

FIXED INCOME CLEARING CORPORATION

---

RESPONSE TO THE DISCLOSURE FRAMEWORK FOR SECURITIES  
SETTLEMENT SYSTEMS

---

February 2005

Table of Contents

Disclosure Framework

Introduction .....	3
I. BASIC INFORMATION.....	4
II. RULES AND PROCEDURES OF THE SSS.....	13
III. RELATIONSHIPS WITH PARTICIPANTS.....	15
IV. RELATIONSHIPS WITH OTHER SSSs AND COMMERCIAL INTERMEDIARIES.....	24
V. SECURITIES TRANSFERS, FUNDS TRANSFERS AND LINKAGES BETWEEN TRANSFERS.....	27
VI. DEFAULT PROCEDURES.....	34
VII. SECURITIES OVERDRAFTS, SECURITIES LENDING AND BACK-TO- BACK TRANSACTIONS.....	38
VIII. RISK CONTROL MEASURES.....	42
IX. OPERATIONAL RISKS.....	50

## Introduction

The following document consists of the responses made by the Fixed Income Clearing Corporation (“FICC”) to the questionnaire entitled Disclosure Framework for Securities Settlement Systems (the “Disclosure Framework”). The Disclosure Framework was developed under the auspices of the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions.

Consistent with the purpose of the Disclosure Framework, FICC’s response provides only a general overview of how FICC deals with certain risk management issues. Therefore, this document should not be relied upon by FICC participants or others as a complete discussion of these matters.

Requests for further information may be directed to:

Nikki Poulos  
Vice President and General Counsel  
Phone: (212) 855-7633  
Fax: (212) 855-3215  
E-mail: npoulos@dtcc.com

## **I. BASIC INFORMATION**

### **A. *What is the name of the SSS?***

Fixed Income Clearing Corporation (FICC)

### **B. *Where and in which time zone is the SSS located?***

FICC is located in New York, New York in the Eastern Time zone.

### **C. *What functions does the SSS perform?***

FICC is the successor to the Government Securities Clearing Corporation (GSCC) and the MBS Clearing Corporation (MBSCC). Effective January 1, 2003, MBSCC merged with and into GSCC, and GSCC was renamed the “Fixed Income Clearing Corporation,” or FICC. FICC consists of two divisions, the Government Securities Division and the Mortgage-Backed Securities Division, which provide the same services as were provided by GSCC and MBSCC, respectively.

#### **1. *Does the SSS serve as a securities depository and/or provide securities settlement services?***

The Government Securities Division does not serve as a securities depository, but does provide securities settlement services.

The Mortgage-Backed Securities Division does not serve as a securities depository, but it does provide settlement services. However, unlike the Government Securities Division, the Mortgage-Backed Securities Division does not serve as a settlement counterparty. Instead, the Mortgage-Backed Securities Division issues settlement balance orders to its participants, who then settle outside of the Division and subsequently inform the Division when their settlements have been completed.

#### **(a) *What types of instruments are eligible for deposit at the SSS (e.g., debt, equities, warrants, etc.)?***

Not applicable.

#### **(b) *What types of instruments are eligible for transfer within the SSS?***

Essentially all United States Treasury and Agency securities that are FedWire-eligible are eligible for “netting” and “settlement” at the Government Securities Division. In addition, certain

mortgage-backed securities are eligible for netting and settlement in the GCF Repo® service of the Government Securities Division.

The MBS Division processes mortgage-backed securities issued or guaranteed by the Government National Mortgage Association, Freddie Mac, and the Federal National Mortgage Association.

**(c) Please describe whether eligible securities are dematerialized, immobilized or transferred physically.**

The eligible securities of both Divisions of FICC are not physically transferred; such securities exist in dematerialized form.

**(d) Does the SSS provide safekeeping for physical certificates?**

No, neither Division of FICC provides safekeeping for physical certificates.

**2. Does the SSS provide cash accounts and/or provide funds transfers in conjunction with securities transfers? If so, in what currencies?**

The Government Securities Division of FICC provides funds transfers in conjunction with securities transfers. The Division also conducts a separate funds-only settlement process, whose major components are mark-to-market payments and coupon pass-throughs. All transfers are conducted in U.S. dollars.

The Mortgage-Backed Securities Division of FICC does not interpose itself between the two settling participants of the trades that it processes; therefore, there are not funds transfers that are arising as a result of securities transfers. The movement of funds that is occurring through the Mortgage-Backed Securities Division represents billing, interest income, margin, and monies due as a result of netting the trades processed by the Division.

**3. Does the SSS provide a trade matching service? Do others provide such services for securities settled at the SSS?**

Both Divisions of FICC operate trade matching services as part of their comparison systems. In both Divisions, comparison of trades is a

prerequisite for netting. Both Divisions provide confirmations of the comparison of trades on a real-time basis.

The rules of the Government Securities Division also provide for the acceptance of pre-matched trades that are submitted by approved trade sources. For example, the Government Securities Division receives data on netting members' Treasury auction awards on a pre-matched or "locked-in" basis from the Federal Reserve Banks.

At this time, the Federal Reserve Banks, with regard to Treasury auction purchases by netting members, Freddie Mac, with regard to Freddie Mac auction purchases by netting members, and the inter-dealer broker netting members, with regard to GCF Repo® transactions entered into by netting members, provide trade matching services for securities settled at the Government Securities Division.

**4. *Does the SSS provide a trade netting service (as distinct from undertaking the settlement of securities transfers on a net basis)? Do others provide such services for securities settled at the SSS? In either case, what types of netting (bilateral or multilateral), if any, are performed?***

Both Divisions of FICC operate a trade netting service; multilateral netting is performed. No others provide such services for securities processed at the Divisions.

**5. *Does the SSS offer a securities lending or borrowing program?***

Neither Division of FICC offers a securities lending or borrowing program. However, both Divisions provide services that facilitate securities lending and borrowing transactions initiated by their members.

**6. *Does the SSS provide custodial and/or related services such as the collection of interest, dividends, principal or withholding tax reclamations? Which types of service of provided?***

Neither Division of FICC provides custodial and/or related services such as the collection of interest.

The Government Securities Division does provide netting services for eligible repurchase and reverse repurchase ("repo") agreement transactions. In conjunction with these repo services, the Division provides automated coupon tracking and pass-through. The Division

passes the coupon payment from the holder of securities (the reverse or short participant) to the funds borrower (the repo or long participant) when the repo term crosses a coupon payment date. In addition, in a fail to deliver situation, the Division also passes through a coupon payment to the rightful owner of the securities.

The Mortgage-Backed Securities Division passes through any interest payments that it receives in connection with the securities collateral that it holds to the participants that deposited the securities. In addition, the Mortgage-Backed Securities Division invests its cash collateral and credits participants with the interest earned.

**7. *Does the SSS act as a central counterparty or principal to transactions with its participants?***

The Government Securities Division acts as a central counterparty to, and guarantor of, all netted and novated trades. The Government Securities Division interposes itself between all receive and deliver obligations and related funds payment obligations, so that all participants receive securities from, or deliver securities to (in conjunction with the related funds payment obligations), the Government Securities Division (through its clearing agent banks).

The Mortgage-Backed Securities Division nets member trades and issues settlement balance orders, but it is not a central counterparty, does not guarantee the settlement of positions, and does not novate such positions. It should be noted that there is an on-going initiative to convert the Mortgage-Backed Securities Division to a central counterparty.

**8. *Other? Please specify.***

Other services provided by the Divisions are described currently in FICC's website, [www.ficc.com](http://www.ficc.com).

**D. *What type of organization is the SSS?***

**1. *Please indicate whether the SSS is a public sector or private sector entity.***

FICC is a private sector entity.

- 2. Please indicate whether the SSS is organized on a for-profit or a non-profit basis.***

FICC is organized under the New York Business Corporation Law, but is designed to operate on a not-for-profit basis.

- 3. What is the legal basis for the establishment of the SSS and for the securities transfers made through it?***

FICC is legally established as a New York State corporation under the New York Business Corporation Law. FICC is registered as a securities clearing agency with the Securities and Exchange Commission (SEC) pursuant to the provisions of Section 17A and 19(a) of the Securities Exchange Act of 1934, as amended (Exchange Act).

- E. Please describe and provide a diagram outlining the organizational and ownership structure of the SSS.***

Attached as Exhibit 1 is a diagram of the organizational and ownership structure of FICC.

