

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49242; File No. SR-FICC-2003-06]

### Self-Regulatory Organizations; Fixed Income Clearing Corporation; Notice of Filing of a Proposed Rule Change Relating to the Assessment of Funds-Only Settlement Obligations

February 12, 2004.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on July 11, 2003, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") 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 eliminate the complex manual adjustments currently made by FICC's Operations Department with regard to the forward margin debit obligations and credit entitlements of repo broker members of the Government Securities Division ("GSD") of FICC.<sup>2</sup>

#### 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.<sup>3</sup>

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

<sup>2</sup> Forward margin is a component of a netting member's daily funds-only settlement obligation. Forward margin is a mark-to-market payment on forward-settling positions. It is passed through in the form of cash from the debit side to the credit side. The amounts are reversed on the following day with interest collected from the credit side and paid through to the debit side.

<sup>3</sup> The Commission has modified parts of these statements.

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

When GSD initially implemented its blind-brokered repurchase agreement ("repo") service, it operated a system whereby the majority of members submitted trade data in a single batch file at the end of each day. The batch file submission process made it virtually impossible for repo brokers, who expect to net out of their position as middlemen in brokered repos, to timely determine the existence of trades on which they had positions, contact the appropriate counterparties, and correct trade details. As a result, any erroneous submissions on the part of a dealer counterparty resulted in a forward margin assessment to the repo broker. Realizing that a repo broker should always be flat from a net-settlement position perspective, FICC granted repo brokers relief from the forward margin process by providing a look through to the dealer counterparties for purposes of assessing forward margin obligations.<sup>4</sup> However, the look through involves a manual adjustment process that requires complex calculations inconsistent with FICC's overall management policy.<sup>5</sup>

FICC has determined that it will no longer provide a look through to relieve repo brokers from forward margin obligations. Subsequent to the events of September 11, 2001, FICC decided to eliminate all operations functions that require complex manual adjustment or input as a way to reduce risk in all operations processes. In addition,

<sup>4</sup> FICC, in a prior rule filing, amended its rules to allow management to look through brokered repo transactions in order that repo brokers were not left with debit or credit obligations caused by erroneous submissions on behalf of the dealers. Securities Exchange Act Release No. 38603 (May 9, 1997), 62 FR 27088 (May 16, 1997) [File No. SR-GSCC-96-12]. In accordance with FICC's risk strategy at the time, the risk management process worked most effectively if a repo broker was netted out of its positions as a middleman. However, with the advent of real time trade matching and the ready ability of brokers to rectify dealer submission errors, GSD believes that risk management initiatives are better served by using the parameters outlined in this filing.

<sup>5</sup> On each business day, the Operations Division routinely adjusts the overall funds-only settlement obligation of a repo broker that has a forward margin debit or credit. If the repo broker has an overall credit forward margin, GSD will reduce its aggregate funds-only credit obligation or increase its aggregate funds-only debit entitlement by an amount equal to the forward margin credit. Conversely, if the repo broker is in an overall debit forward margin position, GSD will reduce its aggregate funds-only debit obligation or increase its funds-only credit entitlement by an amount equal to the debit; however, it then will apply that amount to the uncomparated dealer (the dealer who failed to submit or submitted erroneously).

almost all repo broker activity is now submitted to FICC on an interactive, real-time basis that allows brokers to readily rectify any outstanding data submission errors during the day. For these reasons, FICC is proposing to modify the forward margin adjustment process to require the repo brokers to satisfy their forward margin obligations including both paying forward margin debits and receiving forward margin credits.

Going forward, FICC proposes to apply the following parameters with respect to the forward margin obligations of repo brokers. Debits and credits up to a predetermined dollar amount cap would be automatically collected or paid as applicable by the repo brokers, as is the case for all other netting members.<sup>6</sup> Debits and credits in excess of the cap would be subject to hybrid processing, meaning that while the dollar amount up to the cap would always be collected or paid in its entirety by the broker, amounts over the cap ("excess debits" or "excess credits") would be financed by GSD at the discretion of FICC.

