

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AC15

Investment of Customer Funds and Record of Investments

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission”) is amending its regulations regarding investment of customer funds and related recordkeeping requirements. The amendments address standards for investing in instruments with certain features, requirements for adjustable rate securities, concentration limits on reverse repurchase agreements (“reverse repos”), transactions by futures commission merchants (“FCMs”) that are also registered as securities broker-dealers (“FCM/BDs”), rating standards and registration requirement for money market mutual funds (“MMMFs”), the auditability standard for investment records, and certain technical changes. Among those technical changes is an amendment to the Commission’s recordkeeping rules in connection with repurchase agreements (“repos”) and proposed transactions by FCM/BDs.

EFFECTIVE DATE: [date 30 days from date of publication in Federal Register].

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SUPPLEMENTARY INFORMATION:

I. Background

Commission Rule 1.25 (17 CFR 1.25) sets forth the types of instruments in which FCMs and derivatives clearing organizations (“DCOs”) are permitted to invest customer assets that are required to be segregated under the Commodity Exchange Act (“Act”).¹ Rule 1.25 was substantially amended in December 2000 to expand the list of permitted investments beyond the Treasury and municipal securities that are expressly permitted by the Act.² In connection with that expansion, the Commission added several provisions intended to control exposure to credit, liquidity, and market risks associated with the additional investments.

On June 30, 2003, the Commission published for public comment proposed amendments to two provisions of Rule 1.25, and it further requested comment (without

¹ Section 4d(a)(2) of the Act, 7 U.S.C. 6d(a)(2), requires segregation of customer funds. It provides, in relevant part, that customer-deposited “money, securities, and property shall be separately accounted for and shall not be commingled with the funds of [the FCM] or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held.”

² See 65 FR 77993 (Dec. 13, 2000) (publishing final rules); and 65 FR 82270 (Dec. 28, 2000) (making technical corrections and accelerating effective date of final rules from February 12, 2001 to December 28, 2000).

proposing specific amendments) on several other provisions of the rule.³ In February 2004, the Commission adopted final rule amendments regarding repos with customer-deposited securities and modified time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs.⁴ The Commission did not, however, take any action on the other matters raised in its June 30, 2003 release.

On February 3, 2005, the Commission published for public comment proposed rule amendments related to the remaining issues raised in its June 30, 2003 request for comment. The Commission also solicited comment on additional proposed amendments to Rule 1.25 and Rule 1.27, including certain technical amendments.⁵

The Commission received comment letters from the Chicago Mercantile Exchange (“CME”), Joint Audit Committee (“JAC”), Futures Industry Association (“FIA”), National Futures Association (“NFA”), and Goodwin Proctor LLC, on behalf of Federated Investors, Inc. (“Federated”).⁶ In general, the comments supported the Commission’s efforts to expand the list of permitted investments for customer funds. In addition, each comment letter specifically addressed one or more of the following four topics: instruments with certain features, permitted benchmarks for adjustable rate securities, the auditability standard for investment records, and elimination of rating requirements for money market mutual funds. These comments will be discussed below in connection with each topic.

Taking into consideration the comments received, the Commission has determined to adopt amendments to Rule 1.25 and Rule 1.27, as proposed, with two exceptions. First, the

³ 68 FR 38654 (June 30, 2003).

⁴ 69 FR 6140 (Feb. 10, 2004).

⁵ The proposed amendments to Rule 1.27 dealt with issues related to changes in Rule 1.25.

⁶ These letters are available in the comment file accompanying the February 3, 2005 release, at <www.cftc.gov>.

Commission is modifying its revisions to Rule 1.25(b)(3)(iv) regarding permitted benchmarks for adjustable rate securities.⁷ Second, the Commission is modifying the language of the new auditability standard established under Rule 1.27(a)(8).⁸

The final rules, discussed in section II.A. through G. of this release, relate to standards for investing in instruments with certain features, permitted benchmarks for adjustable rate securities, concentration limits on reverse repos, permitted transactions (“in-house transactions”) by FCM/BDs,⁹ elimination of the rating requirement for MMMFs, required registration for MMMFs under Securities and Exchange Commission (“SEC”) Rule 2a-7, and an auditability standard for investment records.

Certain technical amendments to Rule 1.25 and Rule 1.27 are discussed in Section II.H. of this release. Those amendments clarify the following: (1) the next-day redemption requirement for MMMFs (also codifying previously published exceptions to that requirement); (2) the rating standards for certificates of deposit; (3) the permissibility of investing in corporate bonds; (4) the inapplicability of segregation rules to securities transferred pursuant to a repo; (5) payment and delivery procedures for repos and reverse repos; and (6) the distinction between investment of customer money and investment of customer-deposited securities. The Commission is also adopting technical amendments to conform references to applicable marketability standards, update and conform the terminology referring to a DCO, conform the terminology referring to a government sponsored enterprise (“GSE”), conform the terminology referring to an FCM, and clarify the meaning of the term “NRSRO.”

⁷ See section II.B.2. of this release.

⁸ See section II.G. of this release.

⁹ In connection with this amendment, the Commission is also adopting technical amendments to Rule 1.27 to clarify the recordkeeping requirements applicable to repos and in-house transactions by FCM/BDs.

II. Discussion of the Final Rules

A. Instruments with Certain Features

As originally adopted in 2000, Rule 1.25(b)(3)(i) expressly prohibited investment of customer funds in instruments with any embedded derivatives. At the request of market participants, in June 2003, the Commission requested comment on whether instruments with certain features should be permitted, notwithstanding the general prohibition of Rule 1.25(b)(3)(i). After considering the formal comments submitted by the FIA, as well as additional information provided during discussions with FIA representatives, the Commission proposed to amend Rule 1.25(b)(3)(i) to permit FCMs and DCOs to invest customer money in instruments with certain features, subject to certain express standards.

Proposed paragraph (b)(3)(i)(A) would permit an instrument to have a call feature, in whole or in part, at par, on the principal amount of the instrument before its stated maturity date. Proposed paragraph (b)(3)(i)(B) would permit caps, floors, or collars on the interest paid pursuant to the terms of an adjustable rate instrument. Proposed paragraph (b)(3)(i) would further provide that the terms of the instrument must obligate the issuer to fully repay the principal amount of the instrument at not less than par value, upon maturity.

The Commission received three comment letters discussing these proposed amendments. In its comment letter, the CME stated that, as a clearinghouse, it would have to determine whether to accept as performance bond permitted instruments that “are illiquid or pose operational or risk management challenges to the clearing organization,” listing as possible examples securities with embedded derivatives, variable rate securities, auction rate securities,

and reverse repos.¹⁰ The CME did not specifically identify any operational or risk management challenges presented by instruments with the two types of features described in the request for comment.

In addition, the CME expressed concern about the ability of certain FCMs to adequately evaluate and manage investments in instruments with embedded derivatives generally, noting certain “complexities associated with evaluating [such] instruments.”¹¹ The CME did not, however, identify any particular complexities associated with instruments with the two types of features described in the request for comment. The CME also noted that “if [it] is to accept instruments with embedded derivatives or auction rate securities, CME will continue to exercise its discretion and judgment to design a program that accepts and values these instruments in a manner that CME believes will ensure the safety and soundness of the customers and firms that use our markets.”¹²

The JAC agreed with the CME, stating “we share the concern expressed by the [CME] in its comment letter that certain FCMs may not have the tools and systems needed to understand the risks and implications of the instruments they will be permitted to invest in.”¹³ As with the CME, however, the JAC comments appeared to refer to instruments with embedded derivatives generally and did not identify any particular risks or challenges presented by instruments with call features or adjustable rate instruments with caps, floors, or collars on their interest payments.

¹⁰ See letter from Craig S. Donohue, Chief Executive Officer, CME, dated March 7, 2005 (“CME Letter”) at 2.

¹¹ Id.

¹² Id.

¹³ See letter from Joseph D. Sanguedolce, Chairman, JAC, dated March 7, 2005 (“JAC Letter”) at 2.

The FIA, in its comment letter, specifically responded to the CME's comment letter. It disagreed with the CME, stating that "we do not believe that the instruments authorized under the proposed rule will pose particular operational or risk management challenges."¹⁴ In support of its view, the FIA pointed to the Commission's requirements for instruments with embedded derivatives, adding that "securities with embedded derivatives often have similar or lower levels of risk than fixed-rate securities in which FCMs are currently authorized to invest under rule 1.25."¹⁵

With respect to the CME's concern that instruments with embedded derivatives might not be appropriate investments for all FCMs, the FIA stated that it did not anticipate that every FCM would want to take advantage of the added investment opportunities provided by the proposed amendments. The FIA further noted that "FCMs can obtain the necessary tools and systems to monitor compliance with rule 1.25 from third party providers and, therefore, will not necessarily have to incur the significant costs."¹⁶

The Commission has carefully considered the comment letters and has decided to adopt the amendments as proposed. The Commission believes that the final rules establish prudential standards by limiting the number and scope of acceptable features to call features and caps, floors, or collars on interest paid, as described above. The limitations imposed by paragraph (b)(3)(i), in combination with the other risk-limiting standards imposed by Rule 1.25, create an appropriate framework for protecting principal and maintaining an acceptable level of risk. Moreover, the Commission has not received any data that suggests that the price transparency of an instrument is reduced when it provides for a call feature or a cap, floor, or collar on interest paid.

¹⁴ See letter from John. M. Damgard, President, FIA, dated March 7, 2005 ("FIA Letter") at 3.

¹⁵ Id.

¹⁶ Id. at 4, FN 6.

