

allocate losses associated with, among other things, clearing agency functions.<sup>5</sup> In determining the appropriate standard of care, the Commission has reviewed clearing agency services on a case-by-case basis in order to balance the need for a high degree of care at clearing agencies with the effects that liabilities may have on clearing agency operations, costs, and safekeeping of securities and funds.<sup>6</sup> Because standards of care represent an allocation of rights and liabilities between a clearing agency and its members or participants, which are sophisticated financial entities, the Commission has refrained from establishing a unique federal standard of care and has allowed clearing agencies and other self-regulatory organizations and their participants to establish their own standards of care.<sup>7</sup>

GSCC believes that adopting a rule<sup>8</sup> limiting GSCC's liability to its members to direct losses caused by GSCC's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action: (1) Memorializes an appropriate commercial standard of care that will protect GSCC from undue liability; (2) permits the resources of GSCC to be appropriately utilized for promoting the prompt and accurate clearance and settlement of securities; and (3) is consistent with similar rules adopted by

other self-regulatory organizations and approved by the Commission.<sup>9</sup>

### III. Comment Letters

The Commission received a comment letter from Dan W. Schneider, Counsel to AGC, and a response comment letter from GSCC. The AGC letter asserted that registered clearing agencies should be subject to a negligence standard of care in safeguarding funds and securities and in performing processing obligations relating to custody functions. In addition, registered clearing agencies like GSCC that provide the securities markets and the securities processing community with centralized essential utility services and that become focal points for concentrated risk should meet at least the same standard of care that is required of commercial custodians under Commission rules designed to protect investors. Finally, AGC opined that permitting registered clearing agencies that are central facilities in the national clearance and settlement system to conform their conduct to gross negligence while requiring bank custodians to adhere to a higher standard of care creates a liability differential for which no appropriate statutory or policy basis exists.

GSCC responded that the proposed rule change would not affect GSCC's standard of performance because registered clearing agencies such as GSCC are subject to rigorous regulatory standards for their operations under Section 17A of the Act. The proposed rule change only relates to GSCC's standard of liability and not to the Commission's regulatory operational standards for GSCC. Also, GSCC has operated for 15 years with a gross negligence standard of liability under SEC temporary registration orders without any financial loss to its members or third parties arising from a failure of performance by GSCC. Neither the Act nor prior Commission orders require that a particular level of liability for private rights of action be assumed by registered clearing agencies, as distinguished from the high regulatory standards imposed by the Commission for clearing agency operations under Section 17A. In addition, GSCC members are sophisticated parties who can best determine the allocation of GSCC risk for unintentional loss. GSCC pointed out that adoption of a universal simple negligence standard of liability for GSCC would likely result in a gap between the liability limitation of GSCC

and the gross negligence liability limitation of clearing banks and other service providers to which GSCC is dependent for certain key operational services.

### IV. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>10</sup> The Commission believes that approval of GSCC's rule change is consistent with this Section because it will permit the resources of GSCC to be appropriately utilized for promoting the prompt and accurate clearance and settlement of securities.

Although the Act does not specify the standard of care that must be exercised by registered clearing agencies, the Commission has determined that a gross-negligence standard of care is acceptable for non-custodial functions where the parties contractually agree to limit liability.<sup>11</sup> GSCC's functions are

<sup>10</sup> 15 U.S.C. 78q-1(b)(3)(F).

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

<sup>5</sup> Securities Exchange Act Release Nos. 20221 (September 23, 1983), 48 FR 45167 and 22940 (February 24, 1986), 51 FR 7169.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> The language of new Section 3 to Rule 39 is as follows: Section 3—Limitation on Liability of the Corporation Notwithstanding any other provision in the Rules:

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

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

<sup>9</sup> See, e.g., Securities Exchange Act Release Nos. 37421 (July 11, 1996), 61 FR 37513 [SR-CBOE-96-02] and 37563 (August 14, 1996), 61 FR 43285 [SR-PSE-96-21].