

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51659; File No. SR-FICC-2004-22)

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of a
Proposed Rule Change Relating to Establishing a Sponsored Membership Program

May 5, 2005

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ notice is hereby given that on November 12, 2004, the Fixed Income Clearing Corporation (“FICC”) filed a proposed rule change with the Securities and Exchange Commission (“Commission”) and on February 28, 2005, 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 establish a sponsoring member-sponsored member relationship in FICC’s rules whereby certain existing netting members would be permitted to sponsor certain buy-side entities into membership.

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 such statements.

¹ 15 U.S.C. 78s(b)(1).

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In an effort to have buy-side entities, such as registered investment companies, become members of FICC’s Government Securities Division (“GSD”), FICC is proposing to add a new Rule 3A to GSD’s rules that would govern the rights and obligations of sponsoring members and sponsored members and to make conforming changes to existing rules to accommodate the introduction of these new membership categories.

GSD will initially permit only bank netting members to apply to become sponsoring members.² In order to be eligible to apply to become a sponsoring member, a bank netting member will have to meet more stringent minimum financial requirements than those required for GSD netting membership. Specifically, the sponsoring member will have to have a level of equity capital of at least \$5 billion and will have to satisfy the ratios established by the Federal Deposit Insurance Corporation for being “well-capitalized.” If the sponsoring member has a bank holding company that is registered under the Bank Holding Company Act of 1956, then the bank holding company will also have to be “well-capitalized” under the relevant regulations of the Board of Governors of the Federal Reserve System. These financial criteria will also be the sponsoring member’s continuing minimum financial requirements that it will have to be maintained on an on-going basis. Applications for sponsoring membership will be considered by FICC’s Membership and Risk Management Committee.³

To become a sponsored member, GSD will permit only entities that are (i) registered investment companies under the Investment Company Act of 1940 and (ii) qualified institutional

² FICC understands that submission of a rule filing will be necessary in order to expand the types of entities that may be sponsoring members.

³ Proposed Rule 3A, Section 2.

buyers under Rule 144A of the Securities Act of 1933.⁴ In addition, an entity will only be able to become a sponsored member if there is a sponsoring member willing to sponsor the entity into membership. FICC will require a sponsoring member to represent in writing that each entity it wishes to make its sponsored member meets these requirements. Thereafter, sponsoring members will have to make these representations on an on-going basis as well. GSD management will approve entities to become sponsored members.⁵

The risk management of this arrangement would occur primarily at the sponsoring member level. FICC believes that this obviates the need for it to conduct financial reviews and on-going financial surveillance of sponsored members as it performs for netting members and as it will perform for sponsoring members.

Since a sponsoring member would act as the processing agent for its sponsored members, FICC would interact solely with the sponsoring member for operational purposes. The sponsoring member would have to establish an omnibus account for all of its sponsored members' activity. The omnibus account would be in addition to the sponsoring member's regular netting account. FICC would permit the sponsoring member to submit sponsored member activity on a locked-in basis if it chooses to do so.⁶

FICC would provide its settlement guaranty to each sponsored member with respect to its respective net settlement positions (i.e., for clearing fund calculation, each sponsored member's trading activity is treated separately). For operational and securities clearance purposes,

⁴ FICC understands that submission of a rule filing will be necessary in order to expand the types of entities that may be sponsored members.

⁵ Proposed Rule 3A, Sections 2(d) and 3.

⁶ Proposed Rule 3A, Sections 5 and 6.

however, all of the activity in the omnibus account would be netted as if it were the activity of one netting member. Therefore, the omnibus account would have only one net settlement obligation per CUSIP on a daily basis as an operational matter.⁷ The same would be true with respect to funds-only settlement.⁸

The margin requirement of each sponsored member whose activity is submitted to the omnibus account would be calculated in the same manner as is done for a netting member except that FICC would compute the required clearing fund deposit for each sponsored member on a standalone basis. FICC then would add those figures to two additional figures that would be calculated at the omnibus account level (for adjusted funds-only settlement amounts and fail net settlement positions) to come to a total clearing fund requirement for the omnibus account. For risk management purposes, FICC would not net the resulting clearing fund calculations of each sponsored member within the omnibus account with those of other sponsored members in the omnibus account.⁹

FICC has learned that the custodial banks that are likely to be interested in becoming sponsoring members generally collateralize their custody clients (i.e., the potential sponsored members) at 102 percent for U.S. Treasury repurchase agreements.¹⁰ Under the current GSD clearing fund formula, this would cause a sponsoring member to pay an additional 4 percent of its overall transactional volume with sponsored members in the form of clearing fund margin,

⁷ Proposed Rule 3A, Sections 7 and 8.

