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THE BOND MARKET ASSOCIATION

February 28, 2005

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OFFICE OF THE SECRETARY

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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: File No. SR-FICC 2004- 15

Dear Mr. Katz:

The Bond Market Association (the "Association" or "TBMA")[1] is writing to provide staff of the Securities and Exchange Commission (the "SEC") with its comments regarding a recent rule filing (FICC 2004-15) by the Government Securities Division (the "GSD") of the Fixed Income Clearing Corporation (the "FICC") that would require the submission to FICC of eligible transactions conducted by certain non-member affiliates of FICC members and would prohibit certain practices (the "Rule Proposal").

1. Executive Summary/Central Observations

- The Association supports the Rule Proposal as a method of maintaining FICC's ability to ensure the integrity of its netting and risk management function and thus reduce systemic risk.
- The Association believes that certain practices which are designed to deliberately delay and reduce submission of trades to FICC should be discouraged. The overall reduction of credit, operational and systemic risk resulting from expanding FICC trade submission requirements justifies the restrictions on these practices contained in the Rule Proposal.
- The Association's members have some concern regarding the costs and timing of developing and implementing systems to submit affiliate transactions to FICC daily on a trade-by-trade basis. The Association believes that the SEC should

[1] The Association represents securities firms and banks that underwrite, distribute and trade in fixed income securities, both domestically and internationally, including all primary dealers recognized by the Federal Reserve Bank of New York. Our members are also actively involved in the funding markets for such securities, including the repurchase and securities lending markets. Further information regarding the Association, its members, and activities, can be obtained from our public website http://www.bondmarkets.com.

direct FICC to engage in appropriate dialogue with its members to facilitate implementation of and compliance with the Rule Proposal.

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- The Association supports approval of the Rule Proposal even though the Rule Proposal would have a disparate impact on FICC netting members. The proposed rule would require some on-shore affiliates that are active market participants to submit their trades while excluding some equally active off-shore affiliates. Additionally, the proposed rule excludes transactions by a non-member affiliate of a netting member if the affiliate engages in "de minimis" eligible activity.[2] We nevertheless support the Rule Proposal. However, we also urge the SEC to ensure periodic review of FICC's trade submission requirements to determine they're reasonable given both the costs and the benefits associated with affiliate transaction submission.

- The Rule Proposal will enhance FICC's ability to reduce operational risk by facilitating the resolution of unsettled transactions associated with 9/11 type disruption events and endemic fail situations.

2. Introduction

2.1. FICC Plays a Crucial Role in Reducing Risk and Ensuring the Proper Functioning of the U.S. Government Securities Market

FICC provides: (i) an important[3] centralized and, automated system for clearing and settling trades in U.S. government securities; (ii) comparison and netting services for its members; and (iii) a credit risk reduction and containment system for its members.

As the only U.S. government securities clearing agency currently registered under 17A of the Securities Exchange Act of 1934 ("Exchange Act"), FICC plays a crucial role in maintaining the proper functioning of one of the largest fixed income markets in the world - the primary and secondary market for U.S. government securities. As a registered clearing agency, FICC is a self regulatory organization ("SRO") and is thus subject to certain statutory obligations under Section 17A and 19 of the Exchange Act including an obligation to file with the SEC any proposed rule changes and the duty to propose and adopt rules that help ensure that investors are protected and that securities transactions are settled as promptly and accurately as possible.[4]

[2] De minimis activity is defined in the Rule Proposal as less than 30 eligible trades per business day during any one month period within the prior year.

[3] The value and amount of transactions cleared and settled via FICC each day continues to grow each year. For instance, FICC experienced the 10 highest volume days for government securities transactions in its history last year, and on a single day in December 2004 FICC processed a total par value of almost $2.5 trillion in U.S. government securities transactions. In 2004 FICC's Government Securities Division added twelve new netting members, bringing the Division's total membership to 125.

