

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50607; File No. SR-FICC-2004-15)

October 29, 2004

Self-Regulatory Organizations; The Fixed Income Clearing Corporation; Notice of Filing of a Proposed Rule Change Relating to Trade Submission Requirements and Pre-Netting

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ notice is hereby given that on July 30, 2004, The Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as 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 persons.

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 broaden its trade submission requirements and to prohibit pre-netting activities of certain affiliates of its members.

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

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

¹ 15 U.S.C. 78s(b)(1).

² The Commission has modified the text of the summaries prepared by FICC.

Through a recent survey of GSD members and through other means, FICC has learned that there is a great deal of Government securities activity that is currently being executed or cleared and guaranteed as to settlement by affiliates of FICC's netting members, some of which are active market participants, and is not being submitted to FICC. This currently does not represent a violation of the GSD's rules, which require that netting members submit their own eligible trading activity but do not address member affiliate trading activity.

FICC has also determined that its trade submission requirements have been ineffective in preventing the "pre-netting" of otherwise netting-eligible activity by netting members as well as their affiliates. In fact, FICC believes that certain members may be purposefully funneling eligible transactions through their non-member affiliates in order to avoid having to submit these transactions to the clearing corporation. Such pre-netting practices, which may take the form of "internalization," "summarization," or "compression," prevent the submission to the clearing corporation of transactions on a trade-by-trade basis.³ The GSD's rules currently prohibit certain pre-netting practices by requiring that all eligible member-executed trades be submitted on a trade-by-trade basis. The proposed rule change further expands this requirement and extends it to affiliate trades.

The submission to FICC of eligible activity of each GSD netting member and that of its affiliates that are active market participants is necessary to preserve the integrity of the netting

³ In this regard, it should be noted that on February 28, 2003, the National Securities Clearing Corporation ("NSCC"), an FICC affiliate, issued a paper titled "Managing Risk in Today's Equity Market: A White Paper on New Trade Submission Safeguards," in which it defined recent trade submission practices that are creating risks in the equities market. See <http://www.dtcc.com/ThoughtLeadership/index.htm>. In the paper, NSCC defined three trade submission practices that are some form of pre-netting: (i) compression, which is a technique to combine submissions of data for multiple trades to the point where the identity of the party actually responsible for the trades is masked; (ii) internalization, which is a technique in which trade data on separate correspondents' trades completely "crossed" on a clearing member's books are not reported at all to the clearing corporation; and (iii) summarization, which is a technique in which the clearing broker nets all trades in a single CUSIP by the same correspondent broker into fewer submitted trades.

process and the safety and soundness of the overall clearance and settlement process. The consequence of a gap in FICC's trade submission requirements is the introduction of significant risk issues for FICC and the Government securities marketplace as a whole.

The GSD employs several methods to reduce risk including collateral and mark-to-market requirements and various monitoring procedures. These methods have been highly successful in protecting the GSD and its members from loss. The most powerful risk management tool employed by the GSD is its multilateral netting by novation process, which eliminates the need to settle the large majority of receive and deliver obligations created by the trading activity of members. (For example, each business day during the first half of 2004, the netting process safely eliminated the settlement risk posed by an average of about 73,000 government securities transactions worth approximately \$1.82 trillion.) The integrity of this netting process depends upon the submission to the GSD of all eligible activity on a trade-by-trade basis.

For this reason, FICC, similar to other registered clearing agencies, seeks to prohibit pre-netting activity on the part of members.⁴ Indeed, it is the avoidance of "broker pre-netting" that was a fundamental reason for the formation of the Government Securities Clearing Corporation, the predecessor of the GSD, in the 1980s. The absence from the GSD's netting and settlement

⁴ GSD Rule 11, Netting System, Section 3, Obligation to Submit Trades, currently provides that each netting member must submit to FICC for comparison and netting data on all of its non-repo trades:

(including trades executed and settled on the same day and trades executed between it or an Executing Firm on whose behalf it is acting) with Comparison-Only Members or with other Netting Members (or an Executing Firm on whose behalf it or another Member is acting) that are eligible for netting pursuant to these Rules.... If the Corporation determines that a Netting Member has, without good cause, violated its obligations pursuant to this Section, such Netting Member may be reported to the appropriate regulatory body, put on the Watch List pursuant to Rule 4, or subject to an additional fee.

In addition, Rule 5, Comparison System, Section 4, Submission Size Alternatives, essentially provides that every non-GCF Repo trade must be submitted to FICC "in the full size and in the exact amount in which the trade was executed."

processes of all eligible trades of an active market participant that is a GSD netting member or an affiliate of a GSD netting member presents systemic risk to the marketplace for a number of reasons, including the following:

1. Counterparty Credit Risk

Management of the risk of trades that are not submitted to the clearing corporation falls to each direct counterparty including ones that may have insufficient capital or financial strength and/or inadequate internal processes to mitigate such risk. Counterparty risk is not managed in a centralized, transparent manner, and the myriad of risk protections built into the FICC process that have been supported by the industry and have been approved by the Commission are not available.

2. Operational Risk

Eligible trades that are not submitted to FICC introduce operational risk, including “9-11” type risk, to the extent such trades are not submitted to FICC for comparison and guaranteed settlement within minutes of execution through the Real-Time Trade Matching System. Should a catastrophic event occur after trade execution, submission of trade data could be significantly delayed or such data even lost. Trade guaranty would also not be obtained immediately, if at all, because the trade did not compare.

