Electronic Comments

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/delist.shtml*); or

• Send an e-mail to *rule-comments@sec.gov*. Please include the File Number 1–32334 or;

Paper Comments

• Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–9303.

All submissions should refer to File Number 1–32334. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/delist.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

The Commission, based on the information submitted to it, will issue an order granting the application after the date mentioned above, unless the Commission determines to order a hearing on the matter.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[5]

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. E5–3369 Filed 6–28–05; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51908; File No. SR–FICC–2004–15]

Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Trade Submission Requirements and Pre-Netting

June 22, 2005.

I. Introduction

On July 30, 2004, the Fixed Income Clearing Corporation (''FICC'') filed with the Securities and Exchange Commission (''Commission'') proposed rule change SR–FICC–2004–15 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'').[1] Notice of the proposal was published in the **Federal Register** on November 4, 2004.[2] Eleven comment letters were received.[3] FICC amended the proposed rule change on March 4, 2005. Notice of the amended proposed rule change was published in the **Federal Register** on March 18, 2005.[4] No comments were received on the amendment. On June 22, 2005, FICC further amended the proposed rule change to clarify the rule language regarding de minimus trades. Republication of the notice was not necessary because the June 22 amendment made only a technical change to the proposed rule change.

For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

Through a recent survey of FICC's Government Securities Division (''GSD'') members and through other means, FICC has learned that there is a great deal of Government securities activity that is currently being executed or cleared and guaranteed as to settlement by affiliates of FICC's netting members, some of which are active market participants, and is not being submitted to FICC. This currently does not represent a violation of the GSD's rules, which require that netting members submit their own eligible trading activity but do not address trading activity of members' affiliates.

FICC has also determined that its trade submission requirements have been ineffective in preventing the ''pre-netting'' of otherwise netting-eligible activity by netting members as well as their affiliates. In fact, FICC believes that certain members may be purposefully funneling eligible transactions through their non-member affiliates in order to avoid having to submit these transactions to the clearing corporation. Such pre-netting practices, which may take the form of ''internalization,'' ''summarization,'' or ''compression,'' prevent the submission to FICC of transactions on a trade-by-trade basis.[5] The GSD's rules currently prohibit certain pre-netting practices by requiring that all eligible trades executed by its netting members be submitted on a trade-by-trade basis. The proposed rule change expands this requirement to extend it to affiliate trades.

The submission to FICC of eligible activity of each GSD netting member and that of its affiliates that are active market participants is necessary to preserve the integrity of the netting process and the safety and soundness of the overall Government Securities clearance and settlement process. The consequence of a gap in FICC's trade submission requirements raises significant risk issues for FICC and the Government securities marketplace as a whole.

The GSD employs several methods to reduce risk including collateral and mark-to-market requirements and various monitoring procedures. These methods have been highly successful in protecting the GSD and its members from loss. The most powerful risk management tool employed by the GSD is its multilateral netting by novation process, which eliminates netting members' need to settle the large majority of receive and deliver obligations created by in trading activities. (For example, each business day during the first half of 2004, the netting process safely eliminated the settlement risk posed by an average of about 73,000 Government securities transactions worth approximately $1.82 trillion.) The integrity of this netting

[1] 15 U.S.C. 78s(b)(1).

[2] Securities Exchange Act Release No. 50607 (October 29, 2004), 69 FR 64343.

[3] Scott Gordon, Chief Executive Officer, Rosenthal Collins Group, LLC (November 26, 2004); Stephen Merkel, Executive Managing Director and General Counsel, Cantor Fitzgerald Securities (November 26, 2004); Scott Gordon, Chief Executive Officer, Rosenthal Collins Group, LLC (November 29, 2004); John P. Murphy, Managing Director of Operations, Hilliard Farber & Co., Inc. (December 15, 2004); Ronald A. Purpora, Chief Executive Officer, ICAP North American Securities, Garban LLC (December 17, 2004); Robert F. Gartland, Managing Director, Morgan Stanley & Co. Incorporated (December 23, 2004); Frank Tripodi, Managing Director & CFO, TD Securities (USA) LLC (December 17, 2004); David Cassan, Countrywide Securities Corp. (January 4, 2004); Jeffrey F. Ingber, General Manager, Fixed Income Clearing Corporation (January 14, 2005); Emil Assentato, President, Tradition Asiel Securities, Inc. (February 17, 2005); Eric L. Foster, Vice President and Associate General Counsel, The Bond Market Association (February 28, 2005).

