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All submissions should refer to the File No. SR-Amex-2004-12 and should be submitted by April 2, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>6</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49373; File No. SR-FICC-2003-09]

### Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change to Establish a Comprehensive Standard of Care and Limit the Mortgage-Backed Securities Division's Liability to its Participants

March 8, 2004.

#### I. Introduction

On August 19, 2003, the Fixed Income Clearing Corporation ("FICC")<sup>1</sup> filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2003-09 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>2</sup> Notice of the proposal was published in the **Federal Register** on January 15, 2004.<sup>3</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

#### II. Description

FICC is establishing a comprehensive standard of care and limitation of liability for the participants of MBSD that is identical to that of FICC's Government Securities Division

("GSD").<sup>4</sup> Historically, the Commission has left to user-governed clearing agencies the question of how to allocate losses associated with, among other things, clearing agency functions.<sup>5</sup> In past considerations, the Commission has reviewed clearing agency services on a case-by-case basis and in determining the appropriate standard of care has balanced the need for a high degree of clearing agency care with the effect the resulting liabilities may have on a clearing agency's operations, costs, and ability to safekeep securities and funds.<sup>6</sup> Because standards of care limitations of liability represent an allocation of rights and liabilities between a clearing agency and its participants, which are generally sophisticated financial entities, the Commission has refrained from establishing a unique federal standard of care and has allowed clearing agencies and other self-regulatory organizations and their participants to establish their own standard of care.<sup>7</sup>

MBSD rules already provide for a standard of care similar to that now provided for in the GSD rules. The proposed rule changes make the MBSD standard of care provision in its rules identical to the provision in GSD's rules. Thus, in addition to being responsible to participants for gross negligence and willful misconduct, MBSD will be liable for direct losses caused by its violation of Federal securities laws for which there is a private right of action. MBSD will not be liable for the acts or omissions of third parties unless MBSD was grossly negligent, engaged in willful misconduct, or in violation of Federal securities laws for which there is a private right of action in selecting such third party. Moreover, MBSD will be relieved of any liability for consequential and other indirect damages. By making these changes to MBSD rules, both GSD and MBSD rules will be identical, lending consistency to FICC's approach to these issues.

FICC believes that adopting a uniform rule<sup>8</sup> limiting MBSD's liability to its

participants to direct losses caused by MBSD's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action: (a) Memorializes an appropriate commercial standard of care that will protect MBSD from undue liability; (b) permits the resources of MBSD to be appropriately utilized for promoting the accurate clearance and settlement of securities; and (c) is consistent with similar rules adopted by other self-regulatory organizations and approved by the Commission.<sup>9</sup>

#### III. Discussion

Section 19(b) of the Act directs the Commission to approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to such organization. Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to promote the prompt and accurate clearance and settlement of securities transactions.<sup>10</sup> The Commission believes that approval of FICC's rule change is consistent with this Section because it will permit the resources of MBSD to be appropriately utilized for promoting the prompt and accurate clearance and settlement of securities.

Although the Act does not specify the standard of care that must be exercised by registered clearing agencies, the Commission has determined that a gross negligence standard of care is acceptable for noncustodial functions where a

action, hereunder or otherwise to fulfill the Corporation's obligations to its Participants [EPN users and Participants], other than for losses caused directly by the Corporation's gross negligence, willful misconduct, or violation of Federal securities laws for which there is a private right of action. Under no circumstances will the Corporation 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 Corporation was grossly negligent, engaged in willful misconduct, or in violation of Federal securities laws for which there is a private right of action in selecting such Third Party; and

(b) Under no circumstances will the Corporation 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 Corporation has been advised of the possibility of such damages or whether such damages otherwise could have been foreseen or prevented.

<sup>9</sup> See, e.g., Securities Exchange Act Release Nos. 37421 (July 11, 1996), 61 FR 37513 [SR-CBOE-96-02] and 37563 (August 14, 1996), 61 FR 43285 [SR-PSE-96-21].

<sup>10</sup> 15 U.S.C. 78q-1(b)(3)(F).

