

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53534; File No. SR-FICC-2005-18)

March 21, 2006

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Enhance the Repo Collateral Substitution Process of FICC's Government Securities Division

I. Introduction

On September 30, 2005, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") and on December 20, 2005, amended proposed rule change SR-FICC-2005-18 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").¹ Notice of the proposal was published in the Federal Register on January 5, 2006.² No comment letters were received. On March 20, 2006, FICC filed an amendment to the proposed rule change.³ For the reasons discussed below, the Commission is approving the proposed rule change as amended.

II. Description

In general, FICC is enhancing the repo collateral substitution process of its Government Securities Division ("GSD"). The rule change: (i) permits the repo dealer or repo broker, as appropriate, to submit a substitution notification to FICC without information about the replacement collateral, (ii) revises the repo collateral substitution process deadline and fee schedule, and (iii) implements certain risk management measures and technical changes.

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 53036 (December 29, 2005), 71 FR 629.

³ The amendment, as noted below, is not substantive and did not require republication of the notice.

A. Initial Substitution Notification without Replacement Collateral Information

The GSD's repo collateral substitution process provides a mechanism for a repo dealer to process its right to substitute the original collateral it provided as part of a repo transaction with replacement collateral. With respect to a brokered transaction, typically the repo dealer notifies the broker that it wishes to substitute the repo collateral before it specifically identifies the replacement collateral.⁴ The repo broker then contacts the reverse repo dealer and informs it that a repo collateral substitution process is being initiated. The reverse repo dealer then sends the original repo collateral to FICC. However, since under FICC's current system the repo dealer's substitution notification that it must send to FICC must contain information about the replacement collateral, often the substitution notification is not delivered to FICC by the time FICC receives the returned original repo collateral from the reverse repo dealer. When the repo dealer does determine what securities will constitute the replacement collateral, it often delivers the replacement collateral to FICC before sending the repo collateral substitution notification. Thus the original and replacement collateral frequently are delivered to FICC before FICC is able to forward the collateral to the appropriate party. This leaves FICC in an overdraft position at the clearing bank, which can cause expense and risk to FICC and to its members and can cause settlement processing delays.

The rule change permits the repo dealer or repo broker, as appropriate, to submit a substitution notification to FICC without information about the replacement collateral. FICC

⁴ With respect to a non-brokered repo transaction, the repo dealer would contact the reverse repo dealer directly about the repo collateral substitution.

will deliver the original collateral to the repo party's account at its clearing bank upon receipt of the substitution notification so the original collateral will no longer linger in FICC's account.⁵

B. Revised Repo Collateral Substitution Process Deadline and Fee Schedule

The rule change in repo processing requires a revision to GSD's schedule of time frames. Currently, there is a two-tiered deadline for a repo party to submit a substitution notification and associated late-fee.⁶ The rule change establishes: (i) an 11:00 a.m. Eastern Time deadline⁷ for a repo party to submit a substitution notification and (ii) a late-fee of \$100 for each substitution notification that is received after the deadline. The rule change also establishes a two-tiered deadline for a repo party to submit replacement collateral information and an associated late-fee schedule. The deadlines for submission of replacement collateral information are: (i) 12:00 p.m. Eastern Time and (ii) 12:30 p.m. Eastern Time. The late-fee assessments are: (i) \$100 for each submission of replacement collateral information that is received after the first deadline but

⁵ The changes necessary to reflect this part of the rule change are contained in GSD Rule 18, Sections 3(a), (b), (c), and (d) and in the Schedule of Required and Accepted Data Submission Items for a Right of Substitution. A new schedule, titled Schedule of Required and Accepted Data Submission Items for New Securities Collateral, is being added to the rules to reflect that information on the replacement collateral will be contained in a separate submission to FICC.

⁶ The current deadlines are 12:00 p.m. Eastern Time and 12:30 p.m. Eastern Time. The deadlines are extended by one hour on days that: (i) FICC determines are high-volume days or (ii) The Bond Market Association announces in advance will be high-volume days. FICC assesses a late-fee of: (i) \$100 for each substitution notification that is received after the first deadline but before the second deadline and (ii) \$250 for each substitution notification that is received after the second deadline.

