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: Proposed rule.

SUMMARY: The Commodity Futures Trading Commission ("Commission") is proposing to amend its regulations regarding investment of customer funds and related recordkeeping requirements. The proposed amendments address standards for investing in instruments with embedded derivatives, requirements for adjustable rate securities (including auction 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"), 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.

DATES: Comments must be received on or before [date 30 days from date of publication in Federal Register].

ADDRESSES: Comments on the proposed amendments should be sent to Jean A. Webb, Secretary, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Comments may be sent by facsimile transmission to (202) 418-5521, by e-mail to secretary@cftc.gov, or electronically by accessing http://www.regulations.gov. Reference should be made to "Proposed Amendments to Rule 1.25."

FOR FURTHER INFORMATION CONTACT: Phyllis P. Dietz, Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581. Telephone (202) 418-5430.

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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[1] ("Act"). The Commission believes that it is important to have customer funds invested in a manner that minimizes their exposure to credit, liquidity, and market risks not only because they are customer assets, but also because, to the extent they represent a performance bond against customer obligations under derivatives contracts, these assets must be capable of being quickly converted to cash at a predictable value to minimize systemic risk.

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 exposures 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 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

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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).

3 68 FR 38654 (June 30, 2003).

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.

The Commission is now proposing specific rule amendments related to the remaining issues raised in its June 30, 2003 request for public comment. These proposed amendments, discussed in section II.A. through C. of this release, relate to standards for investing in instruments with embedded derivatives, permitted benchmarks for adjustable rate securities,[5] and concentration limits on reverse repos. The discussion of these issues incorporates comments submitted by the Futures Industry Association ("FIA"), National Futures Association ("NFA"), and Lehman Brothers, in 2003.[6]

The Commission is also proposing amendments that address several new issues, as discussed in section II.D. through G. of this release. In this regard, the Commission is proposing an amendment requested by the FIA regarding certain transactions by FCM/BDs,[7] an amendment to eliminate the rating requirement for MMMFs, an amendment to require that all permitted MMMFs be registered with the Securities and Exchange Commission ("SEC"), and an amendment establishing an auditability standard for investment records.

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4 69 FR 6140 (Feb. 10, 2004).

5 In addition to addressing the issues raised in its June 30, 2003 release, the Commission is also proposing two supplemental requirements for adjustable rate securities, as well as technical amendments relating to terminology. Among the technical amendments is a proposal to substitute the term "adjustable rate security" for the term "variable-rate security," as the latter term is currently used. See Section II.B.3. of this release for a discussion of proposed changes in terminology.

6 These comment letters are available in the comment file accompanying the June 30, 2003 release, at <www.cftc.gov>.

7 In connection with this proposal, the Commission is also proposing technical amendments to Rule 1.27 to clarify the recordkeeping requirements applicable to repos and proposed transactions by FCM/BDs.

Further, in Section II.H. of this release, the Commission is proposing technical amendments to Rule 1.25 to 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 technical amendments would also 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."

The Commission solicits comment on all aspects of the proposed amendments to Rules 1.25 and 1.27. Commenters are welcome to offer their views regarding any other matters that are raised by the proposed rules.

II. Discussion of the Proposed Rules

A. <u>Instruments with Embedded Derivatives</u>

Rule 1.25(b)(3)(i) expressly prohibits investment of customer funds in instruments with embedded derivatives.[8] Some market participants have suggested that there are certain instruments containing embedded derivatives that have a level of risk similar to or lower than some of the other investments permitted under the rule and that embedded derivatives may otherwise have risk-neutral or even risk-mitigating effects. In June 2003, the Commission

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[8] Rule 1.25(b)(3)(i) currently provides that "[w]ith the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, including but not limited to a call option, put option, or collar, cap, or floor on interest paid."

requested comment on whether Rule 1.25(b)(3)(i) should be amended to modify the prohibition on investments in securities that contain an embedded derivative. In this regard, commenters were asked to describe how the level of risk of such securities could be limited.

The FIA commented that many GSE securities contain caps, floors, puts, and calls. The FIA recommended that the Commission permit FCMs to invest in securities with such features, provided they are directly related to the interest rate characteristics of the security. The FIA stated that this standard is similar to one found in Generally Accepted Accounting Principles Statement of Financial Accounting Standards No. 133, under which embedded derivatives that are "clearly and closely related" to the "host contract" are accounted for together with the underlying instrument. The FIA further stated that caps, floors, puts and calls would all be considered "clearly and closely related" as long as they are a function of the same rate in the underlying security.

