

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51066; File No. SR-FICC-2005-02)

January 21, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of Proposed Rule Change to Amend the Application and Continuing Membership Standards of the Government Securities Division and the Mortgage-Backed Securities Division

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ notice is hereby given that on January 7, 2005, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on January 14, 2005, amended 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 amend the rules of the Government Securities Division (“GSD”) and the Mortgage-Backed Securities Division (“MBSD”) to: (1) provide that when an applicant, member, or participant becomes subject to an order of statutory disqualification or order of similar effect, including an order issued by a non-U.S. regulator or examining authority, the FICC Membership and Risk Management Committee (“Committee”) shall determine whether such order shall be the basis for denial of the membership applicant or termination of membership rather than such denial or termination being automatic; (2) impose a fine on members and participants that fail to notify FICC within two business days of falling out of compliance with specified membership standards, including becoming subject to an order of

¹ 15 U.S.C. 78s(b)(1).

statutory disqualification or order of similar effect; and (3) require applicants, members, and participants to notify FICC within two business days if they become aware of an investigation or similar proceeding against them that could lead them to violate a FICC membership standard.

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 these statements.²

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

FICC is seeking to amend the application and continuing membership standards of the GSD and the MBSD to: (1) provide that when an applicant, member, or participant becomes subject to an order of statutory disqualification or order of similar effect, including an order issued by a non-U.S. regulator or examining authority, the Committee shall determine whether this shall be the basis for denial of the membership applicant or termination of membership, rather than such denial or termination being automatic; (2) impose a fine on members and participants that fail to notify FICC within 2 business days of falling out of compliance with specified membership standards, including becoming subject to an order of statutory disqualification or order of similar effect; and (3) require applicants, members, and participants

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

to notify FICC within two business days if they become aware of an investigation or similar proceeding against them that could lead them to violate a FICC membership standard.

1. Action in Cases of Statutory Disqualification or Orders of Similar Effect

The GSD and MBSD rules currently provide that a membership applicant that is subject to an order of statutory disqualification under Section 3(a)(39) of the Act or an order of similar effect is not eligible for membership.³ Currently, a waiver of this requirement by the Committee is necessary in order for FICC to admit such applicant into membership. The admission requirements also serve as continuance standards for current members and participants. Therefore, if a member or participant becomes subject to a statutory disqualification, a waiver must be sought in order for membership in FICC to continue.

At the time it was organized as a clearing corporation, the Government Securities Clearing Corporation, the predecessor to FICC, modeled its rules provisions regarding statutory disqualifications on those of other clearing agencies which are now subsidiaries of The Depository Trust & Clearing Corporation. The understanding at the time was that instances of statutory disqualification were a rare occurrence and called into question the entity's ability to meet membership requirements or to remain a member in good standing. More recently, firms

³ For example, GSD Rule 3, "Financial Responsibility and Operational Capability Standards," Section 1, "Admissions Criteria for Comparison-Only Members," provides that an applicant may not be subject to an order of statutory disqualification or "an order of similar effect issued by a Federal or State banking authority, or other examining authority or regulator." Section 3(a) (39) of the Act, which sets forth the definition of "statutory disqualification," specifically covers orders issued by foreign financial regulatory authorities that are the equivalent to Commission-issued orders covered by the definition. The statutory definition also includes specific references to entities being barred from the "foreign equivalent of a self-regulatory organization [or a] foreign or

are increasingly becoming subject to statutory disqualification, but the reasons for a firm's statutory disqualification may have little or no bearing on its ability to become or remain a member in good standing.⁴ FICC would retain the ability to deny membership to or terminate as a member or participant a firm whose ability to meet applicable membership requirements is called into question. However, to the extent an order of statutory disqualification does not call this into question, FICC does not believe it appropriate for the Committee to issue a waiver in order to admit or retain the member.

The proposed rule change would eliminate the automatic need to obtain a waiver in cases where an entity is subject to an order of statutory disqualification or order of similar effect but would keep such orders as a criterion to be considered for membership or continued membership. FICC management would continue to present all instances of such orders to the Committee, and the Committee would make all final determinations with respect to these entities. In this manner, FICC management and the Committee would be able to thoroughly evaluate the risks presented by an applicant, member, or participant that becomes subject to an order. The proposed rule change would allow the Committee to permit FICC to admit or retain

(..continued)

international securities exchange” under “any substantially equivalent foreign statute or regulation.”