⁷ The proposed 11:00 a.m. Eastern Time deadline will not be extended on high-volume days.

before the second deadline and (ii) \$250 for each submission of replacement collateral information that is received after the second deadline.⁸

In order to accommodate members' preparations to comply with the time frames contained herein, the proposed changes to the schedule of time frames and applicable late-fees will be implemented at a later date than the other rule changes contained in this filing. FICC will announce the implementation of the proposed schedule of time frames by Important Notice at least thirty calendar days prior to implementation. Until such implementation, currently existing time frames and late-fees applied to repo collateral substitutions shall remain in effect.

C. Risk Management Measures and Technical Changes

Generally, FICC is implementing certain measures to address the risk presented to it by the failure of a party to submit in a timely manner information regarding the replacement collateral to FICC. Specifically, FICC is: (i) increasing the clearing fund calculation of the repo dealer and allowing margining with respect to replacement collateral based on applicable generic CUSIP numbers only⁹ and (ii) imposing mark-to-market consequences on both the repo dealer and the reverse dealer with respect to unknown replacement collateral.

⁸ The allocation of collateral deadlines will be extended by one hour on days that: (i) FICC determines are high-volume days or (ii) The Bond Market Association announces in advance will be high-volume days. The rule changes necessary to affect this part of the proposed rule are contained in the Schedule of Timeframes and in the Fee Structure under "Late Fees."

⁹ Generic CUSIP numbers represent the range of permissible securities that can constitute the replacement collateral. For example, there is a generic CUSIP number which represents Treasury securities with remaining maturity of fewer than thirty years.

1. Clearing Fund Calculation and Permissible Margin Offsets

With respect to the calculation of the repo dealer's clearing fund requirement, FICC is assigning a value of 150 percent of the contract value of the original securities collateral to a repo transaction where FICC has not received information regarding the replacement collateral.¹⁰ FICC also is applying the highest applicable margin factor in its rules in connection with the repo transaction. In GSD's rules, the highest margin factor is the factor for securities with a remaining maturity of 15 years and 16 days or greater. Therefore, if the generic CUSIP number that is assigned to the unknown replacement collateral is the generic CUSIP number for Treasury securities with a remaining maturity of 15 years and 16 days or greater, FICC will use the existing margin factor of 1.450 (applicable to category 1 members with positions in non-zeros).¹¹

The proposed risk management measures applicable to non-timely allocation of replacement collateral will further affect the clearing fund calculation of the repo dealer by limiting permissible offsets. A regular part of the GSD's margining system is to permit offsets between resulting margin amounts of long and short net settlement positions. The GSD's rules contain disallowance factor tables that set forth specific limits on these permissible offsets. For example, where a short net settlement position in Treasury Offset Class A is to be offset against a long net settlement position in Treasury Offset Class B, the applicable disallowance factor table

¹⁰ New subsection 3(f) is being added to Rule 18 in order to effect this change. It should be noted that the application of the 150 percent for clearing fund purposes applies to both the receive/deliver and repo volatility components of the clearing fund calculation.

¹¹ The GSD's margin factor schedules apply different margin factors to category 1 and category 2 dealers. In this example, if the member were a category 2 member electing to receive credit forward mark adjustment payments, the applicable margin factor under the proposed rule change would be 2.0.

provides that 30 percent of this offset will be disallowed.¹² For offset purposes under the proposed rule change, FICC is defining two new offset classes to capture the generic CUSIP numbers that can be assigned to unknown replacement collateral. These new offset classes are identified as “H” for Treasury securities and “h” for non-mortgage-backed Agency securities. Under the proposed rule change, as a further risk management measure, FICC will not permit offsets between Offset Classes H and h or between Offset Classes H or h and any other existing GSD Offset Class.

