

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

George A. Fitzsimmons  
Secretary

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 16900/June 17, 1980**

**REGULATION OF CLEARING AGENCIES**

**ACTION:** Announcement of Standards for the Registration of Clearing Agencies.

**SUMMARY:** The Securities and Exchange Commission today announced standards to be used by the Division of Market Regulation in connection with the registration of clearing agencies. The standards are intended to serve as staff guidelines to assist clearing agencies in modifying their organizations, capacities and rules to comply with the clearing agency registration provisions of the Securities Exchange Act of 1934.

**EFFECTIVE DATE:** June 17, 1980.

**FOR FURTHER INFORMATION CONTACT:** JoAnn Carpenter, Esq., Division of Market Regulation, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549, (202) 272-2913.

**SUPPLEMENTARY INFORMATION:** The Commission today announced standards that the Division of Market Regulation (the "Division") will use in reviewing the organizations, capacities and rules of clearing agencies that currently are registered temporarily with the Commission and of clearing agencies that may apply for registration in the future. The Division intends to apply these standards in making its recommendations to the Commission regarding the grant or denial of registration. The standards announced herein are not Commission standards, but rather a statement of the views and positions of the Division regarding the manner in which clearing agencies should comply with provisions of the Securities Exchange Act of 1934 (the "Act") applicable to registration.

**BACKGROUND**

Section 17A(b) of the Act, which was added by the Securities Acts Amendments of 1975,<sup>1</sup> makes it unlawful for a clearing agency<sup>2</sup> to perform clearing agency functions with respect to any security (other than an exempted security, as defined in Section 3(a)(12) of the Act) on December 1, 1975 and thereafter unless the clearing agency is registered with the Commission. Section 17A(b)(3) of the Act requires the Commission, before granting registration, to make a number of determinations with respect to a clearing agency's organization, capacity and rules.<sup>3</sup>

On November 3, 1975, the Commission adopted Rule 17Ab2-1, 17 CFR §240.17Ab2-1, and related Form CA-1, 17 CFR §249b.200, for the registration of clearing agencies.<sup>4</sup> Paragraph (c)(1) of Rule 17Ab2-1 provides that, if requested by an applicant, the Commission may grant registration for 18 months or such longer period as it may provide by order without making all of the determinations called for by Section 17A(b)(3). This approach to registration was intended to permit clearing agencies in operation at that time to be registered in compliance with the Act by December 1, 1975 upon a finding that their operations were safe, while affording the Commission sufficient time to make the other determinations called for by Subparagraphs (A)-(I) of Section 17A(b)(3). This approach to registration also was used for the registration of three clearing agencies that began operating after December 1, 1975.

Each of the thirteen clearing agencies currently registered with the Commission has been granted temporary registration in accordance with

<sup>1</sup>Pub. L. No. 94-29 (June 4, 1975).

<sup>2</sup>The term "clearing agency" is defined in Section 3(a)(23) of the Act.

<sup>3</sup>The determinations are contained in Subparagraphs (A) through (I) of Section 17A(b)(3) of the Act.

<sup>4</sup>Securities Exchange Act Release No. 11787 (November 3, 1975), 40 FR 52356 (November 10, 1975).

paragraph (c)(1) of Rule 17Ab2-1.<sup>5</sup> The Commission, by order, has extended until March 31, 1981 the temporary registrations of the clearing agencies that have been in operation for more than 18 months since the initial grant of registration. As required by Rule 17Ab2-1, the Commission also has instituted proceedings to determine whether to grant or deny registration at the expiration of the temporary registrations.<sup>6</sup>

On June 1, 1977, the Commission published proposed standards for determining whether clearing agencies' organizations, capacities and rules satisfy the Act's criteria.<sup>7</sup> Thirteen comment letters were received. After reviewing those letters, the Commission substantially revised the proposed standards and republished them for public comment on March 6, 1978.<sup>8</sup> Fourteen letters of comment were received. The fourteen comment letters were considered and certain changes, as indicated in this release, were made to the revised proposed standards in response to some of the commenters' suggestions.

It should be noted that the standards previously were proposed as Commission standards. The Commission has decided, however, not to adopt Commission standards at this time, but instead to publish standards that the Division will use in evaluating clearing agencies' organizations, capacities and rules. This decision is based on the fact that, in connection with its review of the various clearing agency applications for registration, the Commission will be presented with a number of important substantive issues concerning the application of the relevant statutory provisions. In addition, this review will be the first occasion, other than for the temporary purposes previously noted, on which the Commission will apply those statutory provisions to particular clearing agencies. Under these circumstances and in view of differences in the operation and organization of the thirteen clearing agencies, the Commission has concluded that it would be preferable to reach judgments about the application of the Section 17A(b)(3) provisions in the context of passing upon the individual applications of the clearing agencies.

At the same time, the Commission recognizes the desirability of providing guidance to the clearing agencies in amending their organizations, capacities and rules to comply with the provisions of Section 17A(b)(3). The Commission has determined, therefore, that it would be useful for

clearing agencies to be apprised of the views and positions of the Division that will evaluate the clearing agencies' organizations, capacities and rules and thereafter make recommendations to the Commission regarding the registration of such entities.<sup>9</sup>

## REGISTRATION STANDARDS

In Subparagraphs (A)-(I) of Section 17A(b)(3) ("Subparagraphs (A)-(I)"), Congress set forth general criteria which clearing agencies must satisfy in order to be registered. Congress, however, reserved to the Commission the task of making the specific determinations as to whether the organizations, capacities and rules of clearing agencies satisfy the general criteria. The standards as set forth in this release represent the views and positions of the Division concerning certain approaches which it believes would satisfy the criteria set forth in

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<sup>5</sup>The Depository Trust Company, Bradford Securities Processing Services, Inc., Stock Clearing Corporation of Philadelphia, Boston Stock Exchange Clearing Corporation, Midwest Securities Trust Company, The Options Clearing Corporation, Midwest Clearing Corporation, Pacific Securities Depository Trust Company, Pacific Clearing Corporation, TAD Depository Corporation, New England Securities Depository Trust Company, National Securities Clearing Corporation and Philadelphia Depository Trust Company.

<sup>6</sup>General background information concerning the temporary registrations, the extensions of the registrations and the institution of proceedings is contained in Securities Exchange Act Release Nos. 13584 (June 1, 1977), 42 FR 30065 (June 10, 1977); 13664 (June 23, 1977), 42 FR 33394 (June 30, 1977); 13911 (August 31, 1977); 14531 (March 6, 1978), 43 FR 10288 (March 10, 1978); and 16294 (October 24, 1979).

<sup>7</sup>See Securities Exchange Act Release No. 13584.

<sup>8</sup>See Securities Exchange Act Release No. 14531.

<sup>9</sup>It should be noted that the Commission retains the flexibility to determine that, despite compliance with a particular Division standard, a clearing agency may have to meet more stringent measures in order to comply with the statutory requirements.

Subparagraphs (A)-(I).<sup>10</sup> If a clearing agency believes that the application of a particular standard to it is inappropriate, the clearing agency should submit a detailed description of (i) the reasons why the standard is inappropriate, (ii) the alternative approach suggested by the clearing agency and (iii) the reasons why the clearing agency believes its alternative approach satisfies the statutory criteria. The Division would then make recommendations to the Commission regarding the alternative approach.

Section 17A of the Act directs the Commission to use its authority under the Act to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions ("national system") in accordance with the findings in Section 17A(a)(1). In using its authority, the Commission is to have due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and the maintenance of fair competition among brokers and dealers, clearing agencies and transfer agents. In general, the standards are designed to be flexible and therefore should provide latitude to each clearing agency and the Commission in accomplishing the objectives of the Act.

In addition, Sections 17A(b)(3)(F) and (I) of the Act provide, in part, that the Commission shall not grant registration as a clearing agency to an applicant unless the Commission determines that (i) the applicant's rules are designed to foster cooperation and coordination with persons engaged in securities processing and to remove impediments to and perfect the mechanisms of the national system and (ii) the applicant's rules do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

The remainder of this release is prefaced by an index which lists the caption of each standard followed by

<sup>10</sup>Although the Subparagraph (A)-(I) determinations are similar in many respects to those which the Commission is required to make in connection with the registration of national securities exchanges and securities associations pursuant to Sections 6(b) and 15A(b) of the Act, the clearing agency standards have been formulated in light of the purposes of Section 17A of the Act and are intended to apply only to the determinations required by Section 17A(b)(3) of the Act.

its statutory basis. In the text of the release, each of the standards, which are italicized, is followed by a summary of the Division's intended application of the standard. Therefore, in order to comply fully with the standards, the clearing agency should seek guidance from the explanatory material.