Since the FIA submitted its comment letter, FIA representatives have held further discussions with Commission staff to consider the establishment of more specific criteria that could provide greater clarity for FCMs and DCOs, as well as designated self-regulatory organization and Commission auditors. Such standards would be more readily auditable, furthering the goal of ensuring compliance.

As the Commission has previously stated, it believes that expanding the list of permitted investments can enhance the yield available to FCMs, DCOs, and their customers, without compromising the ability of FCMs to quickly convert such investments to cash at a predictable value.[9] In light of discussions with market participants, the Commission acknowledges that there

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[9] See 65 FR at 39014.

are some embedded derivatives that, at a minimum, do not appear to heighten the material risks of permitted investments and may serve to mitigate risks under certain circumstances.

The Commission, having carefully considered the merits of permitting investment of customer money in a limited selection of instruments with embedded derivatives, proposes to amend Rule 1.25(b)(3)(i) to permit FCMs and DCOs to invest in instruments with certain embedded derivatives, subject to certain express standards. Commission staff have worked with market participants to develop these standards, with the goal of excluding inappropriate instruments while including instruments that offer an attractive yield at an acceptable level of risk.

As a preliminary matter, the Commission proposes a technical amendment to paragraph (b)(3)(iii), to clarify its continued intent to maintain an express prohibition against any instrument that, itself, constitutes a derivative instrument. This was the original intent of paragraph (b)(3)(iii) which already prohibits payments linked to any underlying commodity except as expressly permitted by paragraph (b)(3)(iv) with respect to adjustable rate securities.

Proposed paragraph (b)(3)(i) would continue to generally prohibit investments in instruments with embedded derivatives, carving out an exception only for two categories of embedded derivatives that may be contained in instruments that meet specified criteria.

Proposed paragraph (b)(3)(i) sets forth the types of embedded derivatives that would be permissible. First, proposed paragraph (b)(3)(i)(A) permits 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. The Commission notes that 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. That is, the reinvestment risk presented by callable instruments is of far less supervisory concern, if any, than the credit risk that may be presented by a shifting of investments to less creditworthy issuers, even within the population permitted by the credit rating requirements and other requirements of Rule 1.25.

Second, proposed paragraph (b)(3)(i)(B) addresses permissible interest rate features. The proposed revision now would permit caps, floors, or collars on the interest paid pursuant to the terms of an adjustable rate instrument. Upper and/or lower limits on interest do not jeopardize the principal amount payable at maturity. Although upper limits (caps) on adjustable rates may constrain the yield achieved if prevailing rates rise substantially, lower limits (floors) may protect the yield achieved if prevailing rates fall significantly.

Proposed paragraph (b)(3)(i) further provides 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 preservation of principal is a fundamental premise upon which the Commission has based its policies regarding permitted investments. It is important to ensure that principal is protected, especially as instruments become more complex in their structure.

B. Adjustable Rate Securities

1. Permitted Benchmarks

Rule 1.25(b)(3)(iv) currently permits investment in "variable-rate securities,"[10] 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. Market participants have noted that the benchmarks used in the marketplace evolve over time. 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 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 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. This would allow FCMs to respond to new benchmarks as they evolve. In this regard, the FIA noted its understanding that, in Europe, the Euribor has become more popular than LIBOR as a benchmark in many instruments.

The Commission agrees that it is appropriate to afford greater latitude in establishing benchmarks for floating rate securities, thereby enabling FCMs and DCOs to more readily respond to changes in the market. The Commission therefore proposes to amend Rule 1.25(b)(3)(iv), proposing new paragraph (b)(3)(iv)(A)(2), to provide that, in addition to the

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10 See Section II.B.3. of this release for a discussion of the Commission's proposed amendments to clarify use of the terms "adjustable rate," "floating rate," and "variable rate."

benchmarks already enumerated in the rule, floating rate securities may be benchmarked to rates on any fixed rate instruments that are "permitted investments" under Rule 1.25(a). It should be noted that any resulting interest payment must be determined solely by reference to one or more permissible interest rates or relationships between a constant and one or more permissible interest rates.

In addition, the Commission believes it appropriate to clarify that neither the existing text requiring that the interest payments on variable rate securities "correlate closely and on an unleveraged basis" to certain benchmark rates, nor the proposed text requiring that the interest payments on floating rate securities "be determined solely by reference, on an unleveraged basis," to those and other benchmarks, should be read to foreclose interest payments that include some fixed arithmetic spread added to the benchmark rate itself, provided that no such spread may constitute any multiple of the benchmark rate. This reflects the original intent of this provision, and should eliminate potential errors or ambiguities in interpreting what is meant by the phrase "unleveraged basis."

2. Supplemental Requirements

The Commission is proposing to 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 for FCMs and DCOs. 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.

