

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50659; File No. SR-FICC-2004-11)

November 15, 2004

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval 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

I. Introduction

On May 17, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on August 4, 2004, amended proposed rule change File No. SR-FICC-2004-11 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).<sup>1</sup> Notice of the proposed rule change was published in the Federal Register on October 4, 2004.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

II. Description

The proposed rule change amends the rules of its Government Securities Division (“GSD”) by modifying the penalty assessment process for violations of minimum financial standards and for failure to submit requisite financial reports on a timely basis.

(A) 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

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

<sup>2</sup> Securities Exchange Act Release No. 50457 (September 27, 2004), 69 FR 59283.

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:

<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

<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 ninetieth 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 non-Inter-Dealer Broker Category 2 Dealer Members than are imposed on banks and non-Inter-Dealer Broker Category 1 Members.

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 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 (a) 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 (b) 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.

(B) 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

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<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.

<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 above.

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 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 delinquent members.<sup>8</sup> FICC has proposed two additional measures to enforce timely filing of financial information.

First, FICC will subject delinquent members to a more stringent clearing fund requirement. Specifically, FICC will automatically impose a margin premium equal to the greater of (a) 25 percent of the member's unadjusted clearing fund requirement or (b) \$1,000,000. The margin premium will be applied until the appropriate financial data is submitted to FICC and is reviewed for compliance purposes. In addition, delinquent members will 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 will also automatically be placed on FICC's "watch list" and subject to more frequent and thorough monitoring.

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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].

### III. 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 in its custody or control or for which it is responsible.<sup>9</sup> The Commission finds that FICC's proposed rule change is consistent with this requirement because by encouraging members to maintain their minimum financial standards and to submit their required financial reports on a timely basis, FICC's ability to maintain a financially sound membership base should be enhanced.

### IV. 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 17A of the Act and the rules and regulations thereunder.

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<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>10</sup> that the proposed rule change (File No. SR-FICC-2004-11) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>10</sup> 15 U.S.C. 78s(b)(2).

<sup>11</sup> 17 CFR 200.30-3(a)(12).