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September 5, 2003

COMMENT

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

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Re: Proposed Amendments to Rule 1.25—Investment of Customer Funds
68 *Fed.Reg.* 38654 (June 30, 2003)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit these comments on the Commodity Futures Trading Commission's ("Commission's") proposed amendments to rule 1.25, 68 *Fed.Reg.* 38654 (June 30, 2003).[1] Rule 1.25 sets forth the terms and conditions pursuant to which FCMs may invest customer funds segregated in accordance with section 4d(a)(2) of the Commodity Exchange Act ("Act") and Commission rule 1.20 in certain "permitted investments" as defined in paragraph (a)(1) of the rule. The Commission is proposing to amend this rule in two ways. One amendment would specifically authorize FCMs to enter into repurchase transactions using customer-owned securities held in the customer segregated account. The other amendment would modify the portfolio time-to-maturity requirements for securities deposited in connection with certain collateral management programs of derivatives clearing organizations.

Repurchase Transactions

FIA fully supports the Commission's proposal to authorize FCMs to engage in repurchase transactions using securities that customers have deposited to support positions on US futures exchanges.[2] As the Commission notes in the *Federal Register* release accompanying the

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[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[2] Further, as described in detail at the conclusion of this letter, FIA is recommending an additional amendment to Commission rule 1.25. The proposed amendment would authorize an FCM that is also a registered broker-dealer and that owns or has the unqualified right to pledge securities that are "permitted investments" to invest customer funds by effecting a transfer of such securities that the FCM/broker-dealer holds to the customer segregated account. Similarly, in lieu of entering into a repurchase transaction with a third party, the FCM/broker-dealer would be authorized to effect such transactions by means of a transfer of customer-owned securities with permitted investments that the FCM/broker-dealer holds.

proposed rules, although applicable exchange rules authorize FCMs to accept certain types of securities as margin from customers, FCMs are not able to forward these securities to clearing organizations to satisfy customer margin obligations. These restrictions unnecessarily increase the costs to FCMs. By affording FCMs the opportunity to replace customer-owned securities with securities that clearing organizations accept, the proposed amendment will reduce these costs significantly without exposing the customers' securities to an appreciable risk of loss.

Rule 1.25(a)(2) currently authorizes FCMs to engage in repurchase transactions with securities that FCMs obtain through the investment of customer funds. To assure that such transactions are effected with minimal risk of loss to the customer segregated account, all such repurchase transactions must be effected in accordance with the terms and conditions of paragraph (d) of the rule. In particular, paragraph (d) provides that: (1) securities must be specifically identified by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number; (2) permitted counterparties are limited to banks and registered broker-dealers; (3) the transaction must be made pursuant to a written agreement signed by the parties to the agreement which is consistent with the conditions set forth in paragraph (d); (4) the term of the agreement must be no more than one business day or reversal must be possible on demand; (5) the transfer of securities must be made on a delivery versus payment basis in immediately available funds (*i.e.*, the transfer is not recognized as accomplished until the funds and/or securities are actually received by the custodian of the FCM); and (6) immediately upon entering into the transaction, a written confirmation specifying the terms of the agreement and a safekeeping receipt must be issued to the FCM.[3]

The proposed amendment would require FCMs that engage in repurchase transactions with customer-owned securities to comply with the terms and conditions of paragraph (d). We respectfully submit that these requirements, combined with the additional terms and conditions set forth in paragraph (a)(2)(ii), will be more than sufficient to safeguard both the customer-owned securities specifically as well as the customer segregated account generally. The risk that an FCM assumes in entering into a repurchase transaction using customer-owned securities is essentially no different from the risk the FCM assumes in entering into repurchase transactions with securities that the FCM obtains through the investment of customer funds.

With customer-owned securities, of course, there is a risk that, in the unlikely event of a counterparty default, the securities will not be returned. However, we note that, among other terms and conditions set forth in paragraph (a)(2)(ii), an FCM would be permitted to engage in repurchase transactions only with those customer-owned securities that are "readily marketable" as defined in Securities and Exchange Commission rule 15c3-1. That is, the securities must be traded in a "recognized established securities market in which there exists independent *bona fide* offers to buy and sell so that a price reasonably related to the last sales price or current *bona fide*

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[3] Paragraph (d) also provides that the transaction must be executed in compliance with the concentration limit requirements applicable to the securities held in connection with the agreements to repurchase referred to in paragraphs (b)(4)(ii) and (iii) of this section. As discussed in greater detail below, FIA is recommending that the concentration limit requirements in paragraph (b)(4)(i) apply to all transactions.

