

rules relating to membership, books and records, and legal opinions will provide greater certainty as to FICC's participants' rights and obligations and will enhance FICC's ability to mitigate legal risk posed by non-domestic participants.

### III. 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>9</sup> 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-2003-14) be, and hereby is, approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50389; File No. SR-FICC-2003-06]

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

September 15, 2004.

#### I. Introduction

On July 11, 2003, Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2003-06 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on February 23, 2004.<sup>2</sup> 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 for the most part eliminates 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>3</sup> 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, that 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 margining 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

<sup>3</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>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).

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, 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 will apply the following parameters with respect to the forward margin obligations of repo brokers. Debits and credits up to a predetermined dollar amount cap will 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 will be subject to hybrid processing, whereby the dollar amount up to the cap will always be collected or paid in its entirety by the broker, amounts over the cap ("excess debits" or "excess credits") will be financed by GSD at the discretion of FICC.

The following is an example of hybrid processing for a broker with an excess debit. First, the Operations Department will 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, will determine whether it is appropriate for FICC to finance the excess debit. If FICC finances the excess debit, the broker will be charged a financing fee, representing the interest amount that FICC will be charged by the clearing bank, and the member will be subject to an administrative fee.<sup>7</sup> GSD will collect the calculated interest amount from the repo broker on the subsequent business day. GSD will also reserve the right in certain situations to assess the forward margin amounts in excess of the dollar amount cap by looking through to the dealer, as is done by the current manual process.<sup>8</sup> All extensions of financing by

<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 and will be filed before implementation.

<sup>8</sup> FICC will continue to look through to the dealer counterparty for purposes of assessing forward

<sup>9</sup> 15 U.S.C. 78q-1.

<sup>10</sup> 17 CFR 200.30-3(a)(12).

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

<sup>2</sup> Securities Exchange Act Release No. 49242 (February 12, 2004), 69 FR 8251.

FICC will be secured by the clearing fund deposit of the repo broker.

In applying the hybrid processing to excess credits, the Operations Department in consultation with the Credit Risk Department will determine whether it is appropriate to pass through the excess credit to the repo broker. To the extent that GSD does not pass through to the broker all or a portion of its calculated excess credit, GSD will calculate an interest amount tied to the rate of interest earned by GSD on its overnight cash investment on such unpaid excess credit and will pay this interest amount to the repo broker on the subsequent business day. The proposed rule change will require some manual adjustments when the hybrid approach is used, but these instances will occur infrequently and will not rise to the complexity of the current process.

### III. Discussion

Section 17A(b)(3)(F) of the Act requires, among other things, that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>9</sup> FICC's look-through rule was established to eliminate the forward margin debits and credits of repo broker members of GSD when their dealer counterparties failed to timely submit trade data or submitted incorrect data. The transition to real time trade submission from end of day batch trade submission has significantly reduced the likelihood that repo brokers will be assessed forward margin and in FICC's view has rendered the look-through rule and its attendant manual adjustments unnecessary. Under the proposed rule change, forward margin will be collected from repo brokers or financed by GSD, but FICC will retain the right to look-through to the dealer counterparties when necessary. Accordingly, by significantly reducing the amount of manual processing with regard to forward margin debit obligations and credit entitlements without affecting FICC's ability to collect forward margin, the proposed rule change should help FICC to devote more resources to promoting the prompt and accurate clearance and settlement of securities transactions.

### 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 with the requirements of section 17A of the Act and the rules and regulations thereunder applicable.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2003-06) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>10</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50391; File No. SR-NASD-2004-090]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to the Nasdaq Closing Cross

September 15, 2004.

On June 9, 2004, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), 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 establish auxiliary procedures for administering the Nasdaq Closing Cross on certain significant trading days. On July 23, 2004, Nasdaq amended the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was published for comment in the **Federal Register** on August 2, 2004.<sup>4</sup> The Commission received no comments on the proposal. This order approves the proposed rule change, as amended.

The proposed rule change would establish auxiliary procedures for administering the Nasdaq Closing Cross on days when significant trading volume is expected ("significant trading days"). There are three components of the Nasdaq Closing Cross: (1) The

creation of Market On Close ("MOC"), Limit on Close ("LOC") and Imbalance Only ("IO") order types; (2) the dissemination of an order imbalance indicator; and (3) Closing Cross processing in the Nasdaq Market Center at 4 p.m. that executes the maximum number of shares at a single, representative price that is the Nasdaq Official Closing Price. On significant trading days, the proposed auxiliary procedures would permit Nasdaq: (i) To set earlier times for the end of the order entry periods for IO, MOC, and LOC orders set forth in NASD Rule 4709(a); (ii) to set an earlier time for the order modification and cancellation periods for IO, MOC, and LOC orders set forth in NASD Rule 4709(a); (iii) to set an earlier time for the dissemination times and frequencies for the order imbalance indicator set forth in NASD Rule 4709(b); and (iv) to adjust the threshold values set forth in NASD Rule 4709(c)(2)(D) to no greater than twenty percent.

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.<sup>5</sup> The Commission believes that the proposed rule change is consistent with section 15A(b) of the Act,<sup>6</sup> in general, and furthers the objectives of section 15A(b)(6),<sup>7</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest. The Commission believes that the proposed auxiliary procedures will allow Nasdaq greater flexibility in the administration of the Nasdaq Closing Cross and help Nasdaq maintain a fair and orderly market during the close on significant trading days.

For the foregoing reasons, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and rules and regulations thereunder applicable to a national securities

margin obligations in cases of a systemic outage where any non-submission by one counterparty versus a repo broker exceeds \$1 billion.

<sup>9</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>10</sup> 17 CFR 200.30-3(a)(12).

<sup>11</sup> 15 U.S.C. 78s(b)(1).

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

<sup>3</sup> See letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated July 22, 2004 ("Amendment No. 1"). In Amendment No. 1, Nasdaq restated the proposed rule change in its entirety.

<sup>4</sup> See Securities Exchange Act Release No. 50087 (July 26, 2004), 69 FR 46195.

<sup>5</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>6</sup> 15 U.S.C. 78o-3(b).

<sup>7</sup> 15 U.S.C. 78o-3(b)(6).