

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52853; File No. SR-FICC-2005-14)

November 29, 2005

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to the Federal Reserve's National Settlement System

I. Introduction

On September 9, 2005, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2005-14 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").¹ Notice of the proposal was published in the Federal Register on October 26, 2005.² No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The proposed rule change amends the rules of FICC's Government Securities Division ("GSD") so that funds-only settlement obligation payment processing occurs through the Federal Reserve's National Settlement System ("NSS").³ GSD's funds-only settlement process is set forth in GSD Rule 13. On a daily basis, FICC reports a funds-only settlement amount, which is either a debit amount or a credit amount, to each netting member. Each netting member that has a debit is required to satisfy its obligation by the applicable deadline. Netting members with

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 52631, (October 18, 2005), 70 FR 61859.

³ This is consistent with the manner in which FICC's affiliates, The Depository Trust Company ("DTC") and the National Securities Clearing Corporation ("NSCC"), handle their funds settlement process. DTC and NSCC currently use NSS for the processing of funds debits and not for funds credits whereas FICC will use NSS both for the funds debits and funds credits of GSD's funds-only settlement process.

credits are subsequently paid by FICC by the applicable deadline. All payments of funds-only settlement amounts by netting members to FICC and all collections of funds-only settlement amounts by netting members from FICC are done through depository institutions that are designated by netting members and FICC to act for them with regard to such payments and collections. All payments are made by fund wires from one depository institution to the other.

In 1997, the Commission approved an enhancement to GSCC's⁴ funds-only settlement payment processing ("1997 Filing").⁵ That enhancement gave members the option to participate in an auto-debit arrangement. Under the auto-deposit arrangement, GSCC, the netting member, and the netting member's depository institution would enter into a "funds-only settlement procedures agreement" whereby the depository institution would pay or collect funds-only settlement amounts on behalf of the netting member and GSCC through accounts of the member at the depository institution. As a result, the need to send fund wires for the satisfaction of funds-only settlement payments would be eliminated.⁶

The rule change replaces the auto-debit process of the 1997 Filing and provides more enhancements to the current approach to payment processing than was envisioned by the 1997 Filing. Under this proposed rule change, the required payment mechanism for the satisfaction of

⁴ The Government Securities Clearing Corporation ("GSCC") was the predecessor to GSD. GSCC became the GSD division of FICC when GSCC and the Mortgage Backed Securities Clearing Corporation were merged to create FICC in 2002.

⁵ Securities Exchange Act Release No. 39309 (November 7, 1997), 62 FR 61158 (November 14, 1997) [File No. SR-GSCC-97-06].

⁶ This voluntary arrangement auto-debit was never implemented because until recently GSCC and then GSD continued to make manual adjustments to the final funds-only settlement amounts of netting members. Recently, these manual adjustments have largely been eliminated.

funds-only settlement amounts will be the NSS. FICC will appoint The Depository Trust Company (“DTC”) as its settlement agent for purposes of interfacing with the NSS.⁷

In order to satisfy their funds-only settlement obligations through the NSS process, each netting members must appoint a bank or trust company to act as their “funds-only settling bank.” A netting member that qualifies may act as its own funds-only settling bank.

The GSD is establishing a limited membership category for the funds-only settling banks. Banks or trust companies that are DTC settling banks, as defined in DTC’s rules and procedures, or that are GSD netting members with direct access to the Federal Reserve and the NSS will be eligible to become GSD funds-only settling bank members by executing the requisite membership agreement for this purpose. Other banks or trust companies that desire to become funds-only settling bank members will have to apply to FICC. In order to qualify as a funds-only settling bank, they will have to have direct access to a Federal Reserve Bank and the NSS as well as satisfy the financial responsibility standards imposed by FICC from time to time. Initially, these applicants must meet and maintain a Tier 1 capital ratio of 6 percent.⁸

In addition to the membership agreement, the funds-only settling bank and the netting member must execute an agreement whereby the member will appoint the bank to act on its behalf for funds-only settlement purposes. The bank must also execute any agreements required by the Federal Reserve Bank for participation in the NSS for FICC’s funds-only settlement process.

⁷ DTC currently performs this service for NSCC.

⁸ This is the same financial requirement for NSCC settling bank-only members. Under FICC’s program, FICC will retain the discretion to change this financial criterion by providing advanced notice to the fund-only settling banks and the netting members through Important Notices.