As noted in the Commission's discussion of the proposed rules, the issuer's right to call an instrument prior to maturity does not jeopardize the principal amount, but merely accelerates the maturity of the instrument. Because the issuer of a callable instrument typically offers a higher return to investors in return for the right to call the issue if prevailing interest rates fall, or for other reasons, a callable instrument can afford its holders the opportunity to achieve a higher yield without exposing themselves to greater credit risk by seeking higher yields from other issuers that may be less creditworthy. Similarly, instruments with a cap, floor, or collar on the interest paid do not jeopardize the principal amount payable at maturity. The Commission further notes that the rules require that the terms of the instrument must obligate the issuer to fully repay the principal amount of the instrument at not less than par value, upon maturity.

The Commission agrees with the CME that DCOs have a duty to exercise discretion in determining what forms of collateral should be accepted at the clearinghouse level and how that collateral should be valued. DCOs perform an important risk management function and the Commission supports their efforts to exercise their judgment in maintaining high standards for risk management.

The Commission expects that FCMs will carefully evaluate the appropriateness of each permitted investment in terms of its investment objectives and compliance with the time-to-maturity, concentration limits, and other requirements of Rule 1.25.

DSROs also have a role to play in that they are responsible for seeing that adequate internal controls, risk management policies and practices, and other compliance procedures are adopted and followed by FCMs. The Commission considers a DSRO's examination of an FCM's investments of customer funds to be a critical part of the supervisory framework and notes that the

Joint Audit Program utilized by the DSROs in examining member FCMs contains a module specifically addressing Rule 1.25 compliance.

The Commission did not receive any comments on its proposed technical amendment to expressly prohibit investing in any instrument that, itself, constitutes a derivative instrument. Accordingly, the Commission is amending paragraph (b)(3)(iii), as proposed, to provide that “No instrument may provide payments linked to a commodity, currency, reference instrument, index, or benchmark except as provided in paragraph (b)(3)(iv) of this section, and it may not otherwise constitute a derivative instrument.”

B. Adjustable Rate Securities

Rule 1.25(b)(3)(iv) permits investment in “variable-rate securities,” provided that the interest rates thereon correlate closely and on an unleveraged basis to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, or the one-month or three-month LIBOR rate. In its June 30, 2003 release, the Commission requested comment on whether the provision on permitted benchmarks should be amended and, if so, what the applicable standard should be.

The FIA submitted a comment letter recommending that the Commission expand the list of permitted benchmarks to include any fixed rate instrument that is a “permitted investment” under the rule. The FIA reasoned that, if an FCM is authorized to purchase a fixed rate instrument, e.g., a six-month Treasury bill, and continuously roll that instrument over, then it should be able to purchase an instrument benchmarked to that fixed rate security.

After considering the FIA’s recommendation, the Commission proposed several amendments to paragraph (b)(3)(iv) for the purpose of refining its regulatory approach to variable rate securities, as well as responding specifically to the FIA’s comment.

1. Revised Terminology

As a preliminary matter, the Commission proposed to distinguish between a “floating rate security” and a “variable rate security.” A floating rate security, under proposed new paragraph (b)(3)(iv)(B)(2), would be defined as “a security, the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.” A variable rate security, under proposed new paragraph (b)(3)(iv)(B)(3), would be defined as “a security, the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.” The term “adjustable rate security” would refer to either or both of the foregoing, under proposed new paragraph (b)(3)(iv)(B)(1).

The definitions of floating rate security and variable rate security are the same as those contained in SEC Rule 2a-7,¹⁷ and their use is consistent with the Rule 1.25(b)(5) time-to-maturity provision.¹⁸ The introduction of these terms is intended to clarify, not change, the meaning of paragraph (b)(3)(iv).

The Commission did not receive any comments on these proposed changes in terminology and the Commission is adopting new paragraphs (b)(3)(iv)(B)(1), (2) and (3), as proposed.

¹⁷ See Rule 2a-7(a)(13), 17 CFR 270.2a-7(a)(13) (floating rate security); and SEC Rule 2a-7(a)(29), 17 CFR 270.2a-7(a)(29) (variable rate security).

¹⁸ Under Rule 1.25(b)(5), the portfolio time-to-maturity calculation is computed pursuant to SEC Rule 2a-7.

2. Permitted Benchmarks

As noted above, the FIA recommended that Rule 1.25(b)(3)(iv) be amended to provide that permissible benchmarks can include any fixed rate instrument that is a “permitted investment” under the rule. The Commission agrees that it is appropriate to afford greater latitude in establishing benchmarks for permitted investments, thereby enabling FCMs and DCOs to more readily respond to changes in the market. In its February 3, 2005 release, the Commission proposed new paragraph (b)(3)(iv)(A)(2) which would provide that, in addition to the benchmarks already enumerated in the rule, floating rate securities could be benchmarked to rates on any fixed rate instruments that are “permitted investments” under Rule 1.25(a). The Commission did not, however, expand the list of permitted benchmarks for variable rate securities.

In its March 2005 comment letter, the FIA requested that the Commission expand the list of permitted benchmarks for all adjustable rate securities, stating that “we see no reason why the permitted benchmarks for variable rate securities cannot be identical to the expanded list of permitted benchmarks for floating rate securities.”¹⁹

Similarly, the NFA encouraged the Commission to expand the permitted benchmarks for both floating rate and variable rate securities.²⁰

The Commission has considered the practical implications of limiting the permitted benchmarks as originally proposed, and it has decided to expand the list of permitted benchmarks to include the same reference instruments for both floating rate and variable rate securities. As a result, the Commission is adopting a revised paragraph (b)(3)(iv)(A)(1) to

¹⁹ See FIA Letter at 2.

²⁰ See letter from Thomas W. Sexton, III, Vice President and General Counsel, NFA, dated March 7, 2005 (“NFA Letter”) at 1.

provide that “the interest payments on variable rate securities must correlate closely and on an unleveraged basis to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, the one-month or three-month LIBOR rate, or the interest rate of any fixed rate instrument that is a permitted investment listed in paragraph (a)(1) of this section.” The Commission is adopting, as proposed, new paragraph (b)(3)(iv)(A)(2), which relates to permitted benchmarks for floating rate securities.

3. Supplemental Requirements

The Commission proposed to further amend paragraph (b)(3)(iv) by adding two supplemental requirements that it believes are prudent and necessary in light of the increasing number and complexity of adjustable rate securities that could qualify as permitted investments. Under proposed paragraph (b)(3)(iv)(A)(3), any benchmark rate would have to be expressed in the same currency as the adjustable rate security referencing it. This eliminates the need to calculate and account for changes in applicable currency exchange rates. Under proposed paragraph (b)(3)(iv)(A)(4), the periodic coupon payments could not be a negative amount. This is designed to prevent FCMs and DCOs from investing in instruments that the Commission believes do not reflect an acceptable level of risk.

The Commission did not receive any comments on these proposed new provisions and they are being adopted, as proposed.

C. Reverse Repos--Concentration Limits

Rule 1.25(b)(4)(iii) establishes concentration limits for reverse repos.²¹ These restrictions, which were adopted in response to public comment, as expressed at that time, take into consideration the identity of both the issuer of the securities and the counterparty to the reverse repo. Consideration as to counterparty was based on the counterparty having direct control over which specific securities would be supplied in a transaction.²² Given industry experience over the past several years, however, it has been brought to the attention of the Commission that the ability of FCMs and DCOs to monitor compliance with this two-prong standard has proven to be operationally unworkable. As a result, in June 2003, the Commission requested comment on market participants' experience with the current provisions relating to reverse repos and suggestions on how best to address the risks of these transactions.

In its February 3, 2005 release, the Commission, responding to an FIA recommendation, proposed to amend paragraph (b)(4)(iii) to make reverse repos subject to the concentration limits for direct investments under Rule 1.25(b)(4)(i). The Commission did not receive any comments addressing this proposed change and it is amending paragraph (b)(4)(iii), as proposed.

D. Transactions by FCM/BDs

In its letter responding to the Commission's June 30, 2003 request for public comment, the FIA proposed adding a new provision to Rule 1.25, which would permit an FCM/BD to engage in transactions that involve the exchange of customer money or customer-deposited securities for securities that are held by the FCM in its capacity as a securities broker-dealer ("in-

²¹ As used in this release, the term "reverse repo" means an agreement under which an FCM or DCO buys a security that is a permitted investment from a qualified counterparty, with a commitment to resell that security to the counterparty at a later date. A "repo" is an agreement under which an FCM or DCO sells a security to a qualified counterparty, with a commitment to repurchase that security at a later date.

²² See 65 FR 77993, 78002 (Dec. 13, 2000).

house transactions”).²³ The FIA proposed specific requirements for in-house transactions, many of which were similar to requirements already applicable to repos and reverse repos under Rule 1.25(d). Lehman Brothers also submitted a comment letter in support of the FIA’s proposal.

In its February 3, 2005 release, the Commission proposed to amend Rule 1.25 by adding new paragraphs (a)(3) and (e) to permit FCM/BDs to engage in in-house transactions subject to specified requirements. The authority granted under paragraph (a)(3) would be subject to the requirements of paragraph (e), which incorporates many of the same restrictions currently imposed on repo and reverse repo transactions under paragraph (d).

In considering issues related to the investment of customer money or securities by an FCM, the Commission’s primary interest is in preserving the integrity of the customer segregated account. This is important both for systemic integrity and customer protection reasons. Not only must there be sufficient value in the account at all times, but the quality of investments must reflect an acceptable level of credit, market, and liquidity risk. In this regard, it is important that non-cash assets can be quickly converted to cash at a predictable value. As stated in its February 3, 2005 release, the Commission believes that the in-house transactions, which can provide the economic equivalent of repos and reverse repos, satisfy these standards. Moreover, the in-house transactions can assist an FCM both in achieving greater capital efficiency and in accomplishing important risk management goals, including internal diversification targets.

The Commission did not receive any comments addressing the proposed amendments regarding in-house transactions, including related technical amendments. Accordingly, the Commission is adopting new paragraphs (a)(3)(i), (a)(3)(ii), (a)(3)(iii), and (e), as proposed, and redesignating existing paragraph (e) as paragraph (f).

