

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51340; File No. SR-FICC-2005-02]

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change To Amend the Application and Continuing Membership Standards of the Government Securities Division and the Mortgage-Backed Securities Division

March 9, 2005.

I. Introduction

On January 7, 2005, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") and on January 14, 2005, amended proposed rule change SR-FICC-2005-02 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 January 28, 2005.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

II. Description

FICC is amending the application and continuing membership standards of the Government Securities Division ("GSD") and the Mortgage-Backed Securities Division ("MBSD") to: (1) Provide that when an applicant, member, or participant³ becomes subject to an order of statutory disqualification or order of similar effect, including an order issued by a non-U.S. regulator or examining authority, the FICC Membership and Risk Management Committee ("Committee") shall determine whether this shall be the basis for denial of the membership applicant or termination of membership rather than such denial or termination being automatic; (2) impose a fine on members that fail to notify FICC within 2 business days of falling out of compliance with specified membership standards, including becoming subject to an order of statutory disqualification or order of similar effect; and (3) require applicants and members to notify FICC within two business days if they become aware of an investigation or similar proceeding

against them that could lead them to violate a FICC membership standard.

1. Action in Cases of Statutory Disqualification or Orders of Similar Effect

The GSD and MBSD rules currently provide that a membership applicant that is subject to an order of statutory disqualification under Section 3(a)(39) of the Act or an order of similar effect is not eligible for membership.⁴ Currently, a waiver of this requirement by the Committee is necessary in order for FICC to admit such applicant into membership. The admission requirements also serve as continuance standards for current members. Therefore, if a member becomes subject to a statutory disqualification, a waiver must be sought in order for it to continue as a member of FICC.

At the time it was organized as a clearing agency, the Government Securities Clearing Corporation, the predecessor to FICC, modeled its rules provisions regarding statutory disqualifications on those of other clearing agencies which are now subsidiaries of The Depository Trust & Clearing Corporation. The understanding at the time was that instances of statutory disqualification were a rare occurrence and called into question the entity's ability to meet membership requirements or to remain a member in good standing. More recently, firms are increasingly becoming subject to statutory disqualification, but the reasons for a firm's statutory disqualification may have little bearing on its ability to become or remain a member in good standing. FICC will retain the ability to deny or terminate membership where a firm's ability to meet applicable membership requirements is called into question. However, to the extent an order of statutory disqualification does not call this into question, FICC does not believe it appropriate for the Committee to have to issue a waiver in order to admit or retain the member.

⁴ For example, GSD Rule 3, "Financial Responsibility and Operational Capability Standards," Section 1, "Admissions Criteria for Comparison-Only Members," provides that an applicant may not be subject to an order of statutory disqualification or "an order of similar effect issued by a Federal or State banking authority, or other examining authority or regulator." Section 3(a) (39) of the Act, which sets forth the definition of "statutory disqualification," specifically covers orders issued by foreign financial regulatory authorities that are the equivalent to Commission-issued orders covered by the definition. The statutory definition also includes specific references to entities being barred from the "foreign equivalent of a self-regulatory organization [or a] foreign or international securities exchange" under "any substantially equivalent foreign statute or regulation."

The proposed rule change eliminates the automatic need to obtain a waiver in cases where an entity is subject to an order of statutory disqualification or order of similar effect but will keep such orders as a criterion to be considered for membership. FICC management will continue to present all instances of such orders to the Committee, and the Committee will make all final determinations with respect to these entities. In this manner, FICC management and the Committee will be able to thoroughly evaluate the risks presented by an applicant or member that was or that becomes subject to such an order. The proposed rule change allows FICC to admit and retain members that pose no risk to FICC.⁵ In instances where waivers are still required under the rules and are granted by the Committee, FICC will promptly notify the Commission.

2. Fines for Failure To Notify FICC for Falling Out of Compliance With Membership Criteria

FICC's rules currently require members to promptly notify FICC in the event that they are not meeting membership standards. FICC is now implementing a fine for those members that do not promptly notify FICC of their noncompliance with any membership standard. The membership standards are set forth in GSD Rule 2, "Members," and Rule 3, "Financial Responsibility and Operational Capability Standards," which apply to comparison-only and netting members as applicable and in MBSD Clearing Rules Article III, "Participants," which apply to MBSD clearing participants. For risk management purposes, it is important that FICC learn of a member's failure to meet a membership standard as soon as possible in order that FICC can promptly determine a course of action that will best protect FICC. In addition, in some instances, such as certain cases where a member becomes subject to a statutory disqualification order, FICC is required to promptly notify the Commission.⁶ Given the importance of FICC's membership standards and the need for FICC to learn of noncompliance as soon as possible, FICC is proposing to fine members \$1,000 per instance of a failure to notify FICC within two business days of the

⁵ To the extent the Committee determines to admit or retain a member despite a statutory disqualification, the Committee will still retain all rights it currently has under FICC rules to impose limitations or restrictions on such member or participant.

⁶ Rule 19h-1 of the Act does not require a notification or notice to the Commission in all cases of statutory disqualification.

¹ 15 U.S.C. 78s(b)(1).

² Securities Exchange Act Release No. 51066 (January 21, 2005), 70 FR 4167.