- 1. Who are the owners of the SSS?***

FICC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (DTCC). DTCC, in turn, is industry-owned. Participants of FICC and the other registered clearing agencies that are subsidiaries of DTCC (National Securities Clearing Corporation, Emerging Markets Clearing Corporation, and The Depository Trust Company) are allocated entitlements to purchase the common stock of DTCC based upon their usage of all four registered clearing agencies.

- 2. What entity or entities operate the SSS? Which functions of the SSS, if any, are outsourced to third parties?***

FICC is operated as an independent entity. Certain FICC functions are performed by third parties. For example,

- NSCC's Credit Risk Department provides credit reviews of membership applicants and on-going financial surveillance of participants.
- Since FICC does not have its own FedWire access, designated clearing agent banks provide clearance services.



- Certain non-core functions, such as accounting services, are performed by DTCC.

**3. *Does the SSS have a Board of Directors?***

Yes.

**(a) *What is its composition?***

Please refer to DTCC's website ([www.dtcc.com](http://www.dtcc.com)) for the current composition of the FICC Board of Directors.

**(b) *What are its responsibilities?***

Generally, the Board of Directors is responsible for supervising the business and affairs of FICC in order to promote FICC's ability to serve its participants.

**F. *Please describe the financial resources of the SSS.***

**1. *Amount of paid-in capital and retained earnings?***

As of September 30, 2003, the Government Securities Division had \$37.5 million in shareholders equity and \$28.6 million in retained earnings, and the MBS Division had \$11.6 million in shareholders equity and \$11.1 million in retained earnings.

**2. *Guarantees, insurance coverage or other similar arrangements?***

On occasion, FICC has required certain members to obtain a third-party guarantee of their obligations to FICC. FICC does not have any financial guarantees.

FICC currently maintains insurance coverage in the following areas: blanket bond (includes fidelity) and all risk.

**3. *Credit lines or letters of credit?***

FICC does not have any committed lines of credit; however, with respect to the Government Securities Division, FICC does have the ability to pledge the collateral maintained by its participants to obtain requisite financing.

**4. *Powers to assess participants or equity holders?***

The Government Securities Division has the power to assess netting members in the event of a loss caused by the default of a participant. The Division's loss allocation scheme is based on three principles: first, that the Government Securities Division will look to collateral deposited by the participant whose default caused the Division to incur a loss and to any guaranty payments received by the Division pursuant to a cross-guaranty or cross-margining arrangement to satisfy in full such loss; second, that, if part of the loss remains unsatisfied, the participants that dealt with the defaulting participant most recently prior to its default will be looked to on a pro rata basis in order to satisfy in full that remaining loss; and third, that only if one or more of those counterparty participants that traded with the defaulting participant most recently prior to its default itself fails to pay in full its allocation will other participants be asked to share in the loss.

The rules of the Mortgage-Backed Securities Division provide for a limited loss allocation scheme that is not a true mutualization of loss scheme, as is the case with the Government Securities Division. The Mortgage-Backed Securities Division maintains collateral to protect against losses incurred by participants in the event of a participant default. To the extent that losses exceed the amount of the defaulting participant's collateral held by the Mortgage-Backed Securities Division, the original contra-sides of the defaulting participant will bear the shortfall.

**G. *Please describe whether the SSS or its operator is subject to authorization, supervision or oversight by an external authority.***

FICC and its activities are regulated by the SEC. In addition, the rules of the Government Securities Division are subject to review by the Board of Governors of the Federal Reserve System for consistency with the Federal Reserve's payment systems risk reduction policy.

## **II. RULES AND PROCEDURES OF THE SSS**

- A. *Does the SSS maintain a complete list of the rules and procedures governing the rights and obligations of participants and duties of the SSS?***

Yes, the rights and responsibilities of FICC to its participants and of FICC's participants to FICC are set forth in FICC's rules and procedures.

- 1. *How can participants obtain a copy of the rules and procedures?***

Participants can obtain a copy of the rules and procedures by contacting FICC's Member Services Department. In addition, the most current version of the rules is available on FICC's website, [www.ficc.com](http://www.ficc.com).

- 2. *Does other documentation provided to participants (e.g. user guides) have the same status as rules and procedures?***

No.

- 3. *Describe the process for changing rules and procedures, including any need for regulatory approval.***

- (a) *What authority is required, and how does this differ depending on the type of change involved?***

Approval by FICC's Board of Directors or a Committee of the Board (such as the Membership and Risk Management Committee) is required for rule changes that have a significant impact on FICC's participants (e.g., introduction of new services, changing risk management methodologies, fee changes); FICC management is authorized to file rule changes in all other cases without the need for prior Board or Committee approval. None of the amendments to FICC's rules can become effective until filed with, approved or otherwise permitted by, the SEC pursuant to the standards set forth in Section 19(b) of the Exchange Act. In addition, new services of the Government Securities Division that invoke the Federal Reserve's payment system risk reduction policy may be reviewed by the Federal Reserve.

- (b) *How are participants notified of changes in rules and procedures?***

FICC notifies participants of revisions to its rules by Important Notice.

**(c) *Is there a procedure for participants or others to comment on proposed rule changes?***

Yes. Participants or others may submit their comments to FICC for its consideration with respect to any proposal to revise the rules of the Divisions. Written comments, if any, received by FICC must be submitted to the SEC as part of FICC's filing. Under SEC procedures, the SEC also solicits comments on proposals filed by FICC. It should be noted, however, that most FICC proposals (e.g., proposed new services) are developed in close consultation with participants.

**B. *Are the rules and procedures binding on the SSS as well as its participants? Under what conditions and on whose authority can written rules and procedures be waived or suspended by the SSS?***

The rules of both FICC Divisions are incorporated by reference into the membership agreements that are executed by each participant and FICC, and are binding on both the participant and FICC.

The rules of the Government Securities Division allow for the extension, waiver or suspension of any Government Securities Division rule by the Board or by any officer of FICC having a rank of Managing Director or higher, whenever such action is deemed necessary.

The rules of the Mortgage-Backed Securities Division allow for the extension, waiver, or suspension of any Mortgage-Backed Securities Division rule by FICC, whenever such action is deemed necessary.

### III. RELATIONSHIPS WITH PARTICIPANTS

#### A. *Please describe the types of membership offered by the SSS.*

The Government Securities Division has two types of members: comparison-only members and netting members. There are twelve different categories of netting members: Bank netting members, category 1 dealer netting members, category 2 dealer netting members, category 1 inter-dealer broker netting members, category 2 inter-dealer broker netting members, category 1 futures commission merchant netting members, category 2 futures commission merchant netting members, foreign netting members, government securities issuer netting members, insurance company netting members, registered clearing agency netting members, and registered investment company netting members. There are no separate categories for comparison-only members.

The Mortgage-Backed Securities Division has two types of members: clearing participants and EPN users. The following entities may be approved as clearing participants: mortgage bankers, broker-dealers registered with the SEC, commercial banks, thrift institutions and insurance companies, clearing agencies registered with the SEC, investment companies registered with the SEC, or firms in other categories as the Division may determine from time to time. There are no separate categories for EPN users.

#### 1. *How do the types differ?*

The membership types differ in terms of their level of regulatory oversight, financial reporting requirements, admission and continuance standards, and, in some instances, their required collateral postings.

#### 2. *Within each membership category, are all participants subject to the same rules and procedures? Please describe important exceptions, including both differences in rules and across participants and the rationale for these differences.*

Generally, within each membership category, all participants are subject to the same rules and procedures. With respect to the Government Securities Division, some non-domestic participants that present legal risk to the Division are subject to additional Clearing Fund requirements.

#### B. *Can participants establish accounts for their customers' assets that are*

***segregated from their own asset accounts at the SSS?***

Participants cannot establish accounts for assets at either FICC Division. However, participants of both Divisions can request FICC to provide additional accounts for trading activity in order to permit participants to segregate their trading activity from that of a customer, affiliate or a different division of the participant itself.

- 1. If so, is this accomplished through a single omnibus customer account or through a multiplicity of accounts and/or sub-accounts?***

In both Divisions, the terminology that is used is “additional accounts.”

- 2. Is the segregation optional or compulsory?***

The segregation of trading activity is not compulsory under the rules of either Division. Both Divisions permit their participants to commingle their trading activity with that of their customers; in this case, as in the case where the participant opens an additional account, the participant is responsible for all obligations arising out of activity in all of its accounts, regardless of whether they represent customer activity.