²³ After the submission of its comment letter, the FIA requested that the Commission also authorize transactions in which customer-deposited securities are exchanged for cash.

Under paragraph (a)(3)(i), customer money may be exchanged for securities that are permitted investments and are held by an FCM/BD in connection with its securities broker or dealer activities. Under paragraph (a)(3)(ii), securities deposited by customers as margin may be exchanged for securities that are permitted investments and are held by an FCM/BD in connection with its securities broker or dealer activities. Under paragraph (a)(3)(iii), securities deposited by customers as margin may be exchanged for cash that is held by an FCM/BD in connection with its securities broker or dealer activities.

Paragraph (e)(1) requires that the FCM, in connection with its securities broker or dealer activities, must own or have the unqualified right to pledge the securities that are exchanged for customer money or securities held in the customer segregated account. The securities may be held as part of the broker-dealer inventory or may have been deposited with the broker-dealer by its customers.

Paragraph (e)(2) requires that the transaction can be reversed within one business day or upon demand. This is the same standard that currently applies to repos and reverse repos under Rule 1.25(d)(5), with the goal of establishing investment liquidity.

Paragraph (e)(3) incorporates the Rule 1.25(d)(1) requirement that the securities transferred from and to the customer segregated account must be specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.

Paragraph (e)(4) establishes two general requirements for the types of customer-deposited securities that may be used in the in-house transactions. Paragraph (e)(4)(i) requires that the securities be “readily marketable” as defined in SEC Rule 15c3-1.²⁴ Paragraph (e)(4)(ii) requires that the securities not be “specifically identifiable property” as defined in Rule 190.01(kk).

²⁴ 17 CFR 240.15c3-1.

These same requirements apply to customer-deposited securities used in repos under Rule 1.25(a)(2)(ii).

Paragraph (e)(5) establishes requirements for securities that will be transferred to the customer segregated account as a result of the in-house transaction, clarifying the treatment of these securities once they are held in the customer segregated account. Paragraph (e)(5)(i) requires that the securities be priced daily based on the current mark-to-market value. Paragraph (e)(5)(ii) provides that the securities will be subject to the concentration limit requirements applicable to direct investments. Paragraph (e)(5)(iii) provides that the securities transferred to the customer segregated account must be held in a safekeeping account with a bank, a DCO, or the Depository Trust Company in an account that complies with the requirements of Rule 1.26.²⁵ Paragraph (e)(5)(iv) incorporates the Rule 1.25(d)(7) restrictions on the subsequent use of the securities. It provides that the securities may not be used in another similar transaction and may not otherwise be hypothecated or pledged, except such securities may be pledged on behalf of customers at another FCM or a DCO. It further specifies requirements for permitted substitution of securities.

Paragraph (e)(6) sets forth the payment and delivery procedures for in-house transactions. Adapted from Rule 1.25(d)(8), the provisions are designed to ensure that in-house transactions are carried out in a manner that does not jeopardize the adequacy of funds held in the customer segregated account. Paragraph (e)(6)(i) governs transactions under paragraph (a)(3)(i),

²⁵ Note that the Commission has not included in this paragraph the FIA's proposed one-day time-to-maturity treatment for securities transferred to the customer segregated account. Although an in-house transaction could be reversed within one day, the rule would not require that it be reversed within that time frame. Effectively, these instruments would be subject to the same risks associated with the price sensitivity of direct investments and, accordingly, should be subject to the same standards in order to maximize the protection of principal. Special treatment would undermine the purpose of the time-to-maturity requirement.

paragraph (e)(6)(ii) governs transactions under paragraph (a)(3)(ii), and paragraph (e)(6)(iii) governs transactions under paragraph (a)(3)(iii).

Paragraph (e)(7) provides that the FCM must maintain all books and records with respect to the in-house transactions in accordance with Rules 1.25, 1.27, 1.31, and 1.36, as well as the applicable rules and regulations of the SEC. This clarifies the pre-existing obligations of the FCM, and it is adapted from Rule 1.25(d)(10).

Paragraph (e)(8) incorporates the requirements of Rule 1.25(d)(11). It provides that an actual transfer of securities by book entry must be made consistent with Federal or State commercial law, as applicable. Moreover, at all times, securities transferred to the customer segregated account are to be reflected as “customer property.”

Paragraph (e)(9) provides that, for purposes of Rules 1.25, 1.26, 1.27, 1.28 and 1.29, securities transferred to the customer segregated account would be considered to be customer funds until the money or securities for which they were exchanged are transferred back to the customer segregated account. As a result, in the event of the bankruptcy of the FCM, any securities transferred to and held in the customer segregated account as a result of an in-house transaction could be immediately transferred to another FCM. This provision adapts, in part, the provisions set forth in Rule 1.25(d)(12).

Paragraph (e)(10) addresses the failure to return customer-deposited securities to the customer segregated account. Adapted from Rule 1.25(a)(2)(ii)(D), it provides that, in the event the FCM is unable to return to the customer any customer-deposited securities used in an in-house transaction, the FCM must act promptly to ensure that there is no resulting direct or indirect cost or expense to the customer.

The Commission is also adopting, as proposed, two amendments related to in-house transactions. First, the Commission is amending Rule 1.25(b)(4) by adding a new paragraph (iv) to provide that, for purposes of determining compliance with applicable concentration limits, securities transferred to a customer segregated account pursuant to Rule 1.25(a)(3) will be combined with securities held by the FCM as direct investments. In adding this new provision, the Commission is also redesignating existing paragraphs (b)(4)(iv) and (v) as (b)(4)(v) and (vi), respectively.

Second, the Commission is adopting a technical amendment to Rule 1.27 to clarify the applicability of recordkeeping requirements to securities transferred to and from the customer custodial account pursuant to repos and in-house transactions. In this regard, Rule 1.27 provides that each FCM that invests customer funds and each DCO that invests customer funds of its clearing members' customers or option customers must keep a record showing specified information. Among the items to be recorded are the amount of money so invested (paragraph (a)(3)) and the date on which such investments were liquidated or otherwise disposed of and the amount of money received of such disposition, if any (paragraph (a)(6)). The Commission is amending those provisions by adding, after the reference to "amount of money," the phrase "or current market value of securities." This clarifies that amounts recorded must include the value of securities, as well as cash.

E. Rating Standards for MMMFs

Rule 1.25 permits FCMs and DCOs to invest customer funds in MMMFs, subject to certain standards set forth in the rule. Among those standards is the requirement that MMMFs that are rated by a nationally recognized statistical rating organization ("NRSRO") must be rated

at the highest rating of the NRSRO.²⁶ While the rule does not permit investments in lower rated MMMFs, it does not prohibit investments in unrated MMMFs. As a result, a rated MMMF that does not have the highest rating is not acceptable as a permitted investment, but an unrated MMMF is acceptable.²⁷

By letter dated April 8, 2004, Federated Investors, Inc. (“Federated”) requested that the Commission eliminate the rating requirement for MMMFs.²⁸ Federated expressed the view that the rating requirement creates a competitive inequity for lower rated MMMFs that have yield and portfolio characteristics similar to the unrated funds that are commonly used by FCMs for investment of customer funds.

Recognizing the anomalous situation created by the rating requirement, and in light of the risk-limiting standards imposed by SEC Rule 2a-7²⁹ as well as Rule 1.25(c), the Commission proposed to eliminate the rating requirement. Federated submitted a comment letter in which it reiterated its support for the elimination of the rating requirement and, among other things, emphasized the extensive investor protections of SEC Rule 2a-7 that it believes make the Commission’s existing rating requirement for MMMFs unnecessary.³⁰ In this regard, Federated observed that SEC Rule 2a-7 imposes strict portfolio quality, diversification, and maturity

²⁶ See Rule 1.25(b)(2)(i)(E).

²⁷ The Commission notes that a substantial percentage of customer money invested in MMMFs is invested in unrated funds.

²⁸ See letter from Melanie L. Fein, Goodwin Proctor LLP, on behalf of Federated, dated April 8, 2004, available in the comment file accompanying this rulemaking, at <www.cftc.gov>.

²⁹ As discussed in Section II.F. of this release, the Commission is amending Rule 1.25(c)(1) to eliminate the possibility of a fund obtaining an exemption from the SEC Rule 2a-7 registration requirement.

³⁰ See letter from Melanie L. Fein, Goodwin Proctor LLP, on behalf of Federated, dated February 28, 2005.

standards, which greatly limit the possibility of significant deviation between the share price of a fund and its per share net asset value. Additionally, Federated noted that MMMFs are subject to board oversight regarding credit quality requirements and investment procedures. The Commission did not receive any other comments on this topic.

Accordingly, in consideration of the above, the Commission is eliminating the rating requirement for MMMFs, as proposed, by adopting two amendments to Rule 1.25(b)(2)(i). First, it is revising paragraph (b)(2)(i)(A) to read “U.S. government securities and money market mutual funds need not be rated.” Second, it is eliminating the rating requirement for MMMFs contained in paragraph (b)(2)(i)(E).

F. Registration Requirement for MMMFs

Rule 1.25(c)(1) provides that, generally, an MMMF must be an investment company that is registered with the SEC under the Investment Company Act of 1940 and that holds itself out to investors as an MMMF in accordance with SEC Rule 2a-7. Paragraph (c)(1) further provides that an MMMF sponsor may petition the Commission for an exemption from this requirement, and the Commission may grant such an exemption if the MMMF can demonstrate that it will operate in a manner designed to preserve principal and to maintain liquidity. The exemption request must include a description of how the fund’s structure, operations and financial reporting are expected to differ from the requirements in SEC Rule 2a-7 and applicable risk-limiting provisions contained in Rule 1.25. In addition, the MMMF must specify the information that it would make available to the Commission on an on-going basis.

