

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50790; File No. SR-FICC-2004-16)

December 3, 2004

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Establishment of a Cross-Margining Agreement with The Clearing Corporation

I. Introduction

On August 12, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) proposed rule change File No. SR-FICC-2004-16 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).¹ Notice of the proposed rule change was published in the Federal Register on November 1, 2004.² 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 establishes a cross-margining arrangement between FICC’s Government Securities Division (“GSD”) and The Clearing Corporation (“TCC”).

(1) Background

The Government Securities Division of FICC is entering into a new cross-margining agreement with TCC. FICC had a cross-margining arrangement in place with the Board of Trade Clearing Corporation (“BOTCC”), TCC’s predecessor, through which certain Chicago Board of

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 50594 (October 26, 2004), 69 FR 63421.

Trade (“CBOT”) products were cross-margined with certain FICC products.³ The BOTCC arrangement was terminated on January 2, 2004, the date on which BOTCC ceased being the clearing organization for the CBOT products that were the subject of the arrangement.⁴ On January 2, 2004, the Chicago Mercantile Exchange (“CME”) became the clearing organization for the CBOT products that are now included in the cross-margining arrangement that FICC has with the CME.⁵

TCC recently became the clearing organization for EurexUS and has approached FICC regarding cross-margining certain U.S. Treasury and Agency futures and options on futures products traded on the EurexUS futures exchange and cleared by TCC with certain FICC products.⁶

FICC is entering into a new cross-margining agreement with TCC (“FICC-TCC Agreement”) to cover the EurexUS traded products cleared by TCC. Under the FICC-TCC Agreement, the FICC products that will be eligible for cross-margining will be Treasury securities that fall into the GSD’s offset classes A through G, and GCF Repo Treasury securities with equivalent remaining maturities, non-mortgage-backed Agency securities that fall into the GSD’s offset classes e and f, and GCF Repo non-mortgage-backed Agency securities with equivalent remaining maturities. The TCC products that will be eligible for cross-margining will be the EurexUS products, which are Two-Year Treasury Note Futures contracts and options thereon, Five-

³ Securities Exchange Act Release No. 45335 (January 25, 2002), 67 FR 4768 [File No. SR-GSCC-2001-03].

⁴ Securities Exchange Act Release No. 49142 (January 28, 2004), 69 FR 5623 [File No. SR-FICC-2004-02].

⁵ Securities Exchange Act Release No. 49003 (December 29, 2003), 69 FR 712 [File No. SR-FICC-2003-10].

Year Treasury Note Futures contracts and options thereon, Ten-Year Treasury Note Futures contracts and options thereon, Thirty-Year Treasury Bond Futures contracts and options thereon, Five-Year Agency Note Futures contracts and options thereon, and Ten-Year Agency Note Futures contracts and options thereon, cleared or to be cleared by TCC.⁷

(2) FICC's Cross-Margining Program in General

In general, cross-margining allows members to optimize their capital usage by permitting their clearing organizations to view their positions across clearing organizations as a combined portfolio and to reduce margin requirements accordingly.⁸ Margin based on the net combined risk of correlated positions is based on the cross margining arrangement under which FICC and each Participating CO agree to accept the correlated positions in lieu of supporting collateral.⁹

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⁶ The products traded on the EurexUS futures exchange and cleared by TCC are substantially similar to the CBOT products originally cleared by BOTCC.

⁷ TCC is not currently clearing the Agency futures products. However, because it expects to clear Agency futures products in the future, FICC has included these products in the proposed rule change and the draft agreement. These Agency products are also covered by the current cross-margining agreement between FICC and the CME.

⁸ Cross-margining is available to any FICC GSD netting member (with the exception of inter-dealer broker netting members) that is or that has an affiliate that is a member of a participating clearing organization ("Participating CO"). The FICC member (and its affiliate, if applicable) sign an agreement under which it (or they) agree to be bound by the cross-margining agreement between FICC and the Participating CO and which allows FICC or the Participating CO to apply the member's (or its affiliate's) margin collateral to satisfy any obligation of FICC to the Participating CO (or vice versa) that results from a default of the member (or its affiliate). Ownership of 50 percent or more of the common stock of an entity indicates control of the entity for purposes of the definition of "affiliate."

⁹ FICC employs the "hub-and-spoke" method of cross-margining whereby FICC cross-margins on a multilateral basis (i.e., with more than one Participating CO) with FICC as

All eligible positions maintained by a cross-margining participant in its account at FICC and in its (or its affiliate's) proprietary account at a Participating CO are eligible for cross-margining.¹⁰

Under the arrangement, FICC and each Participating CO holds and manages its own positions and collateral and independently determines the amount of margin that it will make available for cross-margining, which is referred to as the "residual margin amount." FICC computes the amount by which the cross-margining participant's margin requirement can be reduced at each clearing organization (*i.e.*, the "cross-margining reduction") by comparing the participant's positions and the related margin requirements at FICC against those at each Participating CO.¹¹ FICC offsets each cross-margining participant's residual margin amount at FICC against the offsetting residual margin amounts of the participant (or its affiliate) at each Participating CO.