#### I. Participation Standards—Section 17A(b)(3)(B)

- A. Statutory Background
- B. Minimum Participation Requirements
- C. Financial and Operational Requirements
- D. Clearing Agency Interfaces
- E. Other Categories of Participants

#### II. Fair Representation—Section 17A(b)(3)(C)

- A. Statutory Background
- B. Governance Procedures
- C. Notice of Proposed Rule Changes
- D. Public Directors

#### III. Capacity to Enforce Rules and to Discipline Participants in Accordance with Fair Procedures—Sections 17A(b)(3)(A), (G) and (H)

#### IV. Safeguarding of Securities and Funds and Prompt and Accurate Clearance and Settlement of Securities Transactions—Sections 17A(b)(3)(A) and (F)

- A. Statutory Background
- B. General Discussion
- C. Organization and Processing Capacity
- D. Audit Committee
- E. Internal Audit Department
- F. Financial Reports
- G. Internal Accounting Control Reports
- H. Securities, Funds and Data Controls
  - 1. Prevention
  - 2. Recovery

#### V. Obligations to Participants—Sections 17A(b)(3)(A) and (F)

- A. Clearing Funds
- B. Standard of Care

#### VI. Participant Charges—Section 17A(b)(3)(E)

#### VII. Equitable Allocation of Reasonable Dues, Fees and Other Clearing Agency Charges—Section 17A(b)(3)(D)

VIII. Limitation on a Clearing Agency's Scope of Regulation—Section 17A(b)(3)(F)

IX. The National Clearance and Settlement System

X. Other Matters

I. *Participation Standards*

*The rules of a clearing agency concerning eligibility to become a participant should (i) provide the statutory categories of participants access to the clearing agency and its services on a basis which does not discriminate unnecessarily or unfairly, (ii) protect the clearing agency's financial and operational integrity and (iii) carry out the purposes of Section 17A of the Act, including facilitating the establishment of a national clearance and settlement system.*

A. *Statutory Background*

Section 17A(b)(3)(B) of the Act states that a clearing agency shall not be registered unless the Commission determines that,

[s]ubject to the provisions of [Section 17A(b)(4) of the Act], the rules of the clearing agency provide that any (i) registered broker or dealer, (ii) other registered clearing agency, (iii) registered investment company, (iv) bank, (v) insurance company, or (vi) other person or class of persons as the Commission, by rule, may from time to time designate as appropriate to the development of a national system for the prompt and accurate clearance and settlement of securities transactions may become a participant in such clearing agency.

Section 17A(b)(4)(B) of the Act provides that a registered clearing agency may deny or condition the participation of any person who does not meet the standards of financial responsibility, operational capacity, experience and competence prescribed by the rules of the clearing agency.<sup>11</sup> A registered clearing agency also is empowered by the Act to examine and verify the qualifications of an applicant in accordance with procedures established by the rules of the clearing agency. This authority, however, must be viewed in the context of Section 17A(b)(3)(F) of the Act, which provides, among other things, that the rules of a clearing agency may not be "designed to permit unfair discrimination in the admission of participants or among participants

in the use of the clearing agency. . .," and Section 17A(b)(3)(I) of the Act, which provides that the rules of a clearing agency may not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

Together, the Act's provisions recognize that a clearing agency may discriminate among persons in the admission to, or the use of, the clearing agency if such discrimination is based on standards of financial responsibility, operational capability, experience and competence. In addition, the Act requires that the discriminations it sanctions must not be unfair. The Commission must find that clearing agency rules embodying any discriminations are in the public interest and are consistent with the requirements of the Act applicable to clearing agencies.<sup>12</sup>

B. *Minimum Participation Requirements*

The participant categories as enumerated in Section 17A(b)(3)(B) include entities already subject to regulation by various federal and state authorities and by other self-regulatory organizations. The Division does not believe, however, that the requirements of those regulatory authorities necessarily qualify an applicant for participation in a clearing agency. The Division believes that a clearing agency may impose such additional or higher standards as it deems necessary to protect the clearing agency and its participants from

<sup>11</sup>The Section 17A(b)(3)(B) requirement is also subject to Section 17A(b)(4)(A) of the Act which provides that a registered clearing agency may, and in cases in which the Commission, by order, directs as appropriate in the public interest shall, deny participation to any person subject to a statutory disqualification.

It has been suggested that the participation standards should provide for rejection of an applicant on the basis of "moral" or "character" grounds. The Division believes that it is neither necessary nor appropriate at this time to allow a clearing agency to reject an applicant based on undefined subjective terms such as "character."

<sup>12</sup>Sections 17A(a)(2) and 17A(b)(3)(A), (F) and (I) of the Act.

unreasonable risks.<sup>13</sup> Of course, the Commission would have to determine that such standards are consistent with the requirements of the Act and the clearing agency would have the obligation to justify any anticompetitive effect of such standards. Any anticompetitive effect would be judged in light of such factors as the essential nature of the service; the number and type of potential participants denied access to clearance and settlement services; the number of entities providing comparable clearance, settlement and depository services; and the availability of correspondent arrangements to provide indirect access to a clearing agency's services.

### C. Financial and Operational Requirements

In response to the revised proposed standards, some commenters again expressed their view that certain categories of participants such as banks and insurance companies should not be required to comply fully with clearing agency rules establishing internal financial and operational safeguards such as clearing fund deposits. Some commenters disagreed with the view expressed in Securities Exchange Act Release No. 14531 that the risk of loss to a clearing agency from participant default is the same for all categories of participants which avail themselves of similar clearing agency services. They expressed the belief that the risk of loss from bank and insurance company participants may be different from that of broker-dealer participants. Those commenters suggested that the internal financial and operational requirements of clearing agencies should be flexible so that the requirements applicable to such bank and insurance company participants may vary from the requirements applicable to broker-dealer participants. Those

<sup>13</sup>The standards of financial responsibility applicable to each category of participant might vary on the basis of the historical methods of measuring the financial responsibility of participants in each category. For example, the requirements applicable to broker-dealer participants might be stated in terms of net capital as defined in Rule 15c3-1 (17 CFR §240.15c3-1) under the Act.

<sup>14</sup>For example, in an interface between two clearing agencies which use a continuous net settlement system and require mark-to-the-market payments, the mark-to-the-market payments should be made to each other as appropriate.

commenters, however, did not present any analysis or evidence to support their conclusions.

Therefore, the Division is unwilling to conclude at this time that the risk of a loss to a clearing agency resulting from default by a bank, insurance company or broker-dealer is different assuming similar clearing agency services are utilized. Accordingly, all participants utilizing similar clearing agency services, except registered clearing agencies for which specialized requirements are appropriate as discussed below, should be required to comply fully with the clearing agency's internal financial and operational rules such as clearing fund deposits, mark-to-the-market payments and margin deposits related to the service used.

### D. Clearing Agency Interfaces

The Division believes that a clearing agency's registration in general should qualify it for participation in (or interface with) other registered clearing agencies. The Division recognizes, however, that the contra clearing agency has an interest in assuring itself that the participant clearing agency will be able to meet its obligations. For this reason, the Division has determined that clearing agencies may require reasonable assurance of another clearing agency's ability to meet its obligations or the obligations of its participants. Any such requirement, of course, must be designed and administered in a manner that facilitates the establishment of a national clearance and settlement system and that does not unfairly discriminate among clearing agencies or inappropriately burden competition among them.<sup>14</sup>

Comment was markedly divergent concerning the extent to which one clearing agency that is a participant in another should be required to comply with the financial and operational requirements and other rules of the contra clearing agency. One commenter suggested that the only condition on interfaces should be the right of a clearing agency delivering securities to another clearing agency to be paid on the day of delivery by a certified or cashier's check. Some commenters urged that the participant clearing agency should meet all the contra agency's rules; other commenters believed that clearing agencies should be permitted to establish arrangements satisfactory to themselves, and other commenters suggested that such arrangements need not be approved by the Commission.

Interfaces among clearing agencies are important to the development of a national clearance and settlement system composed of multiple autonomous clearing agencies. Differences in the operations of, and functions conducted by, clearing agencies, however, make it difficult to prescribe precise standards for each existing or potential interface. Furthermore, each clearing agency would appear to be well situated to propose safeguards necessary and appropriate to minimize its exposure to the particular risks presented by another clearing agency in an interface arrangement. The Division believes, therefore, that clearing agencies should be permitted to devise suitable arrangements in this area on the basis of the particular type of participation or interface and the applicable facts, but that such arrangements also should be submitted to the Commission for approval pursuant to Rule 19b-4 under the Act. This will enable the Commission to determine whether the specific arrangements meet the requirements of the Act.

#### E. Other Categories of Participants

Section 17A(b)(3)(B) of the Act enumerates the categories of entities entitled to participate in the clearing agency upon compliance with the requirements of such clearing agency. The section further provides that the Commission may from time to time by rule designate as appropriate to the development of a national clearance and settlement system any other persons or class of persons. As indicated in Securities Exchange Act Release No. 14531, the Commission is not proposing to exercise that rulemaking authority to make such designations at this time.

