

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51385; File No. SR-FICC-2004-14)

March 16, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving a Proposed Rule Change Relating to Membership Requirements

On July 14, 2004, the Fixed Income Clearing Corporation (“FICC”) filed with the Securities and Exchange Commission (“Commission”) a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”).<sup>1</sup> On July 15, July 30, August 20, and November 10, 2004, FICC filed amendments 1, 2, 3, and 4 respectively. On January 3, 2005, FICC filed amendment 5 and withdrew amendments 1, 2, 3, and 4. Notice of the proposal was published in the Federal Register on January 18, 2005.<sup>2</sup> The Commission received three comment letters.<sup>3</sup> For the reasons discussed below, the Commission is approving the proposed rule change.

**I. Description**

Under the rule change, FICC will amend the rules of its Government Securities Division (“GSD”) and Mortgage-Backed Securities Division (“MBSD”) regarding membership requirements for non-U.S. applicants and members.

**A. Annual Audited Financial Statements**

Prior to the rule change, GSD required non-U.S. members and applicants to submit financial statements prepared in accordance with U.S. generally accepted accounting principles

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> Securities Exchange Act Release No. 51018 (Jan. 11, 2005), 70 FR 2911.

<sup>3</sup> Letters from Kevin M. Brandt, Director, III Global Ltd., III Finance Ltd., and III Relative Value/Macro Hub Fund Ltd. (Oct. 25, 2004) and Lawrence R. Uhlick, Executive Director and General Counsel, Institute of International Bankers (Oct. 26, 2004, and Feb. 9, 2005). See also Memorandum to File re: Meeting with Institute of International Bankers (Mar. 15, 2005).

(“U.S. GAAP”) “whenever necessary and feasible.” MBSD required non-U.S. members and applicants to submit financial statements prepared in accordance with U.S. GAAP. Both divisions review such financial statements as part of their credit risk management program.

FICC is amending these requirements uniformly across both divisions to enable non-U.S. members and applicants to submit financial statements that are prepared according to any other generally accepted accounting methodology (“non-U.S. GAAP”). Specifically, FICC will increase the existing minimum financial requirements of each applicant and member based on the type of non-U.S. GAAP that was used to prepare the audited financial statement in the following manner:

1. For applicants and members whose financial statements are prepared in accordance with International Financial Reporting Standards (“IFRS”), the Companies Act of 1985 (“U.K. GAAP”), or Canadian GAAP, the minimum financial requirements will be one and one-half times the applicable requirements.
2. For applicants and members whose financial statements are prepared in accordance with a European Union country GAAP (“EU GAAP”) other than U.K. GAAP, the minimum financial requirements will be five times the applicable requirements.
3. For applicants and members whose financial statements are prepared in accordance with any other type of GAAP, the minimum financial requirements will be seven times the applicable requirements.

For example, under GSD’s rules, the minimum financial requirement for a bank netting member is equity capital of US\$100 million. This will continue to be the requirement for all such members (both U.S. and non-U.S. members) whose financial statements are prepared in accordance with U.S. GAAP. However, if such a member’s financial statements were prepared in accordance with IFRS, U.K. GAAP, or Canadian GAAP, the member’s minimum financial requirement would be US\$150 million. If such a member’s financial statements were prepared in accordance with an EU country GAAP other than U.K. GAAP, the member’s minimum

financial requirement would be US\$500 million. If a member's financial statements were prepared in accordance with any other type of GAAP, the member's minimum financial requirement would be US\$700 million.

In order to apply this change to non-U.S. applicants and members, FICC will delete the terms "Excess Liquid Capital" and "Excess Net Capital" in GSD Rule 3, Section 6, and instead will use the term "applicable minimum regulatory capital," which is defined in GSD Rule 3, Section 2 as "regulatory capital as defined by the applicant's home country regulator." MBSD Article III, Rule 1, Section 2(d) will state that the references to the terms "net capital" or "liquid capital" in, "shall be deemed to refer to regulatory capital in cases where the U.S. regulatory capital terms are not applicable to a non-domestic entity."