[4] Securities Exchange Act Release No. 51365 (March 14, 2005), 70 FR 13222.

[5] 17 CFR 200.30–3(a)(1).

[5] In this regard, it should be noted that on February 28, 2003, the National Securities Clearing Corporation (''NSCC''), an FICC affiliate, issued a paper titled ''Managing Risk in Today's Equity Market: A White Paper on New Trade Submission Safeguards.'' (*http://www.dtcc.com/ThoughtLeadership/whitepapers/managingrisk.pdf*). In the paper, which defined recent trade submission practices that are creating risks in the equities market, NSCC defined three trade submission practices that are some form of pre-netting: (i) Compression, which is a technique to combine submissions of data for multiple trades to the point where the identity of the party actually responsible for the trades is masked, (ii) internalization, which is a technique in which trade data on separate correspondents' trades completely ''crossed'' on a clearing member's books are not reported at all to the clearing corporation, and (iii) summarization, which is a technique in which the clearing broker nets all trades in a single CUSIP by the same correspondent broker into fewer submitted trades.

process depends upon the submission to the GSD of all eligible activity on a trade-by-trade basis.

For this reason, FICC, seeks to prohibit pre-netting activity on the part of members. Indeed, it is the avoidance of ''broker pre-netting'' that was a fundamental reason for the formation in the 1980s of the Government Securities Clearing Corporation, the predecessor of the GSD. The absence from the GSD's netting and settlement processes of all eligible trades of an active market participant that is a GSD netting member or an affiliate of a GSD netting member presents systemic risk to the marketplace for a number of reasons, including the following:

1. Counterparty Credit Risk

Management of the risk of trades that are not submitted to FICC becomes the responsibility of each direct counterparty, including ones that may have insufficient capital or financial strength and/or inadequate internal processes to mitigate such risk. Counterparty credit risk is therefore not managed in a centralized, transparent manner, and the myriad of risk protections built into the FICC process that have been supported by the industry and have been approved by the Commission are not employed.

2. Operational Risk

Eligible trades that are not submitted to FICC introduce operational risk, including ''9–11'' type risk, because such trades are not submitted to FICC for comparison and guaranteed settlement within minutes of execution through FICC's Real-Time Trade Matching (''RTTM'') System. Should a catastrophic event occur after trade execution, submission of netted trade data could be significantly delayed or even lost. Trade guaranty would also not be obtained.

It is noteworthy that the GSD now receives approximately ninety-eight percent of its trade data on a real-time basis. That development alone has significantly improved the GSD's ability to timely manage the risk arising from the over two trillion dollars of daily activity in the Government securities marketplace.

3. Legal Risk

Members' failure to submit eligible activity to FICC increases systemic risk to the clearance and settlement system for Government securities by reducing the number of trades without providing clearly enforceable netting rights in the event of member insolvency. In an insolvency proceeding of a netting member of the GSD under U.S. law, the clearing organization netting provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (''FDICIA'') afford clear netting rights to the GSD as a registered securities clearing agency. The United States Bankruptcy Code (''Bankruptcy Code'') and the Federal Deposit Insurance Act (''FDIA''), to the extent applicable, also provide a number of protections to registered securities clearing agencies such as FICC. Although FDICIA, the Bankruptcy Code, and the FDIA also provide similar safe harbors protecting netting rights with respect to certain securities contracts when not submitted to and novated through the GSD and other registered clearing agencies, their applicability is highly dependent upon the types of entities involved and the nature and adequacy of the bilateral documentation. Thus, pre-netting activity has the potential to increase risk absent each trading entity's capacity for comprehensive monitoring to ensure that the proper documentation is in fact used throughout the Government securities marketplace.

