SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-55217; File No. SR-FICC-2006-16)

January 31, 2007

Self-Regulatory Organizations; The Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Replace the Government Securities Division Clearing Fund Calculation Methodology with a Yield-Driven Value-at-Risk Methodology

I. Introduction

On October 4, 2006, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") and on November 14, 2006, amended proposed rule change SR-FICC-2006-16 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 December 27, 2006.[2] The Commission received no comment letters in response to the proposed rule change. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

FICC seeks to replace the Government Securities Division ("GSD") margin calculation methodology with a value-at-risk ("VaR") methodology.

Netting members of FICC's GSD are required to maintain clearing fund deposits. Each member's required clearing fund deposit is calculated daily to ensure that enough funds are available to cover the risks associated with that member's activities. The purposes served by the clearing fund are to: (i) have on deposit at FICC funds from each member sufficient to satisfy any losses that may be incurred by FICC or its members resulting from the default by a member

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

2 Securities Exchange Act Release No. 54964 (December 19, 2006), 71 FR 77835 (SR-FICC-2006-16).

and the resultant close out of that member's settlement positions and (ii) ensure that FICC has sufficient liquidity at all times to meet its payment and delivery obligations.

FICC proposes to replace the current clearing fund methodology used at GSD, which uses haircuts and offsets, with a yield-driven VaR methodology that is expected to better reflect market volatility and more thoroughly distinguish the levels of risk presented by individual securities. VaR is defined to be the maximum amount of money that may be lost on a portfolio over a given period of time within a given level of confidence. With respect to the GSD, FICC will use a 99 percent three-day VaR.[3]

The changes to the components that comprise the current clearing fund methodology compared to the proposed VaR methodology in relation to the risks addressed by the components are summarized below.

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3 Category 2 Dealers and Category 2 Futures Commission Merchants will be subject to higher confidence levels than other Netting Members.

Existing Methodology	**Risk Addressed**	**Proposed Methodology**[4]
Receive/Deliver component using margin factors	Fluctuation in security prices	Interest rate or index-driven model, as appropriate[5]
Repo Volatility component	Fluctuation in repo interest rates	Repo index-driven model[6]
Funds Adjustment Deposit component (based on the average size of the member's 20 highest funds-only settlement amounts over the most recent 75 business days)	Uncertainty of whether a member will satisfy its funds-only settlement obligation	Margin Requirement Differential ("MRD") (a portion of which is based on the historical size of a member's funds-only settlement obligation)
Average Post Offset Margin Amount component (based on the 20 highest margin amounts derived from all outstanding net settlement positions over the most recent 75 business days)	Uncertainty of whether a member will satisfy its next clearing fund call	MRD (a portion of which is based on the historical variability a member's clearing fund requirement)
Not specifically covered	Intraday risk and additional exposure due to	Coverage Component (if necessary, applies

4 Under the current GSD rules, Category 1 Inter-Dealer Brokers are subject to a flat $5 million clearing fund requirement. This proposed rule change does not alter that requirement.

5 FICC will have the discretion to not apply the interest rate model to classes of securities whose volatility is less amenable to statistical analysis, which is usually due to a lack of pricing history. In lieu of such a calculation, the required charge with respect to such positions will be determined based on a historic index volatility model.

6 FICC is adopting a new definition for "Term Repo Transaction" to clarify the types of transactions covered by this component. As proposed, Term Repo Transaction will mean, on any particular Business Day, a Repo Transaction for which settlement of the Close Leg "is scheduled to occur two or more Business Days after the scheduled settlement of the Start Leg." In addition, the existing definition for "Term GCF Repo Transaction" is being revised to conform to the language for "Term Repo Transaction" as the new definition provides greater clarity as to transactions covered.

	portfolio variation and potential loss in unlikely situations beyond the model's effective range	additional minimum charge to bring coverage to the applicable confidence level)

In addition, FICC will be able to include in a member's clearing fund requirement a "special charge" based on such factors as FICC determines to be appropriate from time to time. Such factors may include, but are not limited to, such things as price fluctuation, volatility, or lack of liquidity.

The proposed VaR methodology will necessitate a change to FICC's risk management consequences of the late allocation of repo substitution collateral. Because offset classes and margin rates will no longer be present in the revised GSD rules, FICC will base the margining for such a generic CUSIP on the same calculation as that used for securities whose volatility is less amenable to statistical analysis. [7]

The VaR methodology will not include calculations that are incorporated in the GSD's current cross-margining programs with The Clearing Corporation ("TCC") and with the Chicago Mercantile Exchange ("CME"). In order to provide for continuity of cross-margining following the implementation of the VaR methodology and because certain key calculations required for cross-margining are unique to cross-margining, FICC will continue to perform the applicable cross-margining calculations outside of the VaR model. FICC will then adjust the cross-margining clearing fund calculation using a scaling ratio of the VaR clearing fund calculation to

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[7] Securities Exchange Act Release No. 53534 (March 21, 2006), 71 FR 15781 (March 29, 2006) (File No. SR-FICC-2005-18). This rule change created a generic CUSIP offset and applicable margin rate for determining clearing fund consequences for such late allocations.

the cross-margining clearing fund calculation so that the clearing fund amount available for cross-margining is appropriately aligned with the VaR model. The proposed changes described herein will necessitate amendments to FICC's cross-margining agreements with TCC and with CME as follows:

1. The definition of FICC's "Margin Rate" in each of the agreements will be amended to reflect that the margin rate will no longer be based on margin factors published in the current rules (as these will no longer be applied under the VaR methodology). Instead, they will be determined based on a percentage that will be determined using the same parameters and data (e.g., confidence level and historic indices) as those used to generate margin factors in the current rules.
2. Section 5(a) of each cross-margining agreement will be amended to state that FICC's residual margin amount will be calculated as specified in the agreement and will be adjusted, if necessary, to correct for differences between the methodology of calculating the residual margin amount as described in the agreement and the VaR methodology. This change will be necessary to account for the deletion of relevant margin factors and disallowance schedules (which, like the margin factors, are incorporated into the agreements by reference) from GSD rules and to adjust for the possibility that the new VaR methodology could generate a charge that would otherwise allow for a cross-margining reduction that is greater than the margin requirement.

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. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds in FICC's custody or control or for which it is responsible.[8] Because FICC's proposed rule change implements a VaR methodology that should better reflect market volatility and should more thoroughly distinguish the levels of risk presented by individual securities, FICC should be able to more accurately calculate the risk presented by each of its member's activity and to collect clearing fund to protect against that risk. As a result, FICC should be in a better position to assure the safeguarding of securities and funds 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. In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition and capital formation.[9]

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2006-16) be and hereby is approved.

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8 15 U.S.C. 78q-1(b)(3)(F).

9 15 U.S.C. 78c(f).

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[10]

Florence E. Harmon
Deputy Secretary

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[10] 17 CFR 200.30-3(a)(12).