[4] While Section 17A of the 1934 Act specifically requires registered clearing agencies to adopt rules that safeguard securities and funds and protect investors and the public interest, it also requires them to promote the prompt and

FICC – formerly GSCC - was formed by the industry in November 1986. Regulators and market participants alike supported the formation of FICC because centralized multilateral trade netting systems increase market efficiency and reduce counterparty credit risk and market risk.[5] Trade netting at the central counterparty level substantially reduces the total delivery and payment obligations active market participants must meet each day,[6] thereby reducing for all market participants both total exposure and total settlement costs. By utilizing a central counterparty that novates a trade (i.e. becomes the counterparty to every deliver and receive obligation of its netting members), dealers and other active market participants can significantly reduce the risks of incurring credit losses due to the original trade counterparty defaulting on its payment or delivery obligations.

Since, as discussed below, the Rule Proposal should increase the number of transactions that are compared, novated, netted and settled via FICC each day, the Association supports the Rule Filing.

3. Discussion

3.1. The Association Supports the Rule Proposal as an Important Step Towards Ensuring the Continuing Integrity of FICC's Netting, Guarantee and Risk Management Functions.

3.1.1. Background

The Rule Proposal seeks to expand the requirement of trade-by-trade submission to FICC netting-members' non-member affiliates that are broker-dealers, banks, or futures commission merchants organized in the United States ("Covered Affiliates")[7]. FICC intends to capture trades routed through a Covered Affiliate in an effort to enhance its ability to assess the credit and operational risk posed by its netting-members.

FICC's rules do not currently address members' non-member affiliate trading activity. We believe the Rule Proposal is a reasonable attempt to better evaluate and monitor the activity of FICC's members and to broadly discourage any practices designed to reduce trade submission as described in the National Securities Clearing Corporation's

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accurate clearance and settlement of securities transactions. See 1992 Joint Report on the Government Securities Market ("1992 Joint Report") at B-71 and note 41.

[5] Id. at B-74.

[6] Netting of trades also reduces the number of transactions that have to be settled on a delivery vs. payment basis ("DVP") each day over the FedWire system. This, in turn helps reduce the total potential daylight overdraft charges that the Fed imposes on the clearing banks and thus helps reduce systemic risk (i.e. the risk that the failure of one institution to meet all of its obligations may cause losses at one or more additional institutions or the bankruptcy or failure of one or more financial institutions. Id. at B-75.

[7] The Rule Proposal defines term "Covered Affiliate" to exclude affiliates that are "organized or established under the laws of a country other than the United States" and affiliates that are not registered government securities brokers or dealers, banks, trust companies or futures commission merchants ("FCM").

("NSCC") 2003 report.[8] The Association also believes that, except as noted below, the Rule Proposal's exclusions for certain transactions by Covered Affiliates are reasonable.

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The Association's supports the Rule Proposal because it will enhance the integrity of FICC's internal risk management function and preserve the financial integrity of the FICC's guarantee – a guarantee that is critical to FICC's role in enhancing the efficiency of, and reducing risk in, the U.S. government securities markets.

3.1.2. FICC Has Identified Several Significant Reasons Why Its Trade Submission Requirements Should Be Expanded

In its Rule Filing, FICC identified several concerns with its existing submission requirements. These concerns include:

- The continued existence of inadequate submission requirements undermines the financial integrity of FICC's netting process;
- Current submission requirements potentially compromise FICC's own financial integrity and thus the FICC guarantee that is a cornerstone for the proper functioning of the broader U.S. government securities markets;
- FICC's current inability to receive complete and accurate trade-by-trade data from all of its netting members can create substantial operational risk for FICC and its netting members; and
- FICC's ability to help the industry identify and resolve endemic fails situations and eliminate round robins is undermined by its inability to receive timely and complete information regarding eligible trading activity conducted by members and their affiliates that are active in the U.S. government securities markets.

As discussed below, we agree with the above assertions by FICC and believe that the above concerns may raise significant risk management issues.

3.1.3. FICC Must Receive Complete, Timely and Accurate Information Regarding the Trading Activities of Its Netting Members and Their Relevant Non-Member Affiliates

FICC's purpose is to ensure orderly settlement of U.S. government securities by providing operational and risk management benefits to the clearance and settlement process. FICC achieves this by strongly encouraging its members (via price incentives) to utilize its automated real-time trade matching ("RTTM"), netting, settlement and related services. The intraday submission of all eligible activity to the clearing corporation is crucial to preserving the safety and soundness of FICC. The absence from the netting process of one or more active dealers can ultimately undermine the

[8] See "Managing Risk in Today's Equity Market: A White Paper on New Trade Submission Safeguards", Feb. 28, 2003.

effectiveness of FICC's centralized risk management practices – initial margin, collateral requirements, daily mark-to-market requirements, and credit monitoring.

