

# Joint Audit Committee

## REGULATORY UPDATE

TO: Chief Financial Officers  
Chief Compliance Officers

#12-01

DATE: January 10, 2012

SUBJECT: CFTC Regulations 1.25 and 30.7 – Investment of Customer Segregated and Secured Amount Funds

CFTC Regulations 1.25 and 30.7 were revised and will become effective February 17, 2012. Revised CFTC Regulation 1.25 provides requirements for the investment of customer segregated funds with a goal of enhancing the preservation of principal and maintenance of liquidity. CFTC Regulation 30.7 was revised to align permitted investments with those under CFTC Regulation 1.25. The revised rules address, among other things:

- Certain changes to the list of permitted investments, including, but not limited to, the elimination of foreign sovereign debt as a permitted investment, and the elimination of in-house and affiliate repurchase and reverse repurchase transactions;
- Replacement of the “readily marketable” criterion with a “highly liquid” standard;
- The removal of rating requirements;
- An expansion of concentration limits including asset-based, issuer-based, and counterparty restrictions;
- Revisions to the acknowledgement letter requirement for investment in a money market mutual fund (“MMMF”);
- Clarification to the list of exceptions to the next-day redemption requirement for MMMFs;
- The application of customer segregated funds investment limitations to 30.7 funds; and
- Changes to depository requirements for investments of 30.7 funds.

The final rule was published in the attached Federal Register (December 19, 2011, Vol. 76, No. 243, at page 78776) and can be found on the CFTC’s web site at <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-31689>.

All FCMs must be in compliance with this rule not later than June 18, 2012.

If you have any questions, please contact your DSRO.

**COMMODITY FUTURES TRADING COMMISSION****17 CFR Parts 1 and 30**

RIN 3038-AC79

**Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions****AGENCY:** Commodity Futures Trading Commission.**ACTION:** Final rule.

**SUMMARY:** The Commodity Futures Trading Commission (Commission or CFTC) is amending its regulations regarding the investment of customer segregated funds subject to Commission Regulation 1.25 (Regulation 1.25) and funds held in an account subject to Commission Regulation 30.7 (Regulation 30.7, and funds subject thereto, 30.7 funds). Certain amendments reflect the implementation of new statutory provisions enacted under Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The amendments address: certain changes to the list of permitted investments (including the elimination of in-house transactions), a clarification of the liquidity requirement, the removal of rating requirements, and an expansion of concentration limits including asset-based, issuer-based, and counterparty concentration restrictions. They also address revisions to the acknowledgment letter requirement for investment in a money market mutual fund (MMMF), revisions to the list of exceptions to the next-day redemption requirement for MMMFs, the elimination of repurchase and reverse repurchase agreements with affiliates, the application of customer segregated funds investment limitations to 30.7 funds, the removal of ratings requirements for depositories of 30.7 funds, the elimination of the option to designate a depository for 30.7 funds, and certain technical changes.

**DATES:** This rule is effective February 17, 2012. All persons shall be in compliance with this rule not later than June 18, 2012.

**FOR FURTHER INFORMATION CONTACT:**

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**I. Background****A. Regulation 1.25**

Under Section 4d<sup>1</sup> of the Commodity Exchange Act (Act),<sup>2</sup> customer segregated funds may be invested in obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities) and general obligations of any State or of any political subdivision thereof (municipal securities). Pursuant to authority under Section 4(c) of the Act,<sup>3</sup> the Commission substantially expanded the list of permitted investments by amending Regulation 1.25<sup>4</sup> in December 2000 to permit investments in general obligations issued by any enterprise sponsored by the United States (government sponsored enterprise or GSE debt securities), bank certificates of

deposit (CDs), commercial paper, corporate notes,<sup>5</sup> general obligations of a sovereign nation, and interests in MMMFs.<sup>6</sup> In connection with that expansion, the Commission included several provisions intended to control exposure to credit, liquidity, and market risks associated with the additional investments, *e.g.*, requirements that the investments satisfy specified rating standards and concentration limits, and be readily marketable and subject to prompt liquidation.<sup>7</sup>

The Commission further modified Regulation 1.25 in 2004 and 2005. In February 2004, the Commission adopted amendments regarding repurchase agreements using customer-deposited securities and time-to-maturity requirements for securities deposited in connection with certain collateral management programs of derivatives clearing organizations (DCOs).<sup>8</sup> In May 2005, the Commission adopted amendments related to standards for investing in instruments with embedded derivatives, requirements for adjustable rate securities, concentration limits on reverse repurchase agreements, transactions by futures commission merchants (FCMs) that are also registered as securities brokers or dealers (in-house transactions), rating standards and registration requirements for MMMFs, an auditability standard for investment records, and certain technical changes.<sup>9</sup>

The Commission has been, and continues to be, mindful that customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks both to preserve their availability to customers and DCOs and to enable investments to be quickly converted to cash at a predictable value in order to avoid systemic risk. Toward these ends, Regulation 1.25 establishes a general prudential standard by requiring that all permitted investments be “consistent with the objectives of preserving principal and maintaining liquidity.”<sup>10</sup>

In 2007, the Commission’s Division of Clearing and Intermediary Oversight (Division) launched a review of the nature and extent of investments of Regulation 1.25 funds and 30.7 funds

<sup>5</sup> This category of permitted investment was later amended to read “corporate notes or bonds.” See 70 FR 28190, 28197 (May 17, 2005).

<sup>6</sup> 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).

<sup>7</sup> *Id.*

<sup>8</sup> 69 FR 6140 (Feb. 10, 2004).

<sup>9</sup> 70 FR 28190.

<sup>10</sup> 17 CFR 1.25(b).

<sup>1</sup> 7 U.S.C. 6d.

<sup>2</sup> 7 U.S.C. 1 *et seq.* (2006), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

<sup>3</sup> 7 U.S.C. 6(c).

<sup>4</sup> 17 CFR 1.25. Commission regulations may be accessed through the Commission’s Web site, <http://www.cftc.gov>.

(2007 Review) in order to further its understanding of investment strategies and practices and to assess whether any changes to the Commission's regulations would be appropriate. As part of this review, all registered DCOs and FCMs carrying customer accounts provided responses to a series of questions. As the Division was conducting follow-up interviews with respondents, the market events of September 2008 occurred and changed the financial landscape such that much of the data previously gathered no longer reflected current market conditions. However, that data remains useful as an indication of how Regulation 1.25 was implemented in a more stable financial environment. Additionally, recent events in the economy have underscored the importance of conducting periodic reassessments and, as necessary, revising regulatory policies to strengthen safeguards designed to minimize risk, while retaining an appropriate degree of investment flexibility and opportunities for capital efficiency for DCOs and FCMs investing customer segregated funds.

#### B. Regulation 30.7

Regulation 30.7<sup>11</sup> governs an FCM's treatment of customer money, securities, and property associated with positions in foreign futures and foreign options. Regulation 30.7 was issued pursuant to the Commission's plenary authority under Section 4(b) of the Act.<sup>12</sup> Because Congress did not expressly apply the limitations of Section 4d of the Act to 30.7 funds, the Commission historically has not subjected those funds to the investment limitations applicable to customer segregated funds.

