

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1 and 4

RIN 3038-AD11

Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission” or “CFTC”) is adopting a final rule that amends existing CFTC regulations in order to implement new statutory provisions enacted by Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The rule amendments set forth herein apply to futures commission merchants (“FCMs”), derivatives clearing organizations (“DCOs”), and commodity pool operators (“CPOs”). The rule amendments implement the new statutory framework that requires agencies to replace any reference to or reliance on credit ratings in their regulations with an appropriate alternative standard.

DATES: This rule is effective [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION

I. BACKGROUND

On July 21, 2010, President Obama signed into law the Dodd-Frank Act.¹ In relevant part, Title IX of the Dodd-Frank Act directs Federal agencies to take certain actions concerning any reference to—or requirement of reliance on—credit ratings in each agency’s respective regulations. Specifically, section 939A of the Dodd-Frank Act requires agencies to take three actions by July 21, 2011, the one-year anniversary of the enactment of the Dodd-Frank Act. First, section 939A(a) directs each Federal agency to review “any regulation issued by such agency that requires the use of an assessment of the credit-worthiness of a security or money market instrument [and] any references to or requirements in such regulations regarding credit ratings.” Second, section 939A(b) requires that each Federal agency “modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” To the extent feasible, Federal agencies should “seek to establish . . . uniform standards of credit-worthiness for use by each such agency.” And third, section 939A(c) directs each Federal agency to report to Congress “a description of any modification of any regulation such agency made pursuant to subsection (b).”

Subsequent to the enactment of the Dodd-Frank Act, the Commission reviewed its regulations and identified instances in which credit ratings were referred to or relied

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at <http://www.cftc.gov/LawRegulation/OTCDERIVATIVES/index.htm>.

upon.² The identified regulations could be categorized into two groups: (1) those that rely on ratings to limit how Commission registrants may invest or deposit customer funds; and (2) those that require disclosing a credit rating to describe an investment's characteristics. In keeping with its efforts to comply fully with both the spirit and letter of the Dodd-Frank Act, the Commission proposed to amend all of the identified regulations that rely on credit ratings regarding financial instruments.

On November 2, 2010, the Commission published in the **Federal Register** proposed amendments to certain of its existing regulations (the "Proposing Release") in response to the directives set forth in section 939A of the Dodd-Frank Act.³ Specifically, the Commission addressed two regulations in the Proposing Release: (1) Regulation 1.49, which places qualifications on the types of depositories where FCMs and DCOs might place customer funds; and (2) Regulation 4.24, wherein credit ratings are used to help disclose the characteristics of an investment.⁴

Regulation 1.49, which mirrors Regulation 30.7,⁵ requires that an acceptable

² Commission regulations that are referenced herein are found at 17 CFR Ch. 1 (2010). They are accessible on the Commission's website at <http://www.cftc.gov>.

³ 75 FR 67254, Nov. 2, 2010.

⁴ Separately, the Commission issued Notices of Proposed Rulemaking that addressed references to credit ratings in Commission Regulations 1.25 and 30.7, and in Appendix A to Part 40. See "Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions," 75 FR 67642, Nov. 3, 2010 (proposing amendments to Regulations 1.25 and 30.7); "Provisions Common to Registered Entities," 75 FR 67282, Nov. 2, 2010 (proposing to delete the current Appendix A of Part 40). The amendments proposed in those Notices are not addressed herein and may be subject to future Commission rulemaking.

⁵ See 68 FR 5545, 5548, Feb. 4, 2003 (noting the Commission's view that consistency between Regulations 1.49 and 30.7 on this issue is "appropriate"). In a separate release, the Commission has proposed amendments to Regulation 30.7 that are similar to the amendments to Regulation 1.49 addressed herein. See supra note 4.

foreign depository must either: (1) have in excess of \$1 billion of regulatory capital; or (2) issue commercial paper or a long-term debt instrument that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization (“NRSRO”). In the Proposing Release, the Commission proposed to remove all ratings requirements from Regulation 1.49. The Commission based its proposal on its views regarding the uncertain reliability of ratings as currently administered, particularly in light of the significant weaknesses of the ratings industry that were revealed in recent years. The Commission noted the poor past performance of credit ratings in gauging the safety of certain types of investments, and its view that credit ratings are not necessary to gauge the future ability of certain types of investments to preserve customer funds. The proposal was intended to align Regulation 1.49 with proposed Regulations 1.25 and 30.7, and to greater simplify the regulatory treatment of the investment of customer funds.

With respect to the proposed amendment of Regulation 1.49, the Commission requested comment on: (1) whether relying on a minimum capital requirement of \$1 billion dollars in regulatory capital is an adequate alternative standard to the current Regulation 1.49; and (2) whether another standard or measure of solvency and credit-worthiness should be used as an appropriate, additional test of a bank’s safety, such as a leverage ratio or a capital adequacy ratio requirement consistent with or similar to those in the Basel III accords. The Commission also stated that it would welcome any other comments on the proposal.