As an example of hybrid processing for an excess debit, the Operations Department would first request that the affected repo broker pay the excess debit to FICC. In the event that the repo broker is unable to pay the excess debit, the Operations Department, in consultation with the Credit Risk Department, would determine whether it would be appropriate for FICC to finance the excess debit. If FICC finances the excess debit, the broker would be charged a financing fee, representing the interest amount that FICC would be charged by the clearing bank. The member also will be subject to an administrative fee,<sup>7</sup> and FICC's extension of financing would be secured by the clearing fund deposit of the repo broker. GSD would collect the calculated interest amount from the repo broker on the subsequent business day. GSD would also reserve the right in certain situations to assess the forward margin amounts in excess of the dollar amount cap excess by looking through to the dealer, as is done by the current manual process.<sup>8</sup>

<sup>6</sup> The FICC Membership and Risk Management Committee will determine, based on historical data and risk considerations, what the debit and credit cap will be for forward margin debits and credits. The Committee has approved an initial cap of \$2 million.

<sup>7</sup> This fee will be designed to cover FICC's cost of arranging financing.

<sup>8</sup> FICC will continue to look through to the dealer counterparty for purposes of assessing forward margin obligations in cases of a systemic outage

In applying the hybrid processing to excess credits, the Operations Department, in consultation with the Credit Risk Department, would determine whether it would be appropriate to pass through the excess credit to the repo broker. To the extent that GSD did not pass through to the broker all or a portion of its calculated excess credit, GSD would calculate an interest amount tied to the rate of interest earned by GSD on its overnight cash investment on such unpaid excess credit and pay this interest amount to the repo broker on the subsequent business day.

The proposed rule change would require some manual adjustments when the hybrid approach is used, but these instances will infrequently occur and would not rise to the complexity of the current process.

FICC believes the proposed rule change is consistent with the requirements of Section 17A of the Act and the rules and regulations thereunder because it will enhance FICC's risk management strategy with regard to the daily funds-only settlement process.

*(B) Self-Regulatory Organization's Statement on Burden on Competition*

FICC does not believe that the proposed rule change would have an impact on or impose a 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 nor 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:

- (a) By order approve the proposed rule change or
- (b) institute proceedings to determine whether the proposed rule change should be disapproved.

where any non-submission by one counterparty versus a repo broker exceeds \$1 billion.

**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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: *rule-comments@sec.gov*. All comment letters should refer to File No. SR-FICC-2003-06. 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, comments should be sent in hardcopy or by e-mail but not by both methods. 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 will also be available for inspection and copying at the principal office of FICC and on FICC's Web site at *www.ficc.com*. All submissions should refer to the File No. SR-FICC-2003-06 and should be submitted by March 15, 2004.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Margaret H. McFarland**

*Deputy Secretary*

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<sup>9</sup> 17 CFR 200.30-3(a)(12).

**SECURITIES AND EXCHANGE COMMISSION**

[Release No. 34-49251; File No. SR-ISE-2003-37]

**Self-Regulatory Organizations; Order Approving Proposed Rule Change by the International Securities Exchange, Inc. To Amend the Procedures for Executing Stock-Option Orders Under ISE Rule 722**

February 13, 2004.

**I. Introduction**

On December 18, 2003, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to revise the procedures for executing stock-option orders by: (1) Automating the transmission of the stock leg(s) of a stock-option combination order to a broker-dealer on behalf of members; and (2) allowing for the pricing of the options leg(s) of stock-option combination orders in penny increments. The proposed rule change was published for comment in the **Federal Register** on January 13, 2004.<sup>3</sup> The Commission received no comments on the proposed rule change. This order approves the proposed rule change.

**II. Description of the Proposal**

Under the ISE's current procedure for executing stock-option orders, each party to a stock-option trade must take steps to immediately transmit the stock leg(s) of a stock-option order to a non-ISE market for execution. The ISE has proposed to amend Supplementary Material .01 to ISE Rule 722 and to adopt Supplementary Material .02 to ISE Rule 722 to provide an automated process for executing stock-option orders. Under the automated process, an ISE member will be able to elect to have the ISE electronically communicate the stock leg(s) of a stock-option order to a designated broker-dealer for execution. To participate in the automated process, an ISE member must enter into a customer agreement with the designated broker-dealer. The ISE member will be responsible for fees and other charges the designated broker-dealer imposes for executing the trades, and the ISE has stated that it will not receive any fees

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

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 49023 (January 5, 2004), 69 FR 2030.