As explained in the February 3, 2005 release, the Commission has received several informal inquiries regarding possible exemption requests. In evaluating these inquiries, Commission staff have explored alternative standards that could be used to ascertain whether an

MMMF will operate in a manner designed to preserve principal and to maintain liquidity and, therefore, could be exempted. As a result of this exercise, it has become apparent that establishing such standards presents substantial practical and policy issues.

For example, from a practical standpoint, granting an exemption would require that the Commission, on a case-by-case basis, review a particular MMMF's risk-limiting policies and procedures and determine that, notwithstanding deviations from the Rule 2a-7 requirements, those policies and procedures will operate to preserve principal and to maintain liquidity. Moreover, if an exemption were granted, Commission staff would have to maintain oversight over the exempt MMMF to ascertain that it continues to operate in accordance with the Commission's standards. The Commission believes that it would be inefficient to devote substantial resources to the exemption process. In addition, the Commission is concerned that this process could produce inconsistent results and give rise to an uncertain framework for regulatory oversight.

From a policy standpoint, the Commission is concerned that by granting an exemption, the Commission may be perceived as expressing a view about the adequacy of an MMMF's overall risk-limiting policies and procedures and, ultimately, upon the investment quality of any particular MMMF. The Commission does not wish to provide, or be perceived as providing, any such assurances to FCMs or DCOs that might be interested in investing customer money in an exempt MMMF.

The Commission did not receive any comments on this proposed action. Accordingly, the Commission is amending paragraph (c)(1) to eliminate the availability of an exemption for unregistered funds. While this removes the possibility of adding certain MMMFs to the pool of qualifying permitted investments, the Commission believes that this potential loss will be

mitigated by the availability of additional MMMF investments as a result of the Commission's decision to eliminate the rating requirement for MMMFs.³¹ As a related matter, the Commission is also adopting a technical amendment that would delete the reference to "a fund exempted in accordance with paragraph (c)(1) of this section" at the end of paragraph (c)(2).

G. Auditability Standard for Investment Records

Rule 1.27 sets forth recordkeeping requirements for FCMs and DCOs in connection with the investment of customer funds under Rule 1.25. More specifically, the rule lists the types of information that an FCM or DCO must retain, subject to the further recordkeeping requirements of Rule 1.31.

The Commission proposed to amend Rule 1.27 by adding a new provision to establish an auditability standard for pricing information related to all instruments acquired through the investment of customer funds. Such a standard is intended to facilitate the maintenance of reliable and readily available valuation information that can be properly audited. This is particularly important with respect to instruments for which historical valuation information may not be retrievable from third party sources at the time of an audit.

The Commission proposed to amend Rule 1.27 by adding a new paragraph (a)(8), to require FCMs and DCOs to maintain supporting documentation of the daily valuation of instruments acquired through the investment of customer funds, including the valuation methodology and third party information. Such supporting documentation would have to be sufficient to enable auditors to verify information to external sources and recalculate the valuation for a given instrument.

³¹ See discussion in Section II.E. of this release.

Several commenters provided particularly noteworthy insights on the issue of auditability standards. While supporting the adoption of a comprehensive auditability standard “given the ever-expanding population of complex investments which may become available,”³² the Joint Audit Committee noted the importance under Generally Accepted Auditing Standards of an auditor’s ability to independently verify valuation documents from third parties provided by an FCM. The JAC also requested guidance regarding the evaluation of internal models that certain FCMs may use to value investments of segregated funds.³³ Finally, the JAC also recommended that the auditability standard impose an obligation on FCMs and DCOs to maintain documentation supporting a particular instrument’s compliance with all criteria set forth in Rule 1.25 for permitted investments.³⁴

In its comment letter, the FIA requested that the Commission, in adopting the final rules, confirm certain views expressed by Commission staff in conversations with FIA representatives. More specifically, the FIA sought clarification that (a) FCMs could rely on their custodian banks to provide valuations for securities that are held in the customer segregated account, and daily records of these valuations would be sufficient to comply with the auditability standard; (b) if an FCM used one or more dealers to value certain securities, the FCM would be required to maintain a record of the dealers used and the prices provided; and (c) if an FCM used internal models to value certain securities, the FCM would be required to maintain a daily record of the prices obtained from such models and, separately, be prepared to explain the models when subject to audit.³⁵

³² See JAC Letter at 2.

³³ Id. at 1.

³⁴ Id. at 2.

³⁵ FIA Letter at 2-3.

The NFA similarly encouraged the Commission “to clarify the proposal’s recordkeeping obligations for FCMs to the extent that the valuation of the investments is performed by custodial banks, dealers and an FCM’s internal models.”³⁶

The proposed auditability standard was stated in broad terms to provide flexibility to FCMs and DSROs in establishing verification procedures for the valuation of instruments, particularly those for which historical valuation information may not be readily available from third party sources at the time of an audit. The Commission declined to propose prescriptive rules based on its belief that the broader standard would afford auditors greater latitude in determining what would be “sufficient” for their purposes. The auditability standard is not intended to be a substitute for properly designed and executed internal controls or proper oversight thereof by an FCM’s DSRO. Rather, it is envisioned as a meaningful addition to the matrix of safeguards that are designed to minimize credit, liquidity and market risk in connection with investments of customer funds.

The Commission has decided to adopt the proposed auditability standard with revised language that is intended to clarify the Commission’s intent. Accordingly, the Commission will add language to refer to “readily available” documentation to emphasize that the documentation must be made available to the auditor in a timely and convenient manner. The standard will provide that “[s]uch supporting documentation must be sufficient to enable auditors to verify the valuations and the accuracy of any information from external sources used in those valuations.”

In response to the requests of the FIA and NFA, the Commission confirms that: (a) FCMs may rely on their custodian banks to provide valuations for securities that are held in the customer segregated account, and daily records of these valuations will be sufficient to comply

³⁶ NFA Letter at 1.

with the auditability standard; (b) if an FCM uses one or more dealers to value certain securities, the FCM must maintain a record of the dealers used and the prices provided; and (c) if an FCM uses internal models to value certain securities, the FCM must maintain a daily record of the prices obtained from such models and, separately, be prepared to explain such models, inputs and assumptions thereto, and internal controls thereover.

The Commission acknowledges the JAC's suggestion that the Commission impose a separate obligation on FCMs and DCOs to maintain documentation that would affirmatively demonstrate the compliance of any investment with the various criteria of Rule 1.25, and it will consider whether to solicit public comment on this issue.

H. Additional Technical Amendments

1. Clarifying and Codifying MMMF Redemption Requirements

The Commission permits FCMs and DCOs to invest customer money in MMMFs in accordance with the standards set forth in Rule 1.25(c). Among those standards is the requirement that the MMMF be able to redeem the interest of the FCM or DCO by the business day following a redemption request. The Commission proposed to amend paragraph (c)(5) to clarify that the MMMF must be legally obligated to redeem the interest and make payment in satisfaction thereof by the business day following the redemption request. In addition, the Commission proposed a further amendment to codify previously articulated exceptions to the next-day redemption requirement.

(a) Next-day Redemption Requirement

In response to inquiries from participants in the futures and mutual fund industries, the Commission proposed to amend paragraph (c)(5) to clarify that next-day redemption and payment is mandatory. To effect this, the Commission proposed to eliminate the language

requiring that the MMMF “must be able to redeem an interest by the next business day following a redemption request” and to substitute in its place a provision that requires the fund to “be legally obligated to redeem an interest and make payment in satisfaction thereof by the business day following a redemption request.” The revised language unambiguously establishes the mandatory nature of the redemption obligation and also clarifies the distinction between redemption (valuation) of MMMF interests and actual payment for those redeemed interests. Thus, the next-day redemption requirement is not met even if an MMMF, as a matter of practice, offers same-day or next-day redemption, if there is no binding obligation to do so.

The second provision of paragraph (c)(5) suggests two ways in which an FCM or DCO may demonstrate compliance with the next-day redemption requirement, *i.e.*, an appropriate provision in the fund’s offering memorandum or a separate side agreement between the fund and the FCM or DCO. In view of the revised articulation of the next-day redemption requirement, the Commission determined that it is not necessary to specify ways in which an FCM or DCO can demonstrate that the requirement has been met. The Commission therefore proposed to eliminate the second provision and to substitute in its place a provision that requires the FCM or DCO to retain documentation demonstrating compliance with the next-day redemption requirement. Such documentation can then be produced for audit purposes.

The Commission did not receive any comments on these changes and it is amending paragraph (c)(5), as proposed. This includes the redesignation of existing paragraph (c)(5), as amended, as paragraph (c)(5)(i).

(b) Exceptions to the Next-day Redemption Requirement

In response to an inquiry from the Board of Trade Clearing Corporation in 2001, the Commission’s Division of Trading and Markets issued a letter stating that it would raise no issue

in connection with MMMFs that provide for certain exceptions to the practice of next-day redemption.³⁷

The letter specifically identified circumstances in which next-day redemption could be excused: (1) non-routine closure of the Fedwire or applicable Federal Reserve Banks; (2) non-routine closure of the New York Stock Exchange or general market conditions leading to a broad restriction of trading on the New York Stock Exchange, i.e., a restriction of trading due to market-wide events; or (3) declaration of a market emergency by the SEC. The letter also included a catch-all provision that included emergency conditions set forth in Section 22(e) of the Investment Company Act of 1940.³⁸

The Commission proposed to codify these exceptions in new paragraph (c)(5)(ii). The Commission recognizes that there is some overlap between the enumerated exceptions and those contained in Section 22(e), but it believes that this is appropriate given the need to provide for all relevant circumstances.

The Commission did not receive any comments on this issue and it is adopting paragraph (c)(5)(ii), as proposed.

2. Clarifying Rating Standards for Certificates of Deposit

Rule 1.25(b)(2)(i)(B) provides that “[m]unicipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes, except notes that are asset-backed, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO.” The Commission notes that certificates of deposit, unlike the other instruments listed in that paragraph, are not directly rated by an NRSRO.

