

Reimbursement Obligation"). This means that should a clearing organization become obligated to pay the Maximization Payment, it may rely on the defaulting member's collateral to do so.<sup>7</sup>

A provision has been added to the New FICC-CME Agreement to take into account that a regulator or other entity having supervisory authority over FICC or CME may for safety and soundness purposes direct the clearing organization not to liquidate a defaulting member or to partially liquidate such member. In order to prevent the affected clearing organization from being penalized under the agreement for failing to liquidate or partially liquidating the member in this type of situation, the last two paragraphs of section 7(d) of the New FICC-CME Agreement will provide that the affected clearing organization would be deemed to have a cross-margin gain equal to the base amount of the guaranty (*i.e.*, cross-margining reduction) or a pro rated amount of the base amount of the guaranty in a partial liquidation scenario.

A sentence has been added to section 7(h) making clear that the clearing organizations have security interests in the "Aggregate Net Surplus," a large component of which would be the collateral and proceeds of positions of a defaulting member, as security for any reimbursement obligation including any maximization reimbursement obligation that may arise on the part of a defaulting member.

Language has been added to the cross-margining participant agreements in Appendices D and E in order to further protect the clearing organizations by making clear that the clearing organizations have a security interest in the Aggregate Net Surplus and that a participant will have a reimbursement obligation in the event that a clearing organization becomes obligated to make a maximization payment. Participants in the current arrangement between FICC and CME and those in the arrangement between FICC and BOTCC to the extent they are not the same are being asked to reexecute the revised participant

agreements in order to make them subject to the provisions of the New FICC-CME Agreement.<sup>8</sup>

### 3. Key Proposed Changes to FICC's Cross-Margining of CBOT Products

Because FICC is currently cross-margining its products with certain CBOT products pursuant to its agreement with BOTCC and because these CBOT products will be cross-margining pursuant to the proposed New FICC-CME Agreement if the proposed rule change is approved by the Commission, it is important to note the key differences between the cross-margining of the CBOT products under the existing arrangement with BOTCC and under the proposed new arrangement with the CME.

The minimum margin factor under FICC's cross-margining arrangement with BOTCC is 50 percent. FICC and CME have agreed to a minimum margin factor of 25 percent to apply to the cross-margining of CBOT products versus FICC products. This is the same minimum margin factor as is used in the current cross-margining arrangement with the CME with respect to the eligible Eurodollar products and is the same minimum margin factor used in the arrangement with BCC.

The New FICC-CME Agreement provides for inter-offset class cross-margining whereas the BOTCC arrangement is limited to intra-offset class cross-margining. The new agreement is consistent with the approach in the existing arrangements between FICC and both CME and BCC.

The current agreement between FICC and CME provides that in order to determine the gain or loss from the liquidation of the positions that were cross-margining resulting from a default of a member, only the proceeds from the side of the market that was offset pursuant to the agreement at the last margin cycle are considered. In the New FICC-CME Agreement, this approach will be extended to the CBOT products in order to provide consistency in the liquidation methods.

4. Amendments 1, 2, and 3 to the FICC-BCC cross-margining agreement

FICC is proposing to amend its cross-margining agreement with BCC<sup>9</sup> with Amendment 3 to the agreement. Amendment 3 will (i) add FICC's GCF Repo Treasury and non-mortgage-backed Agency products to the arrangement, (ii) add FICC's non-mortgage-backed Agency offset classes e and f, and (iii) amend the contingency procedures between the clearing organizations (contained in Appendix I of the agreement) to provide that FICC will not wait past 12 a.m. Eastern time for the BCC cross-margining file in order to run its cross-margining system. With respect to (ii), FICC has determined that even though BCC does not currently clear non-mortgage-backed Agency futures, the parties can still cross-margin FICC's Agency products against BCC's Treasury products given that the agreement provides for inter-offset class cross-margining using the appropriate correlation factors. With respect to (iii), the operational procedures provide that FICC will wait until 3 a.m. Eastern time for the BCC file which is the same cut-off time for all of its other cross-margining partners. However, FICC has determined that the 3 a.m. Eastern time cut-off, which is significantly later than the GSD's normal cross-margining processing time, should only be used for extreme situations where not including a particular file would be disruptive to members. Currently, this would not be anticipated to be the case for a BCC file because of BCC's files relatively low historical impact.<sup>10</sup> Therefore, FICC has determined that it would be more prudent from a risk management perspective to adopt a cut-off time of 12 a.m. Eastern time for receipt of BCC files.

As part of this proposed rule change filing, FICC would like to include Amendments 1 and 2 that were previously made with respect to its existing cross-margining agreement with BCC. The purpose of Amendment 1 was to update the list of products being cross-margining. The purposes of Amendment 2 were to remove

<sup>7</sup> The new guaranty provisions with respect to the Maximization Payment Guaranty will be identical to the ones in the current cross-margining agreement between FICC and BCC. In order to protect the clearing organizations in the event that a court determines that any amount of a Maximization Reimbursement Obligation may not be recovered by the clearing organization that made a Maximization Payment pursuant to a Maximization Payment Guaranty, a provision has been added (Section 8C(c)) to the New FICC-CME Agreement to provide that the payee clearing organization will be expected to return that amount. This protective provision is also in the BCC cross-margining agreement.

<sup>8</sup> Cross-margining is available to any FICC GSD netting member (with the exception of inter-dealer broker netting members) that is, or that has an affiliate that is, a member of a Participating CO. The FICC member (and its affiliate, if applicable) sign an agreement under which it (or they) agree to be bound by the cross-margining agreement between FICC and the Participating CO and which allows FICC or the Participating CO to apply the member's (or its affiliate's) margin collateral to satisfy any obligation of FICC to the Participating CO (or vice versa) that results from a default of the member (or its affiliate). Ownership of 50 percent or more of the common stock of an entity indicates control of the entity for purposes of the definition of "affiliate."

<sup>9</sup> Securities Exchange Act Release No. 45656 (March 27, 2002), 67 FR 15646 (April 2, 2002) [File No. SR-GSCC-2002-01].

<sup>10</sup> The operational and contingency procedures contained in the FICC-BCC agreement provide that in the event FICC does not receive BCC's file by the cut-off time, FICC will calculate the applicable cross-margining reductions assuming that BCC submitted a file with no positions available for cross-margining which may result in margin calls for the affected participants by both FICC and BCC. These margin calls would not be disruptive to members because the cross-margining reductions in the program with the BCC are not anticipated to be large amounts.