

the market value of securities is included in the computation of participants' Net Free Equity.³ Net Free Equity of zero or greater is required to be maintained by participants in each of its agency, pledgee transfer, or proprietary accounts in order for transactions to be processed.⁴ Net Free Equity represents PTC's calculation of the amount of excess equity available in a participant's account which PTC may borrow against or liquidate in the event the participant's debit balance is not satisfied at the end of the day.

By including only a portion of the market value of securities in Net Free Equity, PTC attempts to limit the risk caused by fluctuations in the market value of these securities. For Government National Mortgage Association ("GNMA") single-class securities, other than construction, project, and mobile home securities, margins are set at five percent, which is a rate that exceeds their largest historic consecutive two-day downward price movement. GNMA construction, project, and mobile home securities have a higher margin to reflect their reduced liquidity.⁵

CMO Margins

CMO securities that are currently eligible for deposit at PTC are GNMA REMICs, Department of Veterans Affairs ("VA") REMICs, and certain Federal Home Loan Mortgage Corporation ("FHLMC") REMICs. Unlike GNMA single-class securities, CMO securities are structured as a series of tranches or classes, each of which represents a separate security with unique characteristics, such as differing

³ As set forth in PTC Rules, Article II, Rule 9, Net Free Equity is calculated as the sum of (a) the cash balance in the account; (b) the market value of securities in the account less the applicable percentage; (c) the value of the optional deposits to the Participants Fund which are allocated to that account (optional deposits to the Participants Fund are deposits that exceed the minimum deposit required pursuant to PTC's rules and procedures); and (d) 20% of the mandatory deposits to the Participants Fund for the master account (mandatory deposits to the Participants Fund are minimum deposits required to be deposited into such fund pursuant to PTC's rules and procedures) minus (e) "reserve on gain." Reserve on gain means (1) the contract value credited to the cash balance of a delivering participant or limited purpose participant over the market value of securities credited to the transfer account associated with the account of the receiving participant or (2) the market value of securities credited to the transfer account associated with the account of a receiving participant over the contract value credited to the cash balance of the delivering participant or limited purpose participant.

⁴ PTC Rules, Article II, Rule 13, "Transfers of Securities."

⁵ Securities Exchange Act Release No. 33840 (March 31, 1994), 59 FR 16672 (File No. PTC-93-04) (order approving proposed rule change).

payment schedules and price volatility.⁶ PTC, therefore, uses a model which takes into account the unique characteristics of each tranche to predict its potential price movement. The parameters of the model include prepayment speeds, a yield spread, and the yield on a benchmark Treasury security. PTC subjects each CMO tranche to a stress test to determine its response to yield changes in order to assign each tranche an appropriate margin.

Currently, margins are based on a fifty basis point upward movement in the underlying Treasury securities for CMO tranches that exhibit positive effective duration (*i.e.*, rise in value with falling interest rates) or a fifty basis point downward movement in the underlying Treasury security for CMO tranches that exhibit negative effective duration (*i.e.*, decline in value with falling interest rates). CMO tranches that are not modeled by PTC's pricing vendor are margined at one hundred percent and the minimum margin for any CMO tranche is five percent.

PTC believes that the proposed rule change is consistent with section 17A(b)(3)(F) of the Act⁷ and the rules and regulations thereunder because it facilitates the prompt and accurate clearance and settlement of securities transactions and provides for the safeguarding of securities and funds in PTC's custody or control or for which PTC is responsible.

B. Self-Regulatory Organization's Statement on Burden on Competition

PTC does not believe that the proposed rule change imposes any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

PTC has neither solicited nor received comments on this proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

PTC's current margin and pricing methodology for CMO securities was approved by the Commission on a temporary basis through April 30, 1995,⁸ in order to allow PTC further

⁶ A CMO is a multiple-class mortgage cash flow security which redirects the cash flow from an underlying standard mortgage-backed security, such as a GNMA security, and allows the CMO issuer to create classes, or tranches, with many different interest rates, average lives, prepayment sensitivities, final maturities, and payment priorities.

⁷ 15 U.S.C. 78q-1(b)(3)(F) (1988).

⁸ *Supra* note 2.

time in which to evaluate the methodology and to take steps to address any concerns which exist with respect to the methodology. During the temporary approval period, PTC has provided information to the Commission describing the steps taken by PTC to improve the margin and pricing methodology including finalizing arrangements with a second vendor for daily pricing and stress test analysis.⁹

Section 17A(b)(3)(F) of the Act¹⁰ requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds in the custody or control of the clearing agency or for which it is responsible. The Commission believes that extending temporary approval of the current margin and pricing methodology utilized by PTC for CMO securities should help assure the safeguarding of securities and funds in PTC's custody or control. PTC's current margin and pricing methodology helps ensure that CMO margins will be established that take into account the unique characteristics of each CMO tranche and that PTC's reliance on a daily pricing source will provide it with timely price information. The resulting margins will afford PTC protection should it be necessary for PTC to borrow against or liquidate these assets. In addition, the Commission believes that extending the temporary approval will permit PTC to make technical enhancements to its system that will enable it to use and compare data from two sources and also enable PTC to further evaluate the results of the CMO pricing and margin methodology as so enhanced.

PTC has requested that the Commission find good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of the filing. In order to allow PTC to continue employing its current margin and pricing methodology without disruption of service, it is necessary for the Commission to approve the proposed rule change prior to the expiration of the current temporary approval of the methodology on April 30, 1995. The Commission, therefore, finds sufficient cause to accelerate approval of this proposal. In addition, the staff of the Board of Governors of the Federal Reserve System ("Board of Governors")

⁹ Letters from Michael D. Frieband, Senior Vice President and Chief Financial Officer, PTC, to Jerry W. Carpenter, Assistant Director, Division of Market Regulation ("Division"), Commission (August 5, 1994, November 8, 1994, February 27, 1995, and March 23, 1995).

¹⁰ 15 U.S.C. 78q-1(b)(3)(F) (1988).