<sup>6</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> On January 1, 2003, MBS Clearing Corporation ("MBSCC") was merged into the Government Securities Clearing Corporation ("GSCC"), and GSCC was renamed the Fixed Income Clearing Corporation ("FICC"). The functions previously performed by GSCC are now performed by the Government Securities Division ("GSD") of FICC, and the functions previously performed by MBSCC are now performed by the Mortgage-Backed Securities Division ("MBSD") of FICC. Securities Exchange Act Release No. 47015 (December 17, 2002), 67 FR 78531 [File Nos. SR-GSCC-2002-09 and SR-MBSCC-2002-01].

<sup>2</sup> 15 U.S.C. 78s(b)(1).

<sup>3</sup> Securities Exchange Act Release No. 49048 (January 9, 2004), 69 FR 2375.

<sup>4</sup> The Commission has approved identical rule language for GSD establishing a comprehensive standard of care and limitation of liability to its members. Securities Exchange Act Release No. 48201 (July 21, 2003), 68 FR 44128 [File No. SR-GSCC-2002-10].

<sup>5</sup> Securities Exchange Act Release Nos. 20221 (September 23, 1983), 48 FR 45167 and 22940 (February 24, 1986), 51 FR 7169.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> MBSD Clearing Rules Article V, Rule 6, Sections 1(a) and (b) and MBSD EPN Rulebook Article X, Rule 6, Sections 1(a) and (b) now read as follows:

(a) The Corporation will not be liable for any action taken, or any delay or failure to take any

clearing agency and its participants contractually agree to limit the liability of the clearing agency.<sup>11</sup> MBSD's functions are noncustodial in that it does not hold its participants' funds or securities. It is reasonable for MBSD, which is participant-owned and governed, and its participants to agree through board approval of the proposed rule change and to contract with one another in a cooperative arrangement as to how to allocate MBSD's liability among MBSD and its participants. Therefore, the Commission has determined that given the noncustodial nature of MBSD's services, a gross negligence standard of care and limitation of liability is allowable for MBSD.<sup>12</sup>

<sup>11</sup> In the release setting forth standards to be used by the Division of Market Regulation in evaluating clearing agency registration applications, the Division of Market Regulation urged clearing agencies to embrace a strict standard of care in safeguarding participants' funds and securities. Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 4192. In the release granting permanent registration to The Depository Trust Company, the National Securities Clearing Corporation, and several other clearing agencies, however, the Commission indicated that it did not believe that sufficient justification existed at that time to require a unique federal standard of care for registered clearing agencies. Securities Exchange Act Release No. 20221 (October 3, 1983), 48 FR 45167. In a subsequent release, the Commission stated that the clearing agency standard of care and the allocation of rights and liabilities between a clearing agency and its participants applicable to clearing agency services generally may be set by the clearing agency and its participants. In the same release, the Commission stated that it should review clearing agency proposed rule changes in this area on a case-by-case basis and balance the need for a high degree of clearing agency care with the effect resulting liabilities may have on clearing agency operations, costs, and safeguarding of securities and funds. Securities Exchange Act Release No. 22940 (February 24, 1986), 51 FR 7169. Subsequently, in a release granting temporary registration as a clearing agency to The Intermarket Clearing Corporation, the Commission stated that a gross negligence standard of care may be appropriate for certain noncustodial functions that, consistent with minimizing risk mutualization, a clearing agency, its board of directors, and its members determine to allocate to individual service users. Securities Exchange Act Release No. 26154 (October 3, 1988), 53 FR 39556. Finally, in a release granting the approval of temporary registration as a clearing agency to the International Securities Clearing Corporation, the Commission indicated that historically it has left to user-governed clearing agencies the question of how to allocate losses associated with noncustodial, data processing, clearing agency functions and has approved clearing agency services embodying a gross-negligence standard of care. Securities Exchange Act Release No. 26812 (May 12, 1989), 54 FR 21691.