competitive bid and offer quotations can be determined for [the] security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short period of time." 17 CFR §15c3-1(c)(11). Because customer-owned securities that are used in a repurchase transaction must be highly liquid, an FCM should have little difficulty using the cash proceeds of the repurchase agreement held in the customer segregated account to buy the same securities elsewhere in the unlikely event of a counterparty default.[4] Of course, any loss incurred as a result of such difficulty would be borne by the FCM.[5]

For this reason, we do not believe it is necessary or appropriate to require an FCM to obtain the written consent of its customer before engaging in a repurchase transaction with the customer's securities. Nor do we believe that it is necessary to provide a one-way disclosure to customers. All customers are presumed to be aware of the rules and regulations governing their accounts. The provisions of rule 1.25 are sufficient to provide notice to customers that deposit securities with an FCM to margin or secure their positions on US futures markets.[6]

Time-to-Maturity for Certain Collateral

The Commission also proposes to amend paragraph (b)(5) of rule 1.25 to add a new paragraph (ii). Subject to the terms and conditions set forth in that paragraph, securities deposited with a designated clearing organization to satisfy special margin charges, will be deemed to have a time-to-maturity of one day. FIA supports the overarching purpose of the proposed amendment. However, we believe that certain of the proposed terms and conditions unnecessarily restrict the scope of the relief. Most important, we believe the benefits of the amendment should not be limited to those circumstances in which the securities are used "only for the purpose of meeting concentration margin or other similar charges", as the Commission states in proposed paragraph (ii)(C).

FIA understands that the proposed amendment to paragraph (b)(5) is designed in the first instance to address issues arising from a collateral management arrangement that the Chicago Mercantile

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[4] If a counterparty fails to perform, FIA believes that an FCM should make every reasonable effort to replace the customer-owned securities that are the subject of a repurchase transaction.

[5] We understand that the failure of a counterparty to return the customer-owned securities that are the subject of a repurchase transaction could, in certain circumstances, have tax implications. However, as noted above, we believe this possibility is remote. Therefore, we do not believe that the Commission should consider potential tax implications in adopting final rules.

[6] Our position here does not conflict with the views that the Federal Home Loan Mortgage Corporation ("Freddie Mac") expressed in its letter to the Commission dated July 30, 2003. Nothing in the proposed amendments to rule 1.25 or in FIA's position herein would prevent a customer from contracting with its FCM, in the customer agreement or otherwise, to require notice and consent before the FCM engages in repurchase transactions with that customer's securities. Along these same lines, a clearing member FCM could contract with its clearing organization to prohibit or restrict the manner in which the clearing organization engages in repurchase transactions involving securities that the FCM deposits with the clearing organization.

Exchange ("CME") is implementing. Currently, this arrangement, Interest Earning Facility 3 ("IEF 3") is limited to the deposit of concentration margin required to be deposited under CME rules. Nonetheless, we see no reason why, if a clearing organization desired, a comparable program could not be designed for initial margin deposits generally. FIA's views in this regard are consistent with those that the CME expressed in its letter to the Commission on the proposed amendments.[7]

FIA also opposes adoption of the provisions of paragraph (b)(5)(ii)(E), which would require a derivatives clearing organization to reduce the assigned value of any securities deposited to satisfy margin requirements by a haircut of at least two percent. As the Commission is aware, the core principles governing derivatives clearing organizations require these entities to have the ability to manage the risks associated with discharging its responsibilities "through the use of appropriate tools and procedures", including appropriate haircuts on deposited securities. In this connection, clearing organizations currently require clearing members to haircut securities deposited to meet margin obligations. We submit that the Commission should defer to the clearing organization's judgment concerning the appropriate haircuts applicable to such securities, until the Commission has reason to believe that the clearing organization is not complying with this core principle.

Separately, FIA requests the Commission to confirm that, to the extent the concentration limits set forth in rule 1.25 will apply to deposits of securities with clearing organizations under this paragraph, the applicable limits will be the limits for direct investments under paragraph (b)(4)(i).

Requests for Comment

In addition to the above amendments, the Commission requests comment on other aspects of rule 1.25. Our responses to the Commission's requests follow.

1. Time-to-Maturity—Treasury Portfolio. The Commission requests comment on whether an alternate safeguard to limit risk, such as appropriate haircuts, would be more appropriate than the time-to-maturity requirement of rule 1.25(b)(5) with respect to a portfolio consisting exclusively of U.S. Treasury securities. FIA supports an amendment to rule 1.25(b)(5) addressing the time to maturity of a portfolio of securities consisting solely of Treasury instruments. We note that, prior to the adoption of the amendments to rule 1.25 in December 2000, an FCM could invest customer funds exclusively in Treasury securities without regard to the dollar-weighted time to maturity of such instruments. Many FCMs took advantage of this authority, apparently without incident. A portfolio consisting solely of long-dated Treasury instruments certainly is not without risks. However, these risks are addressed through the Commission's minimum financial requirements, pursuant to which the haircuts on Treasury instruments increase as the time-to-maturity increases. 17 CFR §1.17(c)(5)(v).

