

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51669; File No. SR-NSCC-2004-09)

May 9, 2005

Self-Regulatory Organizations; National Securities Clearing Corporation; Order Approving Proposed Rule Change to Establish a Comprehensive Standard of Care and Limitation of Liability to its Members

I. Introduction

On December 8, 2004, the National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change SR-NSCC-2004-09 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposal was published in the Federal Register on April 6, 2005.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

NSCC is establishing a comprehensive standard of care and limitation of liability with respect to its members. Historically, the Commission has left to user-governed clearing agencies the question of how to allocate losses associated with, among other things, clearing agency functions.³ The Commission has reviewed clearing agency services on a case-by-case basis and in determining the appropriate standard of care has balanced the need for a high degree of clearing agency care with the effect the resulting liabilities may have on clearing agency

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 51458 (March 31, 2005), 70 FR 17494.

³ Securities Exchange Act Release Nos. 20221 (September 23, 1983), 48 FR 45167 and 22940 (February 24, 1986), 51 FR 7169.

operations, costs, and safekeeping of securities and funds.⁴ Because standards of care represent an allocation of rights and liabilities between a clearing agency and its members, which are generally sophisticated financial entities, the Commission has refrained from establishing a unique federal standard of care and generally has allowed clearing agencies and other self-regulatory organizations and their members to establish their own standards of care.⁵ In addition, the Commission has recognized that a gross negligence standard of care is appropriate for certain noncustodial functions where a clearing agency, its board of directors, and its members determine to allocate risk to individual service users.⁶

NSCC believes that adopting a uniform rule⁷ limiting NSCC's liability to its members to

⁴ Id.

⁵ Id.

⁶ Securities Exchange Act Release No. 26154 (October 3, 1988), 53 FR 39556. NSCC's services provided to members are noncustodial in that, other than clearing fund deposits, it does not hold its members funds or securities.

⁷ New Section 2 of Rule 58 states:

SEC. 2. Notwithstanding any other provision in the Rules:

(a) The Corporation will not be liable for any action taken, or any delay or failure to take any action, hereunder or otherwise to fulfill the Corporation's obligations to its Members including Settling Members, Settling Bank Only Members, Municipal Comparison Only Members, Insurance Carrier Members, TPA Members, Mutual Fund/Insurance Services Members, Non-Clearing Members, Fund Members and Data Services Only Members, other than for losses caused directly by the Corporation's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action. Under no circumstances will the Corporation be liable for the acts, delays, omissions, bankruptcy, or insolvency, of any third party, including, without limitation, any depository, custodian, sub-custodian, clearing or settlement system, transfer agent, registrar, data communication service or delivery service ("Third Party"), unless the Corporation was grossly negligent, engaged in willful misconduct, or in

direct losses caused by NSCC's gross negligence, willful misconduct, or violation of Federal

(..continued)

violation of Federal securities laws for which there is a private right of action in selecting such Third Party.

(b) Under no circumstances will the Corporation be liable for any indirect, consequential, incidental, special, punitive or exemplary loss or damage (including, but not limited to, loss of business, loss of profits, trading losses, loss of opportunity and loss of use) howsoever suffered or incurred, regardless of whether the Corporation has been advised of the possibility of such damages or whether such damages otherwise could have been foreseen or prevented.

(c) With respect to instructions given to the Corporation by a Special Representative/Index Recipient Agent, the Corporation shall have no responsibility or liability for any errors which may occur in the course of transmissions or recording of any transmissions or which may exist in any magnetic tape, document or other media so delivered to the Corporation.

(d) With respect to the Corporation's distribution facilities, the Corporation assumes no responsibility whatever for the form or content of any tickets, checks, papers, documents or other material (other than items prepared by it) placed in the boxes in its distribution facilities assigned to each Settling Member, Municipal Comparison Only Member, Insurance Carrier Member, TPA Member, Fund Member and Data Services Only Member, or otherwise handled by the Corporation; nor does the Corporation assume any responsibility for any improper or unauthorized removal from such boxes or from the Corporation's facilities of any such tickets, checks, papers, documents or other material, including items prepared by the Corporation.

(e) With respect to Fund/Serv transactions, the Corporation will not be responsible for the completeness or accuracy of any transaction or instruction received from or transmitted to a Settling Member, Data Services Only Member, TPA Member, TPA Settling Entity, Mutual Fund Processor or Fund Member through Fund/Serv, nor for any errors, omissions or delays which may occur in the transmission of a transaction or instruction to or from a Settling Member, Data Services Only Member, TPA Member, TPA Settling Entity, Mutual Fund Processor or Fund Member.