The Division believes, however, that a clearing agency may accept as participants specific categories of persons other than those enumerated in Section 17A(b)(3)(B) of the Act. In determining whether to add other specific categories of participants, however, a clearing agency should be particularly cognizant of the impact that the participation of those categories may have on the safety of the clearing agency and should provide safeguards to protect against that risk.

#### II. Fair Representation

*The rules of the clearing agency should (i) provide participants with a meaningful opportunity to be represented in the selection of the clearing agency's directors and the administration of its affairs and (ii) provide that participants shall be apprised of*

*proposed rule changes in order to facilitate their comment on such changes to the Commission.*

#### A. Statutory Background

Section 17A(b)(3)(C) of the Act states that a clearing agency shall not be registered unless the Commission determines that

[t]he rules of the clearing agency assure a fair representation of its shareholders (or members) and participants in the selection of its directors and administration of its affairs. (The Commission may determine that the representation of participants is fair if they are afforded a reasonable opportunity to acquire voting stock of the clearing agency, directly or indirectly, in reasonable proportion to their use of such clearing agency.)

The Act does not define fair representation but reserves to the Commission the authority to determine whether the rules of the clearing agency give fair voice to participants, as well as to shareholders (or members), in the selection of directors and the administration of its affairs.<sup>15</sup>

<sup>15</sup>The fair representation requirement was adopted verbatim from S. 249, the Senate bill that preceded the Securities Acts Amendments of 1975. The report of the Senate Committee on Banking, Housing and Urban Affairs to accompany S. 249 states:

The rules of the clearing agency must assure fair representation of its shareholders (or members) and participants in the decision making process of the clearing agency. . . . The reference to shareholders of members makes it clear that the bill establishes no norm as to whether clearing agencies should or should not be operated for profit. The bill makes no attempt to set up particular standards of representation or participation. Rather, it provides that the Commission must assure itself that the rules of the clearing agency regarding the manner in which decisions are made give fair voice to participants as well as to shareholders or members. Fair representation of participants may be found if they are afforded an opportunity to acquire voting stock of the clearing agency in proportion to their use of its facilities.

*Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S. 249, S. Rep. 94-75, 94th Cong., 1st Sess. 123-24 (1975).*

## B. Governance Procedures

The Division recognizes that the owners of an organization (including a clearing agency) usually have complete voting power which includes the authority to select the board of directors. The Act, however, provides that a clearing agency must assure a fair representation of its shareholders (or members) and participants in the selection of its directors and the administration of its affairs.

The clearing agencies currently in existence are profit making entities, user cooperatives and affiliates of exchanges, and the owners of clearing agencies generally are not identical to their participants. Therefore, rather than prescribing a single method for providing fair representation, the Division has determined that it will be necessary to evaluate each clearing agency's procedures in this area on a case-by-case basis. In addition to the methods described in Securities Exchange Act Release No. 14531,<sup>16</sup> the Division believes that a number of other methods could comply with the fair representation standard. For example, a number of the directors could be chosen by, and from among, the users.

One commenter suggested that a for-profit clearing agency should not be required to allocate representation on its board of directors to participants, since the affairs of such an agency are governed by a board of directors responsible to its shareholders. The commenter observed that the interests of participants, whether or not they are

<sup>16</sup>These methods include: (1) solicitation of board of directors nominations from all participants; (2) selection of candidates for election to the board of directors by a nominating committee which would be composed of, and selected by, the participants or representatives chosen by participants; (3) direct participation of participants in the election of directors through the allocation of voting stock to all participants based on their usage of the clearing agency; or (4) selection by participants of a slate of nominees for which stockholders of the clearing agency would be required to vote their shares.

<sup>17</sup>The Division is not suggesting, at this time, that quarterly financial statements be provided to participants, except upon request. See Section IV.F.

<sup>18</sup>See Section IV.G.

shareholders, are inconsistent with the duties of directors of such a clearing agency, since the participants are interested in increasing services at the least cost to themselves, whereas the directors are interested in providing services at prices which will produce a fair profit to the shareholders. That commenter suggested that a participant advisory committee meeting periodically with the management and the board of a for-profit clearing agency would satisfy the requirements for fair representation in the governance of the affairs of a clearing agency.

The Division believes that, while a participant advisory committee which has a meaningful opportunity to influence the decisions made by the clearing agency's board of directors might satisfy the requirement regarding fair representation of participants in the administration of the affairs of the clearing agency, it does not satisfy the other requirement of Section 17A(b)(3)(C), *i.e.*, fair representation of participants in the selection of the clearing agency's directors.

## C. Notice of Proposed Rule Changes

The Division believes that participants should have sufficient information concerning a clearing agency's affairs to participate meaningfully in its administration. Accordingly, the Division believes that clearing agencies should furnish participants with annual financial statements<sup>17</sup> and an annual report on internal accounting control prepared by an independent public accountant.<sup>18</sup> The Division also believes that participants should be kept adequately informed of clearing agencies' proposed rule changes. For this reason, and for the reasons discussed below, the Division believes that clearing agencies prior to, or as soon as possible after, filing a proposed rule change with the Commission should provide participants and other registered clearing agencies with the text or description of the proposed rule change, its purpose and its effect on the clearing agency's participants.

One commenter suggested that it is not necessary to notify participants of proposed rule changes before the Commission acts upon them in the case of a clearing agency governed by a "user" board (*i.e.*, a board consisting of participants or persons selected by participants) that formulates rules because the user board could be relied upon to represent the interests of their participants. Another commenter expressed the hope that its current practice of

including proposed rule changes in a monthly bulletin sent to all participants would comply with the proposed notice standards.

The Division believes that a clearing agency's user board, which represents the various interests and needs of the participants, may not assure that each interest and need will be represented because of limitations on the size of the board. Exposing proposed rule changes to participants, therefore, can secure the benefits of widespread comment on proposed clearing agency rules and assure that each participant has the opportunity to express its particular needs or concerns.

Nevertheless, the Division does not believe that a clearing agency generally should be required to secure participant comment before filing a proposed rule change with the Commission. Such a requirement may delay the rule change process and may be unnecessary since participants may comment directly to the Commission. Clearing agencies, however, should incorporate in their rules a procedure pursuant to which participants and other registered clearing agencies will normally receive the text or a brief description of the proposed rule and its purpose and effect in sufficient time, in view of the date by which the Commission may be expected to act upon the filing, to permit the participants and other registered clearing agencies to comment to the Commission. While this notice should be provided by all clearing agencies for all proposed rule changes, the opportunity for prompt comment to the Commission generally will not be available if the Commission is expected to take accelerated action under Section 19(b) of the Act or if the proposed rule change will become effective under Section 19(b)(3)(A) or (B) of the Act. In the latter case, comments received during the 60 day period following the filing of these rule changes would be considered by the Commission in determining whether to exercise its authority to abrogate the rule change.

#### D. Public Directors

In Securities Exchange Act Release No. 13584

<sup>19</sup>The term "self-regulatory organization" in this context refers to any national securities exchange, registered securities association or registered clearing agency. See Section 3(a)(26) of the Act.

<sup>20</sup>Securities Exchange Act Release No. 12935, 41 FR 49091 (November 8, 1976).

announcing the proposed standards, the Commission requested comment as to whether it would be in the public interest to require that clearing agencies have one or more directors who would be representatives of issuers or investors and who would not be associated with any participant or self-regulatory organization. The Division does not believe that such a requirement is currently needed. A clearing agency, however, may include such a person or persons on its board if it wishes.

#### III. Capacity to Enforce Rules and to Discipline Participants in Accordance with Fair Procedures

*A clearing agency should have (i) the organization and capacity to enforce compliance by its participants with its rules, (ii) rules providing that infractions of clearing agency rules will be appropriately disciplined and (iii) rules establishing fair procedures that the clearing agency will adhere to in processings relating to discipline, denial of participation, limitation of access to services and summary suspension.*

Section 17A(b)(3)(A) of the Act, in pertinent part, provides that a clearing agency shall not be registered unless the Commission determines that

[the] clearing agency is so organized and has the capacity . . . to enforce (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) compliance by its participants with the rules of the clearing agency. . . .

In reviewing the organization and capacity of a clearing agency, the Division intends to evaluate, among other things, its procedures for determining whether a participant is experiencing financial or operational difficulties, its arrangements for exchanging information with other self-regulatory organizations and the adequacy of its examining staff to enforce compliance by participants with the clearing agency's rules.

Section 17(d)(1) of the Act, among other things, authorizes the Commission, by rule or order, to relieve self-regulatory organizations<sup>19</sup> of regulatory responsibilities for persons who are members of, or participants in, more than one self-regulatory organization. On October 28, 1976, the Commission adopted Rule 17d-2 under the Act, 17 CFR §240.17d-2.<sup>20</sup> That rule allows self-regulatory organizations to file with the Commission for



approval plans allocating specified self-regulatory responsibilities among themselves with respect to members or participants which they have in common. Pursuant to Rule 17d-2(d), Commission approval of a plan relieves a self-regulatory organization of those regulatory responsibilities allocated by the plan to another self-regulatory organization.