FICC will retain the requirement that annual audited financial statements submitted by members and applicants be certified without qualification. The rule change makes clear that annual audited financial statements must be prepared in accordance with generally accepted accounting principles. In addition, all information submitted to FICC will have to be in English or will have to be a fair and accurate English translation if the information is translated into English.

The proposed rule changes will be applied to current members and applicants.

#### **B. Material Regulatory Filings**

As part of its credit risk management, FICC requires applicants and members to submit interim financial data. In the case of U.S. bank and broker-dealer members, GSD and MBSD are able to obtain this financial information through regulatory reports. Non-U.S. MBSD members are required to submit unaudited monthly financial statements to MBSD. Non-U.S. GSD netting members are required to submit certain quarterly financial information to GSD. In addition, the

GSD rules currently require non-U.S. members and applicants to also submit all “material regulatory filings” that the entity makes with its primary regulator in its home jurisdiction. However, FICC cannot specifically identify all such material regulatory filings for non-U.S. members and applicants with confidence.

Under the rule change, which will be adopted uniformly across both FICC divisions, FICC will require non-U.S. members (other than those organized or established in the U.K. and regulated by the Financial Services Authority (“FSA”)) to provide specific monthly or quarterly financial data, as applicable, directly to FICC. FICC will provide the non-U.S. members with a form requesting specific financial data related to capital, assets, liabilities, revenue, pertinent ratios, and various capital requirements, as applicable. Each non-U.S. member will be required to complete the form, have it signed by the entity’s chief financial officer, chief executive officer, or similar high-ranking official, and return it to FICC by a prescribed deadline.

Broker-dealers and banks that are organized or established in the U.K. and regulated by the FSA will be required to submit certain regulatory monthly or quarterly reports, as applicable, that are filed with the FSA.<sup>4</sup> Because FICC will be able to obtain the necessary financial data from these reports, these U.K. firms will not be required to complete and submit FICC’s financial reporting form as are other non-U.S. members. FICC’s rules will provide that failure to submit the financial form or the U.K. regulatory reports, as applicable, to FICC within the timeframes established by FICC will subject a member to the same consequences, including a fine, as is currently provided for in FICC’s rules for late submission of required financial documents.

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Although FICC currently has no U.K. members, FICC is familiar with the regulatory reports filed by banks and broker-dealers that are organized or established in the U.K. and regulated by the FSA.

FICC recognizes that certain regulatory filings provide warnings of possible concerns regarding a member's compliance with regulatory standards and its financial status. For example, under FICC's current rules, GSD's and MBSD's U.S. broker-dealer members are required to submit to FICC SEC Rule 17a-11 reports. GSD's netting members, MBSD's U.S. non-broker-dealer members, and all non-U.S. members must submit to FICC, concurrently with their submission to their relevant regulator, copies of regulatory notifications required to be made when a member's capital levels or other financial requirements fall below prescribed levels.<sup>5</sup>

The rule change expands this by requiring members to submit to FICC any regulatory notifications required to be made when it does not comply with its financial reporting and responsibility standards set by its home country regulator and when it becomes subject to a disciplinary action by its home country regulator. In addition, the rule change makes the late submission of any such filing subject to a fine and other related consequences that have been recently approved by or are pending with the Commission.<sup>6</sup> This rule change requires that such filings be submitted to FICC in English or be in a fair and accurate English translation if they have been translated into English.

Finally, the rule change requires MBSD non-U.S. regulated applicants to certify that they are in compliance with the financial reporting and responsibility standards of their home country. This requirement was recently added to GSD's rules.<sup>7</sup>

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<sup>5</sup> Securities Exchange Act Release Nos. 49947 (June 30, 2004), 69 FR 41316 (July 8, 2004) [File No. SR-FICC-2003-01] and 49156 (Jan. 30, 2004), 69 FR 5881 (Feb. 6, 2004) [File No. SR-MBSCC-2001-06].

