

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51354; File No. SR-FICC-2004-18)

March 10, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change to Clarify Certain Sections of the Loss Allocation Rule of its Government Securities Division

I. Introduction

On October 1, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) and on October 27, 2004, amended proposed rule change File No. SR-FICC-2004-18 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 January 24, 2005.² No comment letters were received. For the reasons discussed below, the Commission is now granting approval of the proposed rule change.

II. Description

The purpose of this proposed rule change is to clarify certain sections of the loss allocation rule of the Government Securities Division (“GSD”) of FICC. If the GSD, upon liquidating a defaulting member’s positions, incurs a loss due to the failure of the defaulting member to fulfill its obligations to the GSD, the GSD looks to the margin collateral deposited by that defaulting member to satisfy the loss. If the defaulting member’s margin collateral is insufficient to cover the loss and if there are no other funds available from any applicable cross-margining and/or cross-guaranty arrangements, the GSD would have a “Remaining Loss”³ and would institute its loss allocation

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 51037 (January 13, 2005), 70 FR 3410.

³ GSD Rules, Rule 4, Section 8(d).

process to cover such Remaining Loss. In doing so, the GSD would determine the types of transactions from which the Remaining Loss has arisen (such as direct transactions and member brokered transactions) and would allocate the Remaining Loss as set forth in Sections 8(d)(i) through (v) of Rule 4 of the GSD Rules.

The allocations in Section 8(d)(ii) of Rule 4 to cover a Remaining Loss that is due to member brokered transactions distributes the loss between the affected broker, including repo brokers, and non-broker members that dealt with the defaulting member, are limited as an initial matter. Specifically, a broker netting member will not be subject to an allocation of loss, for any single loss-allocation event in an amount greater than \$5 million, and a non-broker netting member will not be subject to an allocation of loss for any single loss-allocation event in an amount greater than the lesser of \$5 million or five percent of the overall loss amount allocated to non-broker netting members. If the Remaining Loss from member brokered transactions is not covered due to these limitations on allocations, the uncovered loss will be reallocated as set forth in Section 8(e) of Rule 4. This section calls for a pro rata allocation to the netting membership in general based on each netting member's average daily required clearing fund deposit over the twelve-month period immediately prior to the insolvency. The rule change makes clear that the amounts allocated pursuant to Section 8(e) will be assessed to a netting member in addition to any loss amount allocated pursuant to Section 8(d)(ii). Therefore, a netting member may be subject to an aggregate allocation of loss that may exceed the applicable limitation set forth in Section 8(d)(ii).

Even with the allocation pursuant to Section 8(e) of Rule 4, a broker netting member would not be subject to an aggregate loss allocation for any single loss allocation event in an amount greater than \$5 million. In addition, what has been intended, but is not clear in the current rules, is

that a non-broker netting member can terminate its GSD membership and thus cap any additional loss allocation obligation due to the application of Section 8(e) at the amount of its required clearing fund deposit. Therefore, FICC is making its GSD rules clear that any allocations to members resulting from the application of Section 8(e) of Rule 4 or another firm's failure to pay its assessed share are limited to the extent of a member's required clearing fund deposit if such member chooses to terminate its GSD membership.⁴

In addition, FICC is making it clear that the ability to terminate and cap a loss allocation obligation at the amount of the clearing fund deposit is also applicable to a netting member (aside from the defaulting party) where an auction purchase is the reason for any Remaining Loss. In these instances, as in the instances described above, the netting member assessed a loss allocation obligation will have had no participation in the transaction which led to the Remaining Loss and therefore will be allowed to cap its total losses at the amount of the clearing fund deposit.

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.⁵ The Commission finds that FICC's proposed rule change is consistent with this requirement because clarifying the GSD's rules and procedures with regard

⁴ If a member elects to terminate its membership in FICC, its liability for a loss allocation obligation is limited to the amount of its required clearing fund for the business day on which the notification of such loss allocation is provided to the member.

⁵ 15 U.S.C. 78q-1(b)(3)(F).

to loss allocation assessments to netting members in the event of a default provides enhanced protections to FICC and its members.

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.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁶ that the proposed rule change (File No. SR-FICC-2004-18) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁷

J. Lynn Taylor
Assistant Secretary

⁶ 15 U.S.C. 78s(b)(2).

⁷ 17 CFR 200.30-3(a)(12).