To date, the Commission has not declared effective any plan submitted by a registered clearing agency pursuant to Rule 17d-2, and therefore clearing agencies have not been relieved of their responsibilities to enforce compliance with their rules.<sup>21</sup> Unless and until such authority is exercised in the future, the Division will not recommend to the Commission that a clearing agency be registered unless it has the organization and capacity to determine whether its rules are being complied with and to discipline non-complying participants.

The Division, however, supports the concept of avoiding duplication of regulatory effort wherever possible so long as it is consistent with the purposes of the Act and so long as the financial and operational integrity of the clearing agency and its participants is not endangered as a result. In this regard, one commenter stated that a registered clearing agency should be required to make its own determination as to whether its participants are in compliance with its own rules but that, in order to avoid unnecessary regulatory duplication, a clearing agency should be able to obtain financial information about a participant from the participant's designated examining authority under Rule 17d-1 of the Act, 17 CFR §240.17d-1. Another commenter suggested that a clearing agency should determine compliance with any of its rules which do not require a visit to the participant, but that the designated examining authority should determine compliance with those rules which do require visitation.

The Division believes that, subject to Commission approval under Rule 17d-2, 17 CFR §240.17d-2, clearing agencies may enter into agreements with other self-regulatory organizations for such other self-regulators to perform examination and surveillance activities respecting clearing agency participants who are also members of, or participants in, those self-regulatory organizations. Such agreements may provide for the other self-regulatory organization to determine compliance with rules which require visitation, while the

registered clearing agency could determine compliance with rules which do not require visitation. Any registered clearing agency may agree with any other self-regulatory organization to file, in accordance with the provisions of Section 17(d) of the Act and Rule 17d-2 thereunder, a plan regarding the performance of these responsibilities by the other self-regulatory organization.<sup>22</sup> The Division is prepared, in appropriate circumstances, to recommend to the Commission that registered clearing agencies be relieved of certain of their self-regulatory responsibilities if those responsibilities are assumed by other self-regulatory organizations.

The requirement of Section 17A(b)(3)(A) of the Act concerning enforcement of clearing agency rules is complemented by Sections 17A(b)(3)(G) and (H) which require the rules of a clearing agency to provide that its participants shall be appropriately disciplined for violations of any provision of those rules and to provide fair procedures for disciplining participants, denying participation in the clearing agency to any person, prohibiting or limiting access to the clearing agency's services and reviewing summary suspensions.<sup>23</sup>

The Act contemplates that a clearing agency may "appropriately" discipline its participants by "expulsion, suspension, limitation of activities, functions, and operations, fines, censure, or any other fitting sanction."<sup>24</sup> A clearing agency should have available and should employ an array of

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<sup>21</sup>To date four such plans, none of which involve clearing agencies, have been declared effective by the Commission.

<sup>22</sup>Regardless of whether a clearing agency files a plan pursuant to Rule 17d-2, the Division strongly urges clearing agencies and other self-regulatory organizations to expand existing arrangements for exchanging relevant information with each other regarding a participant who belongs to more than one entity.

<sup>23</sup>Section 17A(b)(5)(C) sets forth the specific circumstances under which a clearing agency may summarily suspend a participant and the minimum procedural requirements which must be observed in effecting a summary suspension.

<sup>24</sup>Section 17A(b)(3)(G) of the Act.

sanctions appropriate to the violations the clearing agency may encounter. Also, the clearing agency's rules should establish the agency's authority and procedures respecting interpretation of its rules and the bringing of charges where rule violations appear to have occurred, and the rules should describe the manner in which disciplinary authority is to be

exercised.<sup>25</sup> The fair procedure requirements of Section 17A(b)(3)(H) of the Act mandate that a clearing agency's rules comply with Section 17A(b)(5) of the Act, which outlines the procedures to be followed by a clearing agency in disciplining participants.<sup>26</sup>

<sup>25</sup>The Division believes that any plan filed jointly by a clearing agency with any other self-regulatory organization pursuant to Rule 17d-2 may provide for the performance of disciplinary functions by the other self-regulatory organization with respect to participants who are members of, or participants in, the clearing agency and the other self-regulatory organization.

<sup>26</sup>In connection with the imposition of final disciplinary sanctions, denial of participation, prohibition or limitation with respect to access and summary suspension by a registered clearing agency, the Act requires a registered clearing agency to give notice of the action to the appropriate regulatory agency for the clearing agency and (if other than the appropriate regulatory agency for the self-regulatory organization) the appropriate regulatory agency for the participant or applicant. The Act also provides for review of the action by the appropriate regulatory agency for the participant or applicant. See Sections 19(d), (e) and (f) of the Act and Rules 19d-1, 2 and 3 adopted thereunder (17 CFR §§240.19d-1, 240.19d-2, 240.19d-3), Securities Exchange Act Release No. 13726 (July 7, 1977), 42 FR 36409 (July 14, 1977). Rules 19d-1, 2 and 3 prescribe the form and content of notices to be filed with the Commission by certain self-regulatory organizations concerning disciplinary sanctions and procedures for certain aggrieved parties to follow in obtaining stays or appeals of such actions.

The Federal bank regulatory agencies (the Board of Governors of the Federal Reserve System, the Comptroller of the Currency and the Federal Deposit Insurance Corporation), which under Sections 3(a)(34)(B) and (C) of the Act are the appropriate regulatory agencies for certain registered clearing agencies and certain clearing agency participants, have adopted rules similar to the Commission's Rules 19d-1, 2 and 3.

#### IV. Safeguarding of Securities and Funds and Prompt and Accurate Clearance and Settlement of Securities Transactions

*In order to assure the safeguarding of securities and funds and the prompt and accurate clearance and settlement of securities transactions, a clearing agency should (i) perform periodic risk assessments of its operations and its automatic data processing systems and facilities, (ii) have an audit committee of its board of directors composed of non-management directors which would select, or participate in the selection of, the clearing agency's independent public accountant and which would review the nature and scope of the work to be performed by the independent public accountant and the results thereof with the independent public accountant, (iii) have an adequately and competently staffed internal audit department which reviews, monitors and evaluates the clearing agency's system of internal accounting control, (iv) furnish annually to participants audited financial statements and furnish quarterly to participants on request unaudited financial statements, (v) furnish annually to participants an opinion report prepared by its independent public accountant based on a study and evaluation of the clearing agency's system of internal accounting control for the period since the last such report and (vi) have detailed plans to assure (1) the physical safeguarding of securities and funds, (2) the integrity of the automatic data processing system and (3) the recovery under a variety of contingencies from loss or destruction of securities, funds or data.*

##### A. Statutory Background

In determining whether to register a clearing agency, the Commission must consider whether

[the] clearing agency is so organized and has the capacity to be able to facilitate the prompt and accurate clearance and settlement of securities transactions for which it is

responsible [and] to safeguard securities and funds in its custody or control or for which it is responsible. . . .<sup>27</sup>

and whether:

[t]he rules of the clearing agency are 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. . . .<sup>28</sup>

### B. General Discussion

As used in this discussion, the term "safeguards" comprises (i) the organization and capacity to safeguard securities and funds and clear and settle transactions promptly and accurately and (ii) the rules designed to achieve those objectives. Moreover, because significant segments of securities clearance and settlement are carried out and controlled through automatic data processing ("ADP"), the term "safeguards" also includes the overall management responsibility of assuring the integrity and accuracy of its ADP operations.

Clearing agency safeguards should anticipate, and be designed to provide protection against, the possibility of theft, accidental or malicious destruction or loss of securities or funds and the possibility of accidental or intentional, but unauthorized, modification, disclosure or destruction of data.<sup>29</sup>

Although the Commission has previously evaluated clearing agency safeguards in connection with granting temporary registrations to clearing agencies pursuant to paragraph (c) of Rule 17Ab2-1, the Commission finds it appropriate in light of the standards that those determinations be re-examined during the registration proceedings. The ensuing discussion describes the requisite standards applicable to clearing agency safeguards.<sup>30</sup>

### C. Organization and Processing Capacity

Clearing agencies should be organized in a manner that effectively establishes operational and audit controls while fostering director independence. For example, the clearing agency's board of directors must be informed by management about the

clearing agency's operations. This flow of information is necessary in order for the board to discharge its oversight responsibility over management's performance of its on-going duties to assure both the operational capability and the integrity of the clearing agency.

The Division believes that management, among other things, should perform periodic risk assessments of the clearing agency's operations and

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<sup>27</sup>Section 17A(b)(3)(A) of the Act.

<sup>28</sup>Section 17A(b)(3)(F) of the Act.

