

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 21, 1986

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
House of Representatives
2125 Rayburn Building
Washington, D.C. 20515

Dear Chairman Dingell:

Thank you for your letter of September 15, 1986, concerning Commission consideration of the appropriate regulation of over-the-counter automated trading systems and the no-action request submitted by Security Pacific National Bank on behalf of its proposed system for trading options on U.S. Treasury securities. I have asked my staff to prepare the enclosed response.

Sincerely yours,

John Shad

Enclosure

cc: Honorable Timothy E. Wirth
Honorable Norman F. Lent
Honorable Fernand J. St Germain

MEMORANDUM

October 10, 1986

TO: John Shad
Chairman

FROM: Richard G. Ketchum, Director
Division of Market Regulation

RE: Chairman Dingell's inquiry regarding the Security Pacific National Bank's
("Security Pacific") no-action request

You have asked the Division to prepare a response to Chairman Dingell's letter, dated September 15, 1986. In his letter, Chairman Dingell inquires generally about Commission oversight of over-the-counter ("OTC") automated trading systems and specifically about the Security Pacific system for OTC trading of options on U.S. Treasury securities ("OTC System"). The Division, after consulting the Division of Corporation Finance, has prepared the following specific responses to Chairman Dingell's questions.

First, Chairman Dingell inquires whether the OTC System "provides facilities for bringing together purchasers and sellers of securities," and thereby constitutes an "exchange" as that term is defined in Section 3(a)(1) of the Securities Exchange Act of 1934 ("Act"). As you are aware, the definition of "exchange" is extremely broad and literally applied could include OTC market makers, brokers' brokers, brokers, and dealers.¹ A broad reading does not appear to be consistent with the statute, which provides separate definitions for each of these terms. We believe the term "exchange" must be read in light of the other definitions included in the Act so that those definitions are not rendered redundant.

The OTC System functions more like a clearing agency or a broker-dealer than an exchange; indeed, its principal functions -- processing trades, exercises, and assignments -- are more analogous to that of the Options Clearing Corporation than they are to any existing exchange. Moreover, the System's additional function, operating a quotation dissemination system, is substantially similar to the role performed by "blind brokers" in government and municipal securities who disseminate over their proprietary systems buy and sell interests to their customers. Blind brokers, who account for significant trading volume in government securities, receive indications of interest from dealers and rebroadcast that interest over their proprietary systems. Blind brokers are not registered as exchanges pursuant to Section 6 of the Act.

Second, Chairman Dingell, inquires whether, assuming the Security Pacific trading system constitutes an exchange, there is any provision in the Act (other than the exemptive procedure set forth in Section 5) that authorizes the Commission or its staff to exempt an exchange from registration under Section 6. As discussed above, however, we do not believe

¹ See Sections 3(a)(38), 3(a)(4), 3(a)(5) of the Act.

that the OTC System is an exchange. Therefore, we do not believe it is necessary to use the exemptive authority in Section 5 of the Act with respect to the OTC System. Rather, consistent with its view that the OTC System is not an exchange, the staff has issued a no-action letter to the OTC System.²

Third, Chairman Dingell inquires whether either (“GOC”) or the Security Pacific Options Services Corporation (“SPOSC”), which will issue the options and clear the options transactions, respectively, will be registered as a clearing agency under Section 17A of the Act. Section 17A does not require a clearing agency that deals exclusively in exempt securities to register. The securities traded on the OTC System will be options on Treasury securities, which are exempt securities under Rule 3a12-7 of the Act.

As you are aware, Rule 3a12-7 was adopted after the Congress amended the definition of “security” in Section 3(a)(10) of the Act to reflect the agreement reached between the Commission and the Commodity Futures Trading Commission to resolve various jurisdictional issues that had arisen between the two commissions (the Shad/Johnson Accord). Specifically, the Securities Acts Amendments of 1982 explicitly added options on exempt securities to the definition of the term security in the Act. At that time, both the House Committee on Energy and Commerce and the Senate Committee on Banking, Housing and Urban Affairs stated that they also expected the Commission to define certain options on Treasury securities to be exempt securities.³

On October 9, 1986, however, Congress passed the Government Securities Act of 1986. That legislation would add a proviso to the definition of exempt security in Section 3(a)(12) of the Act so that government securities (and options thereon) will no longer be exempt securities for purposes of Section 17A of the Act. Therefore, while under the present statutory framework,

² Under the no-action approach, the Commission oversees certain activities of the OTC System. The no-action letter requires Security Pacific to provide data on: (1) the number and identity of (a) participants in the system and (b) applicants who have been denied participation; (2) the volume of transactions through the system; (3) the number of options positions that are (a) closed out by offset, (b) exercised, and (c) allowed to expire; (4) the number of defaults on options contracts; (5) the number of, and cost to, Security Pacific (or its affiliates) of satisfying such defaults; and (6) the number of, and estimated cost to, participants of any defaults not satisfied by Security Pacific, the General Electric Credit Corporation (“GECC”) or GECC Options Corporation (“GOC”). In addition, Security Pacific must provide the staff with current copies of any rules, regulations or similar documents as well as copies of any contracts participants must sign. In addition, the staff position is conditioned upon the agreement of Security Pacific, if Security Pacific should elect to terminate or suspend its Treasury options program for financial, operational or other reasons, to continue to operate the program as long as any options issued under the program remain outstanding.

