

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51896; File No. SR-FICC-2004-22)

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change Establishing a Sponsored Membership Program

June 21, 2005

On November 12, 2004, 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 and on February 28, 2005, and May 6, 2005, amended the proposed rule change.² Notice of the proposal was published in the Federal Register on May 12, 2005.³ No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

I. Description

The rule change creates a new Rule 3A of FICC’s Government Securities Division’s (“GSD”) rules that will establish new membership categories and requirements for sponsoring members and sponsored members whereby certain existing netting members will be permitted to sponsor certain buy-side entities into membership. The rule change will also make conforming changes to FICC’s existing rules to accommodate the introduction of these new membership categories.

¹ 15 U.S.C. 78s(b)(1).

² The May 6, 2005, amendment to the proposed rule change clarified that sponsored members must “immediately” notify the sponsoring member (instead of “promptly” notify FICC as would have been required by the original filing) and that sponsoring members must promptly notify FICC if the sponsored member is no longer in compliance with the membership requirements. Because this change is technical in nature, republication of the notice was not required.

³ Securities Exchange Act Release No. 51659 (May 5, 2005); 70 FR 25129.

GSD will initially permit only bank netting members to apply to become sponsoring members.⁴ In order to be eligible to become a sponsoring member, a bank netting member will have to meet more stringent minimum financial requirements than those required for GSD netting membership. Specifically, the sponsoring member will have to have a level of equity capital of at least \$5 billion and will have to satisfy the ratios established by the Federal Deposit Insurance Corporation for being “well-capitalized.” If the sponsoring member has a bank holding company that is registered under the Bank Holding Company Act of 1956, then the bank holding company will also have to be “well-capitalized” under the relevant regulations of the Board of Governors of the Federal Reserve System. These financial criteria are both the initial and the continuing minimum financial requirements for sponsoring members. All applications for sponsoring membership will be decided on by FICC’s Membership and Risk Management Committee.⁵

To become a sponsored member, GSD will permit only entities that are (i) registered investment companies under the Investment Company Act of 1940 and (ii) qualified institutional buyers under Rule 144A of the Securities Act of 1933.⁶ In addition, an entity will only be able to become a sponsored member if there is a sponsoring member willing to sponsor the entity into membership. FICC will require each sponsoring member to represent in writing that each entity it wishes to sponsor meets these requirements. Thereafter, sponsoring members will have to make these representations to FICC on an on-going basis. Sponsored members will have to

⁴ FICC will submit a proposed rule change should it decide to expand the types of entities that may be sponsoring members.

⁵ Rule 3A, Section 2.

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immediately notify their sponsoring member anytime it is no longer in compliance with the membership requirements. GSD management will decide on entities applying to become sponsored members.⁷

Since a sponsoring member will act as the processing agent for its sponsored members, FICC will interact solely with the sponsoring member for operational purposes. The sponsoring member will have to establish an omnibus account for all of its sponsored members' activity. The omnibus account will be in addition to the sponsoring member's regular netting account. FICC will permit, but not require, the sponsoring member to submit sponsored member activity on a locked-in basis.⁸

FICC will provide its settlement guaranty to each sponsored member with respect to its respective net settlement positions (i.e., for clearing fund calculation, each sponsored member's trading activity is treated separately). For operational and securities clearance purposes, however, all of the activity in the omnibus account will be netted as if it were the activity of one netting member. As a result, the omnibus account will have only one net settlement obligation per CUSIP on a daily basis.⁹ The same will be true with respect to funds-only settlement for the omnibus account.¹⁰

The required clearing fund deposit of each sponsored member whose trading activity is submitted to the omnibus account will be calculated in the same manner as is done for the trading activity of a netting member in its regular netting account except that FICC will compute

⁷ Rule 3A, Sections 2(d) and 3.

⁸ Rule 3A, Sections 5 and 6.

⁹ Rule 3A, Sections 7 and 8.