3. Technical Amendments

The Commission is proposing to revise certain terminology used in paragraph (b)(3)(iv) for the purpose of clarifying, not changing, the meaning of this provision. Paragraph (b)(3)(iv) currently uses the term "variable-rate securities" without distinguishing between securities for which periodic interest payments vary by formula or other reference calculation any time a specified interest rate changes (termed a "floating rate security" by the SEC),[11] and those for which periodic interest payments are adjusted on set dates (termed a "variable rate security" by the SEC).[12] For purposes of clarity and to ensure consistency with the paragraph (b)(5) time-to-maturity provision,[13] the Commission is proposing to amend paragraph (b)(3)(iv) to distinguish the terms "floating rate security" and "variable rate security" and, where appropriate, to use the term "adjustable rate security," to refer to either or both of the foregoing.

In this regard, the Commission proposes to add a new paragraph (b)(3)(iv)(B), defining the above terms for purposes of paragraph (b)(3)(iv). Proposed paragraph (b)(3)(iv)(B)(1) defines "adjustable rate security" as described above. Using the SEC's definition, proposed paragraph (b)(3)(iv)(B)(2) defines "floating rate security" 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

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11 See SEC Rule 2a-7(a)(13),17 CFR 270.2a-7(a)(13).

12 See SEC Rule 2a-7(a)(29),17 CFR 270.2a-7(a)(29).

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

that approximates its amortized cost. Also using the SEC's definition, proposed paragraph (b)(3)(iv)(B)(3) defines "variable rate security" 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.

4. Auction Rate Securities

The Commission received an inquiry from an FCM interested in investing customer funds in certain auction rate securities ("ARS"). The specific instruments described by this FCM were issued by a quasi-governmental corporate entity established in the Commonwealth of Massachusetts. Such an issuer cannot be considered to be a political subdivision of a State as described in the Act and in paragraph (a)(ii) of Rule 1.25 but, rather, must be considered to be a corporate issuer under paragraph (a)(vi).

Currently, paragraph (a)(vi) uses the term "corporate notes," which may create some uncertainty as to the Commission's intent regarding the duration of such instruments. In particular, the specific instruments that were the subject of the inquiry have maturity dates many years in the future. As discussed in section II.H.3. of this release, the Commission is proposing a technical change to now use the term "corporate notes or bonds," for clarity. Accordingly, an ARS that had an initial term to maturity exceeding five or even ten years would not be prohibited outright, but would, as with all other securities in the portfolio, be subject to the portfolio time-to-maturity requirements consistent with paragraph (b)(5), which focuses on the remaining time to maturity.

This inquiry also raises the separate question of whether the process by which the periodic interest payments are determined for ARS is permissible. It appears that the typical process is to reset the interest rate through "Dutch auctions" held on relatively short cycles, such as 7, 14, 28, or 35 days, with interest paid at the end of each auction period. The full principal is due at a set maturity date, typically years from the date of issue. In such an auction, broker-dealers submit bids to an auction agent (typically a large money center bank). The interest rate for the next period is set by identifying the lowest rate that will clear the total outstanding amount of securities. The "auctions" are for the purpose of rate-setting and, absent other express terms of the agreement, do not constitute an opportunity either for the holders to put the securities to the issuer or for the issuer to call the securities from the holders. As with other debt securities, holders of ARS may attempt to resell them by contacting broker-dealers or other potential buyers, but there is no continuous bid/offer stream, although bids and offers may be available upon request from major dealers active in the market.

It has been represented to the Commission that the interest payments on the particular issue which was the subject of the inquiry, and those of many other ARS issues, demonstrate close historical correlation to key short-term interest rates. As described, therefore, the process of establishing periodic interest payments in such a manner would not violate the requirements of current paragraph (b)(3)(iv) or proposed paragraph (b)(3)(iv)(A)(1), if, in fact, they are closely correlated to a permitted benchmark.

C. Reverse Repos--Concentration Limits

Rule 1.25(b)(4)(iii) establishes concentration limits for reverse repos.[14] These restrictions, which were adopted in response to public comment, 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.[15] 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.

The FIA commented that, although the concentration limits for reverse repos were imposed to remove restrictions that commenters previously had identified as inhibiting their use of reverse repos, as a practical matter, an FCM cannot monitor such transactions by security, size and counterparty except through manual processing. As a result, this investment alternative has not proved to be viable. The FIA expressed the view that all securities held by an FCM, either through an investment of customer funds or through a reverse repo, should be subject to the concentration limits for direct investments.

The Commission proposes 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). In re-evaluating the existing concentration limits, the Commission has concluded that imposing issuer-based

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14 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.