³⁷ See CFTC Staff Letter No. 01-31, [2000 –2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,521 (Apr. 2, 2001).

³⁸ 15 U.S.C. 80a-22(e).

Because NRSRO ratings reflect the financial strength of the issuer of an instrument, they offer a useful standard, among others, for determining whether an instrument can be a permitted investment for customer money. Although certificates of deposit are not rated by NRSROs, it is possible to apply a rating standard by using, as a proxy, the ratings of other instruments issued by the issuers of certificates of deposit. For example, the Commission has previously taken this approach in establishing standards for foreign depository institutions that may hold customer funds. In this regard, Rule 1.49(d)(3)(i) provides that, in order to hold customer funds, a bank or trust company located outside the United States must satisfy either of the following requirements: (1) it must have in excess of \$1 billion of regulatory capital; or (2) the bank or trust company's commercial paper or long-term debt instrument, or if the institution is part of a holding company system, its holding company's commercial paper or long-term debt instrument, must be rated in one of the two highest rating categories by at least one NRSRO.

Consistent with this approach, the Commission believes that it is appropriate to use, as a proxy for a certificate of deposit rating, NRSRO ratings for the commercial paper or long-term debt instrument of the issuer of the certificate of deposit or such issuer's parent holding company. Accordingly, the Commission proposed to delete the reference to certificates of deposit in paragraph (b)(2)(i)(B) of Rule 1.25 and revise paragraph (b)(2)(i)(E) to apply the same standard contained in paragraph (b)(2)(i)(B) to the commercial paper or long-term debt instrument issued by the certificate of deposit issuer or its holding company.

The Commission did not receive any comments on this issue. Accordingly, it is amending paragraph (b)(2)(i)(B) and adding new paragraph (E), as proposed.³⁹

3. Clarifying Corporate Bonds as Permitted Investments

³⁹ Paragraph (b)(2)(i)(E) formerly set forth the rating requirement for MMMFs. See discussion in Section II.E. of this release.

Paragraph (a)(vi) currently uses the term “corporate note,” which may be interpreted by some market participants to mean obligations whose original term to maturity does not exceed five years or perhaps ten years. The Commission proposed to clarify that this terminology should not be read to limit the duration of an instrument. It therefore proposed to amend paragraphs (a)(1)(vi), (b)(2)(i)(B) and (C), and (b)(4)(i)(C) to use the term “corporate notes or bonds.” Rather than constrain the types of permitted investments on the basis of their original term to maturity, the Commission has addressed the issue of the greater price sensitivity of longer-term and fixed rate instruments to changes in prevailing interest rates by adopting the portfolio time-to-maturity requirements of paragraph (b)(5); thus, it is the remaining term to maturity that is relevant.

The Commission did not receive any comments on this issue and it is amending paragraphs (a)(1)(vi), (b)(2)(i)(B) and (C), and (b)(4)(i)(C), as proposed.

4. Clarifying References to Transferred Securities

Rule 1.25(a)(2) permits FCMs and DCOs to enter into repos using customer-deposited securities and securities that are permitted investments purchased with customer money. Such transactions are subject to the provisions of paragraph (d) of Rule 1.25. Among those provisions is paragraph (d)(6), which requires that the “securities transferred under the agreement” must be held in a safekeeping account with a bank, a DCO, or the Depository Trust Company in an account that complies with the requirements of Rule 1.26.

The Commission has been asked whether the reference to “securities transferred under the agreement” is intended to include not only in-coming securities, but out-going securities as well. Such an interpretation would mean that any out-going securities, in addition to any in-coming cash, would have to be held in a customer segregated account in accordance with Rule

1.26.⁴⁰ This is not the intended outcome, and the Commission therefore proposed to amend paragraph (d)(6) to clarify that Rule 1.26 applies only to securities transferred to (not from) an FCM or DCO.⁴¹

The Commission also proposed technical amendments to paragraphs (d)(3) and (d)(11) to similarly clarify that the securities referred to in those provisions are securities transferred to (not from) the customer segregated custodial account of an FCM or DCO.

The Commission did not receive any comments on this issue and it is amending paragraphs (d)(3), (d)(6), and (d)(11), as proposed.

5. Clarifying Payment and Delivery Procedures for Reverse Repos and Repos

The Commission proposed to amend paragraph (d)(8) to clarify payment and delivery procedures for reverse repos and repos. Paragraph (d)(8) provides that the “transfer of securities” must be made on a delivery versus payment basis in immediately available funds. The Commission proposed to amend this provision to clarify that the delivery versus payment requirement applies to the transfer of securities to (not from) the customer segregated custodial account, as would be the case in a reverse repo. The Commission further proposed to add a sentence clarifying that the transfer of funds to the customer segregated cash account, as would be the case in a repo, must be made on a payment versus delivery basis.

⁴⁰ Rule 1.26 addresses the treatment of instruments purchased with customer funds, but does not address the treatment of cash received by an FCM or DCO pursuant to a repo. The Commission believes that it is not necessary to specify in Rule 1.26 that cash acquired in exchange for securities under a repo must be held in a customer segregated cash account because this requirement is clear from the language of Section 4d(a)(2) of the Act.

⁴¹ The Commission notes that with respect to the in-house transactions discussed in Section II.D. of this release, proposed Rule 1.25(e)(5)(iii) specifically provides that securities transferred to the customer segregated account as a result of the transaction must be held in a safekeeping account with a bank, a DCO, or the Depository Trust Company in an account that complies with the requirements of Rule 1.26.

The Commission did not receive any comments on this issue and it is amending paragraph (d)(8), as proposed.

6. Changing Paragraph (a)(1) “Customer Funds” to “Customer Money”

Rule 1.25(a)(1) authorizes FCMs and DCOs to invest “customer funds” in enumerated permitted investments. Paragraph (a)(1) uses the term “customer funds” to describe customer money deposited with an FCM or a DCO to margin futures or options positions. Because the term “customer funds” is otherwise defined in Rule 1.3(gg) to include more than customer money, the Commission proposed to amend paragraph (a)(1) to substitute the term “customer money” for the term “customer funds.”

The word “money” is used in Section 4d(a)(2) of the Act with reference to permitted investments, and the term “customer money” was originally used in Rule 1.25. The term was changed to “customer funds” in 1968 when the Commission’s predecessor agency, the Commodity Exchange Authority, adopted revisions to conform the rule to amendments to Section 4d of the Act.⁴² No explanation was given for the change in terminology.

Subsequently, in 1981, the Commission adopted a definition of “customer funds” in Rule 1.3(gg), when it adopted rules related to futures options.⁴³ That term encompasses more than money, and includes securities and other property belonging to the customer.

Substituting the term “customer money” for the term “customer funds” in paragraph (a)(1) conforms the language of that paragraph to the language of Section 4d(a)(2) of the Act and clarifies the meaning of the term in relation to other provisions of Rule 1.25. The need for this proposed change in terminology arises in the context of distinguishing between customer money and customer-deposited securities, which are the subject of Rule 1.25(a)(2)(ii) (repos with

⁴² 33 FR 14455 (Sept. 26, 1968).

⁴³ 46 FR 33312 (June 29, 1981).

customer-deposited securities) and new Rule 1.25(a)(3)(ii) and (iii) (in-house transactions with customer-deposited securities).

The Commission did not receive any comments on this issue and it is amending paragraph (a)(1), as proposed.

7. Conforming Reference to “Marketability” Requirement

Rule 1.25(a)(2)(ii), which permits FCMs and DCOs to sell customer-deposited securities pursuant to repos, sets forth various requirements for such transactions. Among them is the requirement, under paragraph (a)(2)(ii)(A), that securities subject to repurchase must meet the marketability requirement contained in paragraph (b)(1) of Rule 1.25. Paragraph (b)(1), in turn, cross-references the marketability requirement contained in SEC Rule 15c3-1. For purposes of clarity, the Commission proposed to amend Rule 1.25(a)(2)(ii)(A) to eliminate the cross-reference to paragraph (b)(1) and substitute that paragraph’s direct cross-reference to SEC Rule 15c3-1.

The Commission did not receive any comments on this issue and it is amending paragraph (a)(2)(ii)(A), as proposed.

8. Conforming Terminology for “Derivatives Clearing Organizations”

Rule 1.25 uses the term “clearing organization” to describe an entity that performs clearing functions. The Act, as amended by the Commodity Futures Modernization Act of 2000,⁴⁴ now provides that a clearing organization for a contract market must register as a “derivatives clearing organization” and must comply with core principles set forth in the statute.⁴⁵ The Commission proposed technical amendments to Rule 1.25 to change the term

⁴⁴ Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

⁴⁵ See Section 5b of the Act, 7 U.S.C. 7a-1. See also Section 1a(9) of the Act, 7 U.S.C. 1a(9) (defining the term “derivatives clearing organization”).

“clearing organization” to “derivatives clearing organization.” This conforms the language of Rule 1.25 to the language of the Act, more accurately reflecting the current statutory framework.

As an additional matter, in connection with its proposed technical amendments to Rule 1.27,⁴⁶ the Commission also proposed to change the term “clearing organization” to “derivatives clearing organization” in that rule.

The Commission did not receive any comments on this issue and it is amending Rule 1.25 and Rule 1.27, as proposed.

9. Conforming Terminology for “Government Sponsored Enterprise”

The Commission also proposed a technical amendment to Rule 1.25 to change terminology referring to government sponsored “agency” securities to government sponsored “enterprise” securities. This would conform the language in the rule to the terminology commonly used in the marketplace. This change would be reflected in the list of permitted investments (paragraph (a)(1)(iii)), the rating requirements (paragraph (b)(2)(i)(B)), and the concentration limits (paragraph (b)(4)(i)(B)).

The Commission did not receive any comments on this issue and it is amending paragraphs (a)(1)(iii), (b)(2)(i)(B), and (b)(4)(i)(B), as proposed.

