

proposed rule change permitting foreign entities to become members of GSCC's netting system.⁴ The rule change established application and continuing membership requirements for foreign entities, including the delivery to GSCC of an opinion of foreign counsel addressing the particular jurisdictional concerns raised by the admission of a foreign entity to netting system membership.⁵

Having gained experience from reviewing the legal opinions regarding foreign law that were provided in connection with the applications of the foreign banks that GSCC has admitted to its netting system to date, GSCC has determined to clarify its insolvency rule, rule 22, in the manner described in subsection (i) below so that the insolvency rule more appropriately references the types of insolvency proceedings to which a foreign member might become subject. GSCC will also make conforming language changes to GSCC's rules dealing with applications for membership standards as they apply to foreign members.

Some of the legal opinions referred to in the previous paragraph have indicated that GSCC would be exposed to "legal risk" as a result of the application of the particular jurisdiction's law to a foreign member's insolvency or bankruptcy. The legal risk can take the form of prohibiting or delaying GSCC from: Accessing some or all of the clearing fund deposit of the member; performing its netting, close-out, or liquidation of transactions; or setting off obligations as set forth in its clearing fund rule (rule 4), its ceasing to act rule (rule 21), or its insolvency rule (rule 22) or taking any other action contemplated by these rules. GSCC is amending its rules to better protect itself and its members from these types of legal risk in the circumstances where GSCC reasonably determines based upon factors such as outside legal advice or discussions with a relevant regulator that such legal risk exists. The proposed rule changes are described more fully in subsection (ii) below.

GSCC's experience in connection with the admission of U.S. branches of foreign banks has also indicated that certain issues that are described in these opinions could affect GSCC's rights in the event of the insolvency or bankruptcy of a domestic member. GSCC believes, given the importance of its being able to exercise its rights as set

forth in its clearing fund rule, its ceasing to act rule, and its insolvency rule that the proposed rule changes discussed below in subsection (ii) should also apply to domestic members that present GSCC with legal risk. GSCC would reasonably determine that such legal risk exists based upon factors such as outside legal advice or discussions with a relevant regulator.

GSCC is also adding language to its clearing fund rule clarifying its right to rehypothecate the cash deposits of its clearing fund.

(i) *Changes to Insolvency Rule*

GSCC's insolvency rule contains a section that lists the various types of events or proceedings that would permit GSCC to treat a member as insolvent. The rule was written utilizing terms common in United States insolvency or bankruptcy proceedings. GSCC is amending its insolvency rule to add language so that the rule more appropriately references the types of insolvency proceedings to which a foreign member might become subject.

GSCC's foreign membership agreements have already been expanded to incorporate the insolvency triggering events that GSCC is now making part of its rules. The changes will bring the rules into conformity with the foreign membership agreements and specifically give GSCC the right pursuant to its rules to declare a foreign member to be insolvent under the requisite circumstances.⁶

(ii) *Clearing Fund Requirements*

One of GSCC's most important risk management tools is its clearing fund, which is comprised of cash, certain netting-eligible securities, and eligible letters of credit. The purposes served by the clearing fund are: (1) To have on deposit from each netting member assets sufficient to satisfy any losses that may be incurred by GSCC as the result of the default by the member and the resultant close-out of that member's settlement positions; (2) to maintain a total asset amount sufficient to satisfy potential losses to GSCC and its members resulting from the failure of more than one member (and the failure of such members' counterparties to pay their pro rata allocation of loss); and (3) to ensure that GSCC has sufficient liquidity at all times to meet its payment and delivery obligations.

A member's clearing fund deposit, to serve its intended purpose, should be

immediately accessible by GSCC in the event of the member's bankruptcy or insolvency. However, the application of certain domestic or foreign laws could delay or prevent GSCC from accessing the portion of the member's clearing fund deposit that is in the form of cash and securities. The portion of the member's clearing fund deposit that is in the form of letters of credit ("LCs") is generally not subject to the same risk because LCs are typically not considered to be part of the bankrupt/insolvent entity's estate.

The rules with respect to the calculation of a member's clearing fund deposit do not currently address this legal risk. In order to better protect itself and its members, GSCC is amending its rules to require a domestic or foreign member that in management's reasonable view (which may be based upon factors such as outside legal advice or discussions with a relevant regulator) presents heightened legal risk to GSCC to deposit additional collateral over what would normally be required under GSCC's clearing fund rule and/or to post some additional portion of its clearing fund deposit requirement in the form of an LC.⁷

(iii) *Clarification of Rehypothecation Right With Respect to Cash Deposits*

GSCC's clearing fund rule contains a provision that permits GSCC to rehypothecate, transfer, or assign its clearing fund collateral in the event that GSCC needs to secure a loan or to satisfy an obligation incurred by it incident to its clearance and settlement business. GSCC is clarifying the provision with respect to the portions of the clearing funds that may be rehypothecated, transferred, or assigned by GSCC. The provision refers to the securities and the LCs that members pledge or deposit to the clearing fund as well as to the "deposits or other instruments in which the cash deposits" are invested. GSCC believes that this language could be read to not actually refer to the cash deposits themselves. Therefore, GSCC believes that it is prudent to specifically add a reference in the rule to "cash deposits" in order to eliminate any doubt as to GSCC's ability to use the cash portion of the clearing fund in the manner set forth in the clearing fund rule.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the

⁴ Securities Exchange Act Release No. 36788 (January 10, 1996), 61 FR 4500 (February 6, 1996) (File No. SR-GSCC-95-05).

⁵ GSCC also requires each prospective foreign member to provide a legal opinion on insolvency discussing applicable U.S. Federal and State laws.

⁶ In addition, the proposed rule change makes conforming language changes to GSCC's rule 2 (Members) and rule 3 (Financial Responsibility and Operational Capability Standards) as they apply to foreign members.

⁷ GSCC's clearing fund rule requires that LCs constitute no more than 70 percent of a member's clearing fund deposit. GSCC is amending its rule so that it may ask for a higher percentage in the form of an LC if circumstances warrant.