

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50457; File No. SR-FICC-2004-11)

September 27, 2004

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of a Proposed Rule Change to Amend the Rules of the Government Securities Division to Modify the Penalty Assessment Process for Violations of Minimum Financial Standards and for Failures of Members to Submit Requisite Financial Reports on a Timely Basis

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup>, notice is hereby given that on May 17, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on July 8, 2004, amended the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by FICC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FICC is seeking to amend the rules of its Government Securities Division (“GSD”) to modify the penalty assessment process for violations of minimum financial standards and for failures to submit requisite financial reports on a timely basis.

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FICC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

below. FICC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.<sup>2</sup>

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The proposed rule change would amend the rules of the GSD by modifying the penalty assessment process for violations of minimum financial standards and failure to submit requisite financial reports on a timely basis.

(1) Violations of Minimum Financial Standards

The rules of the GSD require netting members and clearing members to meet and maintain certain minimum financial standards at all times. While the majority of GSD members consistently satisfy their minimum financial requirements, occasionally members do breach these requirements and create undue risk for FICC and its GSD members. FICC has decided that a more uniform system of enforcing minimum financial requirements within the GSD would enhance the ability of FICC to minimize risk to itself and its members in a fair and effective manner.

Currently, the GSD Rules provide clearing fund consequences for the various categories of netting members that fall out of compliance with minimum financial requirements as follows:

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<sup>2</sup> The Commission has modified the text of the summaries prepared by FICC.

<b><u>Netting Membership Category</u></b>	<b><u>Current Clearing Fund Consequence for Falling Below Minimum Financial Standard<sup>3</sup></u></b>
Bank Member	Treated as a Category 2 Dealer <sup>4</sup>
Category 1 Dealer Member	Treated as a Category 2 Dealer
Category 2 Dealer Netting Member	Impose Required Fund Deposit equal to 150 percent of the normal calculation of Required Fund Deposit
Category 1 Futures Commission Merchant Member	Treated as a Category 2 Futures Commission Merchant
Category 2 Futures Commission Merchant Member	Impose Required Fund Deposit equal to 150 percent of the normal calculation of Required Fund Deposit
Category 1 Inter-Dealer Broker Member	Treated as a Category 1 Dealer as far as Required Fund Deposit exceeds \$5 million
Category 2 Inter-Dealer Broker Member	Treated as a Category 1 Inter-Dealer Broker, if it qualifies as such, or if it does not so qualify, impose Required Fund Deposit equal to 150 percent of the normal calculation of the Required Fund Deposit
Government Securities Issuer Member	Treated as a Category 2 Dealer

Under the proposed rule change, a violation of a minimum financial requirement by a member<sup>5</sup> of the GSD would result in the imposition on such member of a margin premium equal to the greater of (a) 25 percent of the member's unadjusted<sup>6</sup> clearing fund requirement or (b) \$1,000,000, to continue for ninety calendar days after the later to occur of (i) the member's

<sup>3</sup> Each consequence remains effective for a period beginning on the date on which the member fell below such level and continuing until the 90<sup>th</sup> calendar day after the date on which such member returned to compliance with the applicable standard. If the consequence consists of a reclassification and the member does not return to compliance with its original minimum financial requirement within 90 calendar days of falling out of compliance, then the reclassification becomes permanent.

<sup>4</sup> Treating a bank or other non-Inter-Dealer Broker Category 1 Member as a Category 2 non-Inter-Dealer Broker Member for clearing fund purposes results in a higher clearing fund requirement for such a member because higher margin rates are imposed on on-Inter-Dealer Broker Category 2 Dealer Members than are imposed on banks and non-Inter-Dealer Broker Category 1 Members.

<sup>5</sup> The proposed rule change only applies to GSD members that have minimum financial requirements (i.e., GSD netting members).

<sup>6</sup> "Unadjusted" means the standard calculation before any additional assessments.

return to compliance with applicable minimum financial standards or (ii) FICC's discovery of the applicable violation. This increase would not apply to Category 1 Dealer Netting Members, Category 1 Futures Commission Merchant Netting Members or Category 2 Inter-Dealer Broker Netting Members, where such members would continue to be reclassified as a different category netting member.<sup>7</sup> In addition, such violation would result in (1) a report of the violation to the FICC Membership and Risk Management Committee at its next regularly scheduled meeting or sooner if deemed appropriate by FICC and (2) the placement of such member on FICC's "watch list" subjecting it to more frequent and thorough monitoring. None of these consequences would preclude FICC from imposing any other margin consequences permitted by GSD's Rules.

(2) Failure to Submit Requisite Financial Reports on a Timely Basis

Certain members that are required to provide monthly or quarterly financial data to FICC at times have violated GSD's membership requirements by not timely providing such financial data. In such instances, management contacts each offending member and follows up with a letter.

Failure to timely receive required information creates risk to FICC and as a result hinders FICC's ability to appropriately assess the financial condition of such members. To encourage timely submission of required financial data, FICC has established a mechanism to fine

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<sup>7</sup> If GSD Category 1 Dealer Netting Members, GSD Category 1 Futures Commission Merchant Netting Members and GSD Category 2 Inter-Dealer Broker Netting Members do not meet the membership qualifications applicable to the new category of netting member, then they will be subject to the increased margin premium specified in clause (1) above.

delinquent members.<sup>8</sup> FICC is now proposing two additional measures to enforce timely filing of financial information.

First, FICC proposes to subject delinquent members to a more stringent clearing fund requirement. Specifically, under the proposed rule filing FICC would automatically impose a margin premium equal to the greater of (1) 25 percent of the member's unadjusted clearing fund requirement or (2) \$1,000,000. The margin premium would be applied until appropriate financial data is submitted to FICC and is reviewed for compliance purposes. In addition, delinquent members would be precluded from taking back any excess clearing fund collateral to which they might ordinarily be entitled.

Second, members that fail to submit requisite financial reports on a timely basis would also automatically be placed on FICC's "watch list" and subject to more frequent and thorough monitoring.

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act<sup>9</sup> and the rules and regulations thereunder applicable to FICC because it assures the safeguarding of securities and funds which are in the custody or control of FICC by encouraging members to maintain their minimum financial standards and to submit their required financial reports on a timely basis. As a result, FICC's ability to maintain a financially sound membership base should be enhanced.

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<sup>8</sup> Securities Exchange Act Release No. 49947 (June 30, 2004), 69 FR 41316 [File No. SR-FICC-2003-01].

<sup>9</sup> 15 U.S.C. 78q-1.

(B) Self-Regulatory Organization's Statement on Burden on Competition

FICC does not believe that the proposed rule change will have any impact or impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

Written comments relating to the proposed rule change have not yet been solicited or received. FICC will notify the Commission of any written comments received by FICC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve such proposed rule change or
- (B) institute proceedings to determine whether the proposed rule change should be

disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>) or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FICC-2004-

11 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-FICC-2004-11. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of FICC and on FICC's Web site at <http://www.ficc.com/gov/gov.docs.jsp?NS-query>. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All

submissions should refer to File Number SR-FICC-2004-11 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>10</sup> 17 CFR 200.30-3(a)(12).