It is noteworthy that the GSD now receives approximately ninety-eight percent of its trade data on a real-time basis. That development alone has significantly improved the GSD’s ability to timely manage the risk arising from the over two trillion dollars of daily activity in the Government securities marketplace.

3. Legal Risk

Failure of eligible activity to be submitted to FICC increases systemic risk to the clearance and settlement system for Government securities to the extent that these practices reduce the number of trades and provide for clearly enforceable netting rights in the event of

member insolvency. In an insolvency proceeding of a netting member of the GSD under U.S. law, the clearing organization netting provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”) afford clear netting rights to the GSD as a registered securities clearing agency. The United States Bankruptcy Code (“Code”) and the Federal Deposit Insurance Act (“FDIA”), to the extent applicable, also provide a number of protections to registered securities clearing agencies such as FICC. Although FDICIA, the Code, and the FDIA also provide similar safe harbors protecting netting rights with respect to certain securities contracts when not submitted to and novated through the GSD and other registered clearing agencies, their applicability is highly dependent upon the types of entities involved and the nature and adequacy of bilateral documentation.

Thus, pre-netting activity has the potential to increase risk absent the capacity for comprehensive monitoring to ensure that such documentation and entities are in fact used throughout the Government securities marketplace.

Furthermore, as a practical matter, to the extent that there are any ambiguities in the application of relevant netting or close-out rights, FICC would expect that in general a bankruptcy court or other insolvency tribunal would be more deferential to close-out and netting by a registered securities clearing agency such as FICC than it would be to close-out and netting by another market participant.

4. Resolution of Fails Problems

The failure of netting members to submit eligible trades to FICC decreases the ability of FICC to assist in the resolution of fail problems. The significant fail problem incurred by the industry over the past year with regard to the May 2013 10-Year Note, and similar situations that may occur in the future, likely could be mitigated by submission of eligible data on behalf of non-member affiliates of GSD members by allowing FICC to identify and resolve round robin fail scenarios involving these affiliates.

The failure of FICC to receive all eligible trading activity of an active market participant denigrates FICC's vital multilateral netting process and leads to systemic risk and to FICC not being in as good a position to prevent a market crisis. Given the enormous and growing amount of activity in the government securities marketplace and resultant huge settlement risks, the proposed trade submission requirements and pre-netting prohibitions are the logical next steps for enhancing FICC's netting and risk management processes and ensuring that FICC can continue to perform its vital risk management role for the Government securities marketplace.

As a result, FICC is proposing to broaden its trade submission standards by requiring the submission of data on trades executed or cleared and guaranteed as to their settlement by certain affiliates of members.⁵ The proposed rule change also makes explicit that these affiliate trades must be submitted on a trade-by-trade basis as executed. This would advance the goal of having every active Government securities market participant which is a GSD netting member, or an active affiliate of a GSD netting member, submit or have submitted on its behalf its eligible activity to the GSD on a trade-for-trade basis for netting, risk management, and guaranteed settlement. It would also put the Government securities marketplace on a more equal footing with other markets where the presence of exchange and/or regulatory confirmation or price transparency requirements effectively mandates that all eligible trades be submitted to the clearing corporation.

Specifically, the proposed rule change would apply to a GSD member's non-member affiliates that are registered broker-dealers, banks, or futures commission merchants organized in the United States ("covered affiliates"). The proposed rule change would require members to submit, on a trade-by-trade basis, eligible trades, both buy-sells and repos, executed by their covered affiliates with other netting members or the other members' covered affiliates. The

⁵ Trades that the affiliate clears for another entity but does not guarantee the settlement of will be excluded from the trade submission requirement.

proposed rule change would also require members to submit, on a trade-by-trade basis, eligible trades cleared and guaranteed as to their settlement by their covered affiliates. The proposed rule change is limited to covered affiliates because these are the types of entities that comprise the majority of GSD netting members, and the failure to submit trades executed by registered broker-dealers, banks, and futures commission merchants organized in the United States has given rise to the systemic risk concerns discussed above.

It is important to note that covered affiliates will not be required to join FICC as members. As such, FICC is affording members and their affiliates the flexibility of choosing to have their trades processed by FICC either through direct membership or through a correspondent clearing relationship with an affiliate or other entity. In addition, the proposed rule filing would exempt the following from its coverage, which FICC believes do not raise systemic risk concerns of the type described above: (1) an affiliate that engages in de minimis eligible activity, which would be defined as less than an average of 30 or more eligible trades per business day during any one-month period within the prior year; (2) trades executed between a member and its affiliates or between affiliates of the same member; and (3) trades whose submission to FICC would cause the member to violate an applicable law, rule, or regulation.

The proposed rule filing would provide that failure to abide by the new trade submission requirements would trigger the disciplinary consequences currently in the GSD rules, which can ultimately result in termination of membership.⁶

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act⁷ and the rules and regulations thereunder applicable to FICC because the

⁶ The disciplinary consequences of GSD Rule 48 are being referred to explicitly in this rule filing to emphasize to members the importance of this proposed rule change and to remind members that violations of the GSD's rules, whether of the proposed rule upon Commission approval or other GSD rules, may lead to serious disciplinary consequences, including termination of membership.

proposed rule change will reduce systemic risk in the government securities marketplace and therefore facilitate the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions.

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

FICC does not believe that the proposed rule change would 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 the 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

⁷ 15 U.S.C. 78q-1.

- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FICC-2004-15 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-2004-15. 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 website (<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 website at www.ficc.com. 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-2004-15 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.⁸

Margaret H. McFarland
Deputy Secretary

⁸ 17 CFR 200.30-3(a)(12).