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

concentration limits, as originally proposed for permitted investments including securities obtained through reverse repos, is an appropriate and adequate safeguard.[16] The Commission's primary regulatory concern focuses on the actual holdings in the customer segregated account (i.e., cash, securities, or other property) at any given time. Accordingly, under the proposal, all investment securities in the account, whether obtained pursuant to direct investment or reverse repo, would be subject to the same concentration limits.

D. Transactions by FCM/BDs

In its comment letter responding to the Commission's June 30, 2003 request for public comment, the FIA proposed adding a new provision to Rule 1.25 that 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-house transactions").[17] Lehman Brothers also submitted a comment letter in support of the FIA's proposal.

The FIA recommended that the Commission authorize an FCM/BD that, in its capacity as a broker-dealer, owns or has the unqualified right to pledge securities that are "permitted investments," to invest customer money by effecting a transfer of such securities to the customer segregated account. Similarly, in lieu of using customer-deposited securities in a repo with a third party, the FIA proposed that an FCM/BD should be authorized to effect similar transactions by means of a transfer of customer-owned securities in exchange for permitted investments that the FCM/BD holds in its capacity as a broker-dealer. The FIA further proposed that the FCM/BD transactions be subject to the recordkeeping requirements of Commission rules 1.25,

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16 See 65 FR 39008, 39020 (June 22, 2000).

17 Since the submission of its comment letter, the FIA has further requested that the provision also address transactions in which customer-deposited securities are exchanged for cash.

1.26, 1.27, 1.28, and 1.36, as well as applicable SEC rules. With respect to transactions involving customer-owned securities, the FIA stated that the records should reflect the customer's continued ownership interest in those securities.

The FIA proposed to apply to in-house transactions certain standards that currently apply to repos and reverse repos under Rule 1.25(d), i.e., the identification of securities by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number (paragraph (d)(1)); the ability to unwind a transaction within one business day or on demand (paragraph (d)(5)); and the recognition of an accomplished transaction only when the securities are actually received by the custodian of the FCM's customer segregated account (paragraph (d)(8)). The FIA proposed to apply the concentration requirements applicable to direct investments (paragraph (b)(4)(i)) and to treat the securities deposited in the customer segregated account as a result of the in-house transaction as having a one-day time-to-maturity.

Lehman Brothers asserted its belief that such transactions are permissible under Section 4d(a)(2) of the Act[18] and Rule 1.25, and do not present any unique customer protection concerns. Lehman Brothers described the proposed transactions as an alternative to reverse repos and repos entered into between an FCM/BD and a third party.

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. 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.

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[18] 7 U.S.C. 6d(a)(2).

The in-house transactions proposed by FIA and Lehman Brothers are intended to provide the economic equivalent of repos and reverse repos with third parties. A key benefit that the in-house transactions offer is that they can assist an FCM both in achieving greater capital efficiency and in accomplishing important risk management goals, including internal diversification targets. For example, customer-deposited securities that are not acceptable as collateral for DCO performance bond requirements could be exchanged for securities that are acceptable. This would permit the more efficient use of an FCM/BD's total holdings. There also would be certain operational efficiencies given the ability to readily substitute forms of collateral prior to delivering that collateral to a DCO.

The Commission recognizes that all permitted investments under Rule 1.25(a)(1) do not have the same risk profile, and that substitution of one type of permitted investment for another could alter the risk profile of a customer segregated account. However, the Commission has previously determined that all of the instruments that are permitted investments are appropriate investments for customer money, subject to specified requirements. Thus, the substitution of one permitted invstment for another in an in-house transaction will not present an unacceptable level of risk to the customer segregated account.

In light of the above considerations, the Commission is proposing to amend Rule 1.25 by adding new paragrahs (a)(3) and (e)[19] to permit FCM/BDs to engage in in-house transactions subject to specified requirements.

Proposed paragraph (a)(3)(i) provides that 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. Proposed paragraph (a)(3)(ii) provides that securities

[19] The current paragraph (e) would be redesignated as paragraph (f).

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. Proposed paragraph (a)(3)(iii) provides that 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.

The authority granted under paragraph (a)(3) would be subject to the requirements of proposed new paragraph (e), which incorporates many of the same restrictions currently imposed on repo and reverse repo transactions under paragraph (d). Certain provisions of paragraph (e) have been adapted to reflect the operational differences between an in-house transaction and a third-party transaction.

Proposed 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.

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

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

Proposed paragraph (e)(4) establishes two general requirements for the types of customer-deposited securities that can be used in the in-house transactions. These same requirements apply to customer-deposited securities used in repos under Rule 1.25(a)(2)(ii). Paragraph (e)(4)(i) incorporates the Rule 1.25(a)(2)(ii)(A) requirement that the securities must be "readily marketable" as defined in SEC Rule 15c3-1.[20] Paragraph (e)(4)(ii) incorporates the Rule 1.25(a)(2)(ii)(B) requirement that the securities not be "specifically identifiable property" as defined in Rule 190.01(kk).