<sup>6</sup> Securities Exchange Act Release Nos. 50659 (Nov. 15, 2004), 69 FR 67767 (Nov. 19, 2004) [File No. SR-FICC-2004-11] and 51146 (Feb. 7, 2005), 70 FR 7984 (Feb. 16, 2005) [File No. SR-FICC-2004-13].

<sup>7</sup> Securities Exchange Act Release No. 50617 (Nov. 1, 2004), 69 FR 64796 (Nov. 8, 2004) [File No. SR-FICC-2004-01].

### C. Legal Risk

FICC members that are incorporated outside of the U.S. present FICC with increased legal risk in the event they become insolvent.<sup>8</sup> Notwithstanding the protections for clearing agencies contained in the U.S. federal laws<sup>9</sup> and the New York Banking Law (which is applicable to GSD foreign netting members with New York state-licensed branches and agencies), there is a risk that a U.S. court could determine not to apply New York law to the adjudication of FICC's rights against an insolvent non-U.S. member.<sup>10</sup> In such event, the foregoing protections may not be available to FICC.

In order to mitigate this risk, FICC has required and will continue to require non-U.S. GSD netting and MBSD clearing applicants to submit non-U.S. legal opinions drafted by outside counsel from the jurisdiction in which the member is incorporated and/or primarily conducts its business. As is its current practice, FICC will continue to make a case-by-case determination, based on its analysis of the legal opinion, of the legal risks presented by the home country laws of such applicants. In doing so, FICC will now retain U.S. outside counsel to review the legal opinions and to advise FICC of any risks presented. The rule change makes clear that, based on

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<sup>8</sup> At this time, GSD will continue to only permit non-U.S. banks operating out of U.S. branches or agencies to be Foreign Netting Members.

<sup>9</sup> E.g., the Federal Deposit Insurance Corporation Improvement Act of 1991 and the U.S. Bankruptcy Code.

<sup>10</sup> This particular matter is currently being adjudicated in a case that will be argued before the Second Circuit. The case involves a Serbian governmental agency that has brought a U.S. Bankruptcy Code Section 304 proceeding seeking to have the disposition of the assets of certain Yugoslavian banks with New York state-licensed agencies be considered under home country law. See Agency for Deposit Ins., Rehab., Bankr. & Liquidation of Banks v. Superintendent of Banks, Case No. 03-CV-9320 (JSR), Case No. 03-CV-9321 (JSR), 2004 U.S. Dist. LEXIS 10848 (S.D.N.Y. June 2004).

its review of the legal opinion, FICC will determine what, if any, protective measures it will impose to mitigate any legal risks. Protective action may, for example, take the form of requiring the member to post additional collateral and/or requiring a member to post a certain percentage of its collateral requirement in a certain form (such as letters of credit).

In order to protect FICC against any adverse changes in home country law that may have arisen since the members submitted their legal opinions as a part of the membership/application process and in order to determine whether any positive developments in home country law would support eliminating or relaxing any collateral premiums that may have been imposed on any members,<sup>11</sup> FICC will require all of its current non-U.S. members (except those members whose opinions have been issued within the past 18 months) to submit a current legal opinion from outside non-U.S. counsel addressing the non-U.S. legal issues or to provide a letter on their outside counsel's letterhead stating that no material changes have occurred in home country law since the date of the original legal opinions. FICC will require its current members to submit these updated legal opinions (or letters) within three months of the approval of this filing by the Commission. FICC will then review with the assistance of its outside counsel all such revised legal opinions and those original legal opinions that counsel indicates remain current and will determine whether protective measures need to be taken or whether the current increased collateral requirements should continue, be relaxed, or be eliminated.

