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Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

FIA

March 7, 2005

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

COMMENT

Re: Proposed Amendments to Commission Rules 1.25 and 1.27—Investment of Customer Funds and Record of Investments 70 *Fed.Reg.* 5577 (February 3, 2005)

Dear Ms. Webb:

The Futures Industry Association ("FIA")[1] welcomes this opportunity to write in support of the proposed amendments to Commodity Futures Trading Commission ("Commission") rules 1.25 and 1.27. The proposed amendments to rule 1.25 address matters on which the Commission first requested comment in June 2003[2] and in response to which FIA had submitted extensive comments.[3] We are pleased that the Commission, after considerable analysis, has proposed to adopt the majority of the recommendations that FIA made. The proposed amendments will afford FCMs and designated clearing organizations greater flexibility in investing customer funds, consistent with their obligations under section 4d(a)(2) of the Commodity Exchange Act. We urge the Commission to promulgate final rules without delay. We have only a few comments.

Permitted Benchmarks. The Commission has proposed to amend rule 1.25(b)(3)(iv) to expand the permitted benchmarks for certain adjustable rate securities. Specifically, the Commission has proposed to expand the permitted benchmarks to any fixed rate instrument that is a permitted investment as defined in rule 1.25(a). In doing so, however, the Commission has proposed to distinguish between floating rate securities—securities for which periodic interest payments vary

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1 FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets.

2 68 *Fed.Reg.* 38654 (June 30, 2003). The proposed amendments also clarify certain provisions of rule 1.25

3 Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated September 5, 2003.

by formula or other reference calculation any time a specified interest rate changes—and variable rate securities—securities whose periodic interest payments are adjusted on set dates. The permitted benchmarks have been expanded only for floating rate securities. No change is proposed in the permitted benchmarks for variable rate securities.

We understand that the Commission has proposed to distinguish between floating rate securities and variable rate securities in paragraph (b)(3) in order to assure consistency with paragraph (b)(5), which provides that FCMs must compute the dollar weighted average of the time-to-maturity of the portfolio of securities held through the investment of customer funds pursuant to SEC Rule 2a-7. Under this latter rule, the values of floating rate securities and variable rate securities are calculated using different formulas.

We appreciate and share the Commission's desire to assure consistency in its rules. Nonetheless, we see no reason why the permitted benchmarks for variable rate securities cannot be identical to the expanded list of permitted benchmarks for floating rate securities. In our September 5, 2003 comment letter, we encouraged the Commission to expand the permitted benchmarks "in order to allow FCMs to respond to new benchmarks as they evolve." At that time, we did not distinguish between floating rate securities and variable rate securities, and we see no reason to do so now. In adopting a final rule, we would ask that the Commission to expand the permitted benchmarks to all adjustable rate securities, variable rate securities as well as floating rate securities.

Recordkeeping. The Commission has proposed to amend the recordkeeping requirements set out in rule 1.27 to add a new paragraph (a)(8), which would require each FCM and designated clearing organization that invests customer funds to maintain records showing—

> Daily valuation for each instrument and documentation supporting 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.

In the *Federal Register* release accompanying the proposed rules, the Commission explained that the supporting documentation must include the "valuation methodology." In addition, the supporting documentation "must be sufficient to enable auditors to verify information to external sources and recalculate the valuation for a given instrument."

FIA member firms were unclear on the extent of their recordkeeping obligations under this proposed rule. For example, many FCMs rely on their custodian banks to provide valuations for the majority of the securities that are held in the customer segregated account and it was not clear whether daily records of these valuations would be sufficient to comply with the provisions of paragraph (a)(8). In conversations with Commission staff, we were assured that such records would be sufficient.

Staff further added by way of explanation that, if an FCM uses one or more dealers to value certain securities, the proposed rule would require the FCM to maintain a record of the dealers used and the prices provided. Similarly, if the FCM uses internal models to value securities, the

FCM would be required to maintain a daily record of the prices obtained from such models and, separately, be prepared to explain the models when subject to audit. In adopting the final rules, we ask the Commission to confirm staff's interpretation of paragraph (a)(8).

Chicago Mercantile Exchange Comments. FIA has had an opportunity to review the comment letter that the Chicago Mercantile Exchange ("CME") has filed in connection with this rulemaking and wishes to address a few of the points the CME has raised.[4] In particular, while the CME supports the Commission's proposal to expand the types of instruments in which customer funds may be invested, the exchange also notes that, "to the extent that new instruments are illiquid or pose operational or risk management challenges to the clearing organization—such as may be the case with certain securities with embedded derivatives, variable rate securities, auction rate securities and reverse repos—CME will be required to determine whether to accept these new types of collateral based upon various operational and risk measures."

FIA acknowledges the right of the CME to determine whether to accept certain types of collateral as performance bond for open positions. The CME exercises this right today and currently does not accept many of securities that are permitted investments under rule 1.25. However, we do not believe that the instruments authorized under the proposed rule will pose particular operational or risk management challenges.[5] The Commission has carefully limited the permitted instruments containing embedded derivatives to those instruments that contain a cap, floor or collar on the interest paid. Further, the rule would require the issuer to repay no less than par value upon maturity. As we noted in our September 5, 2003 comment letter, 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.

Similarly, the permitted benchmarks for floating rate securities are proposed to be expanded to include only the interest rates of any fixed rate instrument that is a permitted investment as defined in rule 1.25(a). In addition, the rule provides that the interest rate must be determined on an unleveraged basis. Again, as we stated in our September 5, 2003 comment letter, 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.

The CME notes with justifiable pride that it "has taken the lead in establishing many cutting-edge, low cost and operationally efficient collateral programs that are available to its clearing membership, including the Interest Earning Facility ("IEF"), IEF2, IEF3, IEF4, and IEF5." We respectfully submit that the investments authorized under the proposed amendments will enhance

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[4] Letter from Craig S. Donohue, Chief Executive Officer, Chicago Mercantile Exchange, to Jean A. Webb, Secretary to the Commission, dated March 7, 2005.

[5] In this regard, we note that the CME currently accepts certain bonds that are callable. Certainly, the instruments will not be illiquid. Paragraphs (a)(1) and (b)(2) of Commission rule 1.25, respectively, provide that securities subject to repurchase agreements and securities purchased directly with customer money must be "readily marketable" as defined in SEC Rule 15c3-1.

these programs and make them even more attractive to CME clearing members. FIA looks forward to working with the CME to address any concerns the exchange may have concerning these instruments.[6]

FIA appreciates the opportunity to comment on the proposed amendments to Commission rules 1.25 and 1.27 and again encourages the Commission to promulgate final rules without delay. If you have any questions regarding this letter, please contact Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Fred Hatfield, Commissioner
Honorable Michael V. Dunn, Commissioner

Division of Clearing and Intermediary Oversight
James Carley, Director
John C. Lawton, Deputy Director
Phyllis P. Dietz, Special Counsel

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[6] The CME also noted that certain of the expanded permitted investments might not be appropriate for FCMs that do not "have the robust tools and systems needed to understand the risks and implications of the collateral that they accept." For this reason, among others, do not anticipate that every FCM will want to take advantage of the added flexibility provided in the proposed amendments. However, we also note that FCMs can obtain the necessary tools and systems to monitor compliance with rule 1.25 from third party providers and, therefore, will not necessarily have to incur the significant costs.