Proposed 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. Proposed paragraph (e)(5)(i) requires that the securities be priced daily based on the current mark-to-market value. Proposed paragraph (e)(5)(ii) provides that the securities will be subject to the concentration limit requirements applicable to direct investments, as provided in proposed Rule 1.25(b)(4)(iv) (discussed below). This is the same treatment that the Commission is proposing to apply to repos and reverse repos.[21] Proposed 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. This same requirement is applied to repos and reverse repos under Rule 1.25(d)(6).[22]

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[20] 17 CFR 240.15c3-1.

[21] See section II.C. of this release.

[22] 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.

Proposed 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 permits substitution of securities if: (1) the securities being substituted and the original securities are specifically identified by date of substitution, market values substituted, coupon rates, par amounts, maturity dates and CUSIP or ISIN numbers; (2) substitution is made on a “delivery versus delivery” basis; and (3) the market value of the substituted securities is at least equal to that of the original securities.

Proposed 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.

Proposed paragraph (e)(6)(i) governs transactions under proposed paragraph (a)(3)(i). It provides that the transfer of securities to the customer segregated custodial account must be made simultaneously with the transfer of money from the customer segregated cash account. Money held in the customer segregated cash account cannot be disbursed prior to the transfer of securities to the customer segregated custodial account. Any transfer of securities to the customer segregated custodial account cannot 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 must receive same-day funds credited to such account simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

Proposed paragraph (e)(6)(ii) governs transactions under proposed paragraph (a)(3)(ii). It provides that the transfer of securities to the customer segregated custodial account must be made simultaneously with the transfer of securities from the customer segregated custodial account. Securities held in the customer segregated custodial account cannot be released prior to the transfer of securities to that account. Any transfer of securities to the customer segregated custodial account cannot be recognized as accomplished until the securities are actually received by the custodian of such account. Upon unwinding of the transaction, the customer segregated custodial account must receive the securities simultaneously with the delivery or transfer of securities from the customer segregated custodial account.

Proposed paragraph (e)(6)(iii) governs transactions under proposed paragraph (a)(3)(iii). It provides that the transfer of money to the customer segregated cash account must be made simultaneously with the transfer of securities from the customer segregated custodial account. Securities held in the customer segregated custodial account cannot be released prior to the transfer of money to the customer segregated cash account. Any transfer of money to the customer segregated cash account cannot be recognized as accomplished until the money is actually received by the custodian of such account. Upon unwinding of the transaction, the customer segregated custodial account must receive the securities simultaneously with the disbursement of money from the customer segregated cash account.

Proposed 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).

Proposed 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."

Proposed 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 will 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).

Proposed 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.

As explained above, under proposed paragraph (e)(5)(ii), the Commission would apply the concentration limits for direct investments to securities transferred to the customer segregated account as a result of an in-house transaction. To effect this treatment, the Commission proposes to amend 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 would also redesignate existing paragraphs (b)(4)(iv) and (v) as (b)(4)(v) and (vi), respectively.

The Commission also proposes an additional 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. 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 proposes to insert, after the reference to "amount of money" the phrase "or current market value of securities." This would clarify 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.[23] 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.[24]

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23 See Rule 1.25(b)(2)(i)(E).

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

The Commission has been asked to consider eliminating the rating requirement for MMMFs. In particular, Federated Investors, Inc. ("Federated") has expressed the view that the rating requirement creates a competitive inequity for rated MMMFs that have yield and portfolio characteristics similar to the unrated funds that are commonly used by FCMs for investment of customer funds.[25] According to Federated, lower rated MMMFs, like many unrated MMMFs, do not qualify for the highest rating by an NRSRO because they hold split-rated and other securities in their portfolios, which are not approved by the NRSROs for triple-A rated funds, and because the average maturity of their portfolios may exceed 60 days.

As an example of the competitive inequity, Federated points to its Federated Prime Value Obligations Fund, a single-A rated fund that it describes as having essentially the same yield and portfolio characteristics as unrated competitors. Like unrated competitors, the fund cannot receive a triple-A rating because it holds split-rated and other securities in its portfolio, which are not approved by the NRSROs for triple-A rated funds, and because the average maturity of its portfolio may exceed 60 days. Because of the single-A rating, however, the Prime Value Obligations Fund, unlike competing unrated funds, cannot be used for investment of customer funds. Federated believes that the fact that the fund is rated should make it a more acceptable investment than an unrated fund.