Furthermore, as a practical matter, to the extent that there are any ambiguities in the application of relevant netting or close-out rights, FICC would expect that in general a bankruptcy court or other insolvency tribunal would be more deferential to close-out and netting by a registered clearing agency such as FICC than it would be to close-out and netting by nother market participants.

4. Resolution of Fails Problems

The failure of netting members to submit eligible trades to FICC decreases the ability of FICC to assist in the resolution of fail problems. The significant fail problem incurred by the industry with regard to the May 2013 10-Year Note likely could have been mitigated by submission of eligible data on behalf of non-member affiliates of GSD members. With submission, FICC could have identified and resolved fail situations involving these affiliates.

The failure of FICC to receive all eligible trading activity of an active market participant denigrates FICC's vital multilateral netting process and causes FICC to not be in as good a position to prevent future market crises. Given the enormous and growing amount of activity in the government securities marketplace and the resultant huge settlement risks, the proposed trade submission requirements and pre-netting prohibitions are the logical next steps for enhancing FICC's netting and risk management processes and for ensuring that FICC can continue to perform its vital risk management role for the Government securities marketplace.

As a result, FICC is broadening its trade submission standards by requiring the submission of data on trades executed or cleared and guaranteed as to their settlement by certain affiliates of members.[6] The proposed rule change also makes explicit that these affiliate trades must be submitted on a trade-by-trade basis as executed. This should advance the goal of having every active Government securities market participant which is a GSD netting member or is an active affiliate of a GSD netting member submit or have submitted on its behalf its eligible activity to the GSD on a trade-for-trade basis for netting, risk management, and guaranteed settlement. It would also put the Government securities marketplace on a more equal footing with other markets where the presence of regulatory confirmation or price transparency requirements effectively mandates that all eligible trades be submitted to the clearing corporation.

Specifically, the proposed rule change applies to a GSD member's non-member affiliates that are registered broker-dealers, banks, or futures commission merchants organized in the United States (''covered affiliates''). The proposed rule change requires members to submit on a trade-by-trade basis eligible trades, both buy-sells and repos, executed by their covered affiliates with other netting members or with other netting members' covered affiliates. The proposed rule change also requires members to submit on a trade-by-trade basis eligible trades cleared and guaranteed as to their settlement by their covered affiliates. The proposed rule change is limited to covered affiliates because these are the types of entities that comprise the majority of GSD netting members and because the failure to submit trades executed by registered broker-dealers, banks, and futures commission merchants organized in the United States has given rise to the systemic risk concerns discussed above.

It is important to note that covered affiliates will not be required to join FICC as members. As such, FICC is affording members and their affiliates the flexibility of choosing to have their trades processed by FICC either through direct membership or through a correspondent clearing relationship with an affiliate or with another entity. In addition, the proposed rule filing exempts the following trades from its

[6] Trades that the affiliate clears for another entity but does not guarantee the settlement of will be excluded from the trade submission requirement.

coverage: (1) An affiliate that engages in *de minimis* eligible activity, which is defined as less than an average of 30 trades per business day per month within the prior twelve-month period; (2) trades executed between a member and its affiliates or between affiliates of the same member; and (3) trades whose submission to FICC would cause the member to violate an applicable law, rule, or regulation.[7]

The proposed rule filing provides that failure to abide by the new trade submission requirements will trigger the disciplinary consequences currently in the GSD rules, which can ultimately result in termination of membership.[8]

III. Amendment

As originally filed the proposed rule change would have required GSD members of FICC to submit trades that were executed or whose settlement was cleared and guaranteed by affiliates of GSD members registered as U.S. broker-dealers, banks, or futures commission merchants. Because the proposed rule defined a covered affiliate as an entity organized in the U.S., it would not have applied to trades executed by non-U.S. affiliates of GSD members. FICC has stated to the Commission its belief that most of the pre-netting activity is occurring with domestic affiliates and therefore there is no reason to apply the rule to foreign affiliates. Furthermore, FICC did not want to adopt a rule where compliance or enforcement would be difficult.