As a central counterparty to the most active participants in the U.S. government securities marketplace, FICC's financial condition and its ability to monitor and protect itself against the risks posed by its members is crucial. FICC has several layers[9] of protection that insulate it (and thus its members) from the failure of a netting member to meet its financial obligations in a timely manner.

FICC's ability to reduce the overall level of credit and market risk that exists in the government securities markets requires that it have effective risk management processes and safeguards. By ultimately novating and guaranteeing the settlement of each and every trade it accepts into the net (a financial obligation that on many days exceeds $2 trillion dollars on a gross basis), FICC provides market participants with much needed certainty with respect to finality of settlement and any potential credit losses associated with unsettled trades. However, these benefits are only achieved if FICC has adequate rules, processes and systems in place to protect it and its members from credit losses. The Bank for International Settlements ("BIS") has observed that "multilateral netting … has the potential to reduce liquidity risks more than any other institutional form, but this depends critically on the financial condition of any central counterparty."[10] In other words, the FICC guarantee is only as good as its creditworthiness (i.e. its ability to meet all of its obligations).

FICC has adopted many safeguards designed to ensure that both it and its netting members are able to meet their obligations each day. These safeguards include a risk assessment capability and risk reduction and loss containment measures. These risk reduction measures require FICC to have as complete a picture as possible on a real time basis about its members' aggregate positions so that FICC can better assess risks to it and its members posed by their market activity and risks it has as guarantor of any duly compared, novated and netted trades. [11]

Another level of protection from members' default is provided by FICC's recently enhanced RTTM services. Only a few years ago FICC members often submitted their trading activities each day via batch processing. In an effort to further reduce intraday settlement risk, and to streamline and accelerate the comparison, novation and settlement process, FICC developed and implemented an automated real-time interactive messaging facility for eligible securities transactions allowing members to submit trades intraday.

[9] The first level of protection that FICC has is each member's clearing fund margin deposits. These margin deposits are required so that FICC has on hand from each netting member assets sufficient to satisfy any losses that may otherwise be incurred by FICC (and, ultimately, its members) due to the default by the member and the resultant close out of that member's positions.

[10] Bank for International Settlement, Report on Netting Schemes (February 1989) at 6.

[11] FICC's current submission requirements and netting services give it a fairly good picture of its netting members' trades with each other; however, it is not a complete picture. Currently, trades with non-members of FICC and trades between certain affiliates of netting members do not appear anywhere on FICC's historical database.

Doing so made it possible for FICC to offer its members for the first time straight-through processing of trades. The introduction of RTTM makes possible the prompt identification and resolution of unsettled transactions intra-day, helping to reduce the exposure market participants have when their trades have not yet settled. Interactive messaging and RTTM processing are critical steps in helping to reduce risk by ensuring that more transactions are compared earlier in the day and then promptly netted and guaranteed through FICC so that intra-day exposure to counterparties is minimized.[12]

4. The FICC Should Work with Its Members to Facilitate Implementation of the Rule Proposal.

The Association's members have some concern regarding the costs of developing and implementing systems to submit Covered Affiliate transactions to FICC daily on a trade-by-trade basis. Clearly, the Rule Proposal, if approved, will result in some additional systems and transaction costs being incurred by our members. Many of our members have non-member affiliates that would constitute "Covered Affiliates" that are not currently FICC netting or comparison members, and/or are not otherwise submitting their trades to FICC. Our members will therefore need to develop, test and implement new systems for submitting transactions by affiliates that are broker/dealers, banks and registered FCMs.

We encourage the FICC to assist its members in the implementation of and compliance with the Rule Proposal. As an initial matter, the Association believes that reduction of FICC's per-transaction fees, or a move towards volume-based (versus per-transaction based) fees would remove a significant incentive to avoid compliance with the Rule Proposal, and generally encourage such firms to increase submission of transactions to FICC. In this regard, the Association believes FICC's recent changes to its fee structure[13] is a laudable first step in accommodating the increased transaction activity that would result upon implementation of the Rule Proposal, and support FICC's continued efforts to reduce their member firms' operating expenses wherever possible.