If the margin that FICC has available for a participant is greater than the combined margin submitted by the Participating COs, FICC will allocate a portion of its margin equal to the combined margin at the Participating COs. If the combined margin submitted by the Participating COs is

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the "hub." Each Participating CO enters into a separate cross-margining agreement between itself and FICC. No preference is given by FICC to any one Participating CO over another.

¹⁰ Upon implementation of the new arrangement between FICC and TCC, the arrangement will not apply to positions in a customer account at TCC that would be subject to the segregation requirements of the Commodity Exchange Act. This is also the case under the cross-margining arrangement that FICC has in place with the CME.

¹¹ FICC and the Participating COs currently use different margin rates to establish margin requirements for their respective products. Margin reductions in the cross-margining arrangement are always computed based on the lower of the applicable margin rates. This methodology results in a potentially lesser benefit to the participant but ensures a more conservative result (*i.e.*, more collateral held at the clearing organization) for the Participating CO and FICC.

greater than the margin that FICC has available for that participant, FICC will first allocate its margin to the Participating CO with the most highly correlated positions. If the positions are equally correlated, FICC will allocate on a pro rata basis based upon the residual margin amount available at each Participating CO. FICC and each Participating CO may then reduce the amount of collateral that they collect to reflect the offsets between the cross-margining participant's positions at FICC and its (or its affiliate's) positions at the Participating CO.¹²

FICC and each Participating CO will guarantee the cross-margining participant's (or its affiliate's) performance to each other up to a specified maximum amount that relates back to the cross-margining reduction and the results of liquidating the member's positions and ultimately its collateral. The guaranty represents a contractual commitment that each clearing organization has to the other.

A default by a cross-margining participant will trigger the loss sharing provisions of the cross-margining agreement. The loss-sharing provisions determine the guaranty payments, if any, that will flow between the clearing organizations if the default of the participant results in a loss. It should be noted that a declaration of default of a cross-margining participant by one of the clearing organizations in and of itself will provide grounds for the other clearing organization to declare the participant (or its affiliate) in default as well. If the guaranty is triggered, the cross-margining participant becomes obligated to reimburse the guarantor clearing organization for the amount of the guaranty payment, which is called the "Reimbursement Obligation."

¹² FICC and each Participating CO unilaterally have the right not to reduce a participant's margin requirement by the cross-margining reduction or to reduce it by less than the cross-margining reduction. However, the clearing organizations may not reduce a participant's margin requirement by more than the cross-margining reduction.

The cross-margining agreement also provides for the sharing of remaining resources beyond the cross-margining arrangement through a “cross-guaranty” provision. This provision reflects the view that excess collateral of a defaulting member should remain with the clearing organizations, if needed, to cover their losses. Specifically, if after guaranty payments, if any, one of the clearing organizations has a remaining surplus, and the other has a remaining loss, the agreement provides a mechanism for the distribution of that surplus to the clearing organization that still has a remaining loss.

(3) Key Changes to the Former Agreement Between FICC and TCC

(a) The minimum margin factor under the former FICC-BOTCC cross-margining agreement was 50 percent. FICC and TCC have agreed to a minimum margin factor of 25 percent. This is the same minimum margin factor used in the current cross-margining arrangement with the CME.¹³

(b) The FICC-TCC Agreement provides for inter-offset class cross-margining whereas the former BOTCC arrangement was limited to intra-offset class cross-margining. The new agreement is consistent with the approach in the existing arrangement between FICC and the CME.

(c) Appendix B of the FICC-TCC Agreement will include more FICC products than did the former BOTCC arrangement. The former BOTCC agreement covered FICC offset classes C, E, F, G and f, and offset classes E, F, and f were defined more narrowly for purposes of the arrangement than they were defined in the GSD’s rules. The FICC-TCC Agreement includes the

¹³ The minimum margin factor is the contractually agreed upon cap on the amount of the margin reduction that the clearing organizations will allow. Should FICC decide to change the minimum margin factor, it will submit a proposed rule filing under Section 19(b) of the Act.

GSD's offset classes A through G, GCF Repo Treasury securities with equivalent remaining maturities, non-mortgage-backed Agency securities that fall into the GSD's offset classes e and f, and GCF Repo non-mortgage-backed Agency securities with equivalent remaining maturities.

These offset classes are as broad as they are defined in the GSD's rules.