After discussion with the staffs of the Commission and other regulatory entities, FICC amended the proposed rule change to require netting members to report to FICC trades of their non-U.S. affiliates. The trades will be reported to FICC on an annual basis in the format and within the timeframe specified by guidelines to be issued by FICC. The reporting requirement will not apply to ''foreign affiliate trades'' of a foreign affiliate where the foreign affiliate has executed less than an average of 30 ''foreign affiliate trades'' per business day per month within the prior twelve-month period.

The amendment adds definitions of ''foreign affiliate'' and ''foreign affiliate trade'' to GSD's rules. A ''foreign affiliate'' is defined as an affiliate of a netting member that is not itself a netting member and is a foreign person. A ''foreign affiliate trade'' is defined as a trade executed by a ''foreign affiliate'' of a netting member that satisfies the following criteria: (i) the trade is eligible for netting pursuant to GSD's rules and (ii) the trade is executed with another netting member, with a covered affiliate, or with a ''foreign affiliate'' of another netting member. ''Foreign affiliate trade'' does not include a trade that is executed between a member and its affiliate or between affiliates of the same member. For purposes of this definition, the term ''executed'' includes trades that are cleared and guaranteed as to their settlement by the foreign affiliate.

IV. Comments

The Commission received eleven comment letters to the proposed rule change. Cantor Fitzgerald Securities (''Cantor'') and Rosenthal Collins Group, LLC (''RCG'') wrote letters opposing the proposed rule change.[9] FICC submitted a letter responding to those letters.[10] Additionally, the Bond Market Association submitted a comment letter supporting the proposed rule change but making two recommendations regarding the compliance costs of the proposed rule change and regarding foreign affiliates.[11] The remaining comment letters were submitted by FICC netting members that are in favor of the proposed rule change.[12]

Cantor and RCG are each netting members of FICC. RCG has a wholly-owned subsidiary, Rosenthal Global Securities, LLC (''RGS''), which is not a member of FICC. RGS is a registered broker-dealer that engages in proprietary trading of fixed income securities with various institutional counterparties, including Cantor. RCG had been submitting RGS's trades to FICC on a trade-by-trade basis, but in October 2003 RCG began submitting only a net settlement balance to FICC. It was this activity that first brought the affiliate pre-netting issue to FICC's attention. However, Cantor and RCG each claim that many of FICC's members engage in affiliate pre-netting. Cantor's comment letter contained most of the substantive arguments opposing the proposed rule change. RCG submitted two comment letters to the Commission stating that it substantially agrees with the analysis and positions set forth in Cantor's comment letter.

Cantor and RCG argue that FICC's proposal is anticompetitive and that the proposal is not balanced by any benefit such as FICC's claim that the proposed rule change will reduce systemic risk in the Government securities marketplace. They argue that FICC, as the only registered clearing agency that provides clearance and settlement services for Government securities, has an economic monopoly and that it is using this monopoly to require additional trade submissions in order to raise its revenue from trade submission fees.

Cantor also addresses each of the specific risks FICC listed in its rule filing (*i.e.*, counterparty credit risk, operational risk, legal risk, and resolutions of fails risk) and disagrees with FICC's assertion that the proposed rule change would reduce any of these risks.

1. Counterparty Credit Risk

Cantor and RCG disagree with FICC's claim that the proposal will reduce counterparty credit risk. They argue that pre-netting is not *per se* a risky activity. They claim that netting is a risk reducing measure, whether done or not done by a clearing agency, and that in this circumstance the parties doing the netting are highly regulated entities (*i.e.*, banks, futures commission merchants, and broker-dealers) that are required to conform to certain capital and risk management standards and that have developed sophisticated risk management techniques. Accordingly, Cantor and RCG argue that these entities can net their trades prior to submission to a clearing agency without adding risk to the marketplace.

Cantor and RCG further argue that if the purpose of the proposed rule change is to reduce risk, FICC would not have excluded non-U.S. affiliates from the proposed rule. They claim that compared to U.S. affiliates non-U.S. affiliates present the same or greater level risk to the marketplace. Cantor claims that a significant portion of government securities are held by foreign entities (43.7% of U.S. government securities other than savings bonds) and that cross-border

[7] FICC believes that exclusion of these trades from the submission requirement's coverage does not raise the systemic risk concerns described above.