⁴ Of note is that in those situations brought by management before the Committee recently, the Commission has permitted the entity to continue operating as a registered broker-dealer, and the relevant designated examining authority has retained the entity as a member. In addition, Rule 19h-1 promulgated pursuant to the Act, does not require that self-regulatory organizations automatically terminate the membership of entities subject to statutory disqualification.

members or participants that pose no risk to FICC.⁵ In instances where waivers are still required under the rules and are granted by the Committee, FICC would promptly notify the Commission.

2. Fines for Failure to Notify FICC for Falling Out of Compliance with Membership Criteria

In addition to the changes above, FICC is proposing to implement a fine for those members and participants that do not promptly notify FICC of their noncompliance with any membership standard.⁶ The membership standards are set forth in GSD Rules 2, “Members,” and 3, “Financial Responsibility and Operational Capability Standards,” which apply to comparison-only and netting members as applicable, and in MBSD clearing rules Article III, “Participants,” which apply to MBSD clearing participants. For risk management purposes, it is important that FICC learn of a member or participant’s failure to meet a membership standard as soon as possible in order to determine a course of action that will best protect FICC. In addition, in some instances, such as certain cases where a member or participant becomes subject to a statutory disqualification order,⁷ FICC is required to promptly notify the Commission. Given the importance of FICC’s membership standards and the need for FICC to learn of noncompliance as soon as possible, FICC is proposing to fine members \$1,000 per instance of a failure to notify FICC within two business days of the member or participant first having knowledge of its falling

⁵ To the extent the Committee determines to admit or retain a member despite a statutory disqualification, the Committee will still retain all rights it currently has under FICC rules to impose limitations or restrictions on such member or participant.

⁶ The rules of FICC currently require members and participants to promptly notify FICC in the event that they are not meeting their membership standards.

⁷ Rule 19h-1 of the Act does not require a notification or notice to the Commission in all cases of statutory disqualification.

out of compliance with the particular membership standard.⁸ Members and participants would be afforded the same due process as is currently available under FICC's rules with respect to other types of fines. As with all fines, FICC will notify the Commission of all fines that are imposed pursuant to this rule change.

In addition, members and participants that fail to timely notify FICC of falling out of compliance with any membership standard would automatically be placed on the Watch List and be subject to more frequent and thorough monitoring as provided for in GSD Rule 4, "Clearing Fund, Watch List, and Loss Allocation," Section 3, "Watch List," and MBSD Article IV, "Participants Fund," Rule 6, "Watch List."

3. Notification of Pending Investigations

The proposed rule change also requires applicants, members, and participants to notify FICC within two business days of first having knowledge of a pending investigation or similar proceeding or condition that could lead them to violate a membership standard. The proposed rule change would provide an exception to this requirement in cases where disclosure to FICC would cause the applicant, member, or participant to violate an applicable law, rule, or regulation.

4. Definitions

Finally, MBSD is proposing to add two definitions to Article I, "Definitions and General Provisions." The term "Associated Person" would be defined to mean, when applied to any "person," any partner, officer, or director of such "person" or any "person" directly or indirectly

⁸ Once FICC is notified of an applicant or member's statutory disqualification, it will follow the provisions of Rule 19h-1 of the Act.

controlling or controlled by such “person,” including an employee of such “person.” The term “Person” would mean a partnership, Corporation or other organization, entity or individual.

FICC believes that the proposed rule change is consistent with the requirements of Section 17A of the Act⁹ and the rules and regulations thereunder applicable to FICC because it amends FICC’s membership criteria in a prudent manner. It imposes fines that will encourage members and participants to notify FICC promptly of falling out of compliance with membership standards, which will enable FICC to act quickly to protect itself and its members and participants and which will better enable FICC to safeguard the securities and funds in its custody or control or for which it is responsible.

(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:

⁹ 15 U.S.C. 78q-1.

(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-2005-02 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-2005-02. 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-2005-02 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.¹⁰

Margaret H. McFarland
Deputy Secretary

¹⁰ 17 CFR 200.30-3(a)(12).