

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54821; File No. SR-FICC-2006-13)

November 28, 2006

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to the Federal Reserve's National Settlement System

I. Introduction

On July 11, 2006, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") and on August 6, 2006 amended proposed rule change SR-FICC-2006-13 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the Federal Register on October 26, 2006.<sup>2</sup>

No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The proposed rule change amends the rules of FICC's Mortgage-Backed Securities Division ("MBSD") to require clearing participants to satisfy their cash settlement amounts ultimately through the Federal Reserve's National Settlement Service ("NSS").<sup>3</sup> The MBSD

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> Securities Exchange Act Release No. 54622, (October 18, 2006), 71 FR 62632.

<sup>3</sup> For a description of NSS, refer to [www.frb services.org/Wholesale/natsettle.html](http://www.frb services.org/Wholesale/natsettle.html).

The Commission previously approved a proposed rule change filed by FICC to make a similar amendment to the rules of its Government Securities Division ("GSD"). Securities Exchange Act Release No. 52853 (November 29, 2005), 70 FR 72682 (December 6, 2005) [File No. SR-FICC-2005-14]. FICC's affiliates, The Depository Trust Company ("DTC") and the National Securities Clearing Corporation ("NSCC") also use NSS in their funds settlement processes. However, DTC and NSCC do not currently use NSS for the payment of credit. MBSD will process both the debits and credits of its cash settlement process through the NSS, as is the case for the GSD.

cash settlement process is set forth in Rule 8 of Article II of the MBSD's rules. On a daily basis, FICC computes a cash balance, which is either a debit amount or a credit amount, per participant account and nets the cash balances across aggregated accounts. Unlike at GSD where cash settlement occurs on a daily basis, at MBSD there are specific dates on which debits and credits are required to be made. Settlement dates at MBSD are based upon the settlement dates of the different classes of MBSD-eligible securities. There is a time deadline for the payment of debits to FICC as announced by the MBSD from time to time. All payments of cash settlement amounts by a MBSD clearing participant to FICC and all collections of cash settlement amounts by a MBSD clearing participant from FICC are done through depository institutions that are designated by MBSD participants and by FICC to act on their behalf with regard to such payments and collections. All payments are made by fund wires from one depository institution to the other.

Under the proposed rule change, the required payment mechanism for the satisfaction of cash settlement amounts will be the NSS. FICC will appoint DTC as its settlement agent for purposes of interfacing with the NSS.<sup>4</sup> In order to satisfy its cash settlement obligations through the NSS process, each MBSD clearing participant will appoint a "cash settling bank." An MBSD clearing participant that qualifies may act as its own cash settling bank.

The MBSD will establish a limited membership category for cash settling banks. Banks or trust companies that are DTC settling banks (as defined in DTC's rules and procedures), GSD funds-only settling bank members (as defined in the GSD's rules), or clearing participants with direct access to a Federal Reserve Bank and NSS will be eligible to become MBSD cash settling

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<sup>4</sup> DTC currently performs this service for the GSD and NSCC.

bank participants by executing the requisite membership agreements for this purpose. Banks or trust companies that do not fall into these categories and that desire to become MBSD cash settling bank participants will need to apply to FICC. Such banks or trust companies will also need to have direct access to a Federal Reserve Bank and the NSS as well as satisfy the financial responsibility standards and operational capability imposed by FICC from time to time. Initially, these applicants will be required to meet and to maintain a Tier 1 capital ratio of 6 percent.<sup>5</sup>

In addition to the membership agreement, each MBSD clearing participant and the cash settling bank it has selected will be required to execute an agreement whereby the participant will appoint the bank to act on its behalf for cash settlement purposes. The bank will also be required to execute any agreements that may be required by the Federal Reserve Bank for participation in the NSS for FICC's cash settlement process. The cash settling banks will be required to follow the procedures for cash settlement payment processing set forth in the proposed rule change. This includes, for example, providing FICC or its settlement agent with the requisite acknowledgement of the bank's intention to settle the cash settlement amounts of the MBSD clearing participants it represents on a timely basis and to participate in the NSS process. Cash settling banks will have the right to refuse to settle for a particular MBSD clearing participant and will also be able to opt out of NSS for one business day if they are experiencing extenuating circumstances.<sup>6</sup> In such a situation, the clearing participant would be responsible for

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<sup>5</sup> This is the same financial requirement for GSD funds-only settling banks that fall into a similar category. As with the GSD, FICC would retain the authority and discretion to change this financial criterion by providing advanced notice to the settling banks and the netting members through an important notice.