[8] The disciplinary consequences of GSD Rule 48 are being referred to explicitly to emphasize to members the importance of this rule and to remind members that violations of the GSD's rules may lead to serious disciplinary consequences, including termination of membership.

[9] Scott Gordon, Chief Executive Officer, Rosenthal Collins Group, LLC (November 26, 2004); Stephen Merkel, Executive Managing Director and General Counsel, Cantor Fitzgerald Securities (November 26, 2004); Scott Gordon, Chief Executive Officer, Rosenthal Collins Group, LLC (November 29, 2004).

[10] Jeffrey F. Ingber, General Manager, Fixed Income Clearing Corporation (January 14, 2005).

[11] Eric L. Foster, Vice President and Associate General Counsel, The Bond Market Association (February 28, 2005).

[12] John P. Murphy, Managing Director of Operations, Hilliard Farber & Co., Inc. (December 8, 2004); Ronald A. Purpora, Chief Executive Officer, ICAP North American Securities, Garban LLC (December 17, 2004); Robert F. Gartland, Managing Director, Morgan Stanley & Co. Incorporated (December 23, 2004); Frank Tripodi, Managing Director & CFO, TD Securities (USA) LLC (December 17, 2004); David Cassan, Countrywide Securities Corp. (January 4, 2004); and Emil Assentato, President, Tradition Asiel Securities, Inc. (February 17, 2005).

transactions raise a number of complex issues.

2. Operational Risk

Cantor does not agree with FICC's assertion that the submission of affiliate trades to FICC on a trade-by-trade basis will reduce operational risk. In the event of operational difficulties in the government securities clearance and settlement system, participants in the government securities markets in all likelihood would be adversely impacted whether or not a transaction was submitted to FICC. Although submitting trades in real-time to FICC's RTTM System reduces the risk of trade data being lost, it does not follow that transactions submitted to FICC somehow reduce operational risk.

3. Legal Risk

Cantor disagrees with FICC's assertion that market participants will have more legal protections in an insolvency proceeding if the trade is submitted to a registered clearing agency. Cantor argues that there are sufficient legal protections in place to protect market participants in the event of an insolvency, with special treatment under several applicable laws for protecting non-defaulting financial institutions upon their repo counterparty's insolvency.

4. Resolution of Fails Problem

Cantor argues that submission of affiliate trades will not make it more likely for FICC to identify round-robin chains as FICC claims. Many market participants are still excluded from FICC's system, including institutional investors which represent most of the buy-side of the government securities market.

Finally, Cantor and RCG claim that the proposed rule change may actually increase systemic risk because it will result in higher fees that will prevent small firms from joining or maintaining membership in FICC. As a result, more transactions will be settled outside of FICC. Cantor also claims that the proposed rule change will affect FICC members disparately because some of FICC's members trade often with affiliates, some not at all, and others trade with foreign affiliates, which are exempt from the proposed rule.

In response to the comment letters from Cantor and RCG, FICC in its comment letter reiterates the reasoning that it laid out in its filing that the proposed rule change would significantly reduce the systemic risk in the government securities clearance and settlement process. FICC disputes Cantor's and RCG's claim that FICC is proposing the rule as a way to collect additional fees by noting that it is owned and governed by its members and pays substantial rebates to its members. Additionally, FICC states that it recently amended its netting fees in recognition of the proliferation of large volume/small dollar trading and to provide cost savings to those firms that engage in this type of trading.[13]

FICC responds to Cantor's comments regarding foreign affiliates by stating that the rule filing was designed to encompass those entities (*i.e.*, banks, futures commission merchants, and broker-dealers) that make up the large majority of its membership. It excluded non-U.S. affiliates from the proposed rule because of the limited ability of domestic FICC members to submit the activity of their non-U.S. affiliates. FICC also states that there are potential regulatory and other legal barriers under foreign law to the application of FICC's rules to non-U.S. affiliates. However, as discussed previously, FICC has amended the proposed rule change to require disclosure from its members regarding foreign affiliate pre-netting following discussion with the Commission.

Finally, FICC addresses the claim that the proposed rule change would create an unfair burden on competition by stating that any burden on competition that the proposal could be regarded as imposing is not unreasonable or inappropriate in light of the substantial benefits that submission of affiliate trades will yield.