10. Conforming Terminology for “Futures Commission Merchant”

The Commission proposed a technical amendment to Rule 1.25 to substitute the term “futures commission merchant” for the abbreviation, “FCM,” as used in paragraph (c)(3). This would provide conformity in the use of the term futures commission merchant throughout the rule.

⁴⁶ See Section II.D. of this release.

The Commission did not receive any comments on this issue and it is amending paragraph (c)(3), as proposed.

11. Clarifying the Meaning of “NRSRO”

Rule 1.25(b)(2) sets forth the rating requirements for permitted investments. The rule refers to ratings by an “NRSRO,” the abbreviation for a “nationally recognized statistical rating organization.” The Commission proposed to amend paragraph (b)(2)(i) to formally set forth the abbreviation as a defined term and to cross-reference the definition of that term contained in SEC Rule 2a-7.

Since the Commission issued its proposed technical amendment, the SEC published for public comment a proposed new rule defining the term “nationally recognized statistical rating organization.”⁴⁷ The Commission continues to believe that it is appropriate to utilize the definition that is the industry standard, as articulated or otherwise applied by the SEC.

Accordingly, the Commission will continue to cross-reference the SEC’s usage. However, the text of paragraph (b)(2)(i) will be modified to accommodate future changes in SEC rule text or applicable statutes. Thus, the language will provide that “[i]nstruments that are required to be rated by this section must be rated by a nationally recognized statistical rating organization (NRSRO), as that term is defined in Securities and Exchange Commission rules or regulations, or in any applicable statute.”

The Commission did not receive any comments on this issue and it is amending paragraph (b)(2)(i), as described above.

⁴⁷ See 70 FR 21306 (Apr. 25, 2005) (proposing new SEC Rule 3b-10, 17 CFR § 240.3b-10).

III. Section 4(c)

Section 4(c) of the Act⁴⁸ provides that, in order to promote responsible economic or financial innovation and fair competition, the Commission, by rule, regulation or order, after notice and opportunity for hearing, may exempt any agreement, contract, or transaction, or class thereof, that is otherwise subject to Section 4(a) of the Act, including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction, from the contract market designation requirement of Section 4(a) of the Act, or any other provision of the Act other than Section 2(a)(1)(C)(ii) or (D), if the Commission determines that the exemption would be consistent with the public interest.

The final rules are promulgated under Section 4d(a)(2) of the Act,⁴⁹ which governs investment of customer funds. Section 4d(a)(2) provides that customer money may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States. It further provides that such investments must be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.

The Commission is expanding the range of instruments in which FCMs may invest customer funds beyond those listed in Section 4d(a)(2) of the Act (i.e., securities with embedded derivatives and MMMFs rated below the highest rating of an NRSRO), to enhance the yield available to FCMs, DCOs, and their customers without compromising the safety of customer funds. These rules should enable FCMs and DCOs to remain competitive globally and domestically, while maintaining safeguards against systemic risk.

⁴⁸ 7 U.S.C. 6(c).

⁴⁹ 7 U.S.C. 6d(a)(2).

The Commission did not receive any comments on the 4(c) exemption discussion in its February 3, 2005 release. Accordingly, in light of the foregoing, the Commission finds that the adoption of final rules that expand the scope of permitted investments of customer funds will promote responsible economic and financial innovation and fair competition, and is consistent with the “public interest,” as that term is used in Section 4(c) of the Act.

IV. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”)⁵⁰ requires federal agencies, in promulgating rules, to consider the impact of those rules on small businesses. The rule amendments adopted herein will affect FCMs and DCOs. The Commission has previously established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.⁵¹ The Commission has previously determined that registered FCMs⁵² and DCOs⁵³ are not small entities for the purpose of the RFA. The Commission did not receive any comments on the Regulatory Flexibility Act in relation to the proposed rulemaking.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (“PRA”) imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The final rules do not require a new collection of information on the part of any entities subject to them. Accordingly, for purposes of the PRA,

⁵⁰ 5 U.S.C. 601 *et seq.*

⁵¹ 47 FR 18618 (Apr. 30, 1982).

⁵² *Id.* at 18619.

⁵³ 66 FR 45604, 45609 (Aug. 29, 2001).

the Commission certified that the proposed rules did not impose any new reporting or recordkeeping requirements.

C. Costs and Benefits of the Proposed Rules

Section 15(a) of the Act requires that the Commission, before promulgating a regulation under the Act or issuing an order, consider the costs and benefits of its action. By its terms, Section 15(a) does not require the Commission to quantify the costs and benefits of a new rule or determine whether the benefits of the rule outweigh its costs. Rather, Section 15(a) simply requires the Commission to “consider the costs and benefits” of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of the following considerations: (1) protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the Commission could, in its discretion, give greater weight to any one of the five considerations and could, in its discretion, determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the Act.

The Commission has evaluated the costs and benefits of the final rules in light of the specific considerations identified in Section 15(a) of the Act, as follows:

1. Protection of market participants and the public. The final rules facilitate greater capital efficiency for FCMs and DCOs, while protecting customers by establishing prudent standards for investment of customer funds. Several of the rule amendments narrow and refine earlier standards based on industry and Commission experience since the December 2000 rulemaking in which Rule 1.25 was substantially revised and expanded. In this regard, for

example, the amendments relating to the mandatory registration requirement for MMMFs and auditability standard for investment records establish stricter standards. Similarly, amendments that expand investment opportunities for FCMs and DCOs, such as those permitting investment in instruments with embedded derivatives, carefully circumscribe the activity in order to protect the customer segregated account.

2. Efficiency, competitiveness, and financial integrity of futures markets. The final rules will facilitate greater efficiency and competitiveness for FCMs and DCOs, but they will not affect the efficiency and competitiveness of futures markets. The amendments will not affect the financial integrity of futures markets.

3. Price discovery. The amendments will not affect price discovery.

4. Sound risk management practices. The final rules impose sound risk management practices upon FCMs and DCOs that invest customer funds under the rules. They balance the need for investment flexibility with the need to preserve customer funds. For example, while permitting FCM/BDs to engage in in-house transactions, the Commission sets forth specific requirements for such transactions. These include standards relating to the type of securities that may be transferred to the customer segregated account, treatment of those securities when held in the account, and procedures for effecting transactions. Such requirements are designed to ensure that at no time will in-house transactions cause the customer segregated account to fall below a sufficient level. Certain other amendments, such as the registration requirement for MMMFs and clarification as to mandatory next-day redemption and payment for MMMF interests, strengthen risk management standards that are already in place.

5. Other public considerations. The final rules amendments reflect industry and Commission experience with Rule 1.25 since the rule was expanded in December 2000. They

provide FCMs and DCOs with greater flexibility in making investments with customer funds, while strengthening the rules that protect the safety of such funds and preserve the rights of customers. For example, the amendments governing in-house transactions provide FCM/BDs with an efficient and cost-effective method for maximizing investment opportunities within the confines of strict risk management requirements. Similarly, the amendments expand the range of investments to include certain instruments with embedded derivatives and MMMFs of any rating, and enable FCMs and DCOs to consider a broader range of investment possibilities within prescribed limitations.

The final rules are expected to enhance the available yield on customer funds invested by FCMs and DCOs, while maintaining safeguards against systemic risk. FCMs and DCOs choosing to make such investments will bear all costs associated with their investments.

Accordingly, after considering the five factors enumerated in the Act, the Commission has determined to adopt the rules and rule amendments set forth below.

Lists of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

In consideration of the foregoing and pursuant to the authority contained in the Commodity Exchange Act, in particular, Sections 4d, 4(c), and 8a(5) thereof, 7 U.S.C. 6d, 6(c) and 12a(5), respectively, the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1--GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 19, 21, 23, and 24, as amended by the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106-554, 114 Stat. 2763 (2000).

2. Section 1.25 is revised to read as follows:

§ 1.25 Investment of customer funds.

(a) Permitted investments. (1) Subject to the terms and conditions set forth in this section, a futures commission merchant or a derivatives clearing organization may invest customer money in the following instruments (permitted investments):

(i) Obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities);

(ii) General obligations of any State or of any political subdivision thereof (municipal securities);

(iii) General obligations issued by any enterprise sponsored by the United States (government sponsored enterprise securities);

(iv) Certificates of deposit issued by a bank (certificates of deposit) as defined in section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank that carries deposits insured by the Federal Deposit Insurance Corporation;

(v) Commercial paper;

(vi) Corporate notes or bonds;

(vii) General obligations of a sovereign nation; and

(viii) Interests in money market mutual funds.

(2)(i) In addition, a futures commission merchant or derivatives clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the instruments, in accordance with the provisions of paragraph (d) of this section.

(ii) A futures commission merchant or a derivatives clearing organization may sell securities deposited by customers as margin pursuant to agreements to repurchase subject to the following:

(A) Securities subject to such repurchase agreements must be “readily marketable” as defined in § 240.15c3-1 of this title.

(B) Securities subject to such repurchase agreements must not be “specifically identifiable property” as defined in § 190.01(kk) of this chapter.

(C) The terms and conditions of such an agreement to repurchase must be in accordance with the provisions of paragraph (d) of this section.

(D) Upon the default by a counterparty to a repurchase agreement, the futures commission merchant or derivatives clearing organization shall act promptly to ensure that the default does not result in any direct or indirect cost or expense to the customer.

(3) In addition, subject to the provisions of paragraph (e) of this section, a futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer pursuant to section 15(b)(1) of the Securities Exchange Act of 1934 may enter into transactions in which:

(i) Customer money is exchanged for securities that are permitted investments and are held by the futures commission merchant in connection with its securities broker or dealer activities;

(ii) Securities deposited by customers as margin are exchanged for securities that are permitted investments and are held by the futures commission merchant in connection with its securities broker or dealer activities; or

(iii) Securities deposited by customers as margin are exchanged for cash that is held by the futures commission merchant in connection with its securities broker or dealer activities.

