

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50718; File No. SR-FICC-2004-09)

November 22, 2004

Self-Regulatory Organizations; Notice of a Proposed Rule Change by the Fixed Income Clearing Corporation Relating to Changes to Membership Requirements

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ notice is hereby given that on April 14, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on November 16, 2004, amended 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

The proposed rule change would amend FICC’s Government Securities Division (“GSD”) and Mortgage Backed Securities Division (“MBSD”) rules to require applicants and members to submit two years of audited annual financial statements or less for newly formed entities, to permit applicants and members to submit audited consolidated statements in situations where audited financial statements are not prepared at the applicant or member level, to eliminate the rule that requires comparison-only members to be in compliance with the capital requirements of their examining authority, and to require non-US banks that wish to become an approved letter of credit issuer to have language in their opinion of counsel indicating that the head office is “ultimately responsible” for the credit obligation of the branch.

II. 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).

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

The proposed rule change would affect GSD's and MBSD's rules in the following areas:

1. Annual Audited Financial Statements

Currently, GSD's rules require US applicants for membership to submit annual audited financial statements for the preceding year and non-US applicants to submit annual audited financial statements for the preceding three years. MBSD's rules currently require US and non-US membership applicants to submit annual audited financial statements for the preceding year.

FICC proposes to amend both divisions' rules to require GSD netting applicants and MBSD clearing applicants to submit two years of annual audited financial statements. However, if an applicant or member has not been in business for two years (i.e., a newly-formed applicant or member³), FICC would permit it to submit annual audited financial statements for a lesser period and/or annual audited financial statements of a predecessor firm in the case of an applicant or member formed by a corporate transaction. If audited financial statements cannot be

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

³ A newly formed applicant may include a company with no business history or a company formed as a result of a corporate transaction such as a merger.

obtained, newly- formed applicants will be permitted to submit unaudited pro forma financial statements.

Firms that submit less than two years of financial statements would also have to submit: (1) annual audited financial statements of a predecessor firm, if applicable; (2) pro forma financial statements signed by a senior officer of the firm; (3) regulatory reports for the period since inception;⁴ and (4) evidence from a third party verifying the applicant's capital at the time of application.

FICC believes the proposed rule change permitting less than two years of annual audited financial statements or unaudited pro forma financial statements is necessary and appropriate in order to accommodate entities that are newly-formed and those that are created as a result of a merger of existing entities or other similar corporate transaction. First, firms that are newly-formed do not have audited financials and in some instances can only provide pro forma financial statements. Second, the GSD's rules already contemplate the admission of entities with

⁴ A regulated entity, such as a US broker-dealer or domestic bank, will file regulatory reports (FOCUS reports for a broker-dealer and CALL reports for a bank) with its regulators in the required time period following its regulatory approval. Such firms' regulators would require them to include as much information in these reports as is normally required of all other entities except where certain information would be unavailable. For example, if a broker-dealer has not yet begun trading, it would not report any trading revenue.

Unregulated and non-U.S. entities would be required to produce specific information that FICC would need in order to develop a risk profile to evaluate creditworthiness. This information would be requested in a form provided to the firms by FICC and signed by a senior officer of the firm. (This form, which is the subject of a pending rule filing, SR-FICC-2004-14, would replace the current requirement for the submission of regulatory reports for non-US entities only and that US-regulated entities will still be required to submit regulatory reports). If necessary, and regardless of whether regulatory reports are available, FICC may seek evidence from a third party to prove that an applicant or newly approved member meets minimum standards. For example, FICC may request a bank statement to verify that cash has been deposited, thereby verifying that the applicant meets FICC's minimum capital requirement.

little or no business history, which often are of equal or even greater credit quality than more established entities. For example, GSD's rules provide that a netting applicant must have an established, profitable business history of a minimum of six months or personnel with sufficient operational background and experience to ensure in the judgment of FICC's Membership and Risk Management Committee the ability of the firm to conduct its business.⁵ Third, FICC believes that the foregoing information will provide sufficient evidence that the applicant meets FICC's membership standards. Upon approval for membership, such a firm will be required to submit interim financial data to FICC, which will be used to monitor adherence to FICC's established financial parameters. As of its fiscal year-end, the firm will be required to provide its annual audited financial statement. At that time, the applicable interim statement will be compared to the audited financial statement. If there are discrepancies, the firm will be required to supply FICC with an acceptable explanation.

2. Financial Statements Prepared at the Applicant or Member Level

The rules of both FICC divisions currently specify that all required audited financial statements be prepared at the applicant or member level. However, some entities do not prepare their own audited financial statements. Their financial status is included in audited consolidated financial statements of a parent company.⁶ Accordingly, FICC proposes to amend both divisions' rules to permit the submission of audited consolidated financial statements in situations where audited financial statements are not prepared at the applicant or member level.

⁵ FICC Rule 2, § 4 and Rule 3, § 2(c).

⁶ References to a "parent" company can mean a direct parent, intermediate parent, or ultimate parent company.

FICC believes that it is not appropriate for it to mandate that members prepare their own audited financial statements if it is not their practice to do so. First, many members are not required to prepare their own audited financial statements by their regulators and doing so would be very expensive. Second, FICC is comfortable in accepting audited consolidated financial statements because FICC is able to obtain information regarding an applicant's or member's financial status through interim financial data on the applicant or member itself. This interim data is on the applicant or member firm level and is obtained from regulatory reports filed by the applicant or member itself or unaudited financial reports prepared internally by the applicant or member. FICC staff compares data from the applicable interim statement to the audited financial statement or applicable audited consolidated financial statement, and if there are discrepancies, the firm would be required to supply FICC with an acceptable explanation. In addition, in instances where the member or applicant is unregulated and regulatory reports are thus not available, FICC may request consolidating financial statements from the member firm, which will show the financials of the entities that were included in the audited consolidated financial statement.

In addition to this change, FICC is proposing to make a technical change to the term "financial statements" in GSD Rule 2, Section 7, to update the current reference to "shareholder's equity" to "owner's equity" to encompass those entities that do not have shareholders.

3. Compliance with Certain Capital Requirements

The GSD's rules currently state that a comparison-only applicant must be in compliance with the capital requirements imposed by its designated examining authority, appropriate

regulatory agency, or other examining authority or regulator, and any other self-regulatory organizations to which it is subject by statute, regulation, or agreement.

FICC proposes to eliminate this requirement because comparison-only membership does not present FICC with any credit or financial risk since FICC does not guarantee that service.

4. Letters of Credit

GSD's rules currently provide that if an approved letter of credit issuer is a non-US bank acting through a branch or agency in the US, it must provide FICC with a "guarantee of performance" of such branch or agency deemed sufficient by FICC. FICC believes that the current language needs to be clarified because it was never meant to require a financial guarantee. FICC believes that it is not appropriate to require the head office of an approved letter of credit issuer to provide a financial guarantee for its branch or agency, given that the latter is simply an "arm" of the head office itself and not a separate legal entity.

Accordingly, FICC proposes to change the current language to specify that non-US banks wishing to become approved letter of credit issuers must have language in their opinion of counsel indicating that the head office is "ultimately responsible" for the credit obligation of the branch or agency. This language is already contained in the pro forma legal opinions that are part of the FICC letter of credit issuer application.

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act⁷ and the rule thereunder because it will enhance FICC's risk management procedures thereby further safeguarding the funds and securities under FICC's control.

B. Self-Regulatory Organization's Statement on Burden on Competition

⁷ 15 U.S.C. 78q-1.

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 it receives.

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. Please include File Number SR-FICC-2004-09 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-2004-09. 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://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-2004-09 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).