The Bond Market Association (''BMA''), an industry group that represents securities firms and banks that underwrite, distribute, and trade in fixed income securities, submitted a comment letter in support of the proposed rule change but made two comments regarding the cost of compliance for FICC's members and the exclusion of foreign affiliates from the scope of the proposed rule. In its comment letter, the BMA notes the value of FICC as a centralized and automated system for clearing and settling trades, comparison and netting services for its members, and a credit risk reduction and containment system for its members. It states that FICC plays an important role in increasing efficiency and reducing risk in the Government securities markets and that practices designed to deliberately delay and reduce submission of trades to FICC should be discouraged. Accordingly, because the proposed rule change should increase the number of transactions that are compared, novated, and settled by FICC everyday, the BMA recommends that the Commission approve the proposed rule change.

However, the BMA has two concerns regarding the proposed rule change. First, the BMA is concerned of the costs to FICC's members of the implementation of the proposed rule change. The BMA believes that a new trade submission requirement for covered affiliates will require its members to develop, test, and implement new systems for submitting transactions by covered affiliates. The BMA requested that FICC evaluate the costs and benefits of the proposed rule change and assist its members in the implementation of compliance with the new rule.

Second, the BMA noted that the proposed rule change would have a disparate impact on FICC's members because it will not apply to foreign affiliates of FICC members. The BMA notes that as drafted the rule proposal will apply to the U.S. branch of a foreign bank but not to the foreign branch of a U.S. bank. The BMA recommends that FICC consider excluding any entity, including U.S. banks' foreign branches, that is domiciled (instead of ''organized'') outside of the U.S. The BMA also recommends that FICC review the de minimus transaction exclusion to ensure that the proposed level is appropriate.

The Commission received seven comment letters from FICC netting members in favor of the proposed rule change. These commenters highlight the importance of FICC's netting and risk management processes and state that the proposed rule change should help to preserve the integrity of these processes by reducing systemic risk. Several commenters note that pre-netting gives FICC members the opportunity to ''cherry-pick'' among their covered affiliate trades and to submit only the riskiest of those trades to FICC for clearance and settlement. One commenter states that if the proposed rule change is not approved other FICC netting members will be driven by competitive forces to lower costs to their customers by also engaging in pre-netting with non-member affiliates. This would further harm FICC's netting and risk management processes and also the Government securities marketplace.

V. Discussion

After carefully considering the proposed rule change as amended and all of the written comments received, the Commission has determined that the

[13] Securities Exchange Act Release No. 50806 (December 7, 2004), 69 FR 72237 (December 13, 2004) [File No. SR–FICC–2004–21].

proposed rule change meets the requirements of Section 17A(b)(3)(F) of the Act. That section provides that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds which are in the clearing agency's control or for which it is responsible. FICC has long recognized that pre-netting of trades by its members affects the operation of its netting system and, accordingly, FICC's Rules expressly require netting members to submit all eligible trades with another FICC netting member to FICC. The proposed rule change extends this requirement to netting between FICC members and their covered affiliates. For the following reasons, the Commission finds that the proposed rule change prohibiting pre-netting between FICC members and covered affiliates meets the requirements of Section 17A. Additionally, in consideration of the comments from Cantor and RCG regarding competition, the Commission finds that the proposed rule change will not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act in accordance with section 17A(b)(3)(I).

Section 3(a)(23)(A) of the Act defines a clearing agency as any person who, among other things, acts as an intermediary to reduce the number of settlements of securities transactions.[14] section 17A(b)(1) of the Act requires that an entity performing the functions of a clearing agency must register as a clearing agency with the Commission.[15] Although netting of affiliates trades alone may not require an entity to register as a clearing agency with the Commission, netting is clearly contemplated by the Act as an operation central to clearing. In general, the Commission feels that a proposed rule change that is designed to require netting to be provided by a registered clearing agency is designed to further the purposes of section 17A of the Act. In this case in particular, FICC's ability to perform the netting function for Government securities is well-established. A rule that is designed to bring additional securities transactions into its netting system is clearly designed to promote the prompt and accurate clearance and settlement of those transactions and to preserve the safety and soundness of the national clearance and settlement system.