The investment guidelines for 30.7 funds are general in nature.<sup>13</sup> Although Regulation 1.25 investments offer a safe harbor, the Commission does not currently limit investments of 30.7 funds to permitted investments under Regulation 1.25. Appropriate depositories for 30.7 funds currently include certain financial institutions in the United States, financial institutions in a foreign jurisdiction meeting certain capital and credit rating requirements, and any institution not otherwise

meeting the foregoing criteria, but which is designated as a depository upon the request of a customer and the approval of the Commission.

#### C. Advance Notice of Proposed Rulemaking

In May 2009, the Commission issued an advance notice of proposed rulemaking (ANPR)<sup>14</sup> to solicit public comment prior to proposing amendments to Regulations 1.25 and 30.7. The Commission stated that it was considering significantly revising the scope and character of permitted investments for customer segregated funds and 30.7 funds. In this regard, the Commission sought comments, information, research, and data regarding regulatory requirements that might better safeguard customer segregated funds. It also sought comments, information, research, and data regarding the impact of applying the requirements of Regulation 1.25 to investments of 30.7 funds.

The Commission received twelve comment letters in response to the ANPR, and it considered those comments in formulating its proposal.<sup>15</sup> Eleven of the 12 letters supported maintaining the current list of permitted investments and/or specifically ensuring that MMMFs remain a permitted investment. Five of the letters were dedicated solely to the topic of MMMFs, providing detailed discussions of their usefulness to FCMs. Several letters addressed issues regarding ratings, liquidity, concentration, and portfolio weighted average time to maturity. The alignment of Regulation 30.7 with Regulation 1.25 was viewed as non-controversial.

The FIA's comment letter expressed its view that "all of the permitted investments described in Rule 1.25(a) are compatible with the Commission's objectives of preserving principal and maintaining liquidity." This opinion was echoed by MF Global, Newedge and FC Stone. CME asserted that only "a small subset of the complete list of Regulation 1.25 permitted investments are actually used by the industry." NFA also wrote that investments in instruments other than U.S. government securities and MMMFs are "negligible,"

and recommended that the Commission eliminate asset classes not "utilized to any material extent."

#### D. The Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>16</sup> Title IX of the Dodd-Frank Act<sup>17</sup> was enacted in order to increase investor protection, promote transparency and improve disclosure.

Section 939A of the Dodd-Frank Act obligates federal agencies to review their respective regulations and make appropriate amendments in order to decrease reliance on credit ratings. The Dodd-Frank Act requires the Commission to conduct this review within one year after the date of enactment.<sup>18</sup> Included in these rule amendments are changes to Regulations 1.25 and 30.7 that remove provisions setting forth credit rating requirements. Separate rulemakings addressed the removal of credit ratings from Commission Regulations 1.49 and 4.24<sup>19</sup> and the removal of Appendix A to Part 40 (which contains a reference to credit ratings).<sup>20</sup>

#### E. The Notice of Proposed Rulemaking

A Notice of Proposed Rulemaking (NPRM) was issued by the Commission on October 26, 2010, having been considered in conjunction with the Dodd-Frank rulemaking regarding credit ratings. The NPRM was published in the **Federal Register** on November 3, 2010, and the comment period closed on December 3, 2010.<sup>21</sup>

The Commission invited comments related to topics covered by Regulations 1.25 and 30.7, including the scope of permitted investments, liquidity, marketability, ratings, concentration limits, portfolio weighted average maturity requirements, and the applicability of Regulation 1.25 standards to foreign futures accounts. The Commission received 32 comment letters.<sup>22</sup>

<sup>16</sup> See 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>.

<sup>17</sup> Pursuant to Section 901 of the Dodd-Frank Act, Title IX may be cited as the "Investor Protection and Securities Reform Act of 2010."

<sup>18</sup> See Section 939A(a) of the Dodd-Frank Act.

<sup>19</sup> See 76 FR 44262 (July 25, 2011).

<sup>20</sup> See 75 FR 44776 (July 27, 2011).

<sup>21</sup> See 75 FR 67642 (Nov. 3, 2010); see also 76 FR 25274 (May 4, 2011) (reopening the comment period for certain NPRMs until June 3, 2011).

<sup>22</sup> Comment letters were received from ADM Investor Services, Inc. (ADM), Bank of New York Mellon (BNYM), BlackRock, Inc. (BlackRock), Brown Brothers Harriman & Co. (BBH), Business

<sup>11</sup> 17 CFR 30.7.

<sup>12</sup> 7 U.S.C. 6(b).

<sup>13</sup> See Commission Form 1–FR–FCM Instructions at 12–9 (Mar. 2010) ("In investing funds required to be maintained in separate section 30.7 account(s), FCMs are bound by their fiduciary obligations to customers and the requirement that the secured amount required to be set aside be at all times liquid and sufficient to cover all obligations to such customers. Regulation 1.25 investments would be appropriate, as would investments in any other readily marketable securities.").

<sup>14</sup> 74 FR 23962 (May 22, 2009).

<sup>15</sup> The Commission received comment letters from CME Group Inc. (CME), Crane Data LLC, The Dreyfus Corporation (Dreyfus), FCStone Group Inc. (FCStone), Federated Investors, Inc. (Federated), Futures Industry Association (FIA), Investment Company Institute (ICI), MF Global Inc. (MF Global), National Futures Association (NFA), Newedge USA, LLC (Newedge), and Treasury Strategies, Inc.. Two letters were received from Federated: a July 10, 2009 letter and an August 24, 2009 letter.

## II. Discussion of the Final Rules

### A. Permitted Investments—Regulation 1.25

In finalizing amendments to Regulation 1.25, the Commission seeks to impose requirements on the investment of customer segregated funds with the goal of enhancing the preservation of principal and maintenance of liquidity consistent with Section 4d of the Act. The Commission has endeavored to tailor its amendments to achieve these goals, while retaining an appropriate degree of investment flexibility and opportunities for attaining capital efficiency for DCOs and FCMs investing customer segregated funds.

In issuing these final rules, the Commission is narrowing the scope of investment choices in order to eliminate the potential use of portfolios of instruments that may pose an unacceptable level of risk to customer funds. The Commission seeks to increase the safety of Regulation 1.25 investments by promoting diversification.

Below, the Commission details its decisions regarding the proposals in the NPRM. The Commission has decided to:

- Retain investments in U.S. agency obligations, including implicitly backed GSE debt securities, and impose limitations on investments in debt issued by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac);
- Remove corporate debt obligations not guaranteed by the United States from the list of permitted investments;

- Eliminate foreign sovereign debt as a permitted investment; and
- Eliminate in-house and affiliate transactions.

#### 1. Government Sponsored Enterprise Securities

In the NPRM, the Commission proposed to amend Regulation 1.25(a)(1)(iii) to expressly add U.S. government corporation obligations<sup>23</sup> to GSE debt securities<sup>24</sup> (together, U.S. agency obligations) and to add the requirement that the U.S. agency obligations must be fully guaranteed as to principal and interest by the United States. As proposed, all current GSE debt securities, including that of Fannie Mae and Freddie Mac, would have been impermissible as Regulation 1.25 investments since no GSE debt securities have the explicit guarantee of the U.S. government. The Commission received 14 comment letters discussing GSEs. Thirteen of those 14 comment letters opposed the proposal.

