

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51037; File No. SR-FICC-2004-18)

January 13, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Clarify Certain Sections of the Loss Allocation Rule of its Government Securities Division

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> notice is hereby given that on October 1, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on October 27, 2004, amended the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by FICC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The purpose of this proposed rule change is to clarify certain sections of the loss allocation rule of the Government Securities Division (“GSD”) of FICC.

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

In its filing with the Commission, FICC 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. FICC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

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

<sup>2</sup> The Commission has modified the text of the summaries prepared by FICC.

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

The purpose of this proposed rule change is to clarify certain sections of the loss allocation rule of the Government Securities Division ("GSD") of FICC. If the GSD, upon liquidating a defaulting member's positions, incurs a loss due to the failure of the defaulting member to fulfill its obligations to the GSD, the GSD looks to the margin collateral deposited by that defaulting member to satisfy the loss. If the defaulting member's margin collateral is insufficient to cover the loss and if there are no other funds available from any applicable cross-margining and/or cross-guaranty arrangements, the GSD would have a "Remaining Loss"<sup>3</sup> and would institute its loss allocation process to cover such Remaining Loss. In doing so, the GSD would determine the types of transactions from which the Remaining Loss has arisen, such as direct transactions and member brokered transactions, and would allocate the Remaining Loss as set forth in Sections 8(d)(i) through (v) of Rule 4 of the GSD Rules.

The allocations in Section 8(d)(ii) of Rule 4 to cover a Remaining Loss that is due to member brokered transactions distributes the loss between the affected broker, including repo brokers, and non-broker members that dealt with the defaulting member, are limited as an initial matter. Specifically, a broker netting member will not be subject to an allocation of loss, for any single loss-allocation event in an amount greater than \$5 million, and a non-broker netting member will not be subject to an allocation of loss for any single loss-allocation event in an amount greater than the lesser of \$5 million or five percent of the overall loss amount allocated to non-broker netting members. If the Remaining Loss from member brokered transactions is not covered due to

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<sup>3</sup> GSD Rules, Rule 4, Section 8(d).

these limitations on allocations, the uncovered loss will be reallocated as set forth in Section 8(e) of Rule 4. This section calls for a pro rata allocation to the netting membership in general based on each netting member's average daily required clearing fund deposit over the twelve-month period immediately prior to the insolvency. The proposed rule change makes clear that the amounts allocated pursuant to Section 8(e) will be assessed to a netting member in addition to any loss amount allocated pursuant to Section 8(d)(ii). Therefore, a netting member may be subject to an aggregate allocation of loss that may exceed the applicable limitation set forth in Section 8(d)(ii).

Even with the allocation pursuant to Section 8(e) of Rule 4, a broker netting member would not be subject to an aggregate loss allocation for any single loss allocation event in an amount greater than \$5 million. In addition, what has been intended, but is not clear in the current rules, is that a non-broker netting member can terminate its GSD membership and thus cap any additional loss allocation obligation due to the application of Section 8(e) at the amount of its required clearing fund deposit. Therefore, FICC is proposing to make its GSD rules clear that any allocations to members resulting from the application of Section 8(e) of Rule 4 or another firm's failure to pay its assessed share are limited to the extent of a member's required clearing fund deposit if such member chooses to terminate its GSD membership.<sup>4</sup>

In addition, FICC wishes to make clear that the ability to terminate and cap a loss allocation obligation at the amount of the clearing fund deposit is also applicable to a netting member (aside from the defaulting party) where an auction purchase is the reason for any Remaining Loss. In these

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<sup>4</sup> If a member elects to terminate its membership in FICC, its liability for a loss allocation obligation is limited to the amount of its required clearing fund for the business day on which the notification of such loss allocation is provided to the member.

instances, as in the instances described above, the netting member assessed a loss allocation obligation will have had no participation in the transaction which led to the Remaining Loss, and therefore will be allowed to cap its total losses at the amount of the clearing fund deposit.

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act<sup>5</sup> and the rules and regulations thereunder applicable to FICC because the proposed rule change would clarify the GSD's rules and procedures with regard to loss allocation assessments to netting members in the event of a default thereby providing enhanced protections to FICC and its members and promoting the prompt and accurate clearance and settlement of securities.

(B) Self-Regulatory Organization's Statement on Burden on Competition

FICC does not believe that the proposed rule change will have any impact or impose any burden on competition.

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

Written comments relating to the proposed rule change have not yet been solicited or received. FICC will notify the Commission of any written comments received by FICC.

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

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

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<sup>5</sup> 15 U.S.C. 78q-1.

(A) by order approve such proposed rule change or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FICC-2004-18 on the subject line.

##### Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-FICC-2004-18. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be

available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of FICC and on FICC's Web site at [www.ficc.com](http://www.ficc.com). All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FICC-2004-18 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

J. Lynn Taylor  
Assistant Secretary

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<sup>6</sup> 17 CFR 200.30-3(a)(12).