<sup>29</sup>A number of studies of security measures in computer systems have been undertaken. See, e.g., National Bureau of Standards Special Publication 500-19, *Audit and Evaluation of Computer Security* (October 1977) [available from Sup. of Doc. U.S. Government Printing Office, Washington, D.C. 20402, Stock No. 003-003-01848-1 (\$4.00)]; Courtney, "A Systematic Approach to Data Security," National Bureau of Standards Special Publication 404, *Approaches to Privacy and Security in Computer Systems*, 29 (September 1974) [available from Sup. of Doc. U.S. Government Printing Office, Washington, D.C. 20402, SD Cat. No. C13.10:404 (\$1.45)]

<sup>30</sup>To the extent that any of the clearing agency's processing or ADP functions are carried out by a facilities manager or "service center," the clearing agency should assure itself that the facilities manager or "service center" complies with all of the safeguards, as appropriate, set forth in the section on "Safeguarding of Securities and Funds and Prompt and Accurate Clearance and Settlement of Securities Transactions" and that these operations will be subject to examination by its independent public accountant, the Commission and the appropriate regulatory agency to the same extent as in the case of a clearing agency which carries out its own processing or ADP functions.

its ADP systems and facilities<sup>31</sup> and provide the board or its designee, such as a board committee, with the risk assessment reports. Management must supervise the establishment, maintenance and updating of safeguards and report periodically to the board or its designee concerning strengths and weaknesses in the clearing agency's system of safeguards. Clearing agency management also must continually consider, and advise the board of directors of, the impact that new or expanded services or volume increases would have on the clearing agency's processing capacity, both

physical, including personnel, and systemic.

#### D. Audit Committee

Clearing agencies should have an audit committee<sup>32</sup> which either selects, or makes a recommendation to the board of directors of the clearing agency regarding the selection of, the clearing agency's independent public accountant.<sup>33</sup> The audit committee should be composed of non-management directors<sup>34</sup> who will devote sufficient time to the work of the committee and who are

<sup>31</sup>Risk assessment has been discussed in a number of publications. See, e.g., S. Reed, *Automatic Data Processing Risk Assessment* (Interim Document—March 1977) [prepared by the Systems Architecture Section, Systems and Software Division, Institute for Computer Sciences & Technology, National Bureau of Standards, Washington, D.C. 20234, available from the National Technical Information Service, Springfield, Virginia 22151 (\$4.00)]; R. Courtney, *Security Risk Assessment in Electronic Data Processing Systems* (Revised ed. December 1975) [available from IBM Corporation, P.O. Box 390, Poughkeepsie, N.Y. 12602], reprinted in Committee on Government Operations, United States Senate, *Problems Associated with Computer Technology in Federal Programs and Private Industry*, 181 (June 1976).

<sup>32</sup>The Commission has long urged the formation of audit committees to participate in arranging corporate audits. See, e.g., Accounting Series Release No. 19 (December 5, 1940), Accounting Series Release No. 123 (March 23, 1972), "Standing Audit Committees Composed of Outside Directors." In addition, the desirability of audit committees has been formally recognized by the American Bar Association in its *Guidebook for Corporate Directors*.

On March 9, 1977, the Board of Directors of the New York Stock Exchange, Inc. ("NYSE") adopted Paragraph 2495H, entitled "Audit Committee Policy," which is contained in the *NYSE Company Manual*. The listing policy requires issuers of securities to establish no later than June 30, 1978, and thereafter to maintain, an audit committee composed of directors independent of management as a condition to listing or continued listing of the issuers' securities on the NYSE.

<sup>33</sup>In accordance with comments received, the Division believes that a publicly-held company or a national securities exchange should be permitted to choose the independent public accountant for its clearing agency subsidiary, provided that the selection, or recommendation for such selection, is made by an audit committee of the parent composed of non-management directors. The audit committee of the subsidiary clearing agency also should meet with the independent public accountant to review, independently of the parent company or exchange, the nature and scope of the work to be performed and the results thereof.

In response to comments received that a parent audit committee could perform all the functions of the registered clearing agency's audit committee, the Division believes that a registered clearing agency should have its own audit committee for the following reasons: The focus of the parent's audit committee would not necessarily be identical to the focus of an audit committee of its clearing agency subsidiary. The parent's audit committee also may not be able to devote as much time and attention to the operation and financial activity of the subsidiary clearing agency as would the clearing agency's own audit committee. Finally, the use of a separate audit committee would strengthen the accountability of the clearing agency's board of directors and that of its management to its participants.

<sup>34</sup>A director is non-management for the purpose of serving on a clearing agency audit committee if the director (i) is not associated with the clearing agency (other than in a user capacity), any self-regulatory organization or other entity affiliated with the clearing agency (other than in a non-management capacity) or any entity which furnishes securities

qualified to discharge effectively the committee's responsibilities.<sup>35</sup>

The Division believes that the audit committee should review the nature and scope of the work to be performed by the independent public accountant and the results thereof. There should be open and free-following communication between the audit committee and the independent public accountant as to the results of the work. The Division therefore expects that meetings will take place as often as may be necessary between the clearing agency's audit committee and its independent public accountant to accomplish these objectives.

#### E. Internal Audit Department

The clearing agency also should have an internal audit department which is adequately staffed with qualified personnel.<sup>36</sup> The department must maintain objectivity in the performance of its duties and should report periodically to the audit committee, in addition to performing its on-going responsibilities to management. The internal audit department's degree of independence varies

#### Footnote 34 continued

processing services to the clearing agency and (ii) is free from any other relationship that, in the opinion of the clearing agency's board of directors, would interfere with the director's exercise of independent judgment.

The Division generally believes that a clearing agency board member who is also an officer of an entity which is affiliated with the clearing agency is in a management-related role and should not serve on a clearing agency's audit committee. The Division, however, agrees with a commenter who suggested that a director of a parent exchange or other affiliated entity may serve on a clearing agency's audit committee provided he is not in a management position with respect to the parent exchange, the clearing agency or any other entity affiliated with the clearing agency.

<sup>35</sup>A clearing agency's audit committee may form an advisory committee to assist it. This committee could be composed of participants or other appropriate persons who would meet the non-management criteria described in footnote 34 *supra*, who possess the necessary technical expertise and who could devote the necessary time.

according to its ability to act independently of the functions being audited and of the individual(s) responsible for those functions. An internal audit department's effectiveness depends on its ability to act as a separate level of control in reviewing and evaluating the clearing agency's internal accounting controls during development and, thereafter, in studying and evaluating them and the operation of the entire system of internal accounting control.<sup>37</sup>

#### F. Financial Reports

Participants who have made clearing fund contributions and/or have money and/or securities in the clearing agency's system should receive timely, audited annual financial statements. Accordingly, a clearing agency should undertake in its rules to furnish to participants, within 60 days following the close of the clearing agency's fiscal year, unconsolidated<sup>38</sup> audited comparative financial statements which are prepared in accordance with generally accepted accounting principles and are covered by a report prepared by its independent public accountant.<sup>39</sup>

<sup>36</sup>The Division believes that the widespread use of ADP by clearing agencies dictates that an internal audit department's staff possess, in addition to sufficient technical training and proficiency in accounting and auditing, expertise in the ADP application of accounting and auditing necessary to perform the internal audit functions. The growing significance of ADP operations to the internal audit function has received attention in a number of publications. See, e.g., Institute of Internal Auditors, Inc. (the "IIA") research project report, *Systems Auditability and Control* (April 1977), which is contained in 3 volumes — *Executive Report*, *Data Processing Control Practices* and *Data Processing Audit Practices Report* — [available from Director of ADP and Research, IIA, Altamonte Springs, Florida 32701 (\$30.00)].

<sup>37</sup>The department should seek assurance that, in the development of new services or change in operations of the clearing agency, the accounting controls are adequate and appropriate under the circumstances.

<sup>38</sup>See discussion *infra* as to those circumstances in which consolidated financial statements would also be appropriate.

<sup>39</sup>Among other things, the financial statements

Securities Exchange Act Release No. 14531, which announced the revised proposed standards, stated that, to the extent that there is adequate disclosure in clearing agency financial statements, a separate statement of changes in the balance and composition of the clearing agency's participants' fund is unnecessary. Adequate disclosure in the financial statements would include, although may not be limited to, (i) the balance of the fund and the breakdown of the fund balance between the various forms of contributions to the fund, e.g., cash and secured open account indebtedness, (ii) the types and amounts of investments made of the cash balance, (iii) the amounts charged to the fund during the year in excess of a defaulting participant's fund contribution and (iv) any other charges to the fund during the year not directly related and chargeable to a specific participant's fund contribution.<sup>40</sup> If the rules of the clearing agency permit it to charge either current earnings or the participants' fund for losses incurred which are in excess of a defaulting participant's clearing fund contribution, disclosure of this option should be made in addition to disclosure of any amounts charged to current earnings during the year.

In deciding that annual financial statements should be furnished to participants within 60 days, the Division believed that a clearing agency's operations are more analogous to that of a broker-dealer rather than a non-broker-dealer issuer. Therefore, the 60-day period applicable to broker-dealers in Rule 17a-5(d)(5) under the Act, 17 CFR §240.17a-5(d)(5), was used as a guideline.