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<sup>11</sup> GSD currently has three non-U.S. netting members that are subject to increased clearing fund requirements due to past determinations of heightened legal risk presented by the insolvency laws of their home jurisdictions. These members are currently posting 100 percent of their clearing fund requirement in the form of one or more letters of credit and an additional 30 percent in the form of cash or securities.

The rule change will also require all non-U.S. members to provide an annual update of their non-U.S. legal opinion or to provide a letter from their outside counsel stating that no material issues have arisen since the issuance of the opinion or the last update. FICC may impose such additional requirements on non-U.S. members as described above based on review of such updated legal opinions.

**D. Additional Changes**

The rule change will delete all references to certifications by the chief executive officer, chief financial officer, or other that accompany financial statements, financial data, or regulatory reports. These certifications do not appear to be standard documentation, and FICC historically has not received such certifications. If a need to request a certification with respect to a particular member or applicant arises, FICC will have the authority to request it pursuant to the general authority that it has in both division's rules to seek additional information.

In addition, in a previous rule change, FICC amended its rules with the intention of giving FICC the option to request that financial figures be submitted in U.S. dollar equivalents.<sup>12</sup> This rule change deletes this option from FICC's rules as FICC performs these calculations itself, intends to continue doing so, and believes that the pending language has the potential for confusion.

Finally, the rule change will amend the number of recent routine regulatory reports that a U.S. GSD netting applicant or MBSD clearing applicant is required to submit to FICC to the number of such reports that the entity has filed during the preceding 12 months or a lesser period if the applicant has been in business or has been registered or licensed for a lesser period. For example, a GSD U.S. broker-dealer applicant that is a monthly FOCUS filer would need to

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Supra note 8, SR-FICC-2004-01.

submit copies of all of its FOCUS reports filed during the preceding 12 months. With respect to 17a-11 reports, where the current rules do not specify the necessary time period, the proposed rule change requires U.S. broker-dealer applicants to submit all 17a-11 reports filed during the preceding 24 months.

## **II. Comments**

The Institute of International Bankers (“IIB”) submitted two comment letters. While the first letter objected to the increased financial requirements for entities submitting financial statements prepared using non-U.S. GAAP, its primarily focus was on its objections to standard clearing fund premiums for all non-U.S. members. After FICC amended the proposal to remove the standard clearing fund premiums for non-U.S. members, the IIB wrote in support of the proposed rule change, particularly with respect to the provisions that address how FICC will manage the legal risk arising from the participation in FICC by branches of international banks that operate in the United States.

The III Global Ltd., III Finance Ltd., and III Relative Value/Macro Hub Fund Ltd. investment companies submitted a comment letter also objecting to standard clearing fund premiums for non-U.S. members. However, as with the IIB’s first letter, this letter also addressed a version of the proposed rule change that the Commission had not yet published for comment and that FICC substantively modified.

## **III. Discussion**

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing be designed to assure the safeguarding of securities and funds which are in its custody or control.<sup>13</sup> The proposed rule change should enhance FICC’s surveillance and assessment of

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15 U.S.C. 78q-1(b)(3)(F).

applicants' and members' financial and legal condition. In addition, the proposed rule change will harmonize both of FICC's division's application and membership requirements and will make clear to all applicants and members of the breadth of financial and legal information that FICC will require and review in order to develop an accurate risk profile to evaluate an applicant's or member's financial condition. Accordingly, the proposed rule should appropriately enhance FICC's ability to mitigate financial risk to itself and to its members and therefore should help FICC to assure the safeguarding of securities and funds that are in its custody or control or for which it is responsible.

#### **IV. Conclusion**

On the basis of the foregoing, the Commission finds that the proposal is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act<sup>14</sup> and the rules and regulations thereunder.

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<sup>14</sup> 15 U.S.C. 78q-1.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2004-14) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>15</sup>

Margaret H. McFarland  
Deputy Secretary

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17 CFR 200.30-3(a)(12).