Cantor and RCG have argued that netting may occur outside of a clearing agency without presenting any additional risks to the clearing agency or to its members and that while FICC as a registered clearing agency is the appropriate party to provide a multilateral netting service it should not be able to prohibit its members from netting trades on a bilateral basis with their non-member affiliates. Netting may be a risk-reducing measure outside of a clearing agency, but here FICC has shown that it is important for it to prohibit its members from pre-netting in order for FICC to maintain the effective operation of its netting service.

FICC has represented to the Commission that its netting system may fail to operate effectively if its members may delay trade submission or cherry-pick among their trades by pre-netting some trades prior to submission to FICC. The Commission finds persuasive FICC's argument that FICC's netting and risk management services are compromised if it receives some but not all of the trade data it needs to effectively perform its netting function. Accordingly, the Commission finds that it is appropriate for FICC to prohibit its members from engaging in pre-netting with covered affiliates before submitting their trades to FICC.

The proposed rule change is also designed to alleviate the risks pre-netting presents to the marketplace which FICC describes in its filing as counterparty credit risk, operational risk, legal risk, and fails risk. The Commission is particularly concerned about the risks that counterparties will be unable to settle their obligations or that trade data will be lost in the event of a market crisis. The proposed rule change, by requiring trade information to be submitted to FICC on a trade-by-trade basis and, in particular, through FICC's RTTM system, will substantially reduce the risk that trades between FICC's members will not settle. Cantor and RCG have argued that requiring trades between members and covered affiliates to be netted within FICC's netting system will not reduce counterparty credit risk or operational risk and that FICC's members are regulated entities that can appropriately manage these risks. Despite these arguments, FICC's netting process and risk management processes are highly sophisticated and specialized services that are subject to Commission oversight. Accordingly, because the proposed rule change should bring more member trades into FICC's netting system, the Commission finds that it is designed to promote prompt and accurate clearance and settlement of securities transactions and to assure the safeguarding of securities and funds which are in FICC's control or for which it is responsible.

Cantor and the BMA have commented that the proposed rule change will result in disparate treatment of FICC's members because it does not apply to trades with foreign affiliates of FICC's members. Section 17(b)(3)(F) provides that the rules of a clearing agency shall not permit unfair discrimination among participants in the use of the clearing agency. Cantor has essentially argued that FICC is discriminating against its smaller, domestic members by proposing that the rule apply only to domestic affiliates. Cantor also argues that FICC is using the proposed rule change to generate additional fees from its smaller members while allowing its larger, more favored members, to continue to engage in the pre-netting of trades. FICC has denied this and states that it is not requiring the submission of trades by foreign affiliates because of potential regulatory barriers and because it does not believe that those entities are engaging in substantial amounts of pre-netting activities.

As discussed in the previous section, FICC amended the proposed rule change to require disclosure by its members of their pre-netting with foreign affiliates. The Commission feels that the amendment requiring disclosure of trades with foreign affiliates is an appropriate measure at this time. If FICC learns through these disclosures that its members are engaging in substantial amounts of affiliate pre-netting with their foreign affiliates, the Commission expects FICC to take appropriate steps to similarly address such activities. Accordingly, because FICC has acted at this time appropriately to address the foreign affiliate pre-netting issue, the Commission finds that the proposed rule change would not permit unfair discrimination among FICC's participants as prohibited by section 17A(b)(3)(F).

Cantor and RCG have also argued that the Commission should not approve the proposed rule change because it imposes a burden on competition not necessary or appropriate in furtherance of the purposes of the Act. The Commission is not persuaded by Cantor's claim that the proposed rule change will result in an undue burden on competition. We find it unlikely that the proposed rule change will force some FICC members to discontinue their membership in FICC. First the Commission does not believe the increased fee implications of the proposed rule change are as significant as Cantor alleges. As noted by FICC in its filing and in its comment letter, it operates as a not-for-profit corporation

[14] 15 U.S.C. 78c(a)(23)(A).

