

(G) Transactions With Exempt Accounts Involving Highly Rated Foreign Sovereign Debt Securities and Investment Grade Debt Securities

On any position resulting from a transaction made for or with an "exempt account" (other than a position subject to paragraph (e)(2)(F)), the margin to be maintained on highly rated foreign sovereign debt and investment grade debt securities shall be, in lieu of any greater requirements imposed under this Rule, (i) 0.5% of current market value in the case of highly rated foreign sovereign debt securities and (ii) 3% of current market value in the case of all other investment grade debt securities. The member organization need not collect any such margin; provided the amount equal to the margin required shall be deducted in computing the Net Capital of the member organization under the Exchange's Capital Requirements. In computing the margin required, any marked to market losses included as a deduction to Net Capital shall be subject to the provisions in paragraph (e)(2)(H) below.

(H) Limits on Net Capital Deductions for Exempt Accounts

(i) Member organizations shall maintain a written risk analysis methodology for assessing the amount of credit extended to exempt accounts pursuant to paragraphs (e)(2)(F) and (e)(2)(G) which shall be made available to the Exchange upon request.

(ii) In the event that the Net Capital deductions taken by a member organization as a result of marked to the market losses incurred under paragraphs (e)(2)(F) and (e)(2)(G) (exclusive of the percentage requirements established thereunder) exceed:

[(i)] (1) On any one account or group of commonly controlled accounts, 5% of the member organization's Tentative Net Capital (Net Capital before deductions on securities); or

[(ii)] (2) On all accounts combined, 25% of the member organization's Tentative Net Capital (Net Capital before deductions on securities); then, unless such excess no longer exists on the fifth business day after it was incurred, the member organization (1) shall give prompt written notice to the Exchange and (2) shall not enter into any new transaction(s) subject to the provisions of paragraphs (e)(2)(F) or (e)(2)(G) that would result in an increase in the amount of such excess under, as applicable, subparagraph (i) or (ii) above.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NYSE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NYSE has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

Background

NYSE Rule 431 prescribes minimum margin requirements for customer accounts held by member organizations. In April 1996, the NYSE established a Rule 431 Committee (the "Committee") to assess the adequacy of NYSE Rule 431 on an ongoing basis, review margin requirements, and make recommendations for change. A number of proposed amendments resulting from the Committee's recommendations have been approved by the NYSE's Board of Directors since the Committee was established.

Rule 15c3-1 under the Exchange Act (the "Net Capital Rule")⁵ provides, in part, that at all times every broker or dealer shall maintain net capital of no less than the minimum required by the Net Capital Rule. Further, it requires brokers or dealers to take certain prescribed haircuts from proprietary positions to reflect actual economic and market risk inherent in maintaining such positions. These haircuts are generally lower than the margin required for comparable securities. Accordingly, the Committee recommended that margin requirements for transactions in certain non-equity securities in the most creditworthy accounts be amended to reflect the actual economic risk inherent in those securities. The proposed amendments discussed below have been recommended by the Committee.

In December 1997, the Board of Governors of the Federal Reserve System amended Regulation T,⁶ which establishes initial margin requirements, to provide that transactions in non-equity securities are subject to "good faith" requirements when transacted in

a "good faith" account, in lieu of a margin or cash account. The term "good faith" within this context means generally that such transactions are subject to the requirements of the self-regulatory organization with regulatory authority over the transactions and such requirements shall be applicable for initial and maintenance purposes. Accordingly, the maintenance margin requirements of NYSE Rule 431 provide ongoing safety and soundness levels for such positions maintained in customer accounts.

Initial Filing

As noted above, in April 1998 the NYSE filed with the Commission proposed amendments to NYSE Rule 431 which, among other things, would revise the margin requirements for investment grade non-equity securities and expand the types of such securities eligible for exempt account treatment. The proposed amendments recognized that in certain instances, margin requirements should be adjusted to reflect both the quality of the securities as well as the creditworthiness of the customer.

The proposed amendments to NYSE Rule 431 would provide for margin requirements on non-equity securities that the Exchange believes are commensurate with the risks associated with positions in such securities held by customers. For example, margin percentages for investment grade debt securities and municipal securities would as proposed be calculated by taking the highest haircut percentages under the Net Capital Rule for proprietary positions in similar securities, instead of the current 20% and 15% respective margin requirements. For other listed non-convertible debt securities, the margin requirement would remain at 20%.

Proposed amendments to NYSE Rule 431(a)(3) also would narrow the definition of "designated account" to include specifically designated institutions such as banks, other broker-dealers, savings associations, insurance companies, investment companies, states or political subdivisions thereof, and ERISA pension and profit sharing plans.

Further, proposed NYSE Rule 431(a)(13) would create a new definition of "exempt account," to include the designated accounts noted above and the following: a member organization, non-member broker-dealer and any person having net worth of at least \$40 million. The proposed amendments increased the financial threshold for a customer to be considered an exempt account from \$16 to \$40 million in net

⁵ 17 CFR 240.15c3-1.

⁶ 12 CFR 220 *et seq.*