- 3. Does the fact that a sub-account at the SSS bears the name of a third party give any rights to that third party as a participant under the rules of the system?***

No. A third party non-member firm whose name may appear on an additional account has no rights under the rules of the FICC Divisions.

***C. Please describe participant requirements for each type of membership.***

- 1. Are participants required to be domiciled or resident in a particular jurisdiction?***

No. However, the home country of foreign members of the Government Securities Division must be on the SEC’s list of countries with whose regulator the SEC has entered a memorandum of understanding for information sharing purposes.

- 2. Are participants required to be subject to a supervisory regime? If so, please describe.***

The rules of the Government Securities Division require entities that wish to become netting members to be subject to an appropriate supervisory regime. Entities that wish to become comparison-only members are not required to be subject to a supervisory regime.

The rules of the Mortgage-Backed Securities Division do not require members to be subject to a supervisory regime.

**3. *Are participants required to hold an equity stake in the SSS?***

No.

**4. *Are there financial, economic, personal or other requirements (e.g. minimum capital requirements, “fit and proper” tests)? If so, please describe.***

- i. An entity is eligible to become a comparison-only member of the Government Securities Division if: (a) it is operationally capable (e.g., able to communicate with the Division and receive output from the Division), (b) it is financially able to pay its fees to the Division, and (c) the Division has not received any substantial information that adversely reflects on the entity (e.g., it is subject to statutory disqualification under the regulations of the SEC or similar regulations).

An entity is eligible to become a netting member of the Government Securities Division if it: (a) is subject to an appropriate regulatory regime, (b) meets all of the requirements for becoming a comparison-only member, (c) has the financial ability to meet its Clearing Fund deposit requirements, (d) has an established, profitable business history of a minimum of six months or personnel with sufficient operational background and experience to ensure the ability of the firm to conduct its business, and (e) meets the following financial requirements:<sup>1</sup>

Bank netting member: equity capital of at least \$100 million, and its capital levels and ratios must meet the applicable minimum levels as required by its primary regulator.

Category 1 dealer netting member: net worth of at least \$50 million and excess net/excess liquid capital of at least \$10 million.

---

<sup>1</sup> FICC has a rule filing pending with the SEC that proposes higher minimum financial requirements for entities that do not prepare their financial statements in accordance with U.S. generally accepted accounting principles. This filing, 2004-14, may be found on FICC’s website, [www.ficc.com](http://www.ficc.com).

Category 2 dealer netting member: net worth of at least \$25 million and excess net/excess liquid capital of at least \$10 million.

Category 1 futures commission merchant netting member: net worth of at least \$50 million and \$10 million in excess adjusted net capital.

Category 2 futures commission merchant netting member: net worth of at least \$25 million and \$10 million in excess adjusted net capital.

Category 1 inter-dealer broker netting member: excess net/liquid capital of at least \$10 million.

Category 2 inter-dealer broker netting member: net worth of at least \$25 million and excess net/liquid capital of at least \$10 million.

Insurance company netting member: (1) an A.M. Best ("Best") rating of "A-" or better, (2) a rating by at least one of the other three major rating agencies (Standard & Poor's ("S&P"), Moody's, and Duff & Phelps ("D&P") of at least "A-" or "A3", as applicable, (3) no rating by S&P, Moody's, and D&P of less than "A-" or "A", as applicable, (4) a risk-based capital ratio, as applicable to Insurance Companies, of at least 200 percent, and (5) statutory capital (consisting of adjusted policyholders' surplus plus the company's asset valuation reserve) of no less than \$500 million; and

Registered Investment Company Netting Member: no minimum financial requirements have been established.

An entity is eligible to become a clearing participant of the Mortgage-Backed Securities Division if: (a) it is operationally capable (*e.g.*, able to communicate with the Division and receive output from the Division), (b) has the financial ability to meet its Participants Fund deposit requirements and its other obligations to the Division, (c) the Division has not received any substantial information that adversely reflects on the entity, and (d) it meets the following minimum financial requirements:

Broker: \$5,000,000 in net capital or liquid capital.

Other applicants: \$10,000,000 in net worth or regulatory net capital.

Any entity that has sufficient financial ability to pay its EPN invoices and that has affirmatively shown that it has, and has undertaken to continue to maintain, adequate personnel, physical facilities, books, records, systems and procedures to fulfill its anticipated commitments to FICC and to other EPN users, may become an EPN user.



***D. Does the SSS engage in oversight of its participants to ensure that their actions are in accordance with its rules and procedures? If so, please describe.***

With the assistance of the NSCC Credit Risk Department, both Divisions of FICC continuously ensure that participants meet their minimum financial requirements, as applicable. In addition, both Divisions continuously monitor the margin requirements, significant positions, and operational proficiency of their participants, as applicable.

***E. Under what conditions can participants terminate their membership in the SSS? Does this mark the end of all liabilities of the participant? If not, please describe what liabilities could remain.***

A participant may terminate its membership in either Division of FICC by so notifying the Division in writing. Notwithstanding any such termination, a participant remains obligated to satisfy any obligations and liabilities arising out of its membership in the Division.

***F. Under what conditions can the SSS terminate a participant's membership in the SSS?***

The Government Securities Division may terminate a participant and close-out its positions in the event that the participant is insolvent. A participant will be treated by the Division in all respects as insolvent:

- a. upon receipt of a notice by the participant that it is insolvent;
- b. in the event that the participant is determined to be insolvent by FICC's Membership and Risk Management Committee, or by any designated examining authority, appropriate regulatory agency, or other examining authority or regulator with jurisdiction over such participant or any self-regulatory organization that such participant is a member of;
- c. if the participant is a member of the Securities Investor Protection Corporation, in the event that a court of competent jurisdiction finds that the participant meets any one of the conditions set forth in clauses (A), (B), (C), or (D) of Section 5(b)(1) of the Securities Investor Protection Act of 1970;

- d. in the event of the entry or the making of a decree or order by a court, regulator or other supervisory authority of competent jurisdiction (i) adjudging the participant as bankrupt or insolvent, (ii) approving as properly filed a petition seeking reorganization, arrangement, liquidation, dissolution, adjustment or composition of or in respect of the participant under the Bankruptcy Code or any other applicable Federal, State or other U.S. or non-U.S. law, including any bankruptcy, insolvency, reorganization, liquidation, dissolution, or similar law, (iii) appointing a receiver, custodian, liquidator, provisional liquidator, administrator, provisional administrator, assignee, trustee, sequestrator (or other similar official) for the participant or for any substantial part of its property, (iv) ordering the winding up or liquidation of its affairs, or (v) consenting to the institution by the participant of proceedings to be adjudicated as a bankrupt or insolvent; or
- e. the filing by the participant of a petition, or any case or proceeding, seeking reorganization or relief under the Bankruptcy Code or any other applicable Federal, State or other U.S. or non-U.S. law, including any bankruptcy, insolvency, reorganization, liquidation, dissolution, or similar law, or the consent by the participant to the filing of any such petition, case or proceeding or to the appointment of a receiver, custodian, liquidator, assignee, trustee, sequestrator or other similar official for the participant or for any substantial part of its property, or the making by the participant of an assignment for the benefit of its creditors, or the admission by the participant in writing of its inability to pay its debts generally as they become due, or the taking of corporate action by the participant in furtherance of any such action.

In addition, the Government Securities Division may cease to act for a participant with respect to a particular transaction or transactions generally if one or more of the following factors is present:

- a. the participant has failed to perform any of its obligations to the Division arising under the Division's rules or has materially violated any rule or procedure of, or any agreement with, the Division;
- b. the participant has failed to make to the Division, on a timely basis, any required payment or deposit provided for in the rules, including any fee, fine or other charge;
- c. the Membership and Risk Management Committee has determined that the participant is no longer in compliance with any provision of (i) the admission standards that would be applicable to it if it were an applicant for membership, or (ii) the continuance standards applicable to it;
- d. the Membership and Risk Management Committee has reasonable grounds to believe that the participant, or any associated person, has been responsible for fraudulent or dishonest conduct or breach of fiduciary duty

or has made a material misstatement or omitted to state a material fact in any statement to the Division or to any officer or employee of FICC in connection with its application to become a member, or thereafter, in connection with any transaction processed or service furnished by the Division;

- e. the Membership and Risk Management Committee has reasonable grounds to believe that the participant is in or is approaching significant financial or operational difficulty or otherwise will be unable to meet its obligations to the Division;
- f. the Membership and Risk Management Committee otherwise has reasonable grounds to believe that such ceasing to act is necessary either for the protection of FICC or any of the other participants or to facilitate the orderly and continuous performance of the Division's services.