Generally, the arguments focused on the safety of GSEs, GSEs' performance during the financial crisis, and the detrimental, unintended consequences of the proposal. In addition, there were several letters from organizations related to the Farm Credit System GSE (Farm Credit System) and FHLB System GSE (FHLB System) supporting, at a minimum, the inclusion of their GSE debt as a permitted Regulation 1.25 investment.

In terms of safety, commenters expressed the view that GSE debt securities are sufficiently liquid and that the U.S. government would not allow a GSE to fail.<sup>25</sup> FFCB remarked that the Securities and Exchange Commission (SEC) has retained GSE debt securities as investments appropriate under SEC Rule 2a-7<sup>26</sup> (which governs MMMFs).<sup>27</sup> In addition to GSEs being safe, BlackRock noted that "any changes in the viability of such entities should be telegraphed well in advance resulting in

minimal disruption to the credit markets."<sup>28</sup>

With respect to Fannie Mae and Freddie Mac, the FHFA's support of those GSEs effectively amounts to a federal guarantee, according to two commenters.<sup>29</sup> As long as the federal government holds exposure of greater than 50 percent in Fannie Mae and Freddie Mac, RJO wrote that it believes that the quality of these issuances is better than those of any bank or corporation.<sup>30</sup>

Commenters averred that the safety of GSEs is further proven by their stability during the financial crisis. MF Global/Newedge, BlackRock and ADM noted that non-Fannie Mae/Freddie Mac GSEs performed well during the financial crisis.<sup>31</sup>

Limiting investments to only those agency obligations backed by the full faith and credit of the U.S. government would be a mistake because "none" satisfy the requirement, according to the NFA, or "only GNMA's" satisfy the requirement, according to ADM.<sup>32</sup> The FHFA wrote that specific criteria for eligible investments is preferable to speculation on the actions of third parties (such as whether the federal government will or will not bail out a GSE).<sup>33</sup>

Several commenters were concerned that the Commission's proposal would have the unintended consequence of harming the broader market for GSEs, as investors would question the safety of such investments.<sup>34</sup> The Farm Credit Council wrote that "[u]ntil and unless Congress signals its intention to erode the federal government's support of GSEs, we respectfully request that the CFTC not amend Regulation 1.25 with respect to investments in GSEs."<sup>35</sup>

Most commenters recommended that GSE debt securities, including those not explicitly guaranteed by the U.S. government, remain permitted investments to varying extents. There were a range of recommendations regarding the debt of Fannie Mae and Freddie Mac. MF Global/Newedge suggested that GSEs with implicit guarantees should have a 50 percent asset-based concentration limit along

Law Society of the University of Mississippi (BLS), CME, Committee on the Investment of Employee Benefit Assets (CIEBA), Dreyfus, Farm Credit Administration (FCA), Farm Credit Council (Farm Credit Council), Farm Financial Inc. (Farm Financial), Federal Farm Credit Banks Funding Corporation (FFCB), Federal Housing Finance Authority (FHFA), Federated, Futures and Options Association (FOA), FIA and International Swaps and Derivatives Association, Inc. (FIA/ISDA), International Assets Holding Corporation and FCStone (INTL/FCStone), ICI, Joint Audit Committee (JAC), J.P. Morgan Futures Inc. (J.P. Morgan), LCH.Clearnet Group (LCH), MF Global and Newedge (MF Global/Newedge), Morgan Stanley & Co. (Morgan Stanley), NFA, Natural Gas Exchange, Inc. (NGX), Office of Finance of the Federal Home Loan Banks (FHLB), R.J. O'Brien and Associates (RJO), and UBS Global Asset Management (Americas) Inc. (UBS). Federated sent multiple letters. Federated's November 30, 2010 letter will be referred to as "Federated I," its December 2, 2010 letter will be referred to as "Federated II," and Arnold & Porter LLP's post-comment period letter on behalf of Federated, dated March 21, 2011, will be referred to as "Federated III." Federated also sent a letter dated November 8, 2010 and a post-comment period letter dated February 28, 2011. The letters from BLS and NGX were received during the reopened comment period, on May 12, 2011 and May 31, 2011, respectively.

<sup>23</sup> See 31 U.S.C. 9101 (defining "government corporation").

<sup>24</sup> GSEs are chartered by Congress but are privately owned and operated. Securities issued by GSEs do not have an explicit federal guarantee, although they are considered by some to have an "implicit" guarantee due to their federal affiliation. Obligations of U.S. government corporations, such as the Government National Mortgage Association (known as GNMA or Ginnie Mae), are explicitly backed by the full faith and credit of the United States. Although the Commission is not aware of any GSE securities that have an explicit federal guarantee, in the NPRM the Commission concluded that GSE securities should remain on the list of permitted investments in the event this status changes in the future.

<sup>25</sup> MF Global/Newedge letter at 4.

<sup>26</sup> 17 CFR 270.2a-7.

<sup>27</sup> FFCB letter at 3.

<sup>28</sup> BlackRock letter at 6.

<sup>29</sup> FIA/ISDA letter at 5, J.P. Morgan letter at 1.

<sup>30</sup> RJO letter at 5.

<sup>31</sup> MF Global/Newedge letter at 5, BlackRock letter at 6, ADM letter at 3. MF Global cited the Student Loan Marketing Association, FFCB Federal Home Loan Banks and Federal Agricultural Mortgage Corporation as examples of GSEs that performed well during the financial crisis.

<sup>32</sup> NFA letter at 2, ADM letter at 3.

<sup>33</sup> FHFA letter at 1.

<sup>34</sup> FCA at 2, Farm Credit Council letter at 3, RJO letter at 4, FFCB letter at 3.

<sup>35</sup> Farm Credit Council letter at 1-2.

with a 10 percent issuer-based limit, or, alternatively, that GSEs meeting specific outstanding float standards should be allowed. MF Global/Newedge stated that, at a minimum, the Commission should allow FCMs to invest in GSEs other than Fannie Mae and Freddie Mac.<sup>36</sup> CME wrote that highly liquid GSEs, including those of Fannie Mae and Freddie Mac, should remain as permitted investments and should have a 25 percent asset-based concentration limit.<sup>37</sup> RJO recommended that all GSE securities be permitted, and that, at the very least, the Commission should permit investments in Fannie Mae and Freddie Mac until December 31, 2012, when the government guarantee expires.<sup>38</sup> FIA/ISDA recommended that investments in GSE securities be permitted subject to the conditions that (i) with the exception of “agency discount notes,” the size of the issuance is at least \$1 billion, (ii) trading in the securities of such agency remains highly liquid, (iii) the prices at which the securities may be traded are publicly available (through, for example, Bloomberg or Trace), and (iv) investments in GSEs are subject to a maximum of 50 percent asset-based and 15 percent issuer-based concentration limits.<sup>39</sup> BlackRock recommended a 30 percent issuer limitation on GSEs.<sup>40</sup>

The Farm Credit Council, FHLB, the FCA, the FFCB and RJO all wrote letters supporting one or both of the FHLB System<sup>41</sup> and Farm Credit System debt securities.<sup>42</sup> FHLB stated that the prohibition on GSEs not explicitly backed by the full faith and credit of the federal government is overly broad. In particular, FHLB noted that FHLB debt securities performed well throughout the financial crisis. FHLB stated that it maintained funding capabilities even during the most severe periods of market stress, due to investors’ favorable views of its debt securities.<sup>43</sup> Similarly,

the Farm Credit Council wrote that Farm Credit debt securities remained safe during the recent period of market volatility, and the Farm Credit System was able to supply much-needed financial support to farmers, rangers, harvesters of aquatic products, agricultural cooperatives, and rural residents and businesses.<sup>44</sup> Farm Credit discount notes, among other Farm Credit debt securities, “have been a staple in risk-averse investor portfolios since the [Farm Credit System’s] inception in 1916 and have proven their creditworthiness across a range of market environments.”<sup>45</sup> During the recent crisis, the Farm Credit System was able to issue and redeem over \$400 billion in discount notes annually, while issuing over \$100 billion per year in longer-maturity debt securities.<sup>46</sup> RJO concurred regarding both GSEs, noting that the FHLB System and Farm Credit System experienced minimal, if any, problems during the crisis.<sup>47</sup>

CIEBA, which represents 100 of the country’s largest pension funds, was the only commenter that backed the proposal.<sup>48</sup>

After reviewing the comments, the Commission has concluded that U.S. agency obligations should remain permitted investments. The Commission acknowledges the fact, mentioned by several commenters, that most GSE debt performed well during the most recent financial crisis.