The funds-only settling banks will be required to follow the procedures for funds-only settlement payment processing set forth in FICC's new rules governing the NSS settlement process. These will include, for example, providing FICC or its settlement agent with the requisite acknowledgement of the bank's intention to settle the funds-only settlement amounts of the netting members it represents on a timely basis and participating in the NSS process. Funds-only settling banks will have the right to refuse to settle for a particular netting member and will also be able to opt out of NSS for one business day if they are experiencing extenuating circumstances.⁹ Under FICC's program, the netting member shall be responsible for ensuring that its funds-only debit is wired to the depository institution designated by FICC for this purpose by the payment deadline. The rule change makes clear that the obligation of a netting member to fulfill its funds-only settlement amount remains at all times with the netting member.

As FICC's settlement agent, DTC will submit instructions to have the Federal Reserve Bank accounts of the funds-only settlement members charged for the debit amounts and credited for the credit amounts. Because utilization of NSS will eliminate the need for the initiation of wire transfers to satisfy funds-only settlement amounts, FICC believes that it will reduce the risk that netting members will incur late payment fines due to delays in wiring funds. The proposal will also reduce operational burden for the operations staff of FICC.

The NSS is governed by the Federal Reserve's Operating Circular No. 12 ("Circular"). Under the Circular, DTC, as FICC's settlement agent, has certain responsibilities with respect to an indemnity claim made by a relevant Federal Reserve Bank as a result of the NSS process. FICC will apportion the entirety of any such liability to the netting members for whom the

⁹ These procedures are consistent with the NSCC and DTC procedures in this respect.

funds-only settling bank to which the indemnity claim relates was acting. This allocation will be done in proportion to the amount of such members' funds-only settlement amounts on the business day in question. If for any reason such allocation is not sufficient to fully satisfy the Federal Reserve Bank's indemnity claim, the remaining loss shall be treated as an "Other Loss" as defined by the GSD's Rule 4 and allocated accordingly.

The proposed rule change will not change the current GSD deadlines regarding the payment and receipt of funds-only settlement amounts, which are set forth in the GSD's rules.

III. Discussion

Section 17A(b)(3)(F) of the Act provides that the rules of a clearing agency should be designed to promote the prompt and accurate clearance and settlement of securities transactions.¹⁰ Funds-only settlement is the payment made to or by FICC's netting members by or to FICC in settlement of their government securities transactions.¹¹ Accordingly, a rule that is designed to improve the efficiency of funds-only settlement should also promote the prompt and accurate clearance and settlement of securities transactions.

The proposed rule change should improve the efficiency of the funds-only settlement process for both FICC and its netting members by establishing a more automated and more centralized payment system for funds-only settlement. The NSS offered by the Federal Reserve System is a reliable and proven service that is used by, among others, other clearing agencies registered with the Commission. Although the proposed rule change will impose new

¹⁰ 15 U.S.C. 78q-1(b)(3)(F).

¹¹ FICC's Rule 1 (Definitions) defines the term Funds-Only Settlement Amount as the net dollar amount of a netting member's obligation, calculated pursuant to FICC Rule 13 (Funds-Only Settlement), either to make a funds-only payment to FICC or to receive a funds-only payment from FICC.

requirements on FICC's netting members to appoint funds-only settling bank members to act on their behalf and to share in any losses incurred with respect to an indemnity claim made by a Federal Reserve Bank, the proposed rule change should ultimately improve the efficiency of funds-only settlement processing for FICC's netting members as well as for FICC.¹²

Each netting member will be required to use the NSS to make funds-only settlement payments in accordance with the procedures set forth in the changes to Rule 13. However, the netting member's obligation to make its funds-only settlement payment to FICC on time remains unchanged. If the netting member's funds-only settlement agent is unable to or chooses not to make a payment through the NSS, the netting member will be required to wire the payment to FICC's depository institution by the payment deadline. Accordingly, because the proposed rule change is designed to improve the efficiency of funds-only settlement payments without affecting netting members' ultimate responsibility for their funds-only settlement payments, the Commission finds that the proposed rule change is also consistent with FICC's obligation under Section 17A(b)(3)(F) to assure the safeguarding of securities and funds in its possession or control or for which it is responsible.¹³

¹² FICC's netting members have received notice of the proposed rule change and the related requirements and have not commented on them to the Commission.

¹³ 15 U.S.C. 78q-1(b)(3)(F).

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, that the proposed rule change (File No. SR-FICC-2005-14) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.¹⁴

Jonathan G. Katz
Secretary

¹⁴ 17 CFR 200.30-3(a)(12).