<sup>12</sup> The Commission notes that the rule change does not alleviate MBSD from liability for violation of the Federal securities laws where there exists a private right of action and therefore is not designed to adversely affect MBSD's compliance with the Federal securities laws and private rights of action that exist for violations of the Federal securities laws.

The Commission's approval of FICC's proposed rule change establishing a comprehensive standard

#### IV. Conclusion

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

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR-FICC-2003-09) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-49372; File No. SR-FICC-2003-08]

#### Self-Regulatory Organizations; Fixed Income Clearing Corporation; Order Approving Proposed Rule Change To Add Adjustable-Rate Mortgage Pass-Through Securities to the GCF Repo Service Repurchase Service

March 5, 2004.

#### I. Introduction

On August 11, 2003, the Fixed Income Clearing Corporation ("FICC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR-FICC-2003-08 pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").<sup>1</sup> Notice of the proposal was published in the **Federal Register** on January 28, 2004.<sup>2</sup> No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

of care and limiting MBSD's liability to its participants does not limit the standard of care required of MBSD by Rule 17f-4 of the Investment Company Act of 1940 and the Division of Investment Management's no-action letter to FICC deeming MBSD to be an eligible fund custodian under Rule 17f-4. Rule 17f-4 and the Division of Investment Management's no-action letter require MBSD to exercise, at a minimum, due care in accordance with reasonable commercial standards in discharging its duties as a securities intermediary. Fixed Income Clearing Corporation (March 13, 2003).

A negligence standard of care continues to be required for custodial clearing agency functions.

<sup>13</sup> 17 CFR 200.30-3(a)(12).

<sup>15</sup> U.S.C. 78s(b)(1).

<sup>2</sup> Securities Exchange Act Release No. 49113 (January 22, 2004), 69 FR 4193.

#### II. Description

FICC is adding adjustable-rate mortgage pass-through securities ("ARMS")<sup>3</sup> to the GCF Repo service.<sup>4</sup> The Government Securities Division ("GSD") of FICC currently accepts Fannie Mae ("FNMA"), Freddie Mac ("FHLMC"), and Ginnie Mae ("GNMA") fixed-rate mortgage pass-through securities ("FRMs") as repurchase agreement collateral in its GCF Repo service. The GSD is adding ARMS to the GCF Repo service and amending the GSD Rules to include the appropriate schedules of margin factors, offset classes, and disallowances as they pertain to ARMS.<sup>5</sup>

The GSD believes that ARMS make a logical addition to the categories of securities currently processed in the GCF Repo service for several reasons. ARMS are generally less risky to FICC and investors than FRMs due to their rate reset feature and faster prepayment rates. Both of these factors contribute to shorter effective duration and price fluctuations that results in lower margin factors as compared to FRMs. In addition, the correlation factors between ARMS and Treasuries are generally higher than those between FRMs and Treasuries because the adjustable rate mortgage pass-through securities reflect more of the current rate conditions than the fixed rate mortgage pass-through securities. Thus, the disallowance factors of ARMS versus Treasuries are smaller than those of FRMs versus Treasuries.

#### III. Discussion

Section 17A(b)(3)(F) of the Act requires that the rules of a clearing agency be designed to perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions.<sup>6</sup> The Commission finds that FICC's proposed rule change is consistent with this requirement because it will promote the prompt and accurate clearance and settlement of securities transactions by enabling the GSD to provide the benefits of its netting, risk management, and

<sup>3</sup> ARMS are mortgage loans in which the contract rates are reset periodically at a predetermined spread (or margin) over a specified reference index (such as the one-year Constance Maturity Treasury or 6 month LIBOR).

<sup>4</sup> The GSD's GCF Repo service enables dealer members to freely and actively transact GCF Repos throughout the day without requiring intraday, trade-for-trade settlement on a delivery-versus-payment basis.

<sup>5</sup> The GSD is also proposing to make technical corrections to the relevant schedules to remove references to "GSCC" or to replace them with references to the Government Securities Division as appropriate.

<sup>6</sup> 15 U.S.C. 78q-1(b)(3)(F).