The Mortgage-Backed Securities Division may cease to act for a participant and order the disposition of the participant's open commitments in the event that a participant is insolvent. The term "insolvent," when applied to a participant of the Division, means that:

- a. the Participant has given the Division notice that it is insolvent;
- b. a court has found that the participant (if the participant is a member of the Securities Investor Protection Corporation) meets any one of the conditions set forth in Section 5(b)(1)(A) of the Securities Investor Protection Act of 1970;
- c. the participant, if not subject to clause (b) above, has been determined to be insolvent by the Securities Exchange Commission or any self-regulatory organization (as that term is defined in Section 3(a)(26) of the Securities Exchange Act of 1934) which regulates such participant;
- d. a court having jurisdiction in the premises has entered a decree or order adjudging the participant a bankrupt or insolvent, or orders relief against the participant as debtor or approves as properly filed a petition seeking reorganization, arrangement, adjustment or composition of or in respect of the participant under any applicable Federal or State law, or appoints a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the participant or of any substantial part of its property, or orders the winding up or liquidation of its affairs;
- e. the participant has instituted proceedings to be adjudicated a bankrupt or insolvent or consented to the institution of bankruptcy or insolvency proceedings against it, or has filed a petition or answer or consent seeking

reorganization or relief under any Federal or State law, or has consented to the filing of any such petition or to the appointment of a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the participant or of any substantial part of its property;

- f. the participant has made an assignment for the benefit of creditors, or has admitted in writing its inability to pay its debts generally as they become due, or has taken corporate action in furtherance of any such action.

In addition, the Mortgage-Backed Securities Division may also cease to act for a participant with respect to any account or set of aggregated accounts, a particular transaction or transactions generally or any system offered or service provided by the Division and take such action with respect to the participant's open commitments as the Division deems appropriate, including disposition of such open commitments, in the event that:

- a. the participant has failed to make timely payment of its cash settlement obligations or to perform its obligations to other participants under the Division's rules;
- b. the Division has determined that the participant no longer meets its membership qualifications;
- c. the Division has reasonable grounds to believe that the participant has been responsible for any fraudulent or dishonest conduct, or has made a material misstatement or omitted to state a material fact in any statement to any officer or employee of FICC in connection with any transaction processed or service furnished by the Division;
- d. the participant has materially violated any of the Division's rules or procedures or any agreement with the Division;
- e. the Division has reasonable grounds to believe that the participant is in or is approaching financial difficulty or will otherwise be unable to meet its obligations to the Division; or
- f. the Division has reasonable grounds to believe that such ceasing to act is necessary for the protection of investors or other participants or to facilitate the orderly and continuous performance of the Division's services.

***G. Please describe the scope of the SSS's liability to participants, including the standard of liability (negligence, gross negligence, willful misconduct, strict liability or other), the force majeure standard, and any limitation to the scope of liability of the SSS (e.g. indirect or consequential damages). Where are these liabilities and their limitations set out (e.g. in statute or contract)?***

The rules of the Government Securities Division provide that it will not be liable for any action taken, or any delay or failure to take any action, or otherwise to fulfill the Division's obligations to its participants, other than for losses caused directly by its gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action. The rules of the Division also state that, under no circumstances will it be liable for the acts, delays, omissions, bankruptcy, or insolvency, of any third party, including, without limitation, any depository, custodian, sub-custodian, clearing or settlement system, transfer agent, registrar, data communication service or delivery service (Third Party), unless the Division, in selecting such Third Party, was grossly negligent, engaged in willful misconduct, or in violation of Federal securities laws for which there is a private right of action. The rules of the Division further provide that under no circumstances will it be liable for any indirect, consequential, incidental, special, punitive or exemplary loss or damage (including, but not limited to, loss of business, loss of profits, trading losses, loss of opportunity and loss of use) howsoever suffered or incurred, regardless of whether the Division has been advised of the possibility of such damages or whether such damages otherwise could have been foreseen or prevented.

FICC has submitted a rule filing to amend the rules of the Mortgage-Backed Securities Division to be similar to those of the Government Securities Division.

#### **IV. RELATIONSHIPS WITH OTHER SSSs AND COMMERCIAL INTERMEDIARIES**

**A. *Does the SSS maintain linkages (including sub-custodian or cash correspondent relationships) or other relationships with other SSSs?***

**1. *Please identify each of the other SSSs used and the type of securities transferred via the linkages.***

**(a) *What is the name of the other SSS? Where is it located?***

The transactions processed by both Divisions of FICC settle on the Federal Reserve's Fedwire system. As stated above, the Government Securities Division provides securities settlement services to its participants. Since the Government Securities Division does not itself maintain an account at a Federal Reserve Bank (because FICC is not a depository institution), the Government Securities Division accesses the Fedwire system through its relationships with its clearing agent banks. The Government Securities Division maintains clearing accounts with its clearing agent banks through which settlements occur.

The transactions processed by the Mortgage-Backed Securities Division also ultimately settle on Fedwire. However, as stated above, the Mortgage-Backed Securities Division issues settlement balance orders to its participants, who then settle outside of the Division and subsequently inform the Division when their settlements have been completed. Therefore, the Mortgage-Backed Division does not maintain clearance accounts with its banks for settlement activity.

**(b) *What securities are eligible for transfer via the linkage to the other SSS?***

All of the securities processed by both Divisions of FICC settle on the Fedwire system.

**(c) *Are transfers of securities made via the linkage to the other SSS limited to only those that are free of payments or are transfers against payment also made via the linkage to the other SSS? If against payment, please***

*describe the timing of the transfers and the corresponding payments.*

The Federal Reserve System provides a real-time delivery-versus-payment system. All deliveries and receipts of securities are made against simultaneous payment or receipt in immediately available funds.

It should be noted that in the GCF Repo® service of the Government Securities Division, the settlement mechanism was done on a tri-party-like basis under an arrangement between FICC and its two clearing agent banks. A description of the GCF Repo® service is available on FICC's website, [www.ficc.com](http://www.ficc.com). The service is currently functioning on an intra-clearing bank basis.

**(d) Does the other SSS provide custody services to the SSS and, if so, who bears any credit or custody risks?**

The Federal Reserve Bank of New York does not provide custodial services for FICC, because as stated above, the relationship between FICC and the Federal Reserve is not a direct one.

**B. Does the SSS use securities custodians (other than the other SSSs addressed in the previous question) and/or commercial cash correspondents? Please identify the custodians or cash correspondents used and the duties that each performs.**

The Government Securities Division uses two clearing agent banks, JPMorgan Chase Bank ("Chase") and The Bank of New York ("BNY"). The Division uses both banks for the clearing of Government securities products and the provision of related fail financing for overnight positions. The Division uses the services of BNY for the following additional services: settlement of funds transfers, custodial services for margin collateral (including investment of cash collateral), and credit extensions. In addition, Chase also provides custodial services for certain margin collateral and credit extensions.

The Mortgage-Backed Securities Division also uses the services of these clearing banks for custody purposes.

**C. Please describe the standards used in approving or reviewing relationships with other SSSs, custodians or cash correspondents, including any financial or operational requirements or the presence of insurance or public supervision.**

A clearing agent or custodial bank must be a member of the Federal Reserve System that is regularly engaged in the business of providing clearing and/or custodial services and that has agreed to provide one or both of the FICC Divisions, upon request and under mutually agreeable terms, with such services. FICC's Board of Directors and/or one or more Board Committees would review any proposed linkage in order to assess any operational and financial risks arising from such linkage.

***D. Does the SSS advance funds or securities to or on behalf of other intermediaries such as issuing or paying agents?***

No. The FICC Divisions do not advance securities or funds to or on behalf of other intermediaries, such as issuing and paying agents.

***E. Please describe measures in place to protect the SSS and its members against the failure of other SSSs or commercial intermediaries to the SSS, including risk controls, collateral or alternative sources of funds and securities.***

As noted above, the FICC Divisions do not advance securities or funds on behalf of other intermediaries. The Divisions employ the services of the clearing agent and custodial banks that are regulated and examined by various banking authorities.



