

IMPORTANT NOTICE

Fixed Income Clearing Corporation



#: GOV115.08
Date: October 6, 2008
To: Government Securities Division Participants
Subject: Special Procedures to Resolve Fails Occurring Outside of FICC

The U.S. Government securities marketplace continues to experience a high rate of failed settlements. Many of our members have asked for Fixed Income Clearing Corporation's ("FICC") assistance in resolving fails between netting members occurring *outside* of FICC.

FICC has previously identified procedures to resolve fails to receive and deliver ex-FICC, in Important Notice, GOV104.03, dated July 31, 2003, **Special Procedures to Resolve Fails Occurring Outside of FICC**. These procedures utilize FICC's system to convert external fails into FICC net settlement positions, in lieu of making securities deliveries. This Important Notice restates that procedure, modified to incorporate FICC's "fail netting process" which was not yet available in 2003. Please see FICC rule filing 2005-11 (approved on July 28, 2005) for additional information on the Government Securities Division's ("GSD") fail netting process.

Please note that Repo fails with inter-dealer brokers have already been assumed by FICC, as part of the existing fail netting procedures, and should be excluded from this special process.

Pursuant to the revised process for resolving fails to receive and fails to deliver ex-FICC, two parties to a fail would agree, on a bilateral basis, to submit their fails to FICC as purchases and sales for the same dollar amount (and same counterparty) as the original fail, and for settlement on the following business day. Fails to deliver would be submitted as sales; fails to receive would be submitted as purchases. By moving the fails into the clearing corporation, they can be automatically resolved through FICC's net settlement process. Further, fails submitted to the clearing corporation obtain the benefits of FICC's performance guarantee and daily mark-to-market, so they may no longer be considered aged fails. (Note: Due to the complexities inherent in repo processing, it is important that members submit these fails to FICC as purchases and sales as opposed to repo and reverse transactions.)

The revised process is illustrated with the following simple example. Dealer A does an overnight repo with Dealer B, and both parties submit their side of the transaction to FICC for comparison. Upon comparison, the close leg enters the FICC netting process, and the start leg fails to settle outside of FICC. The next morning, the following fails result:

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FICC Transactions	Fail to Deliver	Fail to Receive
N/A	Dealer A	Dealer B
DLVF	Dealer B	FICC
RCVF	FICC	Dealer A

As the chart above illustrates, Dealer A owes securities to Dealer B, Dealer B owes securities to FICC, and FICC owes securities to Dealer A. To resolve the situation, the following transactions should be submitted to FICC to move the fails to FICC's books: 1) Dealer A should submit a sale to Dealer B; and 2) Dealer B should submit a purchase from Dealer A. These transactions must be submitted on the same day (to ensure comparison) for next-day settlement at the same final money as the original fail. This will result in the following transactions appearing on FICC's books:

FICC Transactions	Short	Long
A's Sell (in net)	Dealer A	Dealer B
B's Buy (in net)	Dealer B	Dealer A
B's DLVF (in net)	Dealer B	FICC
A's RCVF (in net)	FICC	Dealer A

These transactions net perfectly, without requiring securities deliveries.

We recommend that members clearly identify on their records that fails submitted to FICC as purchases and sales are reconciliation items submitted to FICC solely as a mechanism for cleaning up outstanding aged fails (i.e., that these purchases and sales are essentially "converted fails"). Additionally, when submitting these transactions to FICC, we suggest that members clearly identify that the transactions are not new purchases and sales but, rather, converted fails. This can be accomplished by either including the word "fail" in the X-Ref, or submitting "fail" in the executing firm or contra executing firm fields, or any combination thereof. This will facilitate reconciliation and will also advise the contra-side that the transaction is a converted fail. FICC also reminds members that they must conduct internal balancing and reconciliation procedures following the conversion to preclude out-of-balance conditions, duplicate trades, duplicate fails and/or duplicate deliveries.

Please note this method for cleaning up aged fails can be done at any time, provided counterparties are netting members and submit the transactions on the same date. Again, this process does not include inter-dealer Repo broker netting members because their fails are already assumed by FICC as part of the existing fail netting process.

Questions regarding this Important Notice should be directed to the undersigned at (212) 855-7590 or FICC GSD Operations at (212) 855-7600.

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