In addition to the proposed amendment to Regulation 1.49, the Proposing Release also proposed to amend Regulation 4.24. Regulation 4.24 requires CPOs to disclose the

characteristics of the commodity and other interests that the pool will trade, including, if applicable, their investment rating. In order to comply fully with the spirit and letter of the Dodd-Frank Act, the Commission proposed removing the references to ratings in Regulation 4.24 and replacing that reference with the phrase “credit-worthiness.” In the Proposing Release, the Commission expressly noted that CPOs may still choose to reference an investment rating to describe the credit-worthiness of an investment in its disclosures. However, the Commission noted that the CPO as appropriate should make an independent assessment of the credit-worthiness of those investments.

The Commission requested comment on its proposed amendment of Regulation 4.24, particularly with respect to what effect the removal of the credit ratings reference in Regulation 4.24 might have on the ability of investors and others to understand the disclosures of CPOs regarding the characteristics of a commodity pool. The Commission also requested comment on the ability of CPOs to make independent assessments of the credit-worthiness of their pool’s investments.

II. COMMENTS ON THE PROPOSING RELEASE

In response to the Proposing Release, the Commission received three comments, two of which were not responsive to the issues presented in the Notice. The other commenter forwarded a letter originally submitted in response to an advance notice of proposed rulemaking issued by the federal banking agencies.⁶ The commenter discussed issues and options surrounding the implementation of section 939A of the Dodd-Frank Act, and offered analytical services to refine alternatives to credit ratings. However, the

⁶ See “Advance Notice of Proposed Rulemaking Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies,” 75 FR 52283, Aug. 25, 2010.

commenter did not raise any factual or policy concern relating to the rule amendments proposed by the Commission in the Proposing Release.

After considering the comments received in response to the Proposing Release, the Commission has determined to amend Regulations 1.49 and 4.24 as proposed. Section 939A of the Dodd-Frank Act directs each Federal agency, including the Commission, “to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” As acknowledged in the Proposing Release, the Commission proposed the amendments to Regulations 1.49 and 4.24, in part, to facilitate “its efforts to fully comply with both the spirit and letter of the Dodd-Frank Act.” The amendments set forth herein are narrowly tailored to accomplish that task, while maintaining the commitment to the protection of customer funds that the Commission continually has promoted over the years.

III. CONSIDERATION OF COSTS AND BENEFITS UNDER SECTION 15(A) OF THE COMMODITY EXCHANGE ACT (“CEA”)

Section 15(a) of the CEA requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the Act. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of the five broad areas of market and public concern: (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.⁷ The

⁷ The rule amends the qualifications required of non-U.S. depositories in which customer funds may be held and alters the disclosures that CPOs must provide to their customers. Given the characteristics of the rule and its anticipated effect, the Commission does not

Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.

Although the Commission specifically requested public comment on appropriate alternatives to the rule language contained in the Proposing Release,⁸ the Commission received no such comments, nor did the Commission receive any substantive comments on the costs and benefits related to the rule. Section 939A instructs the Commission to implement the removal of any references to or reliance on credit ratings in its rules and regulations.

Because of the statutory requirement to remove the reference to credit ratings from Regulation 1.49, investments in foreign depositories that have less than \$1 billion in regulatory capital, but that previously were eligible depositories in reliance upon their credit ratings, may no longer be eligible depositories for customer funds. The consequences of this regulatory action may impose transaction costs associated with transferring customer funds, if necessary, to another depositor if a foreign depository is no longer eligible. Costs also may be borne by foreign banks or trusts that will no longer be eligible to receive deposits of customer funds under Regulation 1.49, given the resultant loss of business.

However, the amendments to Regulation 1.49 reflect the statutory mandate set forth under section 939A of the Dodd-Frank Act. The Commission acknowledged in the

believe that the rule will impact the efficiency or competitiveness of futures markets, or have any effect on price discovery.

⁸ See 75 FR 67254, 67256, Nov. 2, 2010.

Proposing Release the uncertain reliability of ratings as currently administered, the poor past performance of credit ratings in gauging the safety of certain types of investments, and the Commission's view that credit ratings are not necessary to gauge the future ability of certain types of investments to preserve customer funds. Although the Commission specifically "request[ed] comment on whether there is another standard or measure of solvency and creditworthiness that might be used as an appropriate, additional test of a bank's safety,"⁹ the Commission received no comments offering an appropriate alternative to the amendments to Regulation 1.49 that were contained in the Proposing Release. In light of the uncertain reliability of ratings and their poor past performance, the Commission believes that the elimination of references to credit ratings in Regulation 1.49 will enhance the protection of market participants and the public, as well as enhance sound risk management practices, by requiring that if customer funds are held in a non-U.S. bank or trust company, the non-U.S. bank or trust company have more than \$1 billion of regulatory capital. The capital standard will afford greater protection of customer funds. Such protections will, in turn, promote the financial integrity of futures markets by reducing the likelihood of loss, relative to the status quo.

