

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59111; File No. SR-FICC-2007-04)

December 17, 2008

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change Relating to Applicant and Member Disqualification Criteria

I. Introduction

On April 30, 2007, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ On February 7, 2008, and March 19, 2008, FICC amended the proposed rule change. On July 9, 2008, the Commission published notice of the proposed rule change to solicit comments from interested persons.² The Commission received two comment letters in response to the proposed rule change.³ For the reasons discussed below, the Commission is approving the proposed rule change, as amended.

II. Description

The proposed rule change will amend FICC’s Government Securities Division’s (“GSD”) and Mortgage Backed Securities Division’s (“MBSD”) (collectively, “Divisions”) rules concerning applicant and member disqualification criteria by making the Divisions’ rules consistent with the rules of FICC’s affiliated clearing agencies, the National Securities Clearing Corporation (“NSCC”) and The Depository Trust Company (“DTC”). The proposed rule changes cover the following areas:

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 58128, 73 FR 40893 (July 16, 2008).

³ Letters from Susanne Trim bath, Ph.D., STP Advisory Services, LLC (Aug. 27, 2008) and Nikki M. Poulos, Managing Director, General Counsel, FICC (Nov. 7, 2008).

1. Management Consideration of Disqualification Criteria⁴

Prior to this rule change, GSD's membership qualification rules required FICC's Board of Directors to determine whether the presence of certain negative factors affecting a membership application should constitute the basis for denying membership to such applicant. Information that might have disqualified an applicant (referred to in GSD's rules as "disqualification criteria") include the applicant being subject to a statutory disqualification⁵ or conviction of various crimes such as bribery. The disqualification criteria in GSD's rules similarly apply as standards for continued membership.

Under the rule change, FICC will amend GSD's disqualification criteria to allow FICC's management, instead of FICC's Board, to determine whether the presence of a potential disqualifier should prevent an entity from obtaining or continuing membership in GSD. Such change would conform to the rules of MBSD, DTC, and NSCC, which allow such determinations to be made by management.

2. Associated and Affiliated Persons

GSD's and MBSD's rules also apply certain applicant and member disqualification criteria to persons "associated" (in GSD's rules) or "affiliated" (in MBSD's rules) with the applicant or member firm. FICC states that it is not always practical for it to ascertain which individuals are "associated" or "affiliated" with a particular entity and therefore proposes to amend these rules to conform them to its internal surveillance procedures and make them consistent across both Divisions. Accordingly, references to persons "associated" or "affiliated" with the member or applicant are being changed to references to "controlling management,"

⁴ GSD Rule 2A, Section 3(d).

⁵ The definition of "statutory disqualification" is found at 15 U.S.C. 78c(a)(39).

which include those officers of the applicant or member that are currently screened by FICC's Risk Management department pursuant to internal procedures.⁶ In addition, FICC will add language to its rules to require applicants to inform FICC as to any member of its controlling management that is or becomes subject to statutory disqualification.

3. Monitoring of Objective Disqualification Criteria

GSD's disqualification criteria is being amended to reflect an approach that such criteria should be objectively and practically monitored. Specifically, FICC will delete one disqualification criterion that refers to an applicant being subject to "closer than normal" surveillance by a regulatory body. FICC states that this event might not be reported in a regulatory background check.

In addition, prior to this rule change, MBSD's rules contained only two criteria that could be the basis for denial of a membership application. These were: (i) an applicant's subjection to a statutory disqualification or similar order by another examining authority and (ii) an applicant or an associated person of the applicant making a misstatement of a material fact in connection with its membership application or thereafter. Under this rule change, MBSD will add GSD's remaining disqualification criteria relating to unlawful acts by the applicant's or member's Controlling Management or the applicant's or member's suspension or expulsion from a self-regulatory organization. These additions to MBSD's rules will result in both Divisions having identical disqualification criteria.

Finally, FICC will add a provision to both Divisions' rules that clarifies FICC's right to deny membership to an applicant or member if FICC learns of any factor or circumstance that

⁶ New GSD Rule 1 and MBSD Article I ("The term 'controlling management' shall mean the Chief Executive Officer, the Chief Financial Officer, and the Chief Operations Officer, or their equivalents, of an applicant or Participant.").

might impact the suitability of that particular applicant or member as a participant.

4. Additional Changes

FICC will make the following changes to provide additional uniformity among the rules of the Divisions, NSCC, and DTC:

(i) Adding to both Divisions' disqualification criteria violations of the Investment Company Act and Investment Advisers Act,⁷ since those statutes apply to their current membership base.