**V. SECURITIES TRANSFERS, FUNDS TRANSFERS AND LINKAGES BETWEEN TRANSFERS**

**A. *Please discuss whether and how settlement instructions are matched between participants prior to processing by the SSS.***

**1. *Is matching required for all transactions without exception?***

Settlement instructions are not required to be matched in either Division. It should be noted, however, that both Divisions have robust trade comparison systems, which operate on a real-time basis. The output of these comparison systems evidences a valid, binding and enforceable contract with respect to each compared trade, thus eliminating the matching of settlement instructions.

Given the answer to this question, the rest of the questions in this subsection A are not applicable to FICC.

\* \* \*

**B. *Are securities transfers within the SSS registered?***

No. Questions 1 through 6 under this subheading are therefore not applicable to FICC's Divisions.

**C. *Please describe how securities transfers are processed within the SSS.***

The Mortgage-Backed Securities Division does not act as the settlement counterparty to the transactions that it processes. Therefore, the questions under this subheading are not applicable to the Mortgage-Backed Securities Division.

**1. *Please indicate whether the transfers are processed as debits and credits to members' accounts or via some other method.***

The Government Securities Division processes transfers as debits and credits to members' accounts.

**2. *On a continuous (real-time basis), or in one or more batches?***

The Government Securities Division processes securities transfers on a real-time basis. Deliveries that come into the Division ordinarily are instantaneously redelivered to another netting member.

3. ***If continuous, during what hours does processing occur? If in batches, at what time or times is the processing initiated and completed?***

Securities originations occur between 8:30 a.m. (at the opening of the securities FedWire) and 3:15 p.m. Securities reversals may continue until 3:30 p.m. (the closing of the securities FedWire). All times are in Eastern Standard Time.

4. ***Do securities settlements occur daily? Please identify securities for which settlement occurs only on specific days of the week or month.***

Securities settlements occur daily with respect to the Government Securities Division.

Securities settlements of participants of the Mortgage-Backed Securities Division (which occur outside of the Division) may occur daily, but generally occur four times per month in accordance with guidelines issued by The Bond Market Association. See [www.bondmarkets.com](http://www.bondmarkets.com) for more information on mortgage-backed securities settlement cycles.

- D. ***Please describe whether final funds transfers in conjunction with the SSS are made as debits and credits to balances held at the SSS, at one or more commercial banks, at the central bank, or via some other method.***

Final funds transfers are made as debits and credits to accounts at the Government Securities Division's clearing agent banks.

As stated above, the funds transfers in connection with the Mortgage-Backed Securities Division are not made in relation to securities transfers. The Division maintains bank accounts at its banks for the movement of participant funds representing billing, interest income, and monies due as a result of the netting of trades.

1. ***Does the SSS maintain cash accounts for its participants? Are these accounts equivalent to deposit accounts at a commercial or central bank or do they serve only as "cash memorandum" accounts?***

Neither Division of FICC maintains cash accounts for its participants.

2. *On what entity (SSS or other) does the participant bear cash deposit risk?*

There is no cash deposit risk.

3. *Under what circumstances does the SSS provide credit extensions or advances of funds to its participants and thereby expose itself to credit risk?*

The Divisions of FICC generally do not provide credit extensions or advances of funds to their participants. In certain instances, for operational reasons and to facilitate the settlement process, FICC may be said to extend credit on a temporary basis.

4. *How long can such credit extensions last? How long do they typically last?*

Over night---in the limited circumstance described in the answer to the previous question.

- E. *Is the SSS a DVP system? If so, please describe the DVP model used according to the models outlined in the DVP Report (see the Introduction). Please also provide a diagram indicating the timing of events in the processing of securities and funds transfers on the SSS. Where the SSS provides more than one alternative for settlement processing, please provide a response for each alternative and indicate the relative importance of each alternative.*

With the exception of the GCF Repo® service, the Government Securities Division utilizes the Fedwire DVP system through its relationships with its clearing agent banks.

The Government Securities Division schedule of timeframes for the DVP service is as follows:

**SCHEDULE OF TIMEFRAMES**  
**(all times are New York City times)**

**8:00 p.m.** – deadline for final input by members to GSCC of trade data.

**8:00 p.m. to 2:00 a.m.** – time during which GSCC's comparison, netting, settlement and margining output normally is made available to members.

**8:30 a.m.** – the securities Fedwire opens, and securities settlements begin

**9:15 a.m.** – netting-eligible auction purchases are received by GSCC from the Federal Reserve Banks (and are immediately redelivered to members in a long position)

**10:00 a.m.** – funds-only settlement payments are due to GSCC from members in a net funds-only debit position

**10:30 a.m.** – normally, the approximate deadline for satisfaction of a Clearing Fund deficiency call (i.e., two hours after the call is made)

**11:00 a.m.** – funds-only settlement payments are due from GSCC to members in a net funds-only credit position

**12:00 p.m.** - first deadline for submission of repo collateral substitution notifications, after which a late fee will be imposed (this deadline will be extended by one hour on days that: (i) the Corporation determines are high volume days, or (ii) The Bond Market Association announces in advance will be high volume days)

**12:30 p.m.** –second deadline for submission of repo collateral substitution notifications, after which notifications will be processed by the Corporation on a good faith basis only and a late fee imposed on those notifications processed by the Corporation (this deadline will be extended by one hour on days that: (i) the Corporation determines are high volume days, or (ii) The Bond Market Association announces in advance will be high volume days)

**3:00 p.m.** (subject to extension) – GSCC closes for Fedwire transfer originations; no further securities movements for that business day (except for reversals, which go on until 3:30 p.m.)

The Mortgage-Backed Securities Division is not a settlement counterparty. The transactions that are processed by the Mortgage-Backed Securities Division ultimately settle on the Fedwire DVP system.

***1. Are funds transfers and securities transfers processed within the same system or in different systems? If different, how are they linked?***

With respect to the Government Securities Division, the determination of net funds and securities transfers are determined within the same system. This is also true with respect to the transactions processed through the Mortgage-Backed Securities Division; however, these transfers are occurring outside of the Mortgage-Backed Securities Division.

***(a) Please describe whether each securities transfer is linked to a specific funds transfer on a trade-by-trade basis or on a net basis or via some other method.***

With respect to the Government Securities Division, each securities transfer is linked to a specific funds transfer on a net

obligation basis. This is also true with respect to the transactions processed by the Mortgage-Backed Securities Division that are submitted for netting; however, these transfers are occurring outside of the Mortgage-Backed Securities Division.

***(b) Does the SSS “split” large transactions into multiple transactions or require participants to do so?***

In recognition of FedWire requirements, the Government Securities Division “splits” large transactions into individual transfers, each of which is \$50 million or less. The exceptions to this are the GCF Repo® and auction take-down trades where the Division permits full-size trades.

The Mortgage-Backed Securities Division will “break” trades resulting from netting into million dollar par value increments conforming to industry good-delivery guidelines.

**2. *When do securities transfers and fund transfers become final?***

***(a) At what time do securities transfers become final? After what event or events?***

Securities transfers become final at the time of the securities’ movements.

***(b) At what time do funds transfers become final? After what event or events? Does this timing allow for same-day retransfer of funds received in exchange for securities?***

Funds transfers (whether against securities or in funds-only settlement) become final at the time of the funds’ movements per Federal Reserve regulations regarding Fedwire. This timing does allow for same-day retransfer of funds received in exchange for securities.

***(c) If final delivery of securities precedes the final transfer of funds, can participants dispose freely of such securities prior to funds finality? If so, what actions will be taken if funds are not received?***

Final delivery of securities does not precede the final transfer of funds. The transfers occur simultaneously.

**(d) *If final delivery of funds precedes the final transfer of securities, can participants dispose freely of such funds prior to securities finality? If so, what actions will be taken if securities are not received?***

Final delivery of funds does not precede the final transfer of securities. The transfers occur simultaneously.

**(e) *Does the timing of finality differ depending on the type of security transferred or the currency in which payment is to be made? Please describe.***

The timing of finality does not differ depending on the type of security transferred; payments are made only in U.S. currency.

**3. *Please discuss whether participants are notified of securities or funds transfers while they are still provisional, only when final, or both.***

Participants of the Government Securities Division will see their final securities and funds transfers on reports issued by the Division.

