SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-59802; File No. SR-FICC-2009-03)

April 20, 2009

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change to Impose a Charge on Members with a Fail-to-Deliver in Treasury Securities

I. Introduction

On February 25, 2009, The Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2009-03 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 March 19, 2009.[2] The Commission received two comment letters.[3] For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The Treasury Markets Practices Group ("TMPG"), a group of market participants that is active in the treasury securities market and is sponsored by the Federal Reserve Bank of New York ("FRBNY"), has been devising ways to address the persistent settlement fails in treasury securities transactions that have arisen, according to the TMPG, due to the recent market turbulence and low short-term interest rates. In order to encourage market participants to resolve fails promptly, the TMPG has proposed for adoption a "best practice" that would call for the market-wide assessment of a charge on fail-to-deliver positions. As part of the implementation

---

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

2 Securities Exchange Act Release No. 59569 (March 12, 2009), 74 FR 11797.

3 Letters from Leslie Rosenthal, Rosenthal Collins Group, L.L.C. (March 31, 2009) and Murray Pozmanter, Managing Director, FICC (April 3, 2009).

of this “best practice,” the TMPG has asked the Government Securities Division (“GSD”) of FICC to impose a charge on failed positions involving treasury securities within FICC.

The charge FICC is adopting will be equal to the product of net money due on the failed position and three (3) percent per annum minus the Target Fed funds target rate that is effective at 5:00 p.m. Eastern Standard Time on the business day prior to the originally scheduled settlement date and will be capped at three (3) percent per annum. The charge will be applied daily and will be a debit on a member’s GSD monthly bill for a fail-to deliver position and a credit on a member’s GSD monthly bill for fail-to-receive position.

The following example illustrates the manner in which the proposed fails charge would apply.

Member A fails to deliver today on a $50 million position on which he is owed $50.1 million. The Target Fed funds rate yesterday at 5:00 p.m. was one (1) percent. The fails charge will be the product of two (2) percent per annum applied to the funds amount of $50.1 million, thus equaling a charge of $2,783.33 for that day. The bill of the member failing to deliver will reflect a debit of $2,783.33.

In the event that FICC is the failing party because, for example, it received securities too close to the close of the Fedwire for redelivery, the fail charge will be distributed pro rata to the netting members based upon usage of the GSD’s services, which is the same methodology that is used when FICC incurs finance charges.[4]

---

[4] FICC Rules, Section 6 of Rule 12.

The rule change provides that the Credit and Market Risk Management Committee of FICC's Board of Directors will retain the right to revoke application of the charge if industry events or practices warrant such revocation.

III. Comment Letters

The Commission received two letters, one from a registered broker-dealer raising concerns about the "unintended consequences" of the proposed rule change and the other from FICC responding to the commenter's letter.[5] The broker-dealer, a member of FICC, raised concerns that the pervasive fails situation that FICC intends to remedy with the rule change no longer exists because the market corrected itself when fails became an issue, and therefore the instances of fails can be held to a minimum if the industry commits to follow best practices. Further, this broker contends that the rule may potentially increase counterparty risk because firms would shift from clearing through FICC to clearing through individual counterparties, where fails are more easily controlled, in an effort to avoid the fails penalty. The unintended consequences of the rule change, the commenter asserted, may be detrimental to the global market by reducing market liquidity caused by the reduction in the supply of securities, by eroding investor confidence, by decreasing securities available for lending, and by introducing the potential to game the system due to wider spreads between bid and offer prices, resulting in allowing someone to take advantage of those inadvertently caught in a fail situation.

In response to these concerns, FICC noted that FICC's delivery allocation process, a process that matches buy obligations to sell obligations and is applicable to all members, is necessary to ensure that the clearing corporation remains flat. Accordingly, FICC contends, the

---

5 Supra note 3.

fails charge would not have any unique impact on the commenter's firm. With regards to the concern that the fails charge may result in firms shifting their business away from FICC in order to avoid a fails charge, FICC agrees that applying the fails charge as proposed by the rule would result in adverse consequences if the rest of the industry does not adopt it. However, FICC argues, FICC would cease applying the charge if the Credit and Market Risk Management Committee of FICC's Board of Directors determines that industry events or practices warrant such a revocation. Finally, FICC rejected the commenters assertions regarding the proposed rule change's effect on market liquidity and providing new opportunities for firms to "game" the system as "highly speculative." Even if these adverse effects developed, FICC argues that it would be able to respond by eliminating the fails charge or taking other appropriate action.

IV. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions, assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible, to foster cooperation and coordination with persons engaged in the clearance and settlement of securities transactions, to remove impediments to and perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions, and, in general, to protect investors and the public interest.[6] The Commission believes the rule change is consistent with Act because the fails-to-deliver charge should discourage firms from creating and maintaining persistent fails-to-deliver in treasury securities, which if permitted to subsist, may adversely affect FICC's ability

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

to safeguard securities or funds in FICC's control or for which it is responsible and to promptly and accurately clear and settle securities transactions. In the event that the rule change does not have the intended affect or produces other undesirable consequences, FICC has the ability to eliminate the rule or take other appropriate action to address any ensuing problems.[7]

Accordingly, for the reasons stated above the Commission believes that the rule change is consistent with FICC's obligation under Section 17A of the Act.

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 with the requirements of Section 17A of the Act and the rules and regulations thereunder.[8]

[7] Elimination or modification of the fails-to-deliver charge would require FICC to file a proposed rule change pursuant to Section 19(b) of the Act.

[8] 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).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2008-03) be and hereby is approved.

For the Commission by the Division of Trading and Markets, pursuant to delegated authority.[9]

Florence E. Harmon
Deputy Secretary

---

9 17 CFR 200.30-3(a)(12).