¹⁰ Rule 3A, Section 9.

the required clearing fund deposit for each sponsored member on a standalone basis. FICC then will add each sponsored member's calculated requirement to two additional figures that will be calculated at the omnibus account level (i.e., the portion of the clearing fund calculation for adjusted funds-only settlement amounts for and fail net settlement positions) to come to a total clearing fund requirement for the omnibus account. For risk management purposes, FICC will not net the resulting clearing fund calculations of each sponsored member within the omnibus account with those of other sponsored members in the omnibus account.¹¹

FICC understands that the custodial banks that are likely to be interested in becoming sponsoring members generally collateralize their custody clients (i.e., the potential sponsored members) at 102 percent for U.S. Treasury repurchase agreements.¹² Under the GSD clearing fund formula, this would cause a sponsoring member to pay clearing fund of an additional 4 percent of its overall transactional volume with its sponsored members, which may potentially amount to hundreds of millions of dollars of additional clearing fund obligations.¹³ FICC

¹¹ Rule 3A, Section 10.

¹² This means that when a custody client wishes to engage in a reverse repo transaction (for example, the custodian client is lending \$100), it will generally require collateral of 102 percent of the value of the money loaned (in this example, \$102 worth of U.S. Treasury securities).

¹³ The following example will illustrate why this occurs under FICC's GSD's clearing fund formula. Assume that the start leg of the repo transaction between the sponsoring member and the sponsored member calls for the sponsored member to lend \$100 and receive \$102 in securities. The next day, the close leg of the repo transaction to which FICC has become counterparty will call for the sponsored member to send the collateral back to FICC, and FICC, which settles at market value, the sponsored member will pay \$102 in funds. This requires FICC to make an adjustment for funds-only settlement purposes by debiting the sponsored member \$2 and crediting the sponsoring member \$2. These funds-only settlement amount payments are referred to as "transaction adjustment payments" in the GSD's rules. Because one component of the clearing fund requires inclusion of the absolute value of the funds-only settlement amounts (i.e.,

believes that this potential adverse impact on a sponsoring member is unnecessary because these additional funds payments are pass-through amounts between sponsored members and their sponsoring members do not represent risk to FICC or its members. Therefore, FICC will amend the clearing fund rule to adjust for this funds-only settlement component when calculating the clearing fund requirements for the sponsored members, the omnibus account, and the sponsoring member's regular netting account. FICC will reserve the right to not adjust the funds-only settlement component when, in its discretion, the circumstances warrant such action (for example, under extraordinary market conditions).

Each sponsored member will be principally liable for satisfying its securities and funds-only settlement obligations. For operational and administrative purposes, FICC will interact with the sponsoring member as agent for the sponsored members for day-to-day satisfaction of these obligations.¹⁴

While the sponsored members will be principally liable for their settlement obligations, the sponsoring member will be required to provide a guaranty to FICC with respect to such obligations. This means that in the event one or more sponsored members do not satisfy their settlement obligations, FICC will be able to invoke the guaranty provided by the sponsoring member.¹⁵

Sponsored members will not be liable for any loss allocation obligations. To the extent that a "remaining loss" (as defined in the GSD's rules) arises in connection with "direct

regardless of whether they are debits or credits), the transaction adjustment payments will artificially inflate the clearing fund requirements related to both the sponsored member omnibus account and the sponsoring member's regular netting account.

¹⁴ Rule 3A, Sections 8 and 9.

¹⁵ Definition of "Sponsoring Member Guaranty" and Rule 3A, Section 2.

transactions” (as defined in the GSD’s rules) between the sponsoring member and its sponsored members (i.e., the sponsoring member is the insolvent party), the sponsored members will not be responsible for or considered in the calculation of the loss allocation obligations. Such obligations will be the obligation of the other netting members that had direct transactions with the sponsoring member in its capacity as a netting member. To the extent there is an allocation other than for direct transactions between the sponsoring member and its sponsored members, the sponsored members will be counted as if they were obligated to pay the loss allocation amounts, but it will be the sponsoring member’s obligation to pay such amounts.¹⁶

II. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing be designed to assure the safeguarding of securities and funds which are in its custody or control.¹⁷ The proposed rule change is consistent with the requirements of Section 17A of the Act and the rules and regulations thereunder because the sponsoring and sponsored membership categories and related rules have been crafted in a manner that, while providing for sponsored members, adequately takes into account any associated risks.

III. Conclusion

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act¹⁸ and the rules and regulations thereunder.

¹⁶ Rule 3A, Section 12.

¹⁷ 15 U.S.C. 78q-1(b)(3)(F).

¹⁸ 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2004-22) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁹

Jill M. Peterson
Assistant Secretary

¹⁹ 17 CFR 200.30-3(a)(12).