2. Modified Mark-to-Market Calculation

FICC also is calculating a modified mark-to-market obligation with respect to the replacement collateral and imposing this on both the repo dealer and the reverse repo dealer in the case where a generic CUSIP number is used for underlying collateral. In a typical scenario where the replacement collateral is identified, FICC reverses any previous mark-to-market calculation for the old collateral and recalculates, collects, and passes through a mark-to-market associated with the actual replacement collateral. This computation is defined as the Forward Mark Adjustment Payment.¹³ In the scenario where the replacement collateral has not been identified, FICC will calculate a modified Forward Mark Adjustment Payment to protect FICC against market risk. Specifically, the definition of Forward Mark Adjustment Payment is amended by noting that with respect to a repo transaction for which a substitution request has

¹² As originally filed, FICC mistakenly stated that 20 percent of the offset would be disallowed. In its March 20, 2006, amendment, FICC changed this to 30 percent to accurately reflect the disallowance factor for such securities.

¹³ The Forward Mark Adjustment Payment is the sum of two components: the Collateral Mark and the Financing Mark. The Collateral Mark is the absolute value of the difference between the trade’s contract value and market value. The Financing Mark reflects the financing cost that would be incurred by FICC if it replaced the reverse side of the repo by buying securities and putting them out on repo.

been made but for which replacement collateral information has not been provided to FICC, a new Forward Unallocated Sub Mark will be applied. This new mark will take into account repo interest that has accrued with respect to the repo transaction to date, as well as changes in the repo rate (to reflect the difference between the contract rate and the market rate for the remaining term of the repo transaction).¹⁴

3. Technical Changes

Additionally, FICC is making certain technical changes to its GSD rules relating to repo collateral substitutions and repo transactions generally.

- a. Section 3(a) of Rule 18: Delete the requirement that details regarding the rights of substitution match between counterparties. Details regarding rights of substitution are not a required trade reporting item and thus will not be a required match item in GSD's system. References in this respect are deleted to reflect actual operating practice.
- b. Sections 3(e) and 3(f) of Rule 18: Delete the requirement that upon receipt of either the original or the replacement collateral, FICC will promptly redeliver the securities to the appropriate party. As stated in the narrative above, FICC may receive securities that are the subject of a repo collateral substitution request but may not yet have the requisite information for delivery of those securities. These provisions are deleted to reflect actual operating practice and also to make the rule consistent with the proposed changes.

¹⁴ The following new definitions effect this change: Accrued Repo Interest-to-Date, Repo Interest Rate Differential, and Forward Unallocated Sub Mark.

- c. Section 3(h) of Rule 18: Delete the provision regarding implications of repo collateral substitutions on margin and mark-to-market requirements. This provision is redundant because the effects of repo substitutions on such requirements are covered in the rules governing these items and the rules to be modified by the proposed rule change.
- d. Section 4 of Rule 18: Make optional a requirement that for general collateral, forward-starting repos, the specific CUSIP and par value be submitted prior to the repo start date. FICC typically does not receive such allocations from its members prior to the repo start date and thus the proposed change aligns the rule with industry practice. The proposed change further reflects operating practice as well as industry expectations that a general collateral, forward-starting repo will be removed from the GSD's books if FICC does not receive the specific CUSIP by the time noted in the rule. Members typically submit new transactions with the specific CUSIPs and expect that the general collateral transaction will be removed from the GSD's books.
- e. Section 5 of Rule 18: Amend the provision that addresses repo transactions with maturing collateral. The proposed rule change provides that the repo party in such a repo transaction must make the required substitution of collateral by the time noted in the rule or FICC will remove the transaction from its books. This is because the underlying contract terminates if the collateral is not replaced in time, and therefore, the proposed rule change reflects industry practice. The proposed rule change further reflects industry practice by deleting the requirement that the replacement collateral meet certain specific criteria and by replacing that

requirement with a requirement that the replacement collateral be “in accordance with the terms of the transaction.” This change also reflects industry practice.

III. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization.¹⁵ Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.¹⁶ The Commission finds that FICC’s rule change is consistent with these requirements. By revising its repo substitution rules to more accurately reflect industry practice, FICC’s proposed rule change should result in repo substitution transactions being completed in a more timely manner. FICC’s proposed rule change also includes revised risk management measures (e.g., revised clearing fund calculation and margin offsets) to address potential risk resulting from the revised repo substitution rules. As such, FICC’s proposed rule change also should result in FICC being able to safeguard securities and funds which are in its possession and 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.

¹⁵ 15 U.S.C. 78s(b).

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (File No. SR-FICC-2005-18) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Nancy M. Morris
Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).