The Commission believes it appropriate to include a limitation for debt issued by Fannie Mae and Freddie Mac, two GSEs which did not perform well during the recent financial crisis. Both entities failed and, as a result, have been operating under the conservatorship of the FHFA since September of 2008. As conservator of Fannie Mae and Freddie Mac, FHFA has assumed all powers formerly held by each entity’s officers, directors, and shareholders. In addition, FHFA, as conservator, is authorized to take such actions as may be necessary to restore each entity to a sound and solvent condition and that are appropriate to preserve and conserve the assets and property of each entity.<sup>49</sup>

<sup>44</sup> Farm Credit Council letter at 1. Farm Credit debt securities are regulated by the FCA and insured by an independent U.S. government-controlled corporation which maintains an insurance fund of roughly 2 percent of the outstanding loans. The total outstanding loan amount was over \$3 billion as of the end of 2009. See Farm Credit Council letter at 2.

<sup>45</sup> FFCB letter at 1.

<sup>46</sup> *Id.*

<sup>47</sup> RJO letter at 4.

<sup>48</sup> CIEBA letter at 3.

<sup>49</sup> See 12 U.S.C. 4617(b)(2)(D). The primary goals of the conservatorships are to help restore

In consideration of the above comments, the Commission is amending Regulation 1.25(a)(1)(iii) by permitting investments in U.S. agency obligations. The Commission is adding new paragraph (a)(3) to include the limitation that debt issued by Fannie Mae and Freddie Mac are permitted as long as these entities are operating under the conservatorship or receivership of FHFA.

## 2. Commercial Paper and Corporate Notes or Bonds

In order to simplify Regulation 1.25 by eliminating rarely-used instruments, and in light of the credit, liquidity, and market risks posed by corporate debt securities, the Commission proposed amending Regulation 1.25(a)(1)(v)–(vi) to limit investments in “commercial paper”<sup>50</sup> and “corporate notes or bonds”<sup>51</sup> to commercial paper and corporate notes or bonds that are federally guaranteed as to principal and interest under the Temporary Liquidity Guarantee Program (TLGP) and meet certain other prudential standards.<sup>52</sup>

The NPRM supported this proposal by noting the credit, liquidity and market risks associated with corporate notes or bonds and referenced that information obtained during the 2007 Review indicated that commercial paper and corporate notes or bonds were not widely used by FCMs or DCOs.<sup>53</sup> Second, the NPRM provided background on the TLGP and explained that TLGP debt would be permissible if: (1) The size of the issuance is greater than \$1 billion; (2) the debt security is denominated in U.S. dollars; and (3) the debt security is guaranteed for its entire term.<sup>54</sup>

Seven comment letters discussed commercial paper and corporate notes

confidence in the entities, enhance their capacity to fulfill their mission, mitigate the systemic risk that contributed directly to instability in financial markets, and maintain Fannie Mae and Freddie Mac’s secondary mortgage market role until their future is determined through legislation. To these ends, FHFA’s conservatorship of Fannie Mae and Freddie Mac is directed toward minimizing losses, limiting risk exposure, and ensuring that Fannie Mae and Freddie Mac price their services to adequately address their costs and risk.

<sup>50</sup> 17 CFR 1.25(a)(1)(v).

<sup>51</sup> 17 CFR 1.25(a)(1)(vi).

<sup>52</sup> Commercial paper would remain available as a direct investment for MMMFs and corporate notes or bonds would remain available as indirect investments for MMMFs by means of a repurchase agreement.

<sup>53</sup> The 2007 Review indicated that out of 87 FCM respondents, only nine held commercial paper and seven held corporate notes/bonds as direct investments during the November 30, 2006—December 1, 2007 period.

<sup>54</sup> Debra Kokal, Joint Audit Committee, CFTC Staff Letter 10–01 [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 31,514 (Jan. 15, 2010) (TLGP Letter).

<sup>36</sup> MF Global/Newedge letter at 5.

<sup>37</sup> CME letter at 3.

<sup>38</sup> RJO letter at 5.

<sup>39</sup> FIA/ISDA letter at 5.

<sup>40</sup> BlackRock at 6.

<sup>41</sup> The FHLB System, which is regulated by the FHFA, comprises an “Office of Finance” and 12 independently-chartered, regional cooperative Federal Home Loan Banks created by Congress to provide support for housing finance and community development through member financial institutions. The 12 Federal Home Loan Banks issue debt securities (FHLB debt securities), the proceeds from which are used to provide liquidity to the 7,900 FHLB member banks through collateralized loans. See FHLB letter at 1–3.

<sup>42</sup> The Farm Credit System comprises five banks and 87 associations which provide credit and financial services to farmers, ranchers, and similar agricultural enterprises by issuing debt (Farm Credit debt securities) through the FFCB.

<sup>43</sup> FHLB letter at 1–3.

or bonds in a substantive manner. Six of the comment letters weighed in favor of retaining commercial paper and corporate notes or bonds to some degree. Comments included statements as to the effects of the proposal, the safety of these instruments, and the lack of reliability of the 2007 Commission review of customer funds investments.

According to three commenters, limiting commercial paper and corporate notes or bonds to just those backed by the TLGP is essentially eliminating the asset class altogether.<sup>55</sup> BlackRock, ADM and RJO asserted that TLGP debt is not liquid due to the lack of available supply and therefore might not be a viable option for investment.<sup>56</sup>

There was general support for maintaining corporate notes or bonds as Regulation 1.25 permitted investments. FIA/ISDA wrote that as long as trading in the relevant security remains highly liquid, such securities should continue to be eligible investments under Regulation 1.25.<sup>57</sup> RJO noted that commercial paper and corporate notes and bonds (i) have many high quality names, (ii) have a mature and liquid secondary market, and (iii) provide greater diversification than merely “financial sector” bank CDs.<sup>58</sup> Further, RJO averred that high quality corporate notes or bonds are no different than those used by prime MMMFs.<sup>59</sup> MF Global/Newedge stated that they were unaware of any instances of an FCM unable to meet its obligations under Regulation 1.25 as a result of investment losses it suffered involving corporate notes or commercial paper. They believe that commercial paper and corporate notes or bonds should continue to be permitted; however, to the extent that there are limitations, they suggest (a) permitting FCMs to invest only in corporate notes or commercial paper issued by entities with a certain minimum capital level or which meet a certain float size, or (b) limiting FCM investments in such instruments to 25 percent of their portfolio and 5 percent with any one issuer. BlackRock supports a 25–50 percent asset-based concentration limit for TLGP debt, but also notes that a lack of creditworthy

supply may prevent an FCM from reaching that limit.<sup>60</sup>

Commenters rejected the Commission’s contention that the lack of investment in commercial paper and corporate notes or bonds illustrated in its 2007 Review was dispositive. MF Global/Newedge suggested that the investment review is outdated and is inadequate to justify removing an important source of revenue for FCMs.<sup>61</sup> RJO noted that commercial paper and corporate notes likely appear to be used minimally during the relevant period because investments in such instruments were not as safe during that time frame.<sup>62</sup>