³ GSD members and MBSD participants are collectively referred to as members for purposes of this order.

member first having knowledge of its falling out of compliance with the particular membership standard.⁷ Members would be afforded the same due process as is currently available under FICC's rules with respect to other types of fines. As with all fines, FICC will notify the Commission of all fines that are imposed pursuant to this rule change.

In addition, members that fail to timely notify FICC of falling out of compliance with any membership standard will automatically be placed on the Watch List and will be subject to more frequent and thorough monitoring as provided for in GSD Rule 4, Section 3 and MBSD Article IV, Rule 6.

3. Notification of Pending Investigations

The proposed rule change also requires applicants and members to notify FICC within two business days of first having knowledge of a pending investigation or similar proceeding or condition that could lead them to violate a membership standard. The proposed rule change will provide an exception to this requirement in cases where disclosure to FICC would cause the applicant or member to violate an applicable law, rule, or regulation.

4. Definitions

Finally, MBSD is proposing to add two definitions to Article I, "Definitions and General Provisions." The term "Associated Person" will be defined to mean, when applied to any "person," any partner, officer, or director of such "person" or any "person" directly or indirectly controlling or controlled by such "person," including an employee of such "person." The term "Person" will mean a partnership, corporation, or other organization, entity or individual.

III. Discussion

Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible.⁸ The Commission finds that FICC's proposed rule change is consistent with this requirement because it will help FICC monitor its members' compliance with membership standards. This should better enable FICC to act quickly to protect itself and its members and as a result will better enable FICC to safeguard the securities and funds in its custody or control or for which it is responsible. The

⁷ Once FICC is notified of an applicant or member's statutory disqualification, it will follow the provisions of Rule 19h-1 of the Act.

⁸ 15 U.S.C. 78q-1(b)(3)(F).

Commission also finds that FICC's proposed rule change is consistent with this requirement because while it will make an action of statutory disqualification only a criteria to be considered in membership matters and not an automatic bar, FICC has designed the proposed rule change in a manner that will not compromise its membership review process.

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-2005-02) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.⁹

Jill M. Peterson,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-51339; File No. SR-NASD-2004-164]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto by National Association of Securities Dealers, Inc. Relating to the Random Selection of Arbitrators by the Neutral List Selection System

March 9, 2005.

On October 28, 2004, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, NASD Dispute Resolution, Inc. ("NASD Dispute Resolution"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to NASD Rule 10308 of the NASD Code of Arbitration Procedure ("Code"). On January 5, 2005, NASD filed Amendment No. 1 to the proposed rule change.³ The **Federal Register**

¹ 17 CFR 200.30-3(a)(12).

² 15 U.S.C. 78s(b)(1).

³ 17 CFR 240.19b-4.

⁴ See letter from Mignon McLemore, NASD, to Catherine McGuire, SEC, dated January 5, 2005. In this letter, NASD stated that it will hire an outside consultant to audit the random selection system

published the proposed rule change, as amended, for comment on February 2, 2005.⁴ The Commission received four comment letters in response to the proposed rule change.⁵ This order approves the proposed rule change, as amended.

The proposed amendment to NASD Rule 10308 would change the method used by the Neutral List Selection System ("NLSS") to select arbitrators from a rotational to a random selection function by incorporating the random selection provision of the proposed Customer and Industry Code revisions.⁶

The Greenberg letter supported the change to a random selection system. The Sugerman letter commented that a rotational system is more fair, asserting that under such a system an arbitrator's name is presented for possible selection with the same frequency as every other arbitrator. The Zimmerman letter suggested that NASD also use a random selection function for selecting mediators. The Levine letter, while addressing issues relating to arbitrators, did not specifically address the change from a rotational to a random arbitrator selection system.⁷

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

after it has been operational for one year and independently verify that the random selection system is operating as described in the proposed rule change. NASD also stated that it will keep statistics on the arbitrators selected by the random selection system who appear on an arbitrator list in order to monitor the effectiveness of the random selection system.

⁴ Securities Exchange Act Release No. 51083, 70 FR 5497 ("Notice").

⁵ See letters to Jonathan Katz, Secretary, Commission, from Les Greenberg, dated February 10, 2005 ("Greenberg letter"); Arnold Levine, dated February 19, 2005 ("Levine letter"); Philip Zimmerman, dated February 21, 2005 ("Zimmerman letter"); and Irwin Sugerman, dated February 21, 2005 ("Sugerman letter").

⁶ NASD Dispute Resolution has filed with the SEC a proposed rule change to the Code to reorganize the current rules, simplify the language, codify current practices, and implement several substantive changes. The rule filing was submitted in three parts: Customer Code, Industry Code, and Mediation Code. The Customer Code was filed on October 15, 2003, and amended on January 3, 2005 and January 19, 2005 (SR-NASD-2003-158); the Industry Code was filed on January 16, 2004, and amended on February 26, 2004 and January 3, 2005 (SR-NASD-2004-011). The Mediation Code was filed on January 23, 2004, and amended on January 3, 2005 (SR-NASD-2004-013). It does not contain any provisions concerning the NLSS. The three new codes will replace the current Code in its entirety. The Code revision is undergoing SEC staff review and has not yet been published for comment.

⁷ The Levine letter commented that NASD should only use professional arbitrators and suggested qualifications that should be required of such arbitrators.