Participants of the Mortgage-Backed Securities Division are required to inform the Division of the completion of their settlements.

**F. *Does the SSS itself “guarantee” funds or securities transfers?***

The Government Securities Division guarantees the settlement of securities and funds transfers arising from net settlement positions. The Mortgage-Backed Securities Division does not guarantee funds or securities transfers.

**1. *Under what circumstances and at what point are transfers guaranteed by the SSS?***

The Government Securities Division’s guaranty becomes effective at the point of comparison of the trade.

**2. *What actions does the guarantee obligate the SSS to take?***

The guarantee obligates the Government Securities Division to settle net obligations created by the Division’s netting system. There is an exception for forward-starting repos, where the Government Securities

Division does not stand in as settlement counterparty. In the case of a default of a participant to a forward-starting repo, the Division will instruct the non-defaulting participant to execute a new repo and put in a claim to the Division for the difference in the repo rates.

**3. *Please indicate whether the guarantee is a feature of the SSS's rules and procedures or of national law or regulations.***

This guarantee is a feature of the rules of the Government Securities Division.

## VI. DEFAULT PROCEDURES

A. *Please discuss the events or circumstances that would constitute default of a participant under the rules and procedures of the SSS or that would lead the SSS to make use of exceptional settlement arrangements or unwind procedures.*

1. *Failure by a participant to meet a test of its solvency under the applicable laws of its jurisdiction?*

The failure by a participant to meet a test of its solvency under the applicable laws of its jurisdiction would constitute a default under the rules of both Divisions of FICC.

2. *Failure to make payments or deliveries of securities within the time specified?*

The failure by a participant to make payments would constitute a default under the rules of both Divisions of FICC. A participant can, however, fail to deliver securities to the Government Securities Division on the scheduled settlement date, and can maintain fails with respect to transactions processed by the Mortgage-Backed Securities Division. Such fails do not constitute defaults.

3. *To the extent that the rules and procedures grant discretion in the determination of the use of default or other exceptional procedures, please discuss where the authority to exercise such discretion resides and the circumstances in which this authority would be used.*

The conditions under which each of the Divisions will cease to act for a participant or treat a participant insolvent, and where the authority to exercise such discretion are set forth in Section III above.



**B. *What procedures are followed by the SSS once it has determined that a default event has occurred or that exceptional settlement arrangements are to be employed?***

**1. *How and at what point are participants notified that this has occurred?***

The rules of the Government Securities Division state that, when the Division treats a participant as insolvent or ceases to act for a participant with respect to a particular transaction or transactions generally, it will promptly notify that participant and all other participants that it has so ceased to act or is treating the participant as insolvent. The rules of the Division do not specify the specific form of the notice; such notice would be an appropriate combination of the following forms of notice: telephone, e-mail, and Important Notices.

The rules of the Mortgage-Backed Securities Division state that, when the Division has determined to cease to act for a participant with respect to any account or set of aggregate accounts, a particular transaction, or transactions generally or any system offered by the Division, the Division will notify all participants of the date as of which it will cease to act. The rules of the Division state that such notice will be sufficient if promptly communicated to one or more recognized financial news wire services and confirmed by first-class mail, or transmitted by telephone, cable or similar medium. Notices from the Division that a participant is insolvent will be transmitted by telephone and will be confirmed by first-class mail.<sup>2</sup>

**2. *Would the SSS be expected to continue to meet all its obligations to participants under these circumstances? Please discuss the resources in place to ensure that this would occur (e.g., collateral, Participants fund, insurance, loss sharing arrangements, etc.).***

Both Divisions of FICC would be expected to continue to meet all of their obligations under these circumstances.

Both Divisions have insurance, marks-to market, Clearing/Participants Fund, and in the case of the Government Securities Division, a loss allocation scheme. In addition, both Divisions participate in a multilateral limited cross-guaranty agreement, pursuant to which there is the possibility in a loss situation to receive excess funds of the defaulting

---

<sup>2</sup> FICC has submitted a rule filing, which is currently pending with the SEC, to update these notification provisions to permit notices via e-mail and the website.

member held by another clearing agency that is a party to the agreement. Finally, the Government Securities Division participates in cross-margining arrangements, pursuant to which it could receive funds in a loss situation.

3. ***Please describe and provide a time line indicating the order in which these resources would be used as well as the timing of participant notifications and important deadlines (e.g., when the SSS's obligations to participants would be met, when participants would need to cover their loss sharing obligations).***

The Government Securities Division would likely use the resources in the following order: Clearing Fund and other collateral of the defaulting participant, any amounts available under a cross-margining agreement, any amounts available under a cross-guaranty agreement, and the loss allocation process.

The Mortgage-Backed Securities Division would likely use the resources in the following order: Participants Fund and other collateral of the defaulting participant and then other resources, such as funds from a cross-guaranty arrangement.

4. ***Please describe all conditions under which provisional transfers of securities or funds could be unwound by the SSS.***

There are no conditions under which provisional transfers of securities or funds could be unwound by FICC. Therefore, the questions in a through e under this subheading are not applicable.

5. ***Can bankruptcy or insolvency be declared retrospectively in the SSS's jurisdiction (e.g., under a "zero-hour" rule), and could this cause provisional securities or funds transfers to be unwound?***

No.

6. ***Please describe any circumstances in which transfers of securities or funds that were defined as final in response to questions V.E.2 above would ever be unwound.***

Transfers of securities or funds so defined are final and would not be unwound.

**C. *Has a participant in the SSS ever been declared in default or become insolvent?***

The Government Securities Division has never declared a participant to be in default or insolvent. The Mortgage-Backed Securities Division has done so.

**1. *Have loss sharing procedures been invoked?***

This question is not applicable in the case of the Government Securities Division. The Mortgage-Backed Securities Division did not invoke its limited loss sharing process.

**2. *Please describe whether any of these defaults or insolvencies resulted in losses for the SSS or its participants and how they were absorbed.***

This question is not applicable to the Government Securities Division. The defaults/insolvencies at the Mortgage-Backed Securities Division did not result in any losses.

## **VII. SECURITIES OVERDRAFTS, SECURITIES LENDING AND BACK-TO-BACK TRANSACTIONS**

### **A. *Is it possible for debit positions (overdrafts) in securities accounts at the SSS to arise?***

The questions under this subheading are not applicable to the Mortgage-Backed Securities Division because it does not act as settlement counterparty.

#### **1. *Under what conditions could such debit positions occur?***

The Government Securities Division does not “build a box” during the day; rather, deliveries that come into the Division (more specifically, in the Division’s accounts at its clearing agent banks) ordinarily are instantaneously redelivered to another netting member (i.e., all movements are in a pre-matched, “bound” status). Debit positions, however, occasionally arise as the result of the Division’s inability to turn around securities that it has been “stuck” with (and is unable to redeliver) at the close of the Fedwire.

##### **(a) *Do these conditions always result in debit positions in securities accounts rather than failed transactions? If not, please explain the basis for differential treatment by the SSS.***

These positions are not treated as failed transactions by the Government Securities Division.

##### **(b) *Are these situations covered explicitly by the rules and procedures of the SSS?***

Yes with respect to the Government Securities Division.

#### **2. *How long can such debit positions last? How long do they typically last?***

Such debit positions are settled on the next business day.

**3. *How are debit positions in securities accounts prevented, rectified or managed?***

Such debit positions are self-financing; the Government Securities Division uses the securities themselves as collateral to finance any required borrowings.

**4. *What procedures would be followed by the SSS in case the debit cannot be rectified (e.g., failure by a participant with a debit balance in a securities account or unavailability of the securities in the market).***

**(a) *Application of loss-sharing provisions allocating the loss to participants?***

**(b) *Absorption of loss by the SSS?***

**(c) *Other? Please specify.***

The Government Securities Division's non-inter-dealer broker netting members would share the resultant financing costs on a pro rata basis based upon their usage of the Division. If, however, the Division determines that a participant had done this on a frequent basis and without good cause, such participant would become obligated for the entire amount of the financing costs.

**B. *Under what circumstances does the SSS provide for the lending of securities to ensure settlements?***

Neither Division of FICC performs securities lending functions.