[15] 15 U.S.C. 78q–1(b)(1).

that matches fees to costs and pays rebates to its members. Furthermore, Cantor and RCG were the only parties to submit negative comments on the proposed rule change. The Commission did not receive comments from any FICC members or potential FICC members, other than from Cantor and RCG, stating that the proposed rule change would make it too expensive for them to remain or to become a member of FICC. Accordingly, for the reasons discussed above, the Commission finds that the proposed rule change is consistent with section 17A(b)(3)(I) of the Act in that it does not impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

VI. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular with the requirements of Section 17A of the Act and the rules and regulations thereunder applicable.

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR–FICC–2004–15) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[16]

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. E5–3381 Filed 6–28–05; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51901; File No. SR–ISE–2005–06]

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto Relating to Fee Changes for Transactions in Options on the Standard & Poor's Depository Receipts®

June 22, 2005.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on May 20, 2005, the International Securities Exchange, Inc. (''Exchange'' or ''ISE'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in items I, II, and III below, which items have been prepared by the Exchange. On June 15, 2005, the Exchange filed Amendment No. 1 to the proposed rule change.[3] ISE has designated this proposal as one establishing or changing a due, fee, or other charge imposed by a self-regulatory organization pursuant to section 19(b)(3)(A) of the Act,[4] and Rule 19b–4(f)(2) thereunder,[5] which renders the proposal effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The ISE proposes to amend its Schedule of Fees to adopt a $.10 per contract surcharge for certain transactions in options based on the Standard & Poor's Depository Receipts®, or SPDRs® (''SPDRs''). The text of the proposed rule change is available on the Exchange's Internet Web site (*http://www.iseoptions.com*), at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend its Schedule of Fees to adopt a $.10 per contract surcharge fee for certain transactions in options on SPDRs.[6]

The Exchange's Schedule of Fees currently has in place a surcharge fee item that calls for a $.10 per contract fee for transactions in certain licensed products. The Exchange entered into a license agreement with Standard and Poor's, a unit of McGraw-Hill Companies, Inc., authorizing the Exchange to list SPDR options. The Exchange is adopting this fee for transactions in SPDR options to defray the licensing costs. The Exchange believes that charging the participants that trade these instruments is the most equitable means of recovering the costs of the license. However, because competitive pressures in the industry have resulted in the waiver of transaction fees for Public Customers,[7] the Exchange proposes to exclude Public Customer Orders[8] from this surcharge fee. Accordingly, this surcharge fee will only be charged to Exchange members with respect to non-Public Customer Orders (*e.g.*, Market Maker and Firm Proprietary orders) and shall apply to Linkage Orders under a pilot program that is set to expire on July 31, 2005.[9]

Additionally, if it is concluded by the courts, after all avenues of appeal, that no license from Standard and Poor's was required by the Exchange to list SPDR options, then upon any refund by Standard and Poor's, the Exchange shall submit a rule filing to the Commission providing for a reimbursement of the surcharge fees paid by members to the Exchange as a result of this surcharge fee.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 6(b) of the Act[10] in general, and furthers the objectives of section 6(b)(4)

[16] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] In Amendment No. 1, the Exchange made non-substantive changes to clarify the purpose for the fee change. The effective date of the original proposed rule change is May 20, 2005, and the effective date of Amendment No. 1 is June 15, 2005. For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change, as amended, under Section 19(b)(3)(C) of the Act, the Commission considers the period to commence on June 15, 2005, the date on which the Exchange submitted Amendment No. 1. *See* 15 U.S.C. 78s(b)(3)(C).

[4] 15 U.S.C. 78s(b)(3)(A).

[5] 5 17 CFR 240.19b–4(f)(2).

[6] The Exchange represents that these fees will be charged only to Exchange members.

[7] Public Customer is defined in ISE Rule 100(a)(32) as a person that is not a broker or dealer in securities.

[8] Public Customer Order is defined in ISE Rule 100(a)(33) as an order for the account of a Public Customer.

[9] *See* ISE Rule 1900(10) (defining Linkage Orders). The surcharge fee will apply to the following Linkage Orders: Principal Acting as Agent Orders and Principal Orders.

[10] 15 U.S.C. 78f(b).