Federated asserts that the rating limitation does not provide additional investor protections. It further argues that the investor protections afforded by SEC Rule 2a-7[26] make the rating requirement unnecessary. In this regard, Federated observes that the rule imposes strict portfolio quality, diversification, and maturity standards, which greatly limit the possibility of

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

26 17 CFR 270.2a-7.

significant deviation between the share price of a fund and its per share net asset value. Additionally, Federated notes that MMMFs are subject to board oversight regarding credit quality requirements and investment procedures.

Rule 1.25(c) sets forth additional requirements for MMMFs. Paragraph (c)(1) establishes SEC Rule 2a-7 as a basic standard of adequacy. More specifically, paragraph (c)(1) provides that, generally, the 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.[27]

It appears that the rating requirement for MMMFs under Rule 1.25(b)(2)(i)(E) is not essential in light of the other risk-limiting provisions applicable to MMMFs under Rule 1.25 and SEC Rule 2a-7. In consideration of the anomalous situation created by the use of unrated funds as permitted investments, the Commission is proposing to amend Rule 1.25(b)(2)(i)(E) to eliminate the rating requirement for MMMFs.

F. Registration Requirement for MMMFs

As discussed above, 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

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[27] A fund sponsor may petition for exemption from this requirement, and the Commission may grant an exemption, if the fund can demonstrate that it will operate in a manner designed to preserve principal and to maintain liquidity. As discussed in Section II.F. of this release, however, the Commission is proposing to eliminate this exemption provision.

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.

The Commission has not received any formal exemption requests under paragraph (c)(1), but it has received several informal inquiries. 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.

In light of the above considerations, the Commission believes that the exemptive process, in this situation, does not serve the best interests of the futures industry or the public. Accordingly, the Commission is proposing to amend paragraph (c)(1) to eliminate the availability of an exemption for unregistered funds.[28] While this removes the possibility of adding certain MMMFs to the pool of qualifying permitted investments, the Commission believes that this potential loss would be mitigated by the availability of additional MMMF investments under the Commission's proposed amendment to permit investments in MMMFs that are rated below the top rating of an NRSRO.[29] The requirement that all MMMFs be registered and qualify as SEC Rule 2a-7 funds, without exception, is consistent with the Commission's reliance on SEC Rule 2a-7 standards in its proposal to eliminate rating requirements for MMMFs.

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 proposes 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

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[28] Related to this, the Commission also proposes 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).

[29] See discussion in Section II.E. of this release.

investment of customer funds. Such a standard will 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.

Accordingly, the Commission proposes 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 must be sufficient to enable auditors to verify information to external sources and recalculate the valuation for a given instrument.

The Commission requests comment on the practices and procedures that FCMs and DCOs would have to implement in order to comply with such a standard and whether compliance would require substantial operational changes. To the extent that there may be issues regarding implementation of procedures to facilitate auditability, the Commission requests comment on how it should address those issues.

H. Additional Technical Amendments

1. Clarifying and Codifying MMMF Redemption Requirements

The Commission currently 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 proposes 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 proposes a further amendment to codify previously articulated exceptions to the next-day redemption requirement.

(i) Next-day Redemption Requirement

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

The Commission recognizes that the phrase, "able to redeem," on its face, could be interpreted to mean the MMMF must have the capability to redeem, but need not have the obligation to redeem. However, this is not the intended meaning of the provision.

In adopting the next-day redemption requirement in December 2000, the Commission responded to a public comment recommending that the one-day liquidity requirement be extended to seven days to be consistent with SEC requirements and the longer settlement time frames associated with direct investments.[30] The Commission explained its position as follows:

> The Commission believes the one-day liquidity requirement for investments in MMMFs is necessary to ensure that the funding requirements of FCMs will not be impeded by a long liquidity time frame. Since a material portion of an FCM's

[30] See 65 FR at 78003.

> customer funds could well be invested in a single MMMF, this is an important provision of the rule. The Commission notes that, although sales of directly-owned securities settle in longer than one-day time-frames, an FCM or clearing organization could obtain liquidity by entering into a repurchase transaction. Therefore, the Commission has retained the one-day liquidity requirement imposed on investments in MMMFs and, in view of the importance of this provision, has clarified that demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and an FCM or clearing organization.[31]

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 proposed changes in the first provision of paragraph (c)(5), the Commission believes 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 proposes 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.

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[31] Id.

(ii) 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.[32]

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.[33]

The Commission proposes to codify these exceptions in new paragraph (c)(5)(ii) and, in so doing, to redesignate the existing paragraph (c)(5), as amended, as paragraph (c)(5)(i). 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.