**C. *How does the SSS settle back-to-back transactions?***

**1. *Under what conditions are delivery instructions by participants receiving and redelivering securities on the same day under back-to-back transactions settled for same-day value?***

The Government Securities Division routinely settles back-to-back transactions for same-day value. As stated above, the Mortgage-Backed Securities Division is not a settlement counterparty, and thus the questions under this subheading are not applicable to this Division.

- (a) *Only if the participant has securities on deposit with the SSS that have been received pursuant to a final securities transfer?*
- (b) *If the participant has securities on deposit with the SSS that have been received pursuant to a provisional securities transfer?*
- (c) *Before securities have been received either provisionally or finally, but when a matched receipt instruction exists for the same or greater value? Is such practice limited to markets where matching is binding?*
- (d) *Before securities have been received either provisionally or finally, but when a third party has promised to deliver to the SSS securities of the same or greater value? Must the provider of the guarantee have itself received the securities through a final transfer? Please describe how the SSS evaluates such promises, and whether they are addressed by the written rules and procedures of the SSS.*
- (e) *Other. Please specify.*

The Government Securities Division settles brokered and matched book transactions. Ordinarily, brokers submit equal and offsetting trades to the Division. Such brokers net “flat” and have no receive or deliver obligations versus the Division.

All securities movements through the Government Securities Division are in a pre-matched, “bound” status. The Division must receive securities from a “bound” delivering participant prior to delivering them to a “bound” receiving participant. All deliveries and receipts of identical securities are made at the same settlement value.

- 2. *Please describe limits or controls in place with respect to any of the above arrangements for the settlement of back-to-back transactions, including limits on amounts involved or related to the liquidity of the underlying securities.*

The Government Securities Division does not impose such limitations.

3. ***Under what conditions are payment instructions by participants in the SSS under back-to-back transactions settled for same-day value? Can participants use the proceeds of an on-delivery of securities without the need for an extension of credit?***

Every securities delivery, whether to or from the Government Securities Division, is made against full payment, at same-day (settlement) value. The Division does not extend credit.

## VIII. RISK CONTROL MEASURES

**A. *Please describe the roles and responsibilities of those areas of the SSS responsible for risk management and control.***

**1. *Please describe the process for the internal review of risk management policies and procedures.***

FICC's senior management and Vice President of Compliance oversee day-to-day risk management, and continuously review risk management policies and procedures. The compliance and risk management functions report to the General Counsel.

There is an internal risk committee whose members represent each of the DTCC clearing agencies and on which FICC's General Counsel sits, which evaluates and coordinates risk management activities within the DTCC organization.

In addition, risk management policies and procedures are reviewed by the Membership and Risk Management Committee and/or the Fixed Income Operations and Planning Committee of FICC's Board of Directors. One or both Committees must review and approve new products and services. In appropriate cases, a project may be subject to risk assessment reviews by attorneys, internal auditors and FICC's independent accountant. FICC also solicits comments with respect to new products and services from its participants and other interested parties.

**2. *Is there a risk management policy that addresses the review and approval of new products and services offered by the SSS? At what level of the organization is risk management approval given for a new product or service?***

As a matter of FICC practice, before being offered, a new product or service must receive risk management approval by FICC's President and Chief Operating Officer.

**3. *Does the SSS have a risk management function with clear independence from and authority over operational marketing functions?***

The operations and marketing areas of both FICC Divisions have separate staff from the risk management area, except at the senior management level.



**4. *Does the Board of Directors review risk management policies and procedures? Does the Board have a risk management or audit committee?***

Yes. FICC's Board of Directors has an Audit Committee whose responsibilities include the review of FICC's risk management policies and procedures.

**B. *Please describe any internal or external audits or supervisory/regulatory examinations that are performed with respect to the SSS. For each such audit or examination, please address the following questions.***

**1. *Who performs the audit or examination?***

FICC's Internal Audit Department and its independent accountant regularly review the adequacy of FICC's internal controls, procedures and records. In addition, the Securities and Exchange Commission routinely examines FICC.

**2. *What is the scope of the audit or examination?***

**(a) *Please indicate whether and how it addresses the sufficiency and compliance with internal controls.***

Evaluations of FICC's financial statements, internal controls, and processing are conducted on a periodic basis. Such examinations cover all critical processing areas of the operation, as well as the data processing environment.

**(b) *Please indicate whether and how its addresses the SSS's compliance with its own rules and procedures.***

All examinations are designed to test for compliance with the rules and procedures of both FICC Divisions. Any instances of noncompliance are reported to senior FICC management and are corrected.

**3. *What is the frequency of the audit or examination?***

FICC's independent accountant conducts an annual review. The SEC conducts an annual inspection of FICC's data processing areas and has conducted periodic inspections of other critical areas.

FICC's Internal Audit Department conducts, on a rotation schedule, an annual audit of all critical areas.

**4. *Are audit or examination reports available for review by participants?***

FICC's independent accountant issues a report on internal controls which is provided to all participants and interested third parties.

**C. *Please discuss whether the SSS has the capacity to value (i.e., mark to market) the securities that it holds.***

**1. *Please describe how these valuations are used by risk control systems at the SSS.***

In both FICC Divisions, marks-to-market are used to revalue securities held as collateral. Such marks enable the Divisions to measure the sufficiency of participants' collateral deposits.

**2. *How frequently are securities revalued?***

Securities are revalued daily.

**3. *What are the sources for security valuations?***

**(a) *What outside price or data sources are used?***

The custodians of the Government Securities Division's Clearing Fund price the securities in the Clearing Fund using generally recognized pricing services.

The Mortgage-Backed Securities Division also uses generally recognized pricing services.

**(b) *If pricing models are used, please describe how the models are chosen and how the model inputs are obtained.***

Pricing models are not used.

**D. Please discuss whether the SSS has a lien on the securities held in or transferred through it.**

- 1. Does the lien apply only to securities owned by participants themselves or does it extend to the securities beneficially owned by customers or participants?**
- 2. Under what circumstances and in what manner would such a lien allow the SSS to use the securities?**

Both Divisions of FICC have a lien on all assets and property placed by a participant in their possession, including all collateral on deposit with the Division pursuant to the Divisions' rules. The lien would permit the Divisions to use the collateral upon a determination by the Divisions of a participant's insolvency or upon a participant's failure to perform its obligations to the Divisions.

**E. Please discuss the circumstances in which the SSS requires collateral to limit or mitigate risks.**

- 1. Does the SSS manage its own collateral system?**

Both FICC Divisions manage their own collateral systems.

- 2. Does the SSS share a collateral system with another SSS or payment system?**

No. Neither FICC Division shares its collateral systems with any other SSS.

FICC has entered into a limited multilateral cross-guaranty agreement with The Depository Trust Company, Emerging Markets Clearing Corporation, National Securities Clearing Corporation, and The Options Clearing Corporation which provides a mechanism for the sharing of excess collateral of a common defaulting participant held at one clearing agency to cover losses incurred at another clearing agency due to the default of the participant.

In addition, the Government Securities Division participates in cross-margining arrangements with certain futures clearing organizations. The agreements governing these arrangements contain cross-guaranty provisions for the sharing of excess collateral among the participating clearing organizations in the event of a loss.

**3. *Can collateral at the SSS be posted and returned on the same day?***

Collateral at both FICC Divisions can be posted and returned on the same day, subject to the timeframes published by the Divisions; at all times, however, participants must meet their minimum collateral requirements.

**4. *What types of transactions at the SSS involve the use of collateral?***

All transactions contained in a net settlement position need to be supported by appropriate margin collateral.

**5. *What are the policies with regard to the type of collateral used or haircuts required?***

For the Government Securities Division, Clearing Fund collateral is limited to cash, securities that are Division-netting eligible (this includes Treasury and certain non-mortgage-backed Agency securities, but excludes mortgage-backed agency securities), and eligible letters of credit. The Division applies the following haircuts to Clearing Fund collateral:

Treasury securities with a remaining maturity of greater than one year and less than ten years will be subject to a haircut of three percent.

Treasury Securities with a remaining maturity of ten years or more will be subject to a haircut of five percent.

All eligible netting securities other than eligible Treasury securities will be subject to a haircut percentage determined to be appropriate by the Division, which will be at least equal to the haircut applicable to eligible Treasury securities, and in no event will the haircut percentage be less than that applied by a bank used by the Division to obtain credit secured by Clearing Fund deposits.

There is a one percent haircut on eligible letters of credit.