The Commission does not find the arguments in favor of retaining corporate notes and bonds to be persuasive. While the Commission encourages FCMs and DCOs to increase or decrease their holdings of certain permitted instruments depending on market conditions, the Commission is following the language of the statute and its goal of eliminating instruments that may, during tumultuous markets, tie up or threaten customer principal. The Commission recognizes that certain high-quality paper and notes may be sufficiently safe. As discussed in Section I.B.4.(a) of this rulemaking, an FCM or DCO may invest up to 50 percent of its funds in prime MMMFs, which may invest in high-quality paper and notes meeting certain standards. To the extent that commenters suggested that the 2007 Report does not accurately reflect the volume of investment of customer segregated funds in commercial paper and corporate notes or bonds, the Commission believes that the 2007 Report contains sufficiently accurate information reflective of the circumstances at that time.<sup>63</sup> Further, notwithstanding the relative paucity of investment in such instruments, the Commission believes that the investment of customer funds in such instruments runs counter to the overarching objective of preserving principal and maintaining liquidity of customer funds.

Although the TLGP expires in 2012, the Commission believes it is useful to include commercial paper and corporate notes or bonds that are fully guaranteed as to principal and interest by the United States as permitted investments. This would permit continuing investment in TLGP debt securities, even though the Commission has otherwise eliminated commercial paper and corporate notes or bonds from the list of permitted investments. Therefore, the Commission is adopting the proposed amendments to Regulation 1.25(a) and (b) that limit the commercial paper and corporate notes or bonds that can qualify as permitted investments to only those guaranteed as to principal and interest under the TLGP and that meet the criteria set forth in the Division’s interpretation.<sup>64</sup> The Commission is amending Regulation 1.25 by (1) amending paragraphs (a)(1)(v) and (a)(1)(vi) to specify that commercial paper and corporate notes or bonds must be federally backed and (2) inserting new paragraph (b)(2)(vi) that describes the criteria for federally backed commercial paper and corporate notes or bonds.<sup>65</sup>

### 3. Foreign Sovereign Debt

Currently, an FCM or DCO may invest in the sovereign debt of a foreign country to the extent it has balances in segregated accounts owed to its customers (or, in the case of a DCO, to its clearing member FCMs) denominated in that country’s currency.<sup>66</sup> In the NPRM, the Commission proposed to remove foreign sovereign debt as a permitted investment in the interests of both simplifying the regulation and safeguarding customer funds in light of

<sup>64</sup> See TLGP Letter; 75 FR 67642, 67645 (Nov. 3, 2010).

<sup>65</sup> In the NPRM, the Commission proposed removing paragraph (b)(3)(iv) (as amended in this rulemaking, paragraph (b)(2)(iv)) which permits adjustable rate securities as limited under that paragraph. As proposed, Regulation 1.25 would have only permitted corporate and U.S. agency obligations that had explicit U.S. government guarantees. However, since the Commission is, for the most part, retaining the current treatment of U.S. agency obligations, as described in more detail in section II.A.1 of this rulemaking, the Commission has decided not to adopt the proposed removal of paragraph (b)(3)(iv) (now paragraph (b)(2)(iv)).

<sup>66</sup> The inclusion of foreign sovereign debt as a permitted investment can be traced to an August 7, 2000 comment letter from the Federal Reserve Bank of Chicago requesting that the Commission allow FCMs and DCOs to invest non-dollar customer funds in the foreign sovereign debt of the currency so denominated. The Commission agreed in its final rule, explaining that an FCM investing deposits of foreign currencies would be required to convert the foreign currencies to a U.S. dollar denominated asset, and that such conversion would “increase its exposure to foreign currency fluctuation risk, unless it incurred the additional expense of hedging.” See 65 FR 78003 (Dec. 13, 2000).

<sup>55</sup> BlackRock letter at 6, RJO letter at 6, ADM letter at 3.

<sup>56</sup> By contrast, the Commission found that TLGP debt that (1) has an issuance size of greater than \$1 billion, (2) is denominated in U.S. dollars and (3) is guaranteed for its entire term, is sufficiently safe and liquid for use as a Regulation 1.25 investment. See TLGP Letter.

<sup>57</sup> FIA/ISDA letter at 5.

<sup>58</sup> RJO letter at 6.

<sup>59</sup> RJO letter at 5.

<sup>60</sup> BlackRock letter at 6.

<sup>61</sup> MF Global/Newedge at 8.

<sup>62</sup> RJO letter at 5.

<sup>63</sup> While the Commission does not have similar data reflecting Regulation 1.25 investments from more recent years, the Commission believes that investment in commercial paper and corporate notes or bonds remains minimal. This belief is supported by a July 21, 2009 letter from NFA, in response to the ANPR, which averred that segregated funds were primarily invested in government securities and MMMFs, while investments in other instruments were “negligible.” Moreover, the Commission has received no evidence to contradict its position.

recent crises experienced by a number of foreign sovereigns. The Commission requested comment on whether foreign sovereign debt should remain, to any extent, as a permitted investment and, if so, what requirements or limitations might be imposed in order to minimize sovereign risk.

Thirteen comment letters discussed foreign sovereign debt. Twelve of the 13 suggested retaining foreign sovereign debt to varying degrees. One comment letter supported the Commission's proposal. As discussed in more detail below, both the importance of hedging against foreign currency exposure as well as the unintended consequences of the proposal were cited frequently by commenters as reasons to retain foreign sovereign debt as a permitted investment.

Six commenters discussed the need to mitigate the risks associated with foreign currency exposure. FIA/ISDA, MF Global/Newedge, J.P. Morgan, LCH, NFA and FOA each noted that when a DCO requires margin deposited in a foreign currency, an FCM will face a foreign currency exposure in order to meet that margin requirement. The FCM is able to mitigate this exposure by investing customer funds in foreign sovereign debt securities denominated in the relevant currency.<sup>67</sup>

The benefits of increased diversification and liquidity were mentioned by three commenters. FOA and ADM noted that outside investment in sovereign debt played a key role, during the recent financial crisis, in maintaining liquidity and demand in such instruments, which, in turn, had a beneficial impact on pricing and spreads.<sup>68</sup> BlackRock wrote that, notwithstanding the current limited investment in foreign sovereign debt, there are opportunities to add diversification and liquidity by allowing such investments.<sup>69</sup> FIA/ISDA, FOA and BlackRock suggested that lack of use should not disqualify an investment as long as permitting it would still serve to preserve principal and maintain liquidity.<sup>70</sup>