(f) The Corporation will not be responsible for the completeness or accuracy of any IPS Data and Repository Data received from or transmitted to an Insurance Carrier Member, Member or Data Services Only Member through IPS nor for any errors, omissions or delays which may occur in the transmission of such IPS Data and Repository Data to or from an Insurance Carrier Member, or Data Services Only Member.

securities laws for which there is a private right of action will: (1) memorialize an appropriate commercial standard of care that will protect NSCC from undue liability;⁸ (2) permit the resources of NSCC to be appropriately utilized for promoting the accurate clearance and settlement of securities; and (3) will be consistent with similar rules adopted by other self-regulatory organizations and approved by the Commission.⁹

III. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. 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 its custody or control.¹⁰ The Commission believes that NSCC's rule change is consistent with this Section because it will permit the resources of NSCC to be appropriately utilized to protect funds and assets.

⁸ NSCC has always operated under a gross negligence standard of care and both internal and external counsel have consistently advised members that this is the case. NSCC is seeking to eliminate any confusion due to the absence of a clear standard set forth in its rules and to memorialize its historical practice. In addition, NSCC has in effect a service agreement with the Fixed Income Clearing Corporation ("FICC") pursuant to which FICC provides services for NSCC's fixed income products. This service agreement provides for a gross negligence standard of care. In the absence of this new rule, NSCC could be in the position of having to pay for losses caused by FICC that are not recoverable under the agreement.

⁹ See, e.g., Securities Exchange Act Release Nos. 37421 (July 11, 1996), 61 FR 37513 [File No. SR-CBOE-96-02]; 37563 (August 14, 1996), 61 FR 43285 [File No. SR-PSE-96-21]; 48201 (July 21, 2003), 68 FR 44128 [File No. SR-GSCC-2002-10]; and 49373 (March 8, 2004), 69 FR 11921 [File No. SR-FICC-2003-09].

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).

Although the Act does not specify the standard of care that must be exercised by registered clearing agencies, the Commission has determined that a gross negligence standard of care is acceptable for noncustodial functions where a clearing agency and its participants contractually agree to limit the liability of the clearing agency.¹¹ NSCC's functions are noncustodial in that it does not hold its members' funds or securities. It is reasonable for NSCC, which is member-owned and governed, and its members to agree through board approval of the proposed rule change and to contract with one another in a cooperative arrangement as to how to

¹¹ In the release setting forth standards that would be used by the Division of Market Regulation in evaluating clearing agency registration applications, the Division of Market Regulation urged clearing agencies to embrace a strict standard of care in safeguarding participants' funds and securities. Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 4192. In the release granting permanent registration to The Depository Trust Company, the National Securities Clearing Corporation, and several other clearing agencies, however, the Commission indicated that it did not believe that sufficient justification existed at that time to require a unique federal standard of care for registered clearing agencies. Securities Exchange Act Release No. 20221 (October 3, 1983), 48 FR 45167. In a subsequent release, the Commission stated that the clearing agency standard of care and the allocation of rights and liabilities between a clearing agency and its participants applicable to clearing agency services generally may be set by the clearing agency and its participants. In the same release, the Commission stated that it should review clearing agency proposed rule changes in this area on a case-by-case basis and balance the need for a high degree of clearing agency care with the effect resulting liabilities may have on clearing agency operations, costs, and safeguarding of securities and funds. Securities Exchange Act Release No. 22940 (February 24, 1986), 51 FR 7169. Subsequently, in a release granting temporary registration as a clearing agency to The Intermarket Clearing Corporation, the Commission stated that a gross negligence standard of care may be appropriate for certain noncustodial functions that, consistent with minimizing risk mutualization, a clearing agency, its board of directors, and its members determine to allocate to individual service users. Securities Exchange Act Release No. 26154 (October 3, 1988), 53 FR 39556. Finally, in a release granting the approval of temporary registration as a clearing agency to the International Securities Clearing Corporation, the Commission indicated that historically it has left to user-governed clearing agencies the question of how to allocate losses associated with noncustodial, data processing, clearing agency functions and has approved clearing agency services embodying a gross-negligence standard of care. Securities Exchange Act Release No. 26812 (May 12, 1989), 54 FR 21691.

allocate NSCC's liability among NSCC and its members. Therefore, the Commission has determined that given the noncustodial nature of NSCC's services, a gross negligence standard of care and limitation of liability is allowable for NSCC.¹²

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular 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-NSCC-2004-09) be and hereby is approved.

¹² The Commission notes that the rule change does not alleviate NSCC from liability for violation of the Federal securities laws where there exists a private right of action and therefore is not designed to adversely affect NSCC's compliance with the Federal securities laws and private rights of action that exist for violations of the Federal securities laws.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland
Deputy Secretary

¹³ 17 CFR 200.30-3(a)(12).

