SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51355; File No. SR-FICC-2004-08)

March 10, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Provide Interpretive Guidance to Members Regarding the Criteria Used to Place Members on Surveillance Status

I. Introduction

On March 29, 2004, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") and on February 28, 2005,[1] and March 3, 2005, amended[2] proposed rule change SR-FICC-2004-08 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").[3] Notice of the proposal was published in the Federal Register on November 23, 2004.[4] No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

FICC is seeking to provide interpretive guidance to members pertaining to the member surveillance rules of the Government Securities Division ("GSD") and the Mortgage-Backed Securities Division ("MBSD") of FICC.

1. Background

1 The February 28, 2005, amendment was withdrawn by FICC on March 3, 2005.

2 In the March 3, 2005, amendment, FICC elaborated on how it applies and monitors the matrix. The amendment did not modify the substance of the proposed rule change and therefore did not require republication of notice.

3 15 U.S.C. 78s(b)(1).

Prior to the Commission's approval of SR-FICC-2003-03,[5] the GSD had the ability to place a member in a surveillance status class depending on whether the member satisfied one or more of the enumerated financial and operational criteria. Upon approval of SR-FICC-2003-03, FICC implemented new criteria for placing members on surveillance. Specifically, all domestic broker-dealers and banks that are GSD netting members and/or MBSD clearing members are now assigned a rating that is generated by entering financial data of the member into a risk assessment matrix ("Matrix"). The Matrix is used by FICC and its affiliated clearing agency, National Securities Clearing Corporation. Specifically, in order to run the Matrix, credit risk staff uses the financial data of each applicable FICC member and the financial data of each applicable member of NSCC. In this way, each applicable member of GSD, MBSD, and NSCC is rated against other applicable members of FICC and NSCC. Members who receive a low rating are placed on an internal "watch list" and are monitored more closely. All members that are not domestic banks or broker-dealers are not included in the Matrix process but are monitored by FICC's credit risk staff using financial criteria deemed relevant by FICC.

FICC will continually evaluate the methodology and its effectiveness and make such changes as it deems prudent and practicable within such time frame as is determined to be appropriate by FICC. FICC will update the Commission staff on its evaluations of the Matrix pursuant to a schedule developed by FICC, NSCC, and Commission staff.

2. Clarification of Rules Provisions

In describing the process by which credit risk staff will implement the Matrix process and

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4 Securities Exchange Act Release No. 50671 (November 16, 2004), 69 FR 68200.

5 Securities Exchange Act Release No. 49158 (January 30, 2004), 69 FR 5624 (February 5, 2004).

review members, FICC included in SR-FICC-2003-03 explanatory footnotes 2 and 3. FICC at this time wishes to clarify its procedures with regard to application of the Matrix.

Credit risk staff approaches its analysis of members pursuant to the new procedures in the following manner. First, as mentioned above, domestic broker-dealers and domestic banks are run through the Matrix and assigned a rating. Low-rated members are placed on the watch list. At this point, credit risk staff may downgrade a particular member's score based on various qualitative factors. For example, one qualitative factor might be that the member in question received a qualified audit opinion on its annual audit. In order to protect FICC and its other members, it is important that credit risk staff maintain the discretion to downgrade a member's rating on the Matrix and thus subject the member to closer monitoring. All rated members, including those on the watch list, are monitored monthly or quarterly, depending upon the member's financial filing frequency, against basic minimum financial requirements and other parameters.

All broker-dealer members included on the watch list are monitored more closely. This means that they are also monitored for various parameter breaks which may include but are not limited to such things as a defined decline in excess net capital over a one month or three month period, a defined period loss, a defined aggregate indebtedness/net capital ratio, a defined net capital/aggregate debit items ratio, and a defined net capital/regulatory net capital ratio. All bank members included on the watch list are also monitored more closely for watch list parameter breaks which may include but are not limited to such things as a defined quarter loss, a defined decline in equity, a defined tier one leverage ratio, a defined tier one risk-based capital ratio, and a defined total risk-based capital ratio. FICC wishes to make clear that monitoring for the above more stringent parameter breaks is only applicable to those members placed on the watch list.

In addition, FICC would like to address footnote 5 of Amendment I to rule filing SR-FICC-2003-03. That footnote stated that credit risk staff would monitor those members not included in the Matrix process (this includes members that are not domestic banks and broker dealers) using the same criteria as those used for members included on the Matrix. FICC wishes to make clear that credit risk staff will not be using the same criteria to monitor these members but will use similar criteria. As stated in the narrative of SR-FICC-2003-03, these criteria may include but are not limited to such things as failure to meet minimum financial requirements, experiencing a significant decrease in equity or net asset value, or a significant loss. This class of members may be placed on the watch list based on credit risk staff's analysis of this information.

III. Discussion

Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to facilitate the safeguarding of securities and funds which are in its custody or control or for which it is responsible.[6] The Commission finds that FICC's proposed rule change is consistent with this requirement because it improves FICC's member surveillance process which should better enable FICC to safeguard the securities and funds which are in its custody or control or for which it is responsible.

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.

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6 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2004-08) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[7]

J. Lynn Taylor
Assistant Secretary

[7] 17 CFR 200.30-3(a)(12).