⁸ Proposed Rule 3A, Section 9.

⁹ Proposed Rule 3A, Section 10.

¹⁰ This means that when a custody client wishes to engage in a reverse repo transaction by lending money (for example, \$100), it will generally require collateral in excess of the money loaned (for example, \$102).

which may potentially amount to hundreds of millions of dollars of additional clearing fund obligations.¹¹ FICC believes that this potential adverse impact on a sponsoring member is unnecessary because these additional funds payments are pass-through amounts and do not represent risk to FICC or its members. Therefore, FICC proposes to amend the clearing fund rule to adjust for this funds-only settlement component when calculating the clearing fund requirements for the sponsored members, the omnibus account, and the sponsoring member's regular netting account. FICC would reserve the right to not adjust the funds-only settlement component under extraordinary circumstances.

Each sponsored member would be principally liable for satisfying its securities and funds-only settlement obligations. For operational and administrative purposes, FICC would interact with the sponsoring member as agent for the sponsored members for day-to-day satisfaction of these obligations.¹²

¹¹ An example will illustrate why this occurs under the clearing fund formula. Assume that the start leg of the repo transaction between the sponsoring member and the sponsored member calls for the sponsored member to lend \$100 and receive \$102 in securities. During the next day, the close leg of the repo transaction to which FICC has become counterparty will call for the sponsored member to send the collateral back to FICC, and FICC, which settles at market value, will pay \$102 in funds. This requires an adjustment to occur for funds-only settlement purposes: FICC will debit the sponsored member \$2 and will, in turn, credit the sponsoring member's regular netting account \$2. These funds-only settlement amount payments are referred to as "transaction adjustment payments" in the GSD's rules. Because one component of the clearing fund requires inclusion of the absolute value of the funds-only settlement amounts (*i.e.*, regardless of whether they are debits or credits), the transaction adjustment payments will artificially inflate the clearing fund requirements related to both the sponsored member omnibus account and the sponsoring member's regular netting account.

¹² Proposed Rule 3A, Sections 8 and 9.

While the sponsored members would be principally liable for their settlement obligations, the sponsoring member would be required to provide a guaranty to FICC with respect to such obligations. This means that in the event one or more sponsored members do not satisfy their settlement obligations, FICC would be able to invoke the guaranty provided by the sponsoring member.¹³

Sponsored members would not be liable for any loss allocation obligations. To the extent that a “remaining loss” (as defined in the GSD’s rules) arises in connection with “direct transactions” (as defined in the GSD’s rules) between the sponsoring member and its sponsored members (i.e., the sponsoring member is the insolvent party), the sponsored members would not be responsible for or considered in the calculation of the loss allocation obligations. Such obligations would be the obligation of the other netting members that had direct transactions with the sponsoring member in its capacity as a netting member. To the extent there is an allocation other than for direct transactions between the sponsoring member and its sponsored members, the sponsored members would be counted as if they were obligated to pay the loss allocation amounts but it will be the sponsoring member’s obligation to pay such amounts.¹⁴

FICC believes that the proposed rule change is consistent with the requirements of the Act and the rules thereunder because it would enable more entities to take advantage of FICC’s services thereby promoting the prompt and accurate clearance and settlement of securities transactions.

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

¹³ Proposed definition of “Sponsoring Member Guaranty” and proposed Rule 3A, Section 2.

¹⁴ Proposed Rule 3A, Section 12.

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

FICC has not solicited or received written comments relating to the proposed rule change. 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-2004-22 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-2004-22. 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-2004-22 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.¹⁵

Margaret H. McFarland
Deputy Secretary

¹⁵ 17 CFR 200.30-3(a)(12).