



DEPARTMENT OF THE TREASURY  
BUREAU OF THE PUBLIC DEBT  
WASHINGTON, DC 20239-0001

MAY 31 2006

Dear Ms. Poulos:

This is in response to your letter of February 3, 2006, in which you request reaffirmation of the exemptions from certain capital and customer protection rules granted in 1989 to government securities broker and dealer participants of the predecessor of the Fixed Income Clearing Corporation ("FICC").

We understand the facts to be as follows. FICC is a registered clearing agency under Section 17A of the Securities Exchange Act of 1934, as amended. In a letter from the Bureau of the Public Debt dated November 22, 1989, Treasury granted exemptions to government securities brokers and dealers that are FICC<sup>1</sup> netting members from the following capital and customer protection requirements regarding aged fails: (i) as incorporated in 17 CFR 402.2(d), paragraphs 17 CFR 240.15c3-1(c)(2)(iv)(E) and (c)(2)(ix); (ii) as incorporated in 17 CFR 403.4, paragraph 240.15c3-3(d)(2) and Exhibit A (Note D of Item 4 and Item 12); and (iii) 17 CFR 403.5(c)(1)(iii). The exemptions applied only to trades processed through FICC's netting system and were subject to certain other conditions.

FICC has put forth this request because one of the facts on which the original granting of the relevant exemptions was based will soon change. Specifically, at the time of the exemptions, fails were not netted with other fails or new trades. FICC has received Securities and Exchange Commission (SEC) approval to amend its rules to implement a daily fail netting process whereby outstanding participant fail obligations will be netted with current settlement activity on a daily basis.<sup>2</sup> FICC plans to implement this netting process early in 2006.

You state that the reason for implementing a daily fail netting process is as follows. In today's Netting System, failed obligations are not netted with trading activity. Instead, they are generally maintained on an independent basis until settled. At the end of each business day, obligations that failed to settle at the clearing bank on that day are closed and marked-to-market. New obligations, which link back to the original fails, are created at the marked price for settlement the next business day. Separate from fail processing, FICC nets activity scheduled to settle for the first time the following business day, creating additional obligations from the results of the net. Under the current process, netting members can end up having positions with FICC on both sides of the market. To address this, the obligations created from new activity can be paired off with equal and opposite obligations created from fails. However, for a pair-off to

---

<sup>1</sup> The exemptions were granted to netting members of FICC's predecessor, the Government Securities Clearing Corporation. See Letter from Richard L. Gregg, Commissioner, Bureau of the Public Debt, to Jeffrey F. Ingber, Associate General Counsel, Government Securities Clearing Corporation (November 22, 1989) [available at <http://www.publicdebt.treas.gov/gsr/gsr029i.htm>].

<sup>2</sup> See Commission Exchange Act Release Nos. 51865 (June 17, 2005) [File No. SR-FICC-2005-11], 70 FR 36679; and 52157 (July 28, 2005) [File No. SR-FICC-2005-11], 70 FR 44959.

occur, the obligations must be equal in par. The current pair-off process, therefore, does not maximize the opportunities to reduce obligations with FICC.

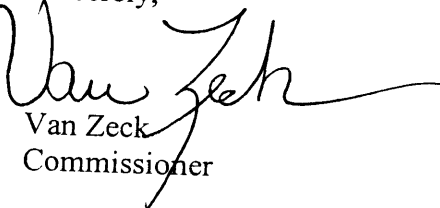
You maintain that, under the proposed daily fail netting process, the risk management of fails as it was considered at the time the exemptions were granted will be maintained. Fails will still be marked to market and, you further maintain, the methodology used for marking fails to market that will be used for fails under the proposed daily fail netting process will continue to employ the identical calculation (including price and value) that is used to compute the mark-to-market amount of the non-failed positions (i.e., the net settlement positions). You also assert that FICC will maintain the ability to track the age of fails under the new process.

Based on these facts and your representations of the proposed daily fail netting process's risk management of fails, we believe that the exemptions granted in 1989 from certain capital and customer protection requirements regarding aged fails should continue to remain in effect. Accordingly, pursuant to 15 U.S.C § 78o-5(a)(5), we therefore hereby reaffirm those exemptions, as described in the second paragraph of this letter, for FICC netting members who are government securities brokers and dealers. These exemptions continue to be limited by the conditions originally set forth in Commissioner Richard L. Gregg's November 22, 1989 letter to GSCC Associate General Counsel Jeffrey F. Ingber.<sup>3</sup> We have consulted with the staff of the SEC, from whom we understand you are requesting an equivalent exemption, in arriving at this decision. We have determined that these exemptions continue to be consistent with the public interest, the protection of investors, and the purposes of the Government Securities Act.

Any change in the facts or circumstances of your request would require further analysis and could lead to a termination of the exemptions.

Under 17 CFR 400.2(c)(7)(i), your incoming letter and this response will be immediately available to the public.

Sincerely,

  
Van Zeck  
Commissioner

Nikki M. Poulos  
Vice President and General Counsel  
Fixed Income Clearing Corporation  
55 Water Street  
New York, NY 10041

<sup>3</sup> The exemptions apply solely to FICC netting members' trades that are processed through FICC's netting system and are conditioned upon the following: (i) in lieu of adhering to the Treasury customer protection (section 403.4) rule's adopted requirement at 17 CFR 240.15c3-3a (Exhibit A) Note D of Item 4, FICC netting members that are government securities broker-dealers required by section 403.4 to maintain a special reserve bank account for the exclusive benefit of customers will at all times maintain a credit balance in Item 4 of the reserve requirement in an amount representing the current market price of the underlying fail to receive security, regardless of the age of such fail; and (ii) the system price will continue to be established by FICC each business day, as represented by FICC, based on current market prices of government securities.

cc:

Michael A. Macchiaroli  
Associate Director  
Division of Market Regulation  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549