In addition, FICC should assist members in the implementation of the Rule Proposal by evaluating the benefits to its risk management capabilities resulting from the expanded submission requirements, and to engage in a suitable cost/benefit analysis once new submission requirements are approved and implemented. Moreover, while we support the Rule Proposal, we will encourage FICC to refine the scope of the safe harbors as

[12] FICC's inability to receive complete and accurate trade-by-trade data from its netting members can create substantial operational and credit risk. While FICC today receives over 98 percent of its trade data on a real-time basis, trades that are internalized, summarized or compressed (and thus not immediately submitted to FICC for comparison and guaranteed settlement via RTTM) create intraday operational risk that a can prove material if any un-submitted trades fail to settle.

[13] Generally, as of January 1, 2005, netting fees at FICC will be calculated based on three components; a reduced fixed charge of $0.43 per ticket and two new variable rate charges. In addition, the fixed clearance charge will be reduced from $2.75 per obligation to $2.35. See, e.g., FICC Important Notice, dated November 8, 2004, available here: http://www.ficc.com/gov/notices/GOV146.04.htm?NS-query.

circumstances dictate. FICC, as an industry owned and operated utility,[14] should always remain sensitive to the industry's need to maintain manageable expenses.

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5. The Association Supports the Rule Proposal but Recommends Clarification and Review of the Exclusions

As currently drafted, the Rule Proposal would amend Section 3 of Rule 11 to require some on-shore affiliates that are active market participants to submit their trades while excluding some equally active off-shore affiliates. This is due to the fact that the Rule Proposal extends only to registered broker-dealers, banks, and FCMs that are organized in the United States. This would mean that the U.S. branch of a foreign bank would be excluded from the reach of the Rule Proposal, while a U.S. bank's foreign branch would not. The Association recommends that FICC review the Rule Proposal to consider excluding, in addition to those entities already excluded, any entity, including U.S. banks' foreign branches, domiciled outside of the U.S. Further, FICC should review with members the de minimis transaction exclusion to ensure that the proposed level is appropriate.

6. The Association Supports the Rule Proposal Because it will Further Enhance FICC's Role in Facilitating the Resolution of Endemic Fails Situations

An additional benefit of the Rule Proposal is that it will enhance FICC's ability to reduce operational risk by facilitating the resolution of unsettled transactions associated with 9/11 type disruption events and other endemic fail situations such as was experienced in the May 2013 10-Year Treasury Note and certain MBS during the summer and fall of 2003. Based on historical experience, we believe that FICC is likely to play an important role in helping to remedy any future widespread or endemic fail situation in U.S. government securities. It is widely recognized that FICC played a crucial role in resolving failed transactions arising in the aftermath of the terrorist attacks of September 11, 2001. FICC also facilitated pair offs of unsettled transactions in the May 2013 10-Year Note in 2003 by allowing its members to resubmit all of their outstanding fails to FICC for a re-netting process. We are confident that FICC would be called on to play a similar role in helping market participants resolve any future endemic fails situation or industry-wide settlement crisis. In fact, the Association recently submitted a letter to the U.S. Treasury Department suggesting various steps to encourage the clean-up of fails including requiring dealers to provide to "a third-party...specific information about the amount and status of [its] existing fails."[15]

In closing, the Association appreciates this opportunity to comment on the Rule Proposal, and we would be more than happy to meet with SEC staff to further elaborate on our

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[14] We note that FICC operates as a subsidiary of The Depository Trust & Clearing Corporation (DTCC), which is, in turn, owned by its principal users. As a industry owned utility, FICC is ultimately indirectly accountable to the industry via its Board of Directors.

[15] See Letter to Lori Santamorena of the Bureau of Public Debt from Eric L. Foster on behalf of The Bond Market Association (January 18, 2005) at 12-13.

position. If you have any questions regarding this letter, please do not hesitate to contact the undersigned at 646.637.9222 or my colleague Robert Toomey at 646.637.9224.

Sincerely,

Eric E. Foster
Vice President and
Associate General Counsel

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cc: Larry Bergmann, *Securities and Exchange Commission*
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