(b) General terms and conditions. A futures commission merchant or a derivatives clearing organization is required to manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity and according to the following specific requirements:

(1) Marketability. Except for interests in money market mutual funds, investments must be “readily marketable” as defined in § 240.15c3-1 of this title.

(2) Ratings. (i) Initial requirement. Instruments that are required to be rated by this section must be rated by a nationally recognized statistical rating organization (NRSRO), as that term is defined in Securities and Exchange Commission rules or regulations, or in any applicable statute. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities and money market mutual funds need not be rated;

(B) Municipal securities, government sponsored enterprise securities, commercial paper, and corporate notes or bonds, except notes or bonds that are asset-backed, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO;

(C) Corporate notes or bonds that are asset-backed must have the highest ratings of an NRSRO;

(D) Sovereign debt must be rated in the highest category by at least one NRSRO; and

(E) With respect to certificates of deposit, the commercial paper or long-term debt instrument of the issuer of a certificate of deposit or, if the issuer is part of a holding company system, its holding company's commercial paper or long-term debt instrument, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO.

(ii) Effect of downgrade. If an NRSRO lowers the rating of an instrument that was previously a permitted investment on the basis of that rating to below the minimum rating required under this section, the value of the instrument recognized for segregation purposes will be the lesser of:

(A) The current market value of the instrument; or

(B) The market value of the instrument on the business day preceding the downgrade, reduced by 20 percent of that value for each business day that has elapsed since the downgrade.

(3) Restrictions on instrument features. (i) With the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, except as follows:

(A) The issuer of an instrument otherwise permitted by this section may have an option to call, in whole or in part, at par, the principal amount of the instrument before its stated maturity date; or

(B) An instrument that meets the requirements of paragraph (b)(3)(iv) of this section may provide for a cap, floor, or collar on the interest paid;

provided, however, that the terms of such instrument obligate the issuer to repay the principal amount of the instrument at not less than par value upon maturity.

(ii) No instrument may contain interest-only payment features.

(iii) No instrument may provide payments linked to a commodity, currency, reference instrument, index, or benchmark except as provided in paragraph (b)(3)(iv) of this section, and it may not otherwise constitute a derivative instrument.

(iv) (A) Adjustable rate securities are permitted, subject to the following requirements:

(1) The interest payments on variable rate securities must correlate closely and on an unleveraged basis to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, the one-month or three-month LIBOR rate, or the interest rate of any fixed rate instrument that is a permitted investment listed in paragraph (a)(1) of this section.;

(2) The interest payment, in any period, on floating rate securities must be determined solely by reference, on an unleveraged basis, to a benchmark of either the Federal Funds target or effective rate, the prime rate, the three-month Treasury Bill rate, the one-month or three-month LIBOR rate, or the interest rate of any fixed rate instrument that is a permitted investment listed in paragraph (a)(1) of this section;

(3) Benchmark rates must be expressed in the same currency as the adjustable rate securities that reference them; and

(4) No interest payment on an adjustable rate security, in any period, can be a negative amount.

(B) For purposes of this paragraph, the following definitions shall apply:

(1) The term adjustable rate security means, a floating rate security, a variable rate security, or both.

(2) The term floating rate security means a security, the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time

until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(3) The term variable rate security means a security, the terms of which provide for the adjustment of its interest rate on set dates (such as the last day of a month or calendar quarter) and that, upon each adjustment until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have a market value that approximates its amortized cost.

(v) Certificates of deposit, if negotiable, must be able to be liquidated within one business day or, if not negotiable, must be redeemable at the issuing bank within one business day, with any penalty for early withdrawal limited to any accrued interest earned according to its written terms.

(4) Concentration. (i) Direct investments. (A) U.S. government securities and money market mutual funds shall not be subject to a concentration limit or other limitation.

(B) Securities of any single issuer of government sponsored enterprise securities held by a futures commission merchant or derivatives clearing organization may not exceed 25 percent of total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(C) Securities of any single issuer of municipal securities, certificates of deposit, commercial paper, or corporate notes or bonds held by a futures commission merchant or derivatives clearing organization may not exceed 5 percent of total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(D) Sovereign debt is subject to the following limits: a futures commission merchant may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its customers denominated in that country's currency; a derivatives clearing organization may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its clearing member futures commission merchants denominated in that country's currency.

(ii) Repurchase agreements. For purposes of determining compliance with the concentration limits set forth in this section, securities sold by a futures commission merchant or derivatives clearing organization subject to agreements to repurchase shall be combined with securities held by the futures commission merchant or derivatives clearing organization as direct investments.

(iii) Reverse repurchase agreements. For purposes of determining compliance with the concentration limits set forth in this section, securities purchased by a futures commission merchant or derivatives clearing organization subject to agreements to resell shall be combined with securities held by the futures commission merchant or derivatives clearing organization as direct investments.

(iv) Transactions under paragraph (a)(3). For purposes of determining compliance with the concentration limits set forth in this section, securities transferred to a customer segregated account pursuant to paragraphs (a)(3)(i) or (a)(3)(ii) of this section shall be combined with securities held by the futures commission merchant as direct investments.

(v) Treatment of securities issued by affiliates. For purposes of determining compliance with the concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(6) of this section, shall be aggregated and deemed the securities of a single issuer. An interest in a permitted money market mutual fund is not deemed to be a security issued by its sponsoring entity.

(vi) Treatment of customer-owned securities. For purposes of determining compliance with the concentration limits set forth in this section, securities owned by the customers of a futures commission merchant and posted as margin collateral are not included in total assets held in segregation by the futures commission merchant, and securities posted by a futures commission merchant with a derivatives clearing organization are not included in total assets held in segregation by the derivatives clearing organization.

(5) Time-to-maturity. (i) Except for investments in money market mutual funds, the dollar-weighted average of the time-to-maturity of the portfolio, as that average is computed pursuant to § 270.2a-7 of this title, may not exceed 24 months.

(ii) For purposes of determining the time-to-maturity of the portfolio, an instrument that is set forth in paragraphs (a)(1)(i) through (vii) of this section may be treated as having a one-day time-to-maturity if the following terms and conditions are satisfied:

(A) The instrument is deposited solely on an overnight basis with a derivatives clearing organization pursuant to the terms and conditions of a collateral management program that has become effective in accordance with § 39.4 of this chapter;

(B) The instrument is one that the futures commission merchant owns or has an unqualified right to pledge, is not subject to any lien, and is deposited by the futures commission merchant into a segregated account at a derivatives clearing organization;

(C) The derivatives clearing organization prices the instrument each day based on the current mark-to-market value; and

(D) The derivatives clearing organization reduces the assigned value of the instrument each day by a haircut of at least 2 percent.

(6) Investments in instruments issued by affiliates. (i) A futures commission merchant shall not invest customer funds in obligations of an entity affiliated with the futures commission merchant, and a derivatives clearing organization shall not invest customer funds in obligations of an entity affiliated with the derivatives clearing organization. An affiliate includes parent companies, including all entities through the ultimate holding company, subsidiaries to the lowest level, and companies under common ownership of such parent company or affiliates.

(ii) A futures commission merchant or derivatives clearing organization may invest customer funds in a fund affiliated with that futures commission merchant or derivatives clearing organization.

(7) Recordkeeping. A futures commission merchant and a derivatives clearing organization shall prepare and maintain a record that will show for each business day with respect to each type of investment made pursuant to this section, the following information:

(i) The type of instruments in which customer funds have been invested;

(ii) The original cost of the instruments; and

(iii) The current market value of the instruments.

(c) Money market mutual funds. The following provisions will apply to the investment of customer funds in money market mutual funds (the fund).

(1) The fund must be an investment company that is registered under the Investment Company Act of 1940 with the Securities and Exchange Commission and that holds itself out to investors as a money market fund, in accordance with § 270.2a-7 of this title.

(2) The fund must be sponsored by a federally-regulated financial institution, a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, an investment adviser registered under

the Investment Advisers Act of 1940, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation.

(3) A futures commission merchant or derivatives clearing organization shall maintain the confirmation relating to the purchase in its records in accordance with § 1.31 and note the ownership of fund shares (by book-entry or otherwise) in a custody account of the futures commission merchant or derivatives clearing organization in accordance with § 1.26(a). If the futures commission merchant or the derivatives clearing organization holds its shares of the fund with the fund's shareholder servicing agent, the sponsor of the fund and the fund itself are required to provide the acknowledgment letter required by § 1.26.

(4) The net asset value of the fund must be computed by 9 a.m. of the business day following each business day and made available to the futures commission merchant or derivatives clearing organization by that time.

(5) (i) General requirement for redemption of interests. A fund shall be legally obligated to redeem an interest and to make payment in satisfaction thereof by the business day following a redemption request, and the futures commission merchant or derivatives clearing organization shall retain documentation demonstrating compliance with this requirement.

(ii) Exception. A fund may provide for the postponement of redemption and payment due to any of the following circumstances:

(A) Non-routine closure of the Fedwire or applicable Federal Reserve Banks;

(B) Non-routine closure of the New York Stock Exchange or general market conditions leading to a broad restriction of trading on the New York Stock Exchange;

(C) Declaration of a market emergency by the Securities and Exchange Commission; or

(D) Emergency conditions set forth in section 22(e) of the Investment Company Act of 1940.

(6) The agreement pursuant to which the futures commission merchant or derivatives clearing organization has acquired and is holding its interest in a fund must contain no provision that would prevent the pledging or transferring of shares.

(d) Repurchase and reverse repurchase agreements. A futures commission merchant or derivatives clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section pursuant to agreements for resale or repurchase of the securities (agreements to repurchase or resell), provided the agreements to repurchase or resell conform to the following requirements:

(1) The securities are specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.

(2) Counterparties are limited to a bank as defined in section 3(a)(6) of the Securities Exchange Act of 1934, a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation, a securities broker or dealer, or a government securities broker or government securities dealer registered with the Securities and Exchange Commission or which has filed notice pursuant to section 15C(a) of the Government Securities Act of 1986.