For the Mortgage-Backed Securities Division, Participants Fund collateral is limited to cash, securities that are Division-netting eligible (this includes Treasury securities and mortgage-backed securities), and eligible

letters of credit. The Division applies the following haircuts to Participants Fund collateral:

Mortgage-backed securities with a maturity of greater than one year will be credited at the lesser of par or 95 percent of the market value.

Mortgage-backed securities with a maturity of less than one year will be credited at the lesser of par or market value to account for the unknown pre-payment factor.

Treasury securities with a maturity of greater than one year will be valued at 95 percent of market value.

Treasury securities with a remaining maturity of less than one year will be valued at market value.

**6. *How are collateral valuation methodologies developed and reviewed?***

Collateral valuation methodologies, with respect to the Government Securities Division, are developed in conjunction with the policies of the custodian, and, with respect to both Divisions, changes to the methodologies would be reviewed by the Membership and Risk Management Committee of FICC's Board of Directors.

**7. *To what extent are collateral policies described in the written rules and procedures of the SSS?***

Collateral policies are documented in the rules and procedures of both FICC Divisions and identified in Important Notices sent to participants.

**F. *Please describe the SSS's use of limits on exposures to monitor and control risks.***

**1. *Please explain the types of limits used and the exposures to which they apply.***

The FICC Divisions do not limit participants' trading per se. Exposure is effectively limited, however, by the Divisions' Clearing/Participants Fund and mark-to-market requirements.

2. ***Do the limits apply to all participants and/or to other SSSs with which the SSS is linked? What are the exceptions to the limit?***

All Government Securities Division netting members and all Mortgage-Backed Division clearing members must post Clearing/Participants Fund and mark collateral commensurate with the level of their exposure.

3. ***Do limits apply to participants individually or in the aggregate or both?***

Clearing/Participant Fund requirements apply to individual participants.

4. ***Do limits apply to implicit as well as explicit extensions of credit or securities (e.g., when on-deliveries of securities are permitted pursuant to provisional but not final delivery of securities)?***

Not applicable. There are no extensions of credit at the FICC Divisions.

5. ***Does the SSS automatically reject transactions that exceed limits or is compliance determined ex post?***

Not applicable.

6. ***How are limit policies developed and reviewed?***

Not applicable.

7. ***To what extent are limit policies described in the written rules and procedures of the SSS? Where does additional authority to set or amend limit policies reside?***

Not applicable.

**G. Please describe other controls to mitigate or reduce risks at the SSS.**

**1. Does the SSS or its participants have the capacity to monitor participants' accounts continuously during the processing?**

Both Divisions of FICC have the capacity to monitor participants' accounts continuously during processing.

**2. Is there a special risk control regime that the SSS would apply to a participant known to be experiencing financial difficulties?**

Both Divisions would place a participant known to be experiencing financial difficulties on a Watch List, which would subject the participant to increased surveillance. This would permit both Divisions to take extraordinary measures to protect FICC and its participants.

**3. Does the SSS maintain or administer loss-sharing arrangements other than those applicable to events of default and addressed in Section VI above? Are these loss-sharing pools pre-funded by participants?**

The FICC Divisions maintain only the loss-sharing arrangements applicable to events of default addressed in Section VI above. In the case of the Mortgage-Backed Securities Division, the loss sharing arrangement is of a limited nature as described above.

## **X. OPERATIONAL RISKS**

**A. *Please provide assessments of the operational reliability of the computer and other systems used by the SSS, including any criteria that the SSS uses internally for this purpose.***

**1. *What is the percentage uptime of the systems used by the SSS?***

**(a) *Whole system overall?***

**(b) *Broken down by major components (e.g., communications network, central processing facility)?***

**(c) *During critical processing periods?***

FICC's whole system overall, including its major components and during critical processing, is essentially up 100 percent of the time.

**2. *Has the SSS experienced major operational problems during the past two years?***

**a. *Have settlements been delayed, been disrupted or otherwise failed because of operational problems during this period?***

**b. *Please describe the nature of any such problems.***

Outside of the events of September 11, 2001 (which did not cause the Divisions of FICC to experience operational problems themselves, but rather others in the industry with whom FICC does business), FICC has not experienced major operational problems during the past two years.

**B. *Please describe contingency or disaster recovery planning at the SSS.***

**1. *Does the SSS have a formal plan for business continuity in place?***

**2. *Is this plan available for review by participants?***

**3. *How often is this plan tested? Does this involve participants in the SSS?***



4. *What are the major elements of the business continuity plan?*
5. *How long would it take the SSS to resume operations if primary systems become unusable?*

FICC has a formal plan for business continuity in place. The plan is not available for review by participants, but is reviewed by the SEC.

FICC has a dual-site configuration, with production databases being maintained in two places simultaneously. The Government Securities Division runs its operations from an alternate site twice annually, and the Mortgage-Backed Securities Division does so every other month. In addition, connectivity of the Government Securities Division's equipment connectivity at the offsite location is tested by the Division's facilities manager on a weekly basis.

The time required for dual-site fold-over is between one half hour and two hours depending upon the time of day that the failure occurs.

- C. *What are the key features of the internal controls covering operations and security at the SSS (e.g., change controls or those covering remote access)?*
1. *Please describe controls or security procedures in place to ensure that the SSS acts only on authentic settlement instructions from valid participants.*
  2. *Are internal operational and security controls included in the internal and/or external audits of the SSS?*
  3. *Are internal operational and security controls covered by regulatory requirements applicable to the SSS?*

Both FICC Divisions ensure that they act only on authentic instructions from valid participants by restricting access to systems and processing screens with security passwords. These controls are included in the internal and external audits of FICC, and are covered by regulatory requirements applicable to FICC.

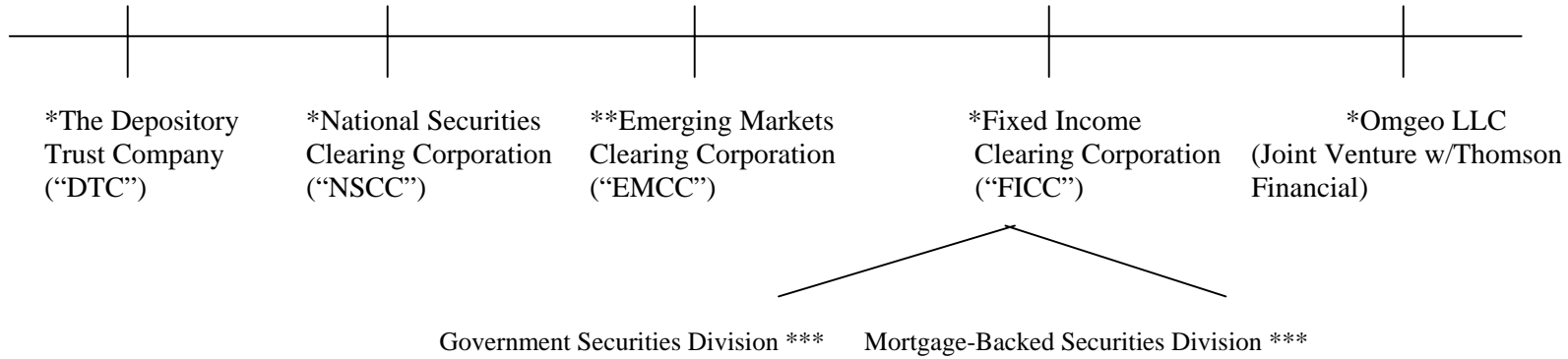
- D. *Does the SSS impose minimum operational or performance standards on third parties (e.g., communications providers)?*
1. *How does the SSS ensure that such standards are met on a continuing basis and what sanctions are available to the SSS if they are not?*

**2. *How would the SSS allocate losses incurred due to operational problems caused by third parties?***

FICC does not impose minimum operational or performance standards on service bureaus that are used by participants to communicate to FICC. It is the responsibility of FICC's participants to select their communication providers, or to use in-house systems, and monitor their performance. Since FICC does not impose minimum operational or performance standards on such service bureaus, it is the responsibility of the individual participants to manage any problems caused by such third parties.

**EXHIBIT 1**

The Depository Trust & Clearing Corporation (“DTCC”)  
DTCC is owned by Participants, the NYSE and the NASD



\*Wholly owned subsidiaries of DTCC.

\*\* Substantially wholly owned subsidiary of DTCC

\*\*\* Division of Fixed Income Clearing Corporation