

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50671; File No. SR-FICC-2004-08)

November 16, 2004

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Provide Interpretive Guidance to Members Regarding the Criteria Used to Place Members on Surveillance Status

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ notice is hereby given that on March 29, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) 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 provide interpretive guidance regarding an approved rule change that amended the criteria used to place members on surveillance status.²

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

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 49158 (January 30, 2004), 69 FR 5624 (February 5, 2004) [File No. SR-FICC-2003-03].

below. FICC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.³

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

FICC is seeking to provide interpretive guidance to members pertaining to the member surveillance rules of the Government Securities Division ("GSD") and the Mortgage-Backed Securities Division ("MBSD") of FICC.

1. Background

Prior to the Commission's approval of SR-FICC-2003-03,⁴ the GSD had the ability to place a member in a surveillance status class depending on whether the member satisfied one or more of the enumerated financial and operational criteria in the specific class. Upon approval of SR-FICC-2003-03, FICC implemented new criteria for placing members on surveillance. Specifically, all domestic broker-dealers and banks that are GSD netting members and/or MBSD clearing members are now assigned a rating that is generated by entering financial data of the member into a matrix ("Matrix"). Members who receive a low rating are placed on an internal "watch list" and are monitored more closely. All other types of netting and clearing members (those who are not domestic banks or broker-dealers) are not included in the Matrix process but are monitored by FICC's credit risk staff using financial criteria deemed relevant by FICC.

³ The Commission has modified the text of the summaries prepared by FICC.

⁴ Supra at 2.

2. Clarification of Rules Provisions

In describing the process by which Credit Risk staff would review members and implement the Matrix process, FICC included in SR-FICC-2003-03 several explanatory footnotes. Specifically, in footnotes 2 and 3 of Amendment I of the filing, FICC explained that members would be placed on the Matrix after a thorough review had been performed of various quantitative factors. FICC also stated that members would be evaluated for certain parameter breaks based on applicable monthly or quarterly reports generated by credit risk staff.⁵ FICC at this time wishes to clarify its procedures in this regard.

Credit risk staff approaches its analysis of members pursuant to the new procedures in the following manner. First, as mentioned above, domestic broker-dealers and domestic banks are run through the Matrix and assigned a rating. Low-rated members are placed on the watch list. At this point, credit risk staff may downgrade a particular member's score based on various qualitative factors. For example, one qualitative factor might be that the member in question received a qualified audit opinion on its annual audit. In order to protect FICC and its other members, it is important that credit risk staff maintain the discretion to downgrade a member's rating on the Matrix and thus subject the member to closer monitoring. Members who receive a

⁵ In Amendment I to FICC-2003-03, footnote 2 stated, "FICC's approach to the analysis of members will be based on a thorough quantitative analysis. A member's rating on the Matrix will be based on factors including (for broker /dealers): size (total excess net capital), capital, leverage, liquidity and profitability. Banks will be reviewed based on: size, capital, asset quality, earnings and liquidity." Footnote 3 stated, "Members will also be evaluated based on their compliance with certain "parameter breaks" which will be determined based on applicable monthly and/or quarterly exception reports generated by Credit Risk. A member may be placed on the Watch List for failure to fall within, for example, prescribed excess net capital, excess liquid capital, aggregate indebtedness, leverage ratio or financial membership requirement parameters."

downgraded rating which makes them eligible for the watch list are also placed on the watch list. All rated members, including those on the watch list, are monitored monthly or quarterly, depending upon the member's financial filing frequency, against basic minimum financial requirements and other parameters.

All broker-dealer members included on the watch list are monitored more closely. This means that they are also monitored for various parameter breaks, which may include but are not limited to, a defined decline in excess net capital over a one month or three month period, a defined period loss, a defined aggregate indebtedness/net capital ratio, a defined net capital/aggregate debit items ratio, and a defined net capital/regulatory net capital ratio. All bank members included on the watch list are also monitored more closely for watch list parameter breaks, which may include but are not limited to, a defined quarter loss, a defined decline in equity, a defined tier one leverage ratio, a defined tier one risk-based capital ratio, and a defined total risk-based capital ratio. FICC wishes to make clear that monitoring for the above more stringent parameter breaks is only applicable to those members placed on the watch list.

In addition, FICC would like to address footnote 5 of Amendment I to rule filing SR-FICC-2003-03. That footnote stated that credit risk staff would monitor those members not included in the Matrix process (this includes netting and clearing members who are not domestic banks and broker dealers) using the same criteria as those used for members included on the Matrix. FICC wishes to make clear that credit risk staff will not be reviewing the same criteria for these members but will use similar criteria. As stated in the narrative of SR-FICC-2003-03, these criteria may include failure to meet minimum financial requirements, experiencing a

significant decrease in equity or net asset value, or a significant loss. This class of members may be placed on the watch list based on credit risk staff's analysis of this information.

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act⁶ and the rules and regulations thereunder applicable to FICC because it will facilitate the safeguarding of securities and funds which are in its custody or control or for which it is responsible and in general will protect investors and the public interest by improving FICC's member surveillance process.

(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

⁶ 15 U.S.C. 78q-1.

(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. Please include File Number SR-FICC-2004-08 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-2004-08. 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 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-2004-08 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.⁷

Margaret H. McFarland
Deputy Secretary

⁷ 17 CFR 200.30-3(a)(12).