<sup>6</sup> These procedures are consistent with the GSD, NSCC, and DTC procedures in this respect.

ensuring that its cash settlement debit was wired to the depository institution designated by FICC to receive such payments by the payment deadline. The proposed rule change makes clear that the obligation of a MBSD clearing participant to fulfill its cash settlement would remain at all times with the MBSD clearing participant.

As FICC's settlement agent, DTC will submit instructions to have the Federal Reserve Bank accounts of the cash settlement banks charged for the debit amounts and credited for the credit amounts. Utilization of NSS will eliminate the need for the initiation of wire transfers in satisfaction of MBSD settlement amounts, and FICC believes that it will therefore reduce the risk that the MBSD clearing participant that designated the bank would incur a late payment fine due to delay in wiring funds. The proposed rule change should also reduce operational burden for the operations staff of FICC and of the MBSD clearing participants.

The NSS is governed by the Federal Reserve's Operating Circular No. 12 ("Circular"). Under the Circular, DTC, as FICC's settlement agent, has certain responsibilities with respect to an indemnity claim made by a relevant Federal Reserve Bank as a result of the NSS process. FICC will apportion the entirety of any such liability to the MBSD clearing participant or clearing participants for whom the cash settling bank to which the indemnity claim relates is acting. This allocation will be done in proportion to the amount of each MBSD clearing participant's cash settlement amount on the business day in question. If for any reason such allocation is not sufficient to fully satisfy the Federal Reserve Bank's indemnity claim, then the remaining loss will be allocated among all MBSD clearing participants in proportion to their relative usage of the facilities of the MBSD based on fees for services during the period in which loss is incurred.

The proposed rule change also amends the GSD's rules regarding the use of the NSS. An additional category for eligible funds-only settling banks is added to include MBSD cash settling banks. This means that an MBSD cash settling bank would be able to become a GSD funds-only settling bank by signing the requisite agreements.

### III. Discussion

The Commission previously approved a proposed rule change to FICC's GSD's rules to require funds-only settlement at GSD to be made through the NSS.<sup>7</sup> In the order granting approval of the GSD proposal, the Commission found that the rule change was designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities in FICC's possession or control or for which FICC is responsible under Section 17A(b)(3)(F) of the Act because the rule was designed to improve the efficiency of GSD's funds-only settlement process without affecting the responsibility of GSD's members to make their funds-only settlement payments on time.

The proposed rule change to Article II, Rule 8 of FICC's MBSD's Rules is essentially the same as the previously approved proposed rule change to GSD Rule 13. The new provisions to MBSD Rule 8 regarding the NSS, the new limited membership category for "cash settling banks," and the procedures for processing payments through NSS are virtually identical to the provisions that are currently in GSD Rule 13. Accordingly, for the same reason we approved GSD Rule 13 we are approving MBSD Rule 8. Namely, that the NSS offered by the Federal Reserve System is a reliable and proven service that should promote the efficiency of cash settlement at MBSD and that the changes to MBSD Rule 8 with respect to membership financial

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<sup>7</sup> Securities Exchange Act Release No. 52853 (November 29, 2005), 70 FR 72682 (December 6, 2005) [File No. SR-FICC-2005-14].

requirements, transaction processing, and loss allocation are designed to prevent any risk of loss to MBSD or to its members. As a result, we find that the proposed rule change is designed to promote the prompt and accurate clearance and settlement of securities transactions under Section 17A(b)(3)(F) of the Act and should not affect FICC's obligation under Section 17A(b)(3)(F) to assure the safeguarding of securities and funds in its possession or under its control or for which it is responsible.<sup>8</sup>

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular Section 17A of the Act and the rules and regulations thereunder.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2006-13) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Nancy M. Morris  
Secretary

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<sup>8</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>9</sup> 17 CFR 200.30-3(a)(12).