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[7] Letter from James J. McNulty, President, Chicago Mercantile Exchange, to Jean A. Webb, Secretary to the Commission, dated July 29, 2003.

2. Embedded Derivatives. The Commission requests 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. FIA supports amending rule 1.25(b)(3)(i) to permit FCMs to invest in securities with embedded derivatives. Securities with embedded derivatives often have similar or lower levels of risk than fixed-rate securities in which FCMs are currently authorized to invest under rule 1.25. We note, in particular, that many Government Agency securities that carry a variable interest rate also contain embedded derivatives, *e.g.*, caps and floors, puts and calls. As a result, the rule currently prevents FCMs from investing in a broad range of Government Agency securities.

FIA recommends that the Commission amend rule 1.25(b)(3)(i) to permit FCMs to invest in securities with embedded derivatives, provided such derivatives are directly related to the interest rate characteristic of the security. The concept underlying this recommendation is similar to one in found in Generally Accepted Accounting Standards ("GAAP"), SFAS 133. In that standard, embedded derivatives that are "clearly and closely related" to the "host contract" are accounted for together with the underlying instrument. Embedded derivatives that do not meet this test must be accounted for separately. 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.

3. Variable Rate Securities—Permitted Benchmarks. The Commission requests comment on whether the provisions on permitted benchmarks should be amended, and if so, what the applicable standard should be. FIA supports amending Commission rule 1.25(b)(3)(iv) to expand the permitted benchmarks for variable rate securities. FIA recommends that this paragraph be amended to provide that the interest rate on variable rate securities may be benchmarked to any fixed rate instrument that is a "permitted investment" under the rule. If an FCM is authorized to purchase a fixed rate instrument, *e.g.*, a six-month Treasury bill, and continuously roll that instrument over, there should be no reason why an FCM cannot purchase a variable rate instrument whose benchmark is that fixed rate security. This change will also allow FCMs to respond to new benchmarks as they evolve. For example, we understand that, in Europe, the Euribor has become more popular than LIBOR as a benchmark in many instruments.

4. Reverse Repurchase Transactions—Concentration Limits. The Commission requests comment on market participants' experience with the current provisions relating to reverse repurchase transactions and suggestions on how best to address the risks of these transactions. FIA encourages the Commission to amend paragraph (b)(4) to remove entirely the concentration limits on securities held by an FCM subject to reverse repurchase agreements. We appreciate that, by concentrating "primarily upon the counterparties and secondarily upon the securities" held in connection with such transactions, the Commission was seeking to remove restrictions commenters previously had identified as inhibiting their use. Practically, however, an FCM cannot monitor such transactions by security, size and counterparty except through manual processing. As a consequence, this investment alternative has generally proved to be not viable. In lieu of the concentration limits in paragraph (b)(4)(iii), therefore, we respectfully suggest that

all securities held by an FCM either through an investment of customer funds or though a reverse repurchase transaction should be subject to the concentration limits for direct investments.

Recommendation Regarding Transactions by FCMs Registered as Broker-Dealers

As indicated in footnote 2 above, FIA is recommending for the Commission's consideration an additional amendment to rule 1.25. The proposed new paragraph (f) to rule 1.25 is set forth in the enclosed exhibit. The purpose of the proposed amendment is to set out the terms and conditions, pursuant to which an FCM that is also registered with the Securities and Exchange Commission ("SEC") as a broker-dealer and that, in connection with such activities, owns or has the unqualified right to pledge securities that are "permitted investments" under paragraph (a) of the rule, may invest customer funds by effecting a transfer of such instruments that the futures commission merchant holds to the customer segregated account. The proposed amendment would also authorize an FCM/broker-dealer, in lieu of selling customer securities to another person pursuant to repurchase agreements, to effect such transactions by means of a transfer of customer-owned securities from the customer segregated account with permitted investments that the futures commission merchant holds.

The proposed amendment is consistent with section 4d(a)(2) of the Commodity Exchange Act ("Act") and the other paragraphs of this rule.[8] As required under this section of the Act, an FCM/broker-dealer electing to take advantage of this paragraph would "treat and deal with all money, securities and property received" from customers as belonging to such customers. Indeed, the protections afforded customer funds under paragraph (f) would be no less, and arguably better, than the protections afforded customer funds under rule 1.25 in effect and as proposed to be amended.

In this regard, proposed paragraph (f) would require an FCM/broker-dealer effecting a transfer under paragraph (f)(1) and (f)(2) to make and maintain those records currently required under Commission rules 1.25, 1.26, 1.27, 1.28, and 1.36. In addition, the FCM/broker-dealer would be required to make and maintain such books and records relating to the transaction as are required under applicable SEC rules and regulations, including SEC regulation 17a-3. Finally, the custodian bank would create and maintain records to confirm that the securities were being held in the FCM/broker-dealer's customer segregated account.