2. Clarifying Rating Standards for Certificates of Deposit

Rule 1.25(b)(2)(i)(B) sets forth the rating requirements for municipal securities, GSE securities, commercial paper, corporate notes that are not asset-backed, and certificates of

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

33 15 U.S.C. 80a-22(e).

deposit.[34] The Commission notes that certificates of deposit, unlike the other instruments listed in that paragraph, are not directly rated by an NRSRO.

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 proposes to delete the reference to certificates of deposit in paragraph (b)(2)(i)(B) of Rule 1.25 and insert a new paragraph (E) that would apply

[34] More specifically, Rule 1.25(b)(2)(i)(B) provides as follows: "Municipal 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 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.

3. Clarifying Corporate Bonds as Permitted Investments

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. However, the Commission proposes to clarify that this is not its intent by amending 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.

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.[35] This is not the intended outcome, and the Commission therefore is proposing to amend paragraph (d)(6) to clarify that Rule 1.26 applies only to securities transferred to (not from) an FCM or DCO.[36]

The Commission also is proposing 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.

5. <u>Clarifying Payment and Delivery Procedures for Reverse Repos and Repos</u>

The Commission is proposing to amend paragraph (d)(8) to clarify payment and delivery procedures for reverse repos and repos. Paragraph (d)(8) currently provides that the "transfer of securities" must be made on a delivery versus payment basis in immediately available funds. The Commission proposes 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 proposes 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.

The Commission requests comment on whether these amendments accurately reflect the current practices of FCMs and DCOs and, if not, how existing business practices operate to

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35 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.

36 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.

otherwise enable FCMs and DCOs engaging in repurchase transactions to maintain the proper amount of funds in segregated accounts at all times.

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 proposes 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.[37] 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.[38] 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

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[37] 33 FR 14455 (Sept. 26, 1968).

[38] 46 FR 33312 (June 29, 1981).

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

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 proposes 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.

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,[39] 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.[40] The Commission proposes technical amendments to Rule 1.25 to change the term "clearing organization" to "derivatives clearing organization." This will conform the language of Rule 1.25 to the language of the Act, more accurately reflecting the current statutory framework.

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

40 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").

As an additional matter, in connection with its proposed technical amendments to Rule 1.27,[41] the Commission also proposes to change the term "clearing organization" to "derivatives clearing organization" in that rule.

9. Conforming Terminology for "Government Sponsored Enterprise"

The Commission is also proposing 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)).

10. Conforming Terminology for "Futures Commission Merchant"

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

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 acronym for a "nationally recognized statistical rating organization." The Commission proposes to amend paragraph (b)(2)(i) to formally set forth the acronym as a defined term and to cross-reference the definition of that term contained in SEC Rule 2a-7.

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41 See Section II.D. of this release.

III. Time to Maturity--Treasury Portfolio

Rule 1.25(b)(5) limits the dollar-weighted average of the time to maturity for permitted investments to no longer than 24 months. In expanding the range of permitted investments in December 2000, the Commission added this requirement as a means for addressing the greater market risk associated with longer-term and fixed rate instruments.

In June 2003, the Commission requested comment on the applicability of time-to-maturity requirements for an FCM that invests solely in obligations of the U.S. Treasury. It had been suggested that, because Treasury securities do not pose the same credit risks as other permitted investments, the time-to-maturity limitation should not apply. The Commission requested comment specifically on whether an alternate safeguard to limit risk, such as appropriate haircuts, would be more meaningful than the time-to-maturity requirement of Rule 1.25(b)(5).

Both the FIA and NFA supported the elimination of the time-to-maturity requirement for a portfolio of securities consisting solely of Treasury instruments. The FIA observed that, prior to the adoption of the December 2000 amendments to Rule 1.25, an FCM could invest customer money exclusively in Treasury securities without regard to the dollar-weighted time to maturity of such instruments. Acknowledging that a portfolio consisting solely of long-dated Treasury instruments is not without (market) risk, the FIA concluded that these risks are addressed by the Commission's minimum financial requirements, pursuant to which the haircuts on Treasury instruments increase as the time to maturity increases.[42] However, the Commission believes that a situation in which an FCM would have to turn to its own capital to meet its obligations to a

[42] See 17 CFR § 1.17(c)(5)(v).

clearing organization or customers is far less desirable than one in which an FCM is able to quickly convert assets acquired with customer funds into cash at a predictable value.

The NFA, while noting that Treasury instruments do not pose the same (credit) risks as other permitted investments, stated its belief that these instruments should be subject to haircuts. However, the introduction of haircut requirements into the segregation calculations would be unprecedented, could involve substantial operational challenges or costs for FCMs, and has not otherwise been proposed or determined to be appropriate.

The Commission believes that the time-to-maturity requirement added by the December 2000 amendments remains an important constraint on the greater market risk inherent with longer-term and fixed rate instruments in a portfolio of customer funds. Rule 1.25(b)(5) requires the calculation of portfolio time-to-maturity as that average is computed pursuant to SEC Rule 2a-7 for MMMFs.[43] It should be noted that this calculation addresses floating rate government securities and variable rate government securities that are adjusted at least every two years by deeming the time to maturity for such instruments to be, respectively, either one day or the time remaining to the next variable rate adjustment.[44] The Commission believes this approach properly considers the lower relative price sensitivities of short-term versus long-term instruments and adjustable rate (floating or variable) versus fixed rate instruments.

Accordingly, the Commission continues to believe that application of this requirement to all portfolios, including those consisting solely of Treasuries or other government securities, does not unduly or improperly restrict an FCM's investment flexibility under Rule 1.25. Thus, the Commission has determined that it will not propose any changes to its time-to-maturity

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43 See 17 CFR § 270.2a-7.

44 See discussion of the terms "floating rate security" and "variable rate security" in Section II.B.3. of this release.

requirement for portfolios consisting solely of Treasury securities. The Commission would be pleased to receive comments on this decision from any interested persons.

V. Section 4(c)

Section 4(c) of the Act[45] 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, 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 proposed rules would be promulgated under Section 4d(a)(2) of the Act,[46] 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 proposes to expand 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

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[45] 7 U.S.C. 6(c).

[46] 7 U.S.C. 6d(a)(2).

funds. These proposed rules should enable FCMs and DCOs to remain competitive globally and domestically, while maintaining safeguards against systemic risk.

In light of the foregoing, the Commission believes that the adoption of the proposed rules regarding the expansion of permitted instruments for the investment of customer funds would promote responsible economic and financial innovation and fair competition, and would be consistent with the "public interest," as that term is used in Section 4(c) of the Act.

The Commission solicits public comment on whether the proposed rules satisfy the requirements for exemption under Section 4(c) of the Act.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act ("RFA")[47] 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.[48] The Commission has previously determined that registered FCMs[49] and DCOs[50] are not small entities for the purpose of the RFA. Accordingly, pursuant to 5 U.S.C. 605(b), the Acting Chairman, on behalf of the Commission, certifies that the proposed rules will not have a significant economic impact on a substantial number of small entities.

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[47] 5 U.S.C. 601 et seq.

[48] 47 FR 18618 (Apr. 30, 1982).

[49] Id. at 18619.

[50] 66 FR 45604, 45609 (Aug. 29, 2001).

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 proposed rule amendments do not require a new collection of information on the part of any entities subject to the proposed rule amendments. Accordingly, for purposes of the PRA, the Commission certifies that these proposed rule amendments, if promulgated in final form, would 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 proposed 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 proposed rules facilitate greater capital efficiency for FCMs and DCOs, while protecting customers by establishing prudent standards for investment of customer funds. Several of the proposed 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 proposed amendments relating to the mandatory registration requirement for MMMFs and auditability standard for investment records establish stricter standards. Similarly, proposed 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 proposed rules will facilitate greater efficiency and competitiveness for FCMs and DCOs, but they will not affect the efficiency and competitiveness of futures markets. The proposed amendments will not affect the financial integrity of futures markets.

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

4. Sound risk management practices. The proposed amendments 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 proposing to permit 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. Proposed 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 proposed 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 proposed 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 proposed 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 proposed 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 proposed amendments are expected to enhance the ability of FCMs and DCOs to earn revenue from the investment of customer funds, 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 propose the rules and rule amendments set forth below. The Commission invites public comment on its application of the cost-benefit provision. Commenters also are invited to submit, with their comment letters, any data that quantifies the costs and benefits of the proposal.

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 proposes to amend 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 proposed to be 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 and 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 § 270.2a-7 of this title. 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, or the one-month or three-month LIBOR rate;

(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, <u>provided, however,</u> 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) <u>Transactions by futures commission merchants that are also registered securities brokers or dealers.</u> 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 and 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 proposed to be amended by inserting the word “derivatives” before the term “clearing organization” in paragraphs (a) and (b).

4. Section 1.27(a)(3) is proposed to be amended by inserting the phrase “or current market value of securities” after the phrase “The amount of money.”

5. Section 1.27(a) is proposed to be 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 documentation supporting the daily valuation for each instrument. Such supporting documentation must be sufficient to enable auditors to validate the valuation and verify the accuracy of input information used in the valuation to external sources for any instrument.

Issued in Washington, DC on January 27, 2005, by the Commission.

Jean A. Webb,

Secretary of the Commission.