(3) The transaction is executed in compliance with the concentration limit requirements applicable to the securities transferred to the customer segregated custodial account in connection with the agreements to repurchase referred to in paragraphs (b)(4)(ii) and (iii) of this section.

(4) The transaction is made pursuant to a written agreement signed by the parties to the agreement, which is consistent with the conditions set forth in paragraphs (d)(1) through (d)(12)

of this section and which states that the parties thereto intend the transaction to be treated as a purchase and sale of securities.

(5) The term of the agreement is no more than one business day, or reversal of the transaction is possible on demand.

(6) Securities transferred to the futures commission merchant or derivatives clearing organization under the agreement are held in a safekeeping account with a bank as referred to in paragraph (d)(2) of this section, a derivatives clearing organization, or the Depository Trust Company in an account that complies with the requirements of § 1.26.

(7) The futures commission merchant or the derivatives clearing organization may not use securities received under the agreement in another similar transaction and may not otherwise hypothecate or pledge such securities, except securities may be pledged on behalf of customers at another futures commission merchant or derivatives clearing organization. Substitution of securities is allowed, provided, however, that:

(i) The qualifying securities being substituted and original securities are specifically identified by date of substitution, market values substituted, coupon rates, par amounts, maturity dates and CUSIP or ISIN numbers;

(ii) Substitution is made on a “delivery versus delivery” basis; and

(iii) The market value of the substituted securities is at least equal to that of the original securities.

(8) The transfer of securities to the customer segregated custodial account is made on a delivery versus payment basis in immediately available funds. The transfer of funds to the customer segregated cash account is made on a payment versus delivery basis. The transfer is not

recognized as accomplished until the funds and/or securities are actually received by the custodian of the futures commission merchant's or derivatives clearing organization's customer funds or securities purchased on behalf of customers. The transfer or credit of securities covered by the agreement to the futures commission merchant's or derivatives clearing organization's customer segregated custodial account is made simultaneously with the disbursement of funds from the futures commission merchant's or derivatives clearing organization's customer segregated cash account at the custodian bank. On the sale or resale of securities, the futures commission merchant's or derivatives clearing organization's customer segregated cash account at the custodian bank must receive same-day funds credited to such segregated account simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

(9) A written confirmation to the futures commission merchant or derivatives clearing organization specifying the terms of the agreement and a safekeeping receipt are issued immediately upon entering into the transaction and a confirmation to the futures commission merchant or derivatives clearing organization is issued once the transaction is reversed.

(10) The transactions effecting the agreement are recorded in the record required to be maintained under § 1.27 of investments of customer funds, and the securities subject to such transactions are specifically identified in such record as described in paragraph (d)(1) of this section and further identified in such record as being subject to repurchase and reverse repurchase agreements.

(11) An actual transfer of securities to the customer segregated custodial account by book entry is made consistent with Federal or State commercial law, as applicable. At all times, securities received subject to an agreement are reflected as "customer property."

(12) The agreement makes clear that, in the event of the bankruptcy of the futures commission merchant or derivatives clearing organization, any securities purchased with customer funds that are subject to an agreement may be immediately transferred. The agreement also makes clear that, in the event of a futures commission merchant or derivatives clearing organization bankruptcy, the counterparty has no right to compel liquidation of securities subject to an agreement or to make a priority claim for the difference between current market value of the securities and the price agreed upon for resale of the securities to the counterparty, if the former exceeds the latter.

(e) Transactions by futures commission merchants that are also registered securities brokers or dealers. A futures commission merchant that is also registered with the Securities and Exchange Commission as a securities broker or dealer pursuant to section 15(b)(1) of the Securities Exchange Act of 1934 may enter into transactions pursuant to paragraph (a)(3) of this section, subject to the following requirements:

(1) The futures commission merchant, in connection with its securities broker or dealer activities, owns or has the unqualified right to pledge the securities that are exchanged for customer money or securities held in the customer segregated account.

(2) The transaction can be reversed within one business day or upon demand.

(3) Securities transferred from the customer segregated account and securities transferred to the customer segregated account as a result of the transaction are specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number.

(4) Securities deposited by customers as margin and transferred from the customer segregated account as a result of the transaction are subject to the following requirements:

- (i) The securities are “readily marketable” as defined in § 240.15c3-1 of this title.
 - (ii) The securities are not “specifically identifiable property” as defined in § 190.01(kk) of this chapter.
- (5) Securities transferred to the customer segregated account as a result of the transaction are subject to the following requirements:
- (i) The securities are priced each day based on the current mark-to-market value.
 - (ii) The securities are subject to the concentration limit requirements set forth in paragraph (b)(4)(iv) of this section.
 - (iii) The securities are held in a safekeeping account with a bank, as referred to in paragraph (d)(2) of this section, a derivatives clearing organization, or the Depository Trust Company in an account that complies with the requirements of § 1.26.
 - (iv) The securities may not be used in another similar transaction and may not otherwise be hypothecated or pledged, except such securities may be pledged on behalf of customers at another futures commission merchant or derivatives clearing organization. Substitution of securities is allowed, provided, however, that:
 - (A) The qualifying securities being substituted and original securities are specifically identified by date of substitution, market values substituted, coupon rates, par amounts, maturity dates and CUSIP or ISIN numbers;
 - (B) Substitution is made on a “delivery versus delivery” basis; and
 - (C) The market value of the substituted securities is at least equal to that of the original securities.

(6) The transactions are carried out in accordance with the following procedures:

(i) With respect to transactions under paragraph (a)(3)(i) of this section, the transfer of securities to the customer segregated custodial account shall be made simultaneously with the transfer of money from the customer segregated cash account. In no event shall money held in the customer segregated cash account be disbursed prior to the transfer of securities to the customer segregated custodial account. Any transfer of securities to the customer segregated custodial account shall not be recognized as accomplished until the securities are actually received by the custodian of such account. Upon unwinding of the transaction, the customer segregated cash account shall receive same-day funds credited to such account simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

(ii) With respect to transactions under paragraph (a)(3)(ii) of this section, the transfer of securities to the customer segregated custodial account shall be made simultaneously with the transfer of securities from the customer segregated custodial account. In no event shall securities held in the customer segregated custodial account be released prior to the transfer of securities to that account. Any transfer of securities to the customer segregated custodial account shall not be recognized as accomplished until the securities are actually received by the custodian of the customer segregated custodial account. Upon unwinding of the transaction, the customer segregated custodial account shall receive the securities simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

(iii) With respect to transactions under paragraph (a)(3)(iii) of this section, the transfer of money to the customer segregated cash account shall be made simultaneously with the transfer of securities from the customer segregated custodial account. In no event shall securities held in the customer segregated custodial account be released prior to the transfer of money to the customer

segregated cash account. Any transfer of money to the customer segregated cash account shall not be recognized as accomplished until the money is actually received by the custodian of the customer segregated cash account. Upon unwinding of the transaction, the customer segregated custodial account shall receive the securities simultaneously with the disbursement of money from the customer segregated cash account.

(7) The futures commission merchant maintains all books and records with respect to the transactions in accordance with §§ 1.25, 1.27, 1.31, and 1.36 and the applicable rules and regulations of the Securities and Exchange Commission.

(8) An actual transfer of securities by book entry is made consistent with Federal or State commercial law, as applicable. At all times, securities transferred to the customer segregated account are reflected as “customer property.”

(9) For purposes of §§ 1.25, 1.26, 1.27, 1.28 and 1.29, securities transferred to the customer segregated account are considered to be customer funds until the customer money or securities for which they were exchanged are transferred back to the customer segregated account. In the event of the bankruptcy of the futures commission merchant, any securities exchanged for customer funds and held in the customer segregated account may be immediately transferred.

(10) In the event the futures commission merchant is unable to return to the customer any customer-deposited securities exchanged pursuant to paragraphs (a)(3)(ii) or (a)(3)(iii) of this section, the futures commission merchant shall act promptly to ensure that such inability does not result in any direct or indirect cost or expense to the customer.

(f) Deposit of firm-owned securities into segregation. A futures commission merchant shall not be prohibited from directly depositing unencumbered securities of the type specified in this

section, which it owns for its own account, into a segregated safekeeping account or from transferring any such securities from a segregated account to its own account, up to the extent of its residual financial interest in customers' segregated funds; provided, however, that such investments, transfers of securities, and disposition of proceeds from the sale or maturity of such securities are recorded in the record of investments required to be maintained by § 1.27. All such securities may be segregated in safekeeping only with a bank, trust company, derivatives clearing organization, or other registered futures commission merchant. Furthermore, for purposes of §§ 1.25, 1.26, 1.27, 1.28 and 1.29, investments permitted by § 1.25 that are owned by the futures commission merchant and deposited into such a segregated account shall be considered customer funds until such investments are withdrawn from segregation.

3. Section 1.27 is amended by inserting the word “derivatives” before the term “clearing organization” in paragraphs (a) and (b).
4. Section 1.27(a)(3) is amended by inserting the phrase “or current market value of securities” after the phrase “The amount of money.”
5. Section 1.27(a)(6) is amended by inserting the phrase “or current market value of securities” after the phrase “the amount of money.”
6. Section 1.27(a) is amended by:
 - a. Deleting “and” at the end of paragraph (a)(6);
 - b. Changing the period to a semi-colon at the end of paragraph (a)(7) and inserting “and” at the end of that paragraph; and
 - c. Adding paragraph (a)(8) to read as follows:

(a) * * *

(8) Daily valuation for each instrument and readily available documentation supporting the daily valuation for each instrument. Such supporting documentation must be sufficient to enable auditors to verify the valuations and the accuracy of any information from external sources used in those valuations.

Issued in Washington, DC on May 11, 2005, by the Commission.

Catherine D. Daniels,

Assistant Secretary of the Commission.