With respect the transactions involving customer-owned securities, the records required to be created and maintained would reflect the customer's continued ownership interest in the securities that it has deposited as well as the fact that the FCM/broker-dealer has moved those securities from the customer segregated account and has substituted them with securities that the FCM/broker-dealer holds. The custodian bank's records would also reflect the proper location of all securities.

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[8] The Commission, of course, has authority under section 4d(a)(2) of the Act to adopt rules and regulations and to prescribe terms and conditions governing the treatment of customer funds.

Moreover, the FCM/broker-dealer would continue to be subject to other relevant provisions of rule 1.25(d). Specifically, the FCM/broker-dealer must identify by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number both the customer securities transferred from the segregated account and the securities transferred to the segregated account. In addition, FCM must be able to unwind the transaction within one business day or on demand.

FIA recognizes that the Commission may have questions or concerns regarding this recommendation. We would be pleased to meet with the Commission and its staff at its convenience to address any such questions or concerns and, further, to explore any additional terms and conditions that the Commission may consider appropriate.[9]

Conclusion

FIA appreciates this opportunity to comment on the proposed amendments and other issues relating to rule 1.25. If the Commission has any questions concerning the comments in this letter, and in particular, the proposed new paragraph (f), please contact Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

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[9] FIA also understands that Commission staff previously has issued interpretative letters or has adopted no-action positions that address at least certain of the types of transactions that would be authorized under proposed paragraph (f). If the Commission determines to adopt the recommendation set forth above, we respectfully request that the Commission make clear in the accompanying *Federal Register* release that the terms and conditions of proposed paragraph (f) would supercede any and all such interpretative letters and no-action positions.

Proposed Paragraph (f)

(f) Futures Commission Merchants Registered as Securities Dealers.

(1) Nothing in paragraph (a)(1) of this section prohibits a futures commission merchant that is also registered with the Securities and Exchange Commission as a securities dealer and that, in connection with such dealer activities, owns or has the unqualified right to pledge securities that are permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section from investing customer funds in permitted investments by effecting a transfer of such instruments that the futures commission merchant holds in lieu of investing customer funds in such instruments through another person.

(2) Notwithstanding any provisions of this section 1.25 to the contrary and subject to the terms and conditions set forth in this paragraph (f), a futures commission merchant that is also registered with the Securities and Exchange Commission as a securities dealer and that, in connection with such activities, owns or has the unqualified right to pledge securities that are permitted investments listed in paragraphs (a)(1)(i) through (viii) of this section may, in lieu of selling customer securities to another person pursuant to repurchase agreements in accordance with paragraph (a)(2)(ii) of this section, effect such transactions by means of a transfer of customer-owned securities from the customer segregated account with permitted investments that the futures commission merchant holds.

(3) A futures commission merchant that elects to effect transactions authorized by paragraphs (f)(1) and (f)(2) of this section shall maintain all books and records with respect to such securities and such transfers in accordance with sections 1.25, 1.27, 1.31 and 1.36 of this Chapter and the applicable rules and regulations of the Securities and Exchange Commission.

(4) A futures commission merchant that, pursuant to paragraph (f)(1) or (f)(2) of this section, transfers securities to the customer segregated account must:

(i) Own or have the unqualified right to pledge such securities to the customer segregated account.

(ii) Be able to unwind the transaction within one business day or on demand.

(iii) Price the securities transferred to the customer segregated account each day based on the current mark-to-market value.

(5) A futures commission merchant that, pursuant to paragraph (f)(2) of this section, transfers securities deposited by customers and deposits in lieu thereof securities that the futures commission merchant holds must specifically identify by coupon rate, par amount, market value, maturity date, and CUSIP or ISIN number both the customer securities transferred from the segregated account and the securities that the futures commission merchant transfers to the segregated account.

(6) Securities that a futures commission merchant transfers to the customer segregated account pursuant to this paragraph (f):

(i) Shall be subject to the concentration limit requirements set forth in paragraph (b)(4)(i) of this section; and

(ii) Shall be treated as having a one-day time-to-maturity.

(7) Any transfer of securities to the customer segregated account pursuant to paragraph (f)(1) or (f)(2) of this section shall not be recognized as accomplished until the securities are actually received by the custodian of the futures commission merchant's customer segregated account.

(8) For purposes of section. 1.25, 1.26, 1.27, 1.28 and 1.29 of this Chapter, securities transferred into the customer segregated account in accordance with paragraph (f)(1) of this section shall be considered customer funds until such investments are withdrawn from segregation and the customer funds or customer-owned securities are transferred concurrently to the segregated account.