(ii) Amending GSD's definition of "self-regulatory organization" to include those entities that are foreign equivalents. The same definition for "self-regulatory organization" would be added to MBSD's rules.

(iii) Removing the word "willful" from both Divisions' disqualification criteria concerning an applicant's or an applicant's controlling management's violation of the specified federal statutes or any rule or regulation promulgated thereunder. FICC believes that a violation of these provisions, whether or not willful, should be considered as a potential disqualification criterion.

(iv) Deleting references in GSD's rules to Section 153 of Chapters 25 and 47 of Title 18 of the United States Code ("Code") because the crimes covered by these statutes (i.e., embezzlement, forgery, false statements, etc.) are captured by the current disqualification criteria. References to those portions of the Code that deal with mail and wire fraud (Sections 1341, 1342 and 1343) would remain. This provision will also be added to MBSD's rules.

Changes are being made to the cease to act provisions of GSD's rules (Rule 21, "Restrictions on Access to Services") in order to ensure consistency within the rules and across

⁷ 15 U.S.C. 80a-1 et seq. and 15 U.S.C. 80b-1 et seq., respectively.

the Divisions.

III. Comment Letters⁸

Susanne Trimbath, Ph.D., of STP Advisory Services, LLC, suggested that FICC should also consider an entity's ability to deliver securities for settlement when determining an applicant's or member's suitability as a participant. Ms. Trimbath pointed out that this recommendation is consistent with the Section 17A(a)(5)(C) of the Act⁹ and claimed that the cost of FICC members failing to deliver securities at settlement is significant and harms fellow FICC members and investors.

Nikki Poulos, FICC's General Counsel, responded to Ms. Trimbath's comment. While Ms. Poulos acknowledged securities transactions fails as a serious issue for the securities industry, she argued that FICC has attempted to reduce the risks posed by fails.¹⁰ Moreover, Ms. Poulos believes that including a participant's fails as a criterion by which FICC would have to assess participation "would only create more risks in that these open obligations would be processed (or not) outside of FICC, without the benefit of, i.e., re-netting."

IV. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in its custody or

⁸ See supra note 3.

⁹ 15 U.S.C. 78q-1(a)(c)(5) ("A registered clearing agency may summarily suspend and close the accounts of a participant who . . . is in default of any delivery of funds or securities to the clearing agency.").

¹⁰ See, e.g., Securities Exchange Act Release Nos. 52157 (July 28, 2005), 70 FR 44959 (Aug. 4, 2005) [FICC-2005-11] (establishing a daily fail netting process basis allowing participants to net outstanding fail obligations with current settlement activity in order to reduce risk exposure among FICC participants) and 54487 (Sept. 22, 2006), 71 FR 58025 (Oct. 2, 2006) [FICC-2005-17] (FICC assumes certain fails of blind brokered repurchase transactions at GSD and obtains financing as necessary in connection with such assumptions).

control or for which it is responsible.¹¹ The proposed rule change should enhance FICC's surveillance and assessment of applicants' and members' regulatory conditions. In addition, the proposed rule change will harmonize both of FICC's division's application and membership requirements and will make clear to all applicants and members of the breadth of information that FICC will require and review in order to develop an accurate risk profile to evaluate an applicant's or member's condition. Accordingly, the proposed rule should strengthen FICC's ability to mitigate financial risk to itself and to its members and therefore should enhanced FICC's ability to assure the safeguarding of securities and funds that are in its custody or control or for which it is responsible.

The Commission also agrees that the issue of "fails" is a serious one for the securities industry. The Commission will continue to monitor developments in this area and will use its regulatory authority if needed to better ensure that appropriate safeguards are in place to facilitate the prompt and accurate clearance and settlement of securities transactions and to protect investors. In this regard, the Commission expects FICC, as a self-regulatory organization and registered clearing agency, to similarly continue to scrutinize its participants' effectiveness in delivering funds and securities in fulfillment of their obligations when using FICC's clearing facilities.

V. 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 17A¹² of the Act and the

¹¹ 15 U.S.C. 78q-1(b)(3)(F).

¹² 15 U.S.C. 78q-1.

rules and regulations thereunder.¹³

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁴ that the proposed rule change (File No. SR-FICC-2007-04), as amended, be and hereby is approved. For the Commission by the Division of Trading and Markets, pursuant to delegated authority.¹⁵

Florence E. Harmon
Acting Secretary

¹³ In approving the proposed rule change, the Commission considered the proposal's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ 17 CFR 200.30-3(a)(12).