³ H.R. Rep. No. 626, Pt. 1, 97th Cong., 2d. Sess. 9 and 12 (1982); S. Rep. No. 390, 97th Cong., 2d. Sess. 5 n.2 (1982).

neither GOC nor SPOSC must be registered with the Commission,⁴ upon enactment of the Government Securities Act, at least SPOSC would be required to register under Section 17A as a securities clearing agency.

As a registered clearing agency, SPOSC would be a self-regulatory organization required to comply with basic statutory requirements through the registration and proposed rule change review process under Sections 17A and 19 of the Act. Under Section 17A, a registered clearing agency must maintain the capacity and have rules to facilitate the prompt and accurate clearance and settlement of securities transactions and to ensure the safeguarding of securities and funds. Registered clearing agencies are authorized to enforce their rules through disciplinary proceedings. They generally are inspected by both the Commission and the Board of Governors of the Federal Reserve System, and are subject to audits by independent outside auditors, as well as internal auditors. Furthermore, under Section 19 and Rule 19b-4, SPOSC would be required to submit all proposed rule changes to the Commission for approval.

Fourth, Chairman Dingell inquires if the prospectus for the options to be issued by GOC will contain all of the disclosures required by Rule 9b-1 of the Act for standardized options; whether the terms and conditions of the financial guarantees will be fully disclosed; and whether the risks of holding an option position that cannot be offset in a liquid market will be fully disclosed. As you know, the Security Pacific proposal does not involve the issuance of standardized options as defined in Rule 9b-1. Accordingly, GOC's registration statement will be on Form S-1 rather than Form S-20, as with previous registration statements involving non-standardized options (i.e. Trans Canada Options Inc.). Under the circumstances, the Division of Corporation Finance will require the information required by Rule 9b-1 to be included in the Form S-1 registration with appropriate modifications necessitated by the fact that GOC will not be issuing standardized options.

The guarantee by GECC also will be registered under the Securities Act of 1933 ("1933 Act"). GECC and GOC will be co-registrants on a combined registration statement under the 1933 Act. That registration statement will provide full disclosure of the terms and conditions of GECC's guarantee. Furthermore, information consistent with the requirements of Rule 9b-1 concerning the market for the options will be included in the Form S-1 registration statement to be filed by GOC. Any discussion of the market for the options will be required to include information concerning any risks inherent in that market.

Chairman Dingell also inquires whether full disclosure of the risk that contracts entered into in the OTC System may be void and unenforceable under Section 29(b) of the Act and that broker-dealers that effect transactions using the System may be in violation of Section 5 of the Act, will be made. We believe that the question of voidability of contracts entered into in the OTC System is a private concern that Security Pacific must address if the issue is contested. We note, however, that if a court determined that Security Pacific was operating an exchange, and was unable therefore to enforce any contractual rights, under the language in Section 29(b), it

⁴ As you know, SPOSC, as a subsidiary of a bank holding company is subject to Federal Reserve Board oversight.

may well be that participants in the OTC System would be able to enforce performance by Security Pacific of the options contracts.

Fifth, Chairman Dingell questions the Commission's judgment in issuing the no-action letter in light of the problems experienced in the government securities markets and the fact that Congress has drafted legislation regarding regulation of the government securities market. It is important to emphasize that the OTC System will not create a new marketplace. Instead it is intended to streamline and make more efficient an existing market in OTC options in government securities. In so doing, the OTC System will enhance the ability of smaller government securities dealers to compete with certain large primary dealers who presently dominate the OTC options market. Moreover, the OTC System has the potential to facilitate the ability of its participants to trade and clear put and call options on Treasury securities, thereby enabling participants to hedge more effectively their Treasury securities positions and potentially increasing liquidity in the market for Treasury securities.

Finally, none of the recent failures of government securities dealers which spurred the passage of the Government Securities Act involved abuses of the OTC options market. The Government Securities Act is narrowly focused on addressing those abuses. Therefore, it generally is limited to registration and regulation of the financial responsibility of participants in that market. The Division does not believe that the OTC System is amenable to the types of abuse which have been the cause of concern. In contrast to the unregistered, individualized credit arrangements which have caused concern in the government securities market, GOC and SPOSC have every incentive to ensure that the commitments made within their System are fully performed. Moreover, the financial arrangements between GOC and SPOSC are in part designed to protect other System participants from such risks. We, of course, intend to remain vigilant for any fraudulent activity which may occur in this market. In that connection, the examination authority provided the Commission and the bank regulators under the Government Securities Act should permit us to effectively review trading activity in the OTC System for any possible fraudulent activity.

Sixth, Chairman Dingell notes that the pending bills to regulate the government securities market differ in their approach to registration of clearing agencies that deal exclusively in government securities: the House bill requires registration, the Senate bill preserves the status quo.⁵ In light of this uncertainty, Chairman Dingell inquires: (1) whether the Commission will require the OTC System to postpone start-up until the Congress takes action and (2) what kind of disclosure Security Pacific and GOC will make in connection with this uncertainty. However, as discussed, after Chairman Dingell's letter was written, Congress passed legislation that requires SPOSC to register within 270 days from enactment of the legislation. We would not anticipate that any particular disclosure would be required by Security Pacific under these circumstances.

⁵ By letter, dated September 25, 1986, the Commission supported enactment of the House alternative. See letters of September 25, 1986 to John D. Dingell, Chairman, House Committee on Energy and Commerce, and Jake Garn, Chairman, Senate Committee on Banking, Housing and Urban Affairs from John Shad, Chairman, SEC.