Several commenters predicted harmful unintended consequences if the proposal to remove foreign sovereign debt as a permitted investment becomes the final rule. CME suggested that the implementation of the Dodd-Frank Act will result in an increase in the amount of customer funds held by FCMs and an

increase in the number of foreign customers and foreign-domiciled clearing members.<sup>71</sup> Removing foreign sovereign debt would limit diversification, would undermine the role of non-US sovereign debt, and would have the unintended consequence of increasing market volatility, according to FOA.<sup>72</sup> LCH and FOA predicted that retaliatory action from foreign jurisdictions also could occur.<sup>73</sup>

Most commenters supported retaining foreign sovereign debt to some degree. CME and FIA/ISDA suggested that foreign sovereign debt be retained as a permitted investment, adding that all investments must be highly liquid under the terms of Regulation 1.25, so risky foreign sovereign debt would not be permitted.<sup>74</sup> LCH recommended that foreign sovereign debt remain permitted as an investment, or, at a minimum, that investments be limited to only high quality sovereign issuers.<sup>75</sup> LCH also noted that DCOs have conservative investment policies in place already.<sup>76</sup> RJO suggested limiting foreign sovereign debt to only G-7 issuers, with limits based upon the margin requirement for all client positions.<sup>77</sup> NGX suggested that DCOs domiciled outside of the U.S., in G-7 countries, be permitted to invest in their country's sovereign debt, adding that not allowing such investments may be a "hardship" on such DCOs.<sup>78</sup> ADM suggested that G-7 countries serve as a "safe harbor" for Regulation 1.25 foreign sovereign debt investments.<sup>79</sup> One commenter, CIEBA, backed the Commission's proposal without further explanation.<sup>80</sup>

The Commission has considered the comments and has decided to adopt the proposed amendment, thereby eliminating foreign sovereign debt from the list of permitted investments. As discussed in more detail below, the Commission believes that, in many cases, the potential volatility of foreign sovereign debt in the current economic environment and the varying degrees of financial stability of different issuers make foreign sovereign debt inappropriate for hedging foreign currency risk. The Commission also is not persuaded that foreign sovereign debt is used with sufficient frequency to justify the commenters' claims that

foreign sovereign debt assists with diversification of customer fund investments, and it is not persuaded that the specter of backlash from other jurisdictions or increased market volatility requires a different outcome.

First, while it appreciates the risks of foreign currency exposure, the Commission does not believe that foreign sovereign debt is, in all situations, a sufficiently safe means for hedging such risk. Recent global and regional financial crises have illustrated that circumstances may quickly change, negatively impacting the safety of sovereign debt held by an FCM or DCO. An FCM or DCO holding troubled sovereign debt may then be unable to liquidate such instruments in a timely manner—and, when it does, it may be only after a significant mark-down. Given the choice between an FCM holding devalued currency, which can be exchanged for a portion of the customers' margin and returned to the customer immediately, and an FCM holding illiquid foreign sovereign debt, which might not be able to be exchanged for any currency in a timely manner, the Commission believes that the former is in the customers' best interests. The Commission notes that FCMs can avoid foreign currency risk by not accepting collateral that is not accepted at the DCO or foreign board of trade, or by providing in its customer agreement that the customer will bear any currency exposure.<sup>81</sup>

Second, the Commission is not persuaded by commenters' assertions that investment in foreign sovereign debt has increased the diversification of customer funds in any meaningful way. The Commission has noted that investment in foreign sovereign debt was minimal in the 2007 Review.<sup>82</sup> The Commission has received no data or evidence from any commenter suggesting that investment in foreign sovereign debt has materially increased since the 2007 Review.

Third, the Commission does not believe that eliminating foreign sovereign debt as a permitted investment of customer funds will cause the market or jurisdictional problems claimed by commenters. As discussed above, no commenter has demonstrated that foreign sovereign debt is widely used, so its elimination should not

<sup>67</sup> FIA/ISDA letter at 6, MF Global/Newedge letter at 5, J.P. Morgan letter at 1, LCH letter at 2, NFA letter at 3, FOA letter at 4.

<sup>68</sup> FOA letter at 2, ADM letter at 2.

<sup>69</sup> BlackRock letter at 6.

<sup>70</sup> FIA/ISDA letter at 6, FOA letter at 3, BlackRock letter at 6.

<sup>71</sup> CME letter at 3.

<sup>72</sup> FOA letter at 3.

<sup>73</sup> LCH letter at 2, FOA letter at 2–3.

<sup>74</sup> CME letter at 3, FIA/ISDA letter at 6.

<sup>75</sup> LCH letter at 2.

<sup>76</sup> *Id.*

<sup>77</sup> RJO letter at 3.

<sup>78</sup> NGX letter at 3.

<sup>79</sup> ADM letter at 2.

<sup>80</sup> CIEBA letter at 3.

<sup>81</sup> Additionally, the Commission believes that it is appropriate to note that Regulation 1.25 does not dictate the collateral that may be accepted by FCMs from customers or by DCOs from clearing member FCMs. If FCMs and DCOs so allow, customers and clearing member FCMs, respectively, may continue to post foreign currency or foreign sovereign debt as collateral.

<sup>82</sup> 75 FR 67642, 67645.

undermine foreign sovereign debt nor cause a disruption in the market.

The foregoing points notwithstanding, the Commission is aware that FCMs and DCOs have varying collateral management needs and investment policies. The Commission also recognizes that the safety of sovereign debt issuances of one country may vary greatly from those of another, and that investment in certain sovereign debt might be consistent with the objectives of preserving principal and maintaining liquidity, as required by Regulation 1.25.

Therefore, the Commission is amenable to considering applications for exemptions with respect to investment in foreign sovereign debt by FCMs or DCOs upon a demonstration that the investment in the sovereign debt of one or more countries is appropriate in light of the objectives of Regulation 1.25 and that the issuance of an exemption satisfies the criteria set forth in Section 4(c) of the Act.<sup>83</sup> Accordingly, the Commission invites FCMs and DCOs that seek to invest customer funds in foreign sovereign debt to petition the Commission pursuant to Section 4(c). The Commission will consider permitting investments (1) to the extent that the FCM or DCO has balances in segregated accounts owed to its customers (or clearing member FCMs, as the case may be) in that country's currency and (2) to the extent that such sovereign debt serves to preserve principal and maintain liquidity of customer funds as required for all other investments of customer funds under Regulation 1.25.

Finally, in response to NGX, the Commission does not agree that foreign domiciled FCMs and DCOs should be able to invest in the sovereign debt of their domicile nation. A compelling argument has not been presented as to why this constitutes a "hardship" to DCOs domiciled outside of the United States.

#### 4. In-house Transactions

The Commission allowed in-house transactions as a permitted investment for the first time in 2005.<sup>84</sup> At that time, the Commission stated that in-house transactions "provide the economic equivalent of repos and reverse repos," and, like repurchase agreements with third parties, preserve the "integrity of the customer segregated account."<sup>85</sup> The Commission further wrote that in-house transactions should not disrupt

FCMs and DCOs from maintaining "sufficient value in the account at all times."<sup>86</sup> In the May 2009 ANPR, the Commission noted that the recent events in the economy underscored the importance of conducting periodic reassessments and refocused its review of permitted investments, including in-house transactions.<sup>87</sup>

In the NPRM, the Commission proposed to eliminate in-house transactions permitted under paragraph (a)(3) and subject to the requirements of paragraph (e) of Regulation 1.25. The Commission noted that "[r]ecent market events have \* \* \* increased concerns about the concentration of credit risk within the FCM/broker-dealer corporate entity in connection with in-house transactions."<sup>88</sup> The Commission requested comment on the impact of this proposal on the business practices of FCMs and DCOs. Specifically, the Commission requested that commenters present scenarios in which a repurchase or reverse repurchase agreement with a third party could not be satisfactorily substituted for an in-house transaction.

