong., 1st Sess. 4-6 (1975).

²¹ Market Reform Act of 1990, § 5, amending § 17A(a)(2) of the Exchange Act, 15 U.S.C. 78q-1(a)(2) (1995 Supp.).

²² 15 U.S.C. 78q-1(b)(1) (1988).

²³ See, e.g., order approving the temporary registration of Government Securities Clearing Corporation ("GSCC") as a clearing agency where the Commission temporarily exempted GSCC from compliance with the Section 17A(b)(3)(C) requirement of the Exchange Act. Securities Exchange Act Release No. 25740 (May 24, 1988), 53 FR 19839.

¹⁶ ProTrade will be subject to NASD margin requirements on its customers' accounts and specifically the margin requirements for options that are not issued by a registered clearing agency. These requirements are set forth in the NASD Manual, Rules of Fair Practice, Art. III, § 30(f)(2)(D)(iii).

¹⁷ As a general rule, the Commission has recommended that a clearing agency have a clearing fund which: (1) Is composed of user contributions based on a formula applicable to all users; (2) is held in cash or highly liquid securities; and (3) is limited in purpose to protecting participants and