The Division believes a clearing agency should furnish to its participants separate financial statements, rather than financial statements consolidated with its parent, since unconsolidated statements provide the participants with specific information regarding the assets, liabilities and financial activities of the clearing agency. The Division agrees with commenters that in certain instances consolidated financial statements also would be meaningful to participants and should be provided to participants as soon as practical after, if not simultaneously with, the unconsolidated financial statements.<sup>41</sup>

The Division believes that it would be appropriate for clearing agencies to provide in their rules that unaudited quarterly financial statements will be available to participants within 30 days following the close of each fiscal quarter. The quarterly financial

statements should, at a minimum, consist of: (i) a statement of financial position as of the end of the most recent fiscal quarter and as of the end of the corresponding period of the preceding fiscal year; (ii) a statement of changes in financial position for the period between the end of the last fiscal year and the end of the most recent fiscal quarter and for the corresponding period of the preceding fiscal year; and (iii) a statement of results of operations, which may be condensed, for the most recent fiscal quarter and for the period between the end of the last fiscal year and the end of the most recent fiscal quarter and for corresponding periods of the preceding fiscal year.

The Division believes that quarterly financial statements should be made available on as timely a basis as practicable. Currently, registered broker-dealers are required to file financial data within 17 business days of the end of each calendar quarter<sup>42</sup>; the Division believes that it is reasonable to expect clearing agencies to have their financial data available within 30 days of the end of each calendar quarter. Because participants have clearing fund deposits, cash and securities in the clearing agency system, the Division believes that a clearing agency, at a minimum, should advise its participants when

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*Footnote 39 continued*

should disclose "clearing system balances and positions." This phrase is meant to refer to both the long valued positions (participants' rights to receive securities from the system against payment) and short valued positions (participants' obligations to deliver securities to the system against payment) in a continuous net settlement system. For purposes of the financial statements, long and short values should be stated separately, rather than netted.

<sup>40</sup>See Clearing Fund discussion *infra*.

<sup>41</sup>For example, consolidated statements of a parent company and subsidiary clearing agency would be meaningful if the subsidiary entity's assets could be reached for satisfying the parent's creditors or if the subsidiary's creditors could attach any of the parent's assets.

<sup>42</sup>Rule 17a-5(a)(2)(ii) and (iii) under the Act, 17 CFR §240.17a-5(a)(2)(ii) and (iii).

quarterly statements are available and that they will be furnished on request.

In the opinion of the Division, information disclosed in financial statements is essential to the ability of a clearing agency's board of directors and participants to remain apprised of the clearing agency's financial condition and the adequacy and accuracy of its records. The availability of financial statements also will assist the Commission and the other appropriate regulatory agencies<sup>43</sup> in the discharge of their regulatory responsibilities with respect to clearing agencies.

In contrast to a commenter's suggestion, the Division believes that the 60 and 30 day time frames for annual and quarterly financial statements should apply in the case of a clearing agency subsidiary of a publicly-held company which is not required to file with the Commission its annual and quarterly parent and subsidiary consolidated financial statements until 90 and 45 days after the end of the respective periods.

The Division believes that the 60 and 30 day time frames should apply to all clearing agencies for the following reasons: First, clearing agencies balance their operations on a daily basis and therefore should have readily available the information necessary to file their financial reports within the 60 and 30 day time frames. Second, a clearing agency's operations are more analogous to those of a broker-dealer than to those of an issuer. Broker-dealers are required to file annual and quarterly reports with the Commission within 60 and 17 (business) days, respectively. Finally, and most importantly, securities professionals and institutional investors are expanding their use of clearing agencies. This expanded use has resulted in a concentration of participants' assets in clearing agencies, as well as

<sup>43</sup>See Section 3(a)(34)(B) of the Act for a definition of "appropriate regulatory agency" for a clearing agency.

<sup>44</sup>AICPA Professional Standards, AU Section 320.28.

<sup>45</sup>The AICPA's expression of the objectives of accounting control was incorporated almost verbatim into The Foreign Corrupt Practices Act of 1977. Title I of The Foreign Corrupt Practices Act (Pub. Law No. 95-213, December 19, 1977) added a new Section 13(b)(2) to the Securities Exchange Act of 1934. This new section requires every issuer that

in an increase in the number of transactions processed through the facilities of clearing agencies. Accordingly, we believe clearing agency participants should be apprised at an early date of the financial status of the clearing agency in which they participate.

The Division notes that a publicly-held corporation with a clearing agency subsidiary raised the concern that the release of the clearing agency's financial information to the clearing agency's participants prior to the filing of the parent corporation's financial information with the Commission could create questions under Rule 10b-5, 17 CFR §240.10b-5, of the Act. The Division notes that the responsibility for not violating Rule 10b-5 under the Act lies with the registrant. Consequently, the registrant should take whatever steps are necessary to ensure that it is not violating Rule 10b-5.

#### G. Internal Accounting Control Reports

The Division believes that the establishment and maintenance of an adequate system of internal accounting control is critical to the security and accuracy of clearing agency operations. The American Institute of Certified Public Accountants (AICPA) defines accounting control as comprising "the plan of organization and the procedures and records that are concerned with the safeguarding of assets and the reliability of financial records. . . ."<sup>44</sup> The Division believes that in a clearing agency the safeguarding of participants' securities and funds moving through or held by the clearing agency and the reliability of related records are primary objectives of a system of internal accounting control.

The Division presumes that the objectives of internal accounting control will be viewed by a clearing agency's directors as a fundamental aspect of management's responsibilities.<sup>45</sup> As part of the

has a class of securities registered pursuant to Section 12 of the Act and every issuer that is required to file reports pursuant to Section 15(d) of the Act to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary: (a) to permit preparation of financial statements in conformity with generally accepted accounting

exercise of its responsibilities, the clearing agency's board of directors should obtain annually an opinion report on the clearing agency's system of internal accounting control. This report, in addition to providing an essential tool for a clearing agency's management and board of directors, will assist the Commission and other appropriate regulatory agencies. The report should be prepared by an independent public accountant and should be based on a study,<sup>46</sup> including a review of the system and tests of compliance, and an evaluation which was made for the purpose of reporting on the entity's overall system of internal accounting control.<sup>47</sup>

At a minimum, the scope of the study and evaluation shall be sufficient to provide reasonable assurance

that any material weakness existing during the period would be discovered. The accountant's report shall describe any material weaknesses discovered and any corrective action taken or proposed to be taken.

For purposes of this report, a material weakness is a condition for which the auditor believes that the prescribed procedures (or lack thereof) or the degree of compliance with them does not provide reasonable assurance<sup>48</sup> that errors or irregularities in amounts that would materially affect the clearing agency or other clearing agencies would be prevented, or detected<sup>49</sup> within a timely period by employees in the normal course of performing their assigned functions.<sup>50</sup>

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*Footnote 45 continued*

principles or other applicable criteria; and (b) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's authorization; and

(iv) the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

<sup>46</sup>The purpose and scope of this study and evaluation would be broader than that normally made in an examination of financial statements performed in accordance with generally accepted auditing standards.

<sup>47</sup>The Auditing Standards Board of the AICPA has issued, for comment, a proposed SAS on "Reporting on Internal Accounting Control." This statement, if adopted, would accomplish much in providing guidance in the performance of this type of study and evaluation. The scope set forth *infra* is broader, however, than in the proposed statement in that it covers the entire period being studied and evaluated.

<sup>48</sup>The concept of reasonable, as opposed to absolute, assurance recognizes that it is not in the interest of the entity involved for the cost of internal accounting control to exceed the benefit thereof. Such benefits, and in many cases such costs, are not likely to be precisely quantifiable. Therefore, many decisions on

reasonable assurance will necessarily depend in part on estimates and judgments which are reasonable under the circumstances.

<sup>49</sup>In any system, errors or irregularities may occur in isolated instances which either individually or in the aggregate may be material. Detection of these isolated instances is important to a system of internal accounting control. Further, if such errors or irregularities occur more frequently than in isolated instances, consideration should be given to whether the system has a material weakness and needs to be improved.

<sup>50</sup>As examples of particular areas of concern, a material weakness in internal accounting control in a clearing agency includes, among other things, any condition individually, or taken as a whole, which could reasonably be expected to (i) inhibit a clearing agency from promptly and accurately completing securities transactions or promptly discharging its responsibilities to its participants, other clearing agencies, debtors or creditors, (ii) result in material financial loss to the clearing agency or other clearing agencies, (iii) result in a material charge to the clearing agency participants' fund resulting from other than the default of a participant, (iv) result in material misstatements in the clearing agency's financial statements, or (v) result in inaccurate books and records maintained by the clearing agency, to an extent that could reasonably be expected to result in the conditions described in (i)-(iv) above. The foregoing examples are not intended to be comprehensive in scope or exhaustive in treatment but only illustrative.



The Division believes that the annual report on internal accounting control should be furnished to all participants promptly after it becomes available to the clearing agency and in any event not later than 60 days after the period covered by the report.<sup>51</sup> The report will apprise the participants of any material weaknesses in the system and whether prompt corrective action was taken or is proposed to be taken. The availability to participants of the information in a report of the scope described above is important because clearing agencies are an integral component in a national system for the clearance and settlement of securities transactions, and the Division believes that an audit of the scope described above will be important in assessing the safety and integrity of clearing agency operations. The Division also believes that an audit of this scope will promote confidence and increased participation in the national clearance and settlement system.

#### H. Securities, Funds and Data Controls

Based on the Division's experience, it is useful to analyze safeguards in terms of the two principal objectives: (i) prevention of loss assured by adequate internal accounting control including data and software integrity, and physical security including data and software integrity, and physical security including organizational structure, procedures and physical safeguards and (ii) recovery of funds, securities, data and operational capacity. Contingency planning and insurance are both useful in achieving the recovery objective.

##### 1. Prevention

The securities industry has had substantial experience with security measures for the safeguarding of securities and funds in vaults, in funds handling areas and in-transit. In the area of ADP operations, experience with necessary components of security is less extensive.<sup>52</sup> While the Division recognizes the need for flexibility in the design and implementation of security systems, on a more general level the Division expects each clearing agency's plan for security to include such traditional measures as: (i) access control on-site, off-site and in-transit; (ii) written procedures detailing steps involved in handling funds and securities; (iii) maintenance of an orderly and secure working environment and (iv) early warning systems and procedures responsive to fire, natural disasters and intrusion.

The application of conventional preventive measures to ADP operations should be augmented by measures designed to assure software integrity, such as stringent quality assurance procedures (including pre-implementation review and testing of new applications, operating systems and components), full documentation of systems design and modifications, requirements for executive approval to modify or update software and periodic post-implementation systems testing to determine (i) conformity to latest system design specifications, (ii) data accuracy and (iii) the adequacy of accounting controls. In addition, the accuracy of data files should be verified periodically.

The Division believes that these preventive measures are appropriate as minimum guidelines for clearing agencies to follow in establishing comprehensive preventive safeguards for securities and funds.

##### 2. Recovery

The recovery objective of securities, funds and data controls, in the Division's opinion, calls for a written contingency plan, which at a minimum covers (i) preparation for contingencies through such devices as appropriate remote and on-site hardware back-up and periodic duplication and off-site storage of data files; (ii) off-site storage of up-to-date, duplicative software, files and critical forms and supplies needed for processing operations; (iii) immediate availability of software modifications, detailed

<sup>51</sup>The study and evaluation may be made separate from the annual examination of the clearing agency's financial statements or may be an extension thereof, provided the scope of the study and evaluation conforms with that set forth above. See also footnote 46 *supra*. The report may be issued on any predetermined annual basis which the clearing agency may select.

<sup>52</sup>See, e.g., the discussion of ADP physical security contained in the National Bureau of Standards Federal Information Processing Standards Publication 31, *Guidelines for Automatic Data Processing, Physical Security and Risk Management*, June 1974, [available from National Technical Information Service, 5285 Port Royal Road, Springfield, Virginia 22161 (\$3.50)].

procedures, organizational charts, job descriptions and personnel for the conduct of operations under a variety of possible contingencies; and (iv) emergency mechanisms for establishing and maintaining communications with participants and other entities involved in the national clearance and settlement system. Contingency plans should be tested periodically to assure their effectiveness and adequacy.

The recovery component of clearing agency safeguards should include adequate insurance coverage, and the clearing agency management and board of directors should periodically review the kinds of risks involved in its business and the types and amounts of insurance coverage available. There should be adequate insurance in both coverage and amount for both the clearing agency's operations and the operations of any sub-custodian, delivery service or other agent used by the clearing agency.<sup>53</sup>

#### V. Obligations to Participants

*A clearing agency should have a clearing fund which (i) is composed of contributions based on a formula applicable to all users, (ii) is in cash or highly liquid securities and (iii) is limited in the purposes for which it may be used.*

*Since the clearing agency is an important component of the national system for the clearance and settlement of securities transactions, it should be held to a uniform standard in its obligations to participants. Accordingly, a clearing agency is responsible for delivering securities in its custody to, or as directed by, the participants for whom such securities are held.*

#### A. Clearing Funds

The Division believes that it is appropriate for a

<sup>53</sup>See also discussion *supra* and footnote 31 *supra* with regard to analysis of risks.

<sup>54</sup>The terms "clearing fund" and "participants' fund" are used interchangeably in this release.

<sup>55</sup>If the clearing fund deposit of a particular participant is charged as a result of a clearing loss solely attributable to that participant, the clearing agency's rules should provide that the participant must promptly replenish the deficiency in its clearing fund deposit.

clearing agency to establish by rule an appropriate level of clearing fund contributions based, among other things, on its assessment of the risks to which it is subject.<sup>54</sup> Contributions to the clearing fund should be based on a formula which applies to all users on a uniform, non-discriminatory basis. The forms of contributions should be in cash or open account indebtedness secured by United States Government obligations, highly rated municipal bonds or such other investments as the rules of the clearing agency may provide which assure safety and liquidity.

Because contributions to clearing funds protect clearing agencies against specified contingencies and are returned when participants withdraw from clearing agencies, the rules of clearing agencies should limit the use that they may make of clearing fund contributions. A clearing agency should not use the fund in a manner that exposes it to unreasonable risks. Therefore, the rules of the clearing agency should limit the investments which it can make with the cash portion of its clearing fund to United States government obligations or any other investments which provide safety and liquidity of the principal invested. In summary, the cash portion of the fund should be invested in light of the clearing agency's fiduciary responsibilities and as provided for in the rules of the clearing agency.

Except as discussed below, the rules of the clearing agency should limit the purposes for which the clearing fund may be used to protecting participants and the clearing agency (i) from the defaults of participants and (ii) from clearing agency losses (not including day-to-day operating expenses) such as losses of securities not covered by insurance or other resources of the clearing agency. In addition, whenever the clearing fund is charged for any reason other than to satisfy a clearing loss attributable to a participant solely from that participant's clearing fund deposit<sup>55</sup>, each participant should promptly be given notice of both the amount of, and the reasons for, the charge. The amount should be promptly assessed pro rata against each participant who must thereafter make good the charge against its clearing fund deposit.

With respect to further assessing a clearing agency participant to cover losses other than losses solely attributable to the participant, the Division believes that a clearing agency's rules should provide for a maximum assessment which is fixed by the clearing agency's rules in order that, at any given time, a

participant can ascertain its maximum potential liability. These limitations must be determined in light of factors such as the clearing agency's risks in its operations and the size of its clearing fund.

Some commenters did not endorse the proposed standard that would limit the use of clearing funds to covering participants' defaults and other losses resulting from clearing agency operations (not including day-to-day operating expenses). One commenter stated that clearing funds should be available when needed to supply operating funds for the clearing agency when, for example, a necessary fee increase could not be implemented in time to make up for a sudden decrease in revenues resulting from lower securities volume. It was argued that clearing agencies should not have to go out of business in that case or other cases such as a temporary delay in payment of funds by a participant resulting from circumstances beyond its control. One commenter maintained that, so long as the funds are properly protected, they should be available for use for certain purposes that facilitate the process of clearing.

The Division appreciates a clearing agency's possible need for temporary applications of a clearing fund in limited amounts to meet unexpected and unusual requirements for funds. The regular or substantial use of a clearing fund for such purposes, however, would be inappropriate. The Division believes that the rules of the clearing agency may permit the clearing agency to use a small percentage of the clearing fund for a short period of time to cover unexpected and unusual requirements for funds.<sup>56</sup> If any such monies are not returned expeditiously to the clearing fund, the clearing fund should be charged and the participants should make good the charge against their clearing fund deposits.

As to the forms of securities which may secure an open-account indebtedness to a participants' fund, some commenters suggested that letters of credit should be allowed. The Division believes that it is not necessary at this time to determine whether letters of credit may be permissible or appropriate to secure a participant's open-account indebtedness to a clearing agency. Such determinations are possible upon a specific application in the form of a proposed rule change pursuant to Rule 19b-4 under the Act, 17 CFR §240.19b-4, that includes a complete description of the kinds of letters of credit and the relationship of their issuers to the participants and an explanation of how the letters of

credit and any conditions attached to their use as security for open-account indebtedness are consistent with the safeguarding of funds and securities and the protection of investors.

#### B. *Standard of Care*

The Division believes that the rules of every clearing agency should provide that, except for securities delivered through the clearing agency to a participant for which the participant has not made payment to the clearing agency, or securities pledged by a participant through the clearing agency, the clearing agency must promptly deliver securities in its custody or control to, or as directed by, the participant for whom they are held. The Division believes that a clearing agency should assure that any sub-custodian holding the clearing agency's securities would deliver the securities to, or as directed by, the clearing agency and otherwise would have the financial and operational capability to perform its functions. However, neither a clearing agency nor its sub-custodian would be required to deliver securities in contravention of any notice of levy, seizure, or similar notice, or order or judgment, issued or directed by a governmental agency or court, or officer thereof, having jurisdiction over such clearing agency or sub-custodian, which on its face affects the securities held for the clearing agency's participants or, in the case of a sub-custodian, for the clearing agency.<sup>57</sup>

The rules of a clearing agency should also provide that it is liable to a participant for the failure to deliver the participant's securities resulting from: (i) the

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<sup>56</sup>The Division believes that there may be legitimate purposes for which a clearing fund may be utilized for a longer period of time so long as (i) the funds are properly protected, (ii) the funds are utilized to facilitate the process of clearance and settlement and (iii) the participants and the Commission specifically approve such use during the registration proceedings.

<sup>57</sup>The clearing agency's organization, capacity, rules, procedures and agreements should be designed and implemented so that broker-dealers can comply with applicable requirements under the federal securities laws such as Rules 8c-1, 15c2-1 and 15c3-3 under the Act, 17 CFR §240.8c-1, 17 CFR §240.15c2-1, and 17 CFR §240.15c3-3.

negligence or misconduct of the clearing agency, the clearing agency's sub-custodian or agent, or any of their respective agents or employees; (ii) the placement, on fully-paid-for participant's securities held by the clearing agency, of any lien, claim, right, or charge of any kind in favor of the clearing agency, the clearing agency's sub-custodian or agent or any person claiming through any one or more of them; (iii) larceny; (iv) mysterious disappearance or (v) any other cause for which the clearing agency has assumed responsibility.

A number of commenters stated that the clearing agency's liability would be higher under this proposal than under the common law standard of a bailee for hire. One of the commenters believed that the standard of care currently applicable was that of a bailee for hire and noted that clearing agency participants had not suffered losses under that standard.

The Division is of the view that clearing agencies should undertake to perform their obligations with a high degree of care. The clearing agencies registered with the Commission are essential to Congressional policy which includes a national clearance and settlement system for securities and the encouragement of broad scale participant therein by securities professionals so as to reduce the physical movement of securities certificates. Such broad scale participation will result in the concentration of securities in a limited number of entities. Since a loss of securities by just one entity could have a significant effect on its participants suffering the loss, the clearing agency should perform its obligations with a high degree of care. In case of loss, the clearing agency, rather than the participants whose securities are missing or lost, should bear the loss. Pursuant to the rules of most clearing agencies, if the clearing agency is liable for a loss not covered by insurance, the loss may be spread among all the participants via charges against the participants' fund on a pro rata basis.

Another factor that favors a high uniform standard of care is the possible difference among state laws governing the liability of a bailee for hire or other forms of bailment. Clearing agencies currently are located in five states, and a much larger number of states may have some jurisdictional nexus. Clearing agency participants may deal with one or more clearing agencies, in circumstances in which the standard of liability changes as their securities move through various clearing agencies.

In view of these circumstances, the Division believes it is necessary and appropriate that clearing agencies assume the standard of liability for the delivery and return of participant securities as set forth in the first two paragraphs of this section. This standard should be reflected in the rules of the clearing agency.

#### VI. Participant Charges

Section 17A(b)(3)(E) of the Act requires a determination that

[t]he rules of the clearing agency do not impose any schedule of prices, or fix rates or other fees, for services rendered by its participants.

This provision precludes a clearing agency from imposing schedules of prices or fixing minimum rates or charges for services which its participants render to others. The Division believes that no further guidance regarding compliance with this provision is necessary at this time.

#### VII. Equitable Allocation of Reasonable Dues, Fees and Other Clearing Agency Charges

Section 17A(b)(3)(D) of the Act requires a determination that

[t]he rules of the clearing agency provide for the equitable allocation of reasonable dues, fees, and other charges among its participants.

With respect to fee schedules in general, as indicated in Securities Exchange Act Release No. 14531, the Commission has a duty to ensure that fees charged by clearing agencies are reasonable and are allocated among participants on an equitable basis. In addition, rules providing for dues, fees or other charges must be designed to meet the other objectives of Section 17A(b)(3) of the Act.<sup>58</sup> The Division anticipates that in instances of significant fee change proposals a clearing agency will apprise its participants of such proposals and the underlying reasons therefor and that participants will be allowed to give their views to the clearing agency regarding the determinations affecting fees prior to the filing of the proposals pursuant to Rule 19b-4 under the Act.

<sup>58</sup>The matter of fees charged by a clearing agency to an interfacing or participant clearing agency will be considered in a separate proceeding.

### VIII. Limitation on a Clearing Agency's Scope of Regulation

Section 17A(b)(3)(F) of the Act provides that the rules of the clearing agency must not be designed "to regulate by virtue of any authority conferred by [the Act] matters not related to the purposes of [Section 17A of the Act] or the administration of the clearing agency." In connection with the registration of clearing agencies, the Division intends to review all clearing agency rules to assure that they are in accord with the foregoing objective.

### IX. The National Clearance and Settlement System

The standards in this release must be viewed in the context of the Commission's responsibilities, among other things, to facilitate the establishment of a national market system and a national clearing system and to use its authority to end the physical movement of certificates in connection with settlements among broker-dealers.<sup>59</sup> The Commission intends to facilitate the development of a national system by using its authority, if and when deemed appropriate, to, among other things, (i) increase the number of securities eligible for the national clearance and settlement system, (ii) encourage institutional and broker-dealer settlement of their transactions in a clearing agency environment and (iii) facilitate interfaces between clearing agencies in a national clearance and settlement system.

In proposing the revised standards (Securities Exchange Act Release No. 14531), the Commission stated:

It is possible that accomplishment of the Commission's responsibilities may be impeded if a dominant entity or entities has an access or other requirement which prevents potential participants from using the entity's [or entities'] facilities. Some commenters suggested that dominant entities should be subject to different standards from those applied to other clearing agencies. The Commission requests comments on whether, and how, the standards for a dominant entity or entities should differ from the standards applied to other entities.

In response to that inquiry, certain commenters suggested that the registration standards be uniform for all registered clearing agencies, while other

commenters urged that there are valid considerations and real differences between large and small clearing agencies which should be reflected in the standards. The Division recognizes the differences in size and operations that exist among clearing agencies but has determined that the general or broad policy objectives of the standards should be initially formulated on a uniform basis for all clearing agencies.

If a clearing agency believes that its organization, capacity and rules provide appropriate alternatives to the standards, the clearing agency should describe such alternatives in a separate statement(s) accompanying its Form CA-1 application.<sup>60</sup> Of course, the alternatives must be designed to assure the achievement of the objectives of the Act.

As an alternative, the clearing agency may wish to request an exemption from any of the statutory criteria listed in Section 17A(b)(3) of the Act. In such case, the request for exemption may not be granted by the Commission unless, as provided in Section 17A(b)(1) under the Act,

the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section, including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds.

### X. Other Matters

A number of specific matters have been raised by individual clearing agencies which are not addressed in this Release but will be handled with each clearing agency on a case-by-case basis.

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<sup>59</sup>See Section 17A(e) of the Act.

<sup>60</sup>See *infra* for a description of the information which must be submitted in connection with the proposed alternative.

[REDACTED]

In order to facilitate the registration of clearing agencies, the Commission requests that by October 31, 1980, each registrant submit a new Form CA-1 which includes, among other things, a complete set of the registrant's current rules<sup>61</sup> as defined in Section 3(a)(27) and Rule 19b-4 under the Act.<sup>62</sup> By that date each registrant also should submit amendments to its rules to comply with the standards set forth in this release, appropriate alternatives to such standards, or exemptive requests if the registrant desires exemptions.

The Commission has consulted and requested the views of the other appropriate regulatory agencies involved in the regulation of clearing agencies before publishing the standards for the registration of clearing agencies.

Accordingly, 17 CFR Part 241 is amended by adding this release thereto.

By the Commission.

George A. Fitzsimmons  
Secretary

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<sup>61</sup>The rules should be submitted in loose-leaf form.

<sup>62</sup>Item 7(b) of Form CA-1, which requests the dollar amount of the potential exposure of the registrant as a result of differences in its clearing agency activities not resolved after 20 business days, should be responded to as of August 31, 1980.

It should be noted that, with respect to a clearing agency for which the Commission is not the appropriate regulatory agency, as defined in Section 3(a)(34)(B) of the Act, Section 17(c)(1) of the Act requires such clearing agency to file with the appropriate regulatory agency for such clearing agency a signed copy of any application, document or report filed with the Commission. See Instruction 2 for use of Form CA-1.

For guidance in requesting confidential treatment of any portion of Form CA-1, the clearing agency should consult Rule 24b-2 under the Act (17 CFR §240.24b-2).