Six commenters discussed in-house transactions. Four requested that in-house transactions be retained to some extent, while two supported the Commission's proposal to eliminate in-house transactions.

FIA/ISDA, CME, MF Global/Newedge and MorganStanley recommended that the Commission allow FCMs to engage in in-house transactions. FIA/ISDA and CME suggested that the current terms of Regulation 1.25(e) should be more than sufficient to assure that the customer segregated account and the foreign futures and foreign options secured amount are protected in the event of an FCM bankruptcy.<sup>89</sup> MorganStanley wrote that FCM efficiency relies heavily on in-house transactions, particularly when customer margin is not appropriate for DCO margin. It further stated that relying entirely on third party repurchase agreements will materially increase operational risk in an area where it is negligible today.<sup>90</sup> According to MorganStanley,

Because the in-house transaction can be effected and recorded through book entries on the FCM/broker-dealer's general ledger, it can be accomplished through automated internal processes that are subject to a high level of control. The same is not routinely true of third-party repurchase arrangements, which often involve greater time lags than do in-house transactions between execution and settlement and also typically require more

manual processing than their in-house counterparts.<sup>91</sup>

MorganStanley further noted that, as with the FCM of Lehman Brothers Holdings Inc. (Lehman Brothers) in 2008, a third party custodial arrangement is not without risk.<sup>92</sup> MF Global/Newedge wrote that removing in-house transactions would not reduce FCM risk, "since FCMs would be unable to enter into and execute such transactions with and through entities and personnel with whom they have created an effective, efficient and liquid settlement framework."<sup>93</sup>

However, RJO stated that in-house transactions currently do not provide "protection to the capital base of the FCM arm of a dually registered entity."<sup>94</sup> Without "ring fencing the capital associated with the separately regulated business lines," RJO does not consider in-house transactions to be satisfactory substitutes for separately capitalized affiliates or third parties.<sup>95</sup>

CME and FIA/ISDA support retaining in-house transactions as they currently are permitted under Regulation 1.25. MorganStanley suggested retaining in-house transactions subject to a concentration limit of 25 percent of total assets held in segregation or secured amount; or if the Commission is determined to eliminate in-house transactions, raising the proposed concentration limit for reverse repurchase agreements to 25 percent of total assets held in segregation or secured amount.<sup>96</sup> RJO, for the reasons noted above, and CIEBA, without explanation, both support the proposal to remove in-house transactions from the list of permitted investments.<sup>97</sup>

Many commenters to the NPRM similarly suggest that the benefits of repurchase and reverse repurchase agreements can also be realized by in-house transactions, without any decrease in safety to customer funds. The Commission rejects this position. The Commission believes that in-house transactions are fundamentally different than repurchase or reverse repurchase agreements with third parties. In the case of a reverse repurchase agreement, the transaction is similar to a collateralized loan whereby customer cash is exchanged for unencumbered collateral, both of which are housed in legally separate entities. The agreement is transacted at arms-length (often by

<sup>91</sup> Morgan Stanley letter at 2.

<sup>92</sup> MorganStanley letter at 3-4.

<sup>93</sup> MF Global/Newedge letter at 7.

<sup>94</sup> RJO letter at 3.

<sup>95</sup> *Id.*

<sup>96</sup> MorganStanley letter at 4.

<sup>97</sup> RJO letter at 3, CIEBA letter at 3.

<sup>83</sup> See 7 U.S.C. 6(c).

<sup>84</sup> 70 FR 28190, 28193.

<sup>85</sup> 70 FR 28193. See also 70 FR 5577, 5581 (February 3, 2005).

<sup>86</sup> 70 FR 28190, 28193.

<sup>87</sup> 74 FR 23963, 23964.

<sup>88</sup> 75 FR 67642, 67646.

<sup>89</sup> CME letter at 3, FIA/ISDA letter at 12.

<sup>90</sup> MorganStanley letter at 2-3.

means of a tri-party repo mechanism), on a delivery versus payment basis, and is memorialized by a legally binding contract. By contrast, in an in-house transaction, cash and securities are under common control of the same legal entity, which presents the potential for conflicts of interest in the handling of customer funds that may be tested in times of crisis. Unlike a repurchase or reverse repurchase agreement, there is no mechanism to ensure that an in-house transaction is done on a delivery versus payment basis. Furthermore, an in-house transaction, by its nature, is transacted within a single entity and therefore cannot be legally documented, since an entity cannot contract with itself (the most one could do to document such a transaction would be to make an entry on a ledger or sub-ledger).

Other advocates of in-house transactions explained that in-house transactions help them better manage their balance sheets. For example, if a firm entered into a repurchase or reverse repurchase transaction with an unaffiliated third party, the accounting of that transaction may cause the consolidated balance sheet of the firm to appear larger than if the transaction occurred in-house. In 2005, the Commission wrote that in-house transactions could “assist an FCM both in achieving greater capital efficiency and in accomplishing important risk management goals, including internal diversification targets.”<sup>98</sup> However, the purpose of Regulation 1.25 is not to assist FCMs and DCOs with their balance sheet maintenance. The purpose of Regulation 1.25 is to permit FCMs and DCOs to invest customer funds in a manner that preserves principal and maintains liquidity.

The Commission reiterates that customer segregation is the foundation of customer protection in the commodity, futures and swaps markets. Segregation must be maintained at all times, pursuant to Section 4d of the Act and Commission Regulation 1.20,<sup>99</sup> and customer segregated funds must be invested in a manner which preserves principal and maintains liquidity in accordance with Regulation 1.25. As such, the Commission must be vigilant in narrowing the scope of Regulation 1.25 if transactions that were once considered sufficiently safe later prove to be unacceptably risky. Based on the concerns outlined above, the Commission now believes that in-house transactions present an unacceptable risk to customer segregated funds under

Regulation 1.25. The final regulation deletes paragraph (a)(3), as proposed.<sup>100</sup>

For the removal of doubt, the Commission wishes to distinguish in-house transactions from in-house sales of permitted investments. An in-house transaction is an exchange of cash or permitted instruments, held by a dually registered FCM/broker-dealer, for customer funds. An in-house sale is the legal purchase of a permitted investment, which may be owned by a dually registered FCM/broker-dealer, with customer funds. Such in-house sales of permitted investments at fair market prices are acceptable and are unaffected by the elimination of in-house transactions.