Similarly, the statutory requirement to modify Regulation 4.24 has the potential benefit of reducing risk in the financial system by placing more responsibility on CPOs to fully understand the credit-worthiness of investments. CPOs will be required to make an independent assessment, as appropriate, of the credit-worthiness of investments in their portfolio rather than relying solely on credit ratings, though CPOs will not be prohibited from relying on credit ratings, as appropriate. Customers of CPOs may benefit from

⁹ Id.

improved disclosure of the credit-worthiness of the investments in which funds are placed. In light of the specific issues identified by the Commission concerning the reliance of credit ratings, as discussed in greater detail supra, the Commission believes that the rule will enhance the protection of market participants and the public, promote the financial integrity of futures markets, and enhance sound risk management practices. Costs may be imposed on CPOs in improving their ability to make independent assessments of credit-worthiness. Although CPOs will not be prohibited from relying on credit ratings under Regulation 4.24, circumstances may require a CPO to engage in further assessments of the credit-worthiness of the investments in which funds are placed, as appropriate, beyond merely citing the ratings of those investments by a NRSRO. However, notwithstanding its costs, this rule is necessary and appropriate to protect the public interest, and effectuates the mandate prescribed in section 939A of the Dodd-Frank Act.

IV. RELATED MATTERS

A. Regulatory Flexibility Act.

The Regulatory Flexibility Act (“RFA”) requires Federal agencies, in promulgating rules, to consider the impact of those rules on small businesses, and whether the rules will have a significant economic impact on a substantial number of small entities.¹⁰ The rule amendments proposed herein will affect FCMs, DCOs, and CPOs. The Commission previously has established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its regulations on small entities

¹⁰ 5 U.S.C. 601 et seq.

in accordance with the RFA, and has determined that registered FCMs,¹¹ DCOs,¹² and CPOs¹³ are not small entities for the purpose of the RFA. Accordingly, as set forth in the Proposing Release,¹⁴ the Chairman, on behalf of the Commission and pursuant to 5 U.S.C. 605(b), certifies that the proposed rules will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act.

The Paperwork Reduction Act (“PRA”)¹⁵ 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. These rule amendments do not require a new collection of information on the part of any entities subject to the rule amendments. Accordingly, for purposes of the PRA, the Commission certifies that these rule amendments will not impose any new reporting or recordkeeping requirements.

List of Subjects

17 CFR Part 1

Brokers, Commodity futures, Consumer protection.

17 CFR Part 4

¹¹ 47 FR 18618, 18619, Apr. 30, 1982.

¹² 66 FR 45604, 45609, Aug. 29, 2001.

¹³ 47 FR at 18619-20.

¹⁴ See 75 FR 67254, 67256, Nov. 2, 2010.

¹⁵ 44 U.S.C. 3501 et seq.

Advertising, Commodity futures, Commodity pool operators, Commodity trading advisors, Consumer protection, Disclosure, Principals, Reporting and recordkeeping requirements.

For the reasons stated in this release, the Commission hereby amends 17 CFR parts 1 and 4 as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 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 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010), and the Commodity Futures Modernization Act of 2000, Appendix E of Pub. L. 106–554, 114 Stat. 2763 (2000).

2. Section 1.49 is amended by revising paragraph (d)(3) to read as follows:

§ 1.49 Denomination of customer funds and location of depositories.

* * * * *

(d) * * *

(3) A depository, if located outside the United States, must be:

- (i) A bank or trust company that has in excess of \$1 billion of regulatory capital;
- (ii) A futures commission merchant that is registered as such with the Commission; or
- (iii) A derivatives clearing organization.

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**PART 4—COMMODITY POOL OPERATORS AND COMMODITY TRADING
ADVISORS**

1. The authority citation for part 4 is revised to read as follows:

Authority: 7 U.S.C. 1a, 2, 4, 6(c), 6b, 6c, 6l, 6m, 6n, 6o, 12a and 23, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

2. Section 4.24 is amended by revising paragraph (h)(1)(i) to read as follows:

§ 4.24 General disclosures required.

* * * * *

(h) * * *

(1) * * *

(i) The approximate percentage of the pool's assets that will be used to trade commodity interests, securities and other types of interests, categorized by type of commodity or market sector, type of security (debt, equity, preferred equity), whether traded or listed on a regulated exchange market, maturity ranges and credit-worthiness, as applicable;

* * * * *

By the Commodity Futures Trading Commission.

Dated: July 20, 2011.


David A. Stawick,
Secretary.

Appendices to Removing Any Reference to or Reliance on Credit Ratings in Commission Regulations; Proposing Alternatives to the Use of Credit Ratings—Commission Voting Summary and Statements of Commissioners

NOTE: The following appendices will not appear in the Code of Federal Regulations

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Sommers, Chilton and O'Malia voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final rulemaking to remove references to credit ratings within the CFTC's regulations. Under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress required the Commission to review credit rating references in our existing regulations and remove reliance upon them. The rule removes them from Regulation 1.49, which limits the types of non-U.S. banks in which futures commission merchants and derivatives clearing organizations may place customer funds. The rule also removes them from Regulation 4.24, which requires commodity pool operators to disclose to their customers where they are putting customer money. Other references included in Regulations 1.25 and 30.7 will be taken up when the Commission considers the proposed rulemaking related to investment of customer funds.