(d) Appendix B of the FICC-TCC Agreement will also include FICC's GCF Repo Treasury and non-mortgage-backed Agency products. FICC is now able to margin its GCF Repo Treasury and non-mortgage-backed Agency products based upon the specific underlying collateral as opposed to the former system of margining these products based upon the longest maturity of eligible underlying collateral.¹⁴ Therefore, these GCF Repo products can now be included in the cross-margining arrangement because they are being margined at a specific rate based on the actual underlying Treasury and Agency collateral. These products are also included in the current cross-margining agreement between FICC and the CME.

(e) The FICC-TCC Agreement provides that the parties will agree from time to time in a separate writing on the disallowance factors that will be used in the program. Prior to the implementation date of the FICC-TCC cross-margining program, the disallowance factors will be tested and agreed to by FICC and TCC in writing.

(f) The current agreement between FICC and CME provides that in order to determine the gain or loss from the liquidation (resulting from a default) of the positions that were

¹⁴ Because of a previous inability to obtain timely data on the actual instruments posted in support of GCF Repo positions, up until recently the GSD calculated affected members' clearing fund requirements based upon the assumption that collateral providers have assigned to each generic CUSIP the most volatile (*i.e.*, the longest maturity) collateral eligible. The GSD recently developed improvements to its margining methodology and is now able to identify the specific CUSIP posted.

cross-margined, only the proceeds from the side of the market that was offset pursuant to the agreement at the last margin cycle will be considered. This approach will also be used in the FICC-TCC program to provide consistency in the liquidation methods.

(g) The former FICC-BOTCC agreement provided for a “Maximization Payment” whereby a clearing organization with a remaining surplus after all guaranty payments in relation to cross-margining were made (“Aggregate Net Surplus”) to distribute funds to one or more cross-margining partners with remaining losses. The FICC-TCC Agreement makes clear that: (i) the Maximization Payment is also a guaranty payment (albeit outside of cross-margining) and (ii) the defaulting member would have a reimbursement obligation with respect to such payment (“Maximization Reimbursement Obligation”). Should a clearing organization become obligated to pay the Maximization Payment, it may rely on the defaulting member’s collateral to do so.¹⁵

(h) A provision has been added to take into account that a regulator or other entity having supervisory authority over FICC or TCC may direct the clearing organization not to liquidate a defaulting member or to partially liquidate such member. In order to prevent the affected clearing organization from being penalized under the agreement for failing to liquidate or partially

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¹⁵ The guaranty provisions with respect to the Maximization Payment Guaranty are identical to the ones in the current cross-margining agreement between FICC and CME. In order to protect the clearing organizations in the event that a court determines that any amount of a Maximization Reimbursement Obligation may not be recovered by the clearing organization that made a Maximization Payment pursuant to a Maximization Payment Guaranty, a provision has been added to the FICC-TCC Agreement that provides that the payee clearing organization will be expected to return that amount. This protective provision is also in the FICC-CME cross-margining agreement.

liquidating the member in this type of situation, the FICC-TCC Agreement provides that the affected clearing organization would be deemed to have a cross-margin gain equal to the base amount of the guaranty (i.e., cross-margining reduction) or a pro rated amount of the base amount of the guaranty in a partial liquidation scenario.

(i) The FICC-TCC Agreement makes clear that the clearing organizations have security interests in the “Aggregate Net Surplus,” a large component of which would be the collateral and proceeds of positions of a defaulting member, as security for any reimbursement obligation, including any maximization reimbursement obligation, that arises on the part of a defaulting member.

(j) The FICC-TCC Cross Margining Participant Agreement contains language to further protect the clearing organizations by making clear that the clearing organizations have a security interest in the Aggregate Net Surplus and that a participant will have a reimbursement obligation in the event that a clearing organization becomes obligated to make a maximization payment. Members that wish to participate in the FICC-TCC cross-margining program will be required to execute the participant agreement to make them subject to the provisions of the FICC-TCC Agreement.

(4) Amendment 1 to the FICC-CME Cross-margining Agreement

FICC is proposing to amend Appendix A of the cross-margining agreement with the CME to add a reference to the FICC-TCC Agreement. In Appendix A, the parties set forth the other cross-margining or similar arrangements that they have in place and indicate whether such other agreements take priority over the FICC-CME Cross-Margining Agreement. As stated above, no preference is given by FICC to one Participating CO over another.

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.¹⁶ The Commission finds that FICC's proposed rule change is consistent with this requirement because by continuing its cross-margin program to include products cleared by TCC, FICC will provide its members with the benefits of cross-margining, including greater liquidity and more efficient use of collateral, in a manner that is consistent with FICC's overall risk management process.

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.

¹⁶ 15 U.S.C. 78q-1(b)(3)(F).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁷ that the proposed rule change (File No. SR-FICC-2004-16) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁸

Margaret H. McFarland
Deputy Secretary

¹⁷ 15 U.S.C. 78s(b)(2).

¹⁸ 17 CFR 200.30-3(a)(12).