In addition, the Commission wishes to distinguish in-house transactions from collateral exchanges for the benefit of the customer. As described above, a dually registered FCM/broker-dealer may not engage in in-house transactions, which are exchanges made at the discretion of the dually registered entity. However, a dually registered FCM/broker-dealer receiving customer collateral not acceptable at the DCO or foreign board of trade may exchange that collateral for acceptable collateral held by its dually registered broker-dealer to the extent necessary to meet margin requirements.<sup>101</sup>

#### B. General Terms and Conditions

FCMs and DCOs may invest customer funds only in enumerated permitted investments “consistent with the objectives of preserving principal and maintaining liquidity.”<sup>102</sup> In furtherance of this general standard, paragraph (b) of Regulation 1.25 establishes various specific requirements designed to minimize credit, market, and liquidity risk. Among them are requirements that the investment be “readily marketable” (a concept borrowed from SEC regulations), that it meet specified rating

requirements, and that it not exceed specified issuer concentration limits. The Commission proposed and has decided to amend these standards to facilitate the preservation of principal and maintenance of liquidity by establishing clear, prudential standards that further investment quality and portfolio diversification and to remove references to credit ratings. The Commission notes that an investment that meets the technical requirements of Regulation 1.25, but does not meet the overarching prudential standard, cannot qualify as a permitted investment.

#### 1. Marketability

Regulation 1.25(b)(1) states that “[e]xcept for interests in money market mutual funds, investments must be ‘readily marketable’ as defined in § 240.15c3–1 of this title.”<sup>103</sup> In the NPRM, the Commission proposed to remove the “readily marketable” requirement from paragraph (b)(1) of Regulation 1.25 and substitute in its place a “highly liquid” standard. The Commission proposed to define “highly liquid” as having the ability to be converted into cash within one business day, without a material discount in value. As an alternative, the Commission offered a calculable standard, in which an instrument would be considered highly liquid if there was a reasonable basis to conclude that, under stable financial conditions, the instrument has the ability to be converted into cash within one business day, without greater than a one percent haircut off of its book value.

The Commission requested comment on whether the proposed definition of “highly liquid” accurately reflected the industry’s understanding of that term, and whether the term “material” might be replaced with a more precise or, perhaps, even calculable standard. The Commission welcomed comment on the ease or difficulty in applying the proposed or alternative “highly liquid” standards.

Six commenters mentioned the “highly liquid” definition. All six supported the proposed, but not the alternative, standard.<sup>104</sup> Several noted that under the alternative standard, even some Treasuries would likely fall outside of the scope of permitted investments. No commenters provided more precise language than “material” or any calculable option.

Certain commenters requested additional clarification. FIA/ISDA wrote

<sup>100</sup> Conversely, transactions that at one point in time are considered to be unacceptably risky may later prove to be sufficiently safe. Should any person, in the future, believe that circumstances warrant reconsideration of the deletion of paragraph (a)(3) regarding in-house transactions, such person may petition the Commission for an amendment in accordance with the procedures set forth in Regulation 13.2, 17 CFR 13.2. Such a petition may include proposed conditions to the listing of in-house transactions as permitted investments in order to address the concerns (e.g., concentration of credit risk within the FCM/broker-dealer corporate entity, potential for conflicts of interest in handling customer funds, etc.) that are the basis for the Commission’s determination to eliminate in-house transactions as permitted investments at this time.

<sup>101</sup> FCMs, whether or not dually registered as broker-dealers, may also engage in collateral exchanges for the benefit of customers with affiliates or third parties.

<sup>102</sup> 17 CFR 1.25(b).

<sup>103</sup> See 17 CFR 240.15c3–1(c)(11)(i) (SEC regulation defining “ready market”).

<sup>104</sup> CME letter at 7, JAC letter at 1–2, FIA/ISDA letter at 3, Farr Financial letter at 3, RJO letter at 7, BlackRock letter at 6.

<sup>98</sup> 70 FR 28193; see also 70 FR 5581.

<sup>99</sup> 17 CFR 1.20.

that some liquid securities do not trade every day and requested that the Commission confirm that, in determining whether a security is highly liquid, an FCM may use, as a reference, securities that are directly comparable, particularly for those issuers with many classes of securities outstanding.<sup>105</sup> FIA/ISDA also asked the Commission to confirm that FCMs may rely on publicly available prices as well as third party pricing vendors such as Bloomberg, TradeWeb, TRACE, IDCG and MSRB.<sup>106</sup> Additionally, JAC requested assurance that the highly liquid standard will not be substituted for “ready market” in other places in Commission regulations, in the Form 1–FR–FCM instructions, or for offsets to debit/deficits on 30.7 statements.<sup>107</sup>

The Commission has considered the comments received and concludes that the “readily marketable” standard is no longer appropriate and should be removed as it creates an overlapping and confusing standard when applied in the context of the express objective of “maintaining liquidity.” While “liquidity” and “ready market” appear to be interchangeable concepts, they have distinctly different origins and uses. The objective of “maintaining liquidity” is to ensure that investments can be promptly liquidated in order to meet a margin call, pay variation settlement, or return funds to the customer upon demand. Meanwhile, the SEC’s “ready market” standard is intended for a different purpose (which is to set appropriate haircuts in order to calculate capital) and is easier to apply to exchange-traded equity securities than debt securities. The Commission is therefore adopting the proposal and amending the text of Regulation 1.25(b)(1) to delete “readily marketable” and replace it with “highly liquid,” defined as having the ability to be converted into cash within one business day, without a material discount in value.

In response to FIA/ISDA’s request for clarification, when determining whether a security which does not trade every day is sufficiently liquid, the Commission believes that an FCM may use any data that reasonably provides evidence of liquidity. However, it is the Commission’s position that theoretical pricing data is not enough, on its own, to establish that a security is highly liquid. FCMs seeking pricing information should be able to use publicly-available as well as third party pricing vendors. Finally, in response to

JAC, the Commission confirms that the “highly liquid” standard is for Regulation 1.25 purposes only. This standard will not be substituted for “ready market” elsewhere in Commission regulations at the present time.

## 2. Ratings

Consistent with Section 939A of the Dodd-Frank Act, the Commission is amending Regulation 1.25, as proposed, by removing all references to ratings requirements.<sup>108</sup> Only one commenter discussed ratings. BlackRock cautioned that complete removal of ratings criteria as a risk filter may place undue responsibility on an FCM or DCO to complete a thorough risk assessment of an issuer’s financial strength.<sup>109</sup>

The Commission notes that the removal of references to ratings does not prohibit a DCO or FCM from taking into account credit ratings as one of many factors to be considered in making an investment decision. Rather, the presence of high ratings is not required and would not provide a safe harbor for investments that do not satisfy the objectives of preserving principal and maintaining liquidity.

## 3. Restrictions on Instrument Features

In the NPRM, the Commission proposed to amend Regulation 1.25(b)(3)(v) (as amended, Regulation 1.25(b)(2)(v)) by restricting CDs to only those instruments which can be redeemed at the issuing bank within one business day, with any penalty for early withdrawal limited to accrued interest earned according to its written terms. Five commenters discussed restrictions on the instrument features of CDs. Four suggested that CDs be retained to varying degrees. One suggested that CDs be removed from the list of permitted investments entirely.

On the subject of safety, MF Global/Newedge asserted that brokered CDs are preferable to non-brokered CDs. In support of this conclusion, MF Global/Newedge pointed out that brokered CDs receive price quotes, are marked-to-market every day and have numerous buyers, while non-brokered CDs have only one buyer, “which creates

significant counterparty risk for FCMs purchasing such products.”<sup>110</sup>

ADM and RJO discussed the liquidity of the market for CDs. ADM suggested that brokered CDs are liquid despite an inactive secondary market.<sup>111</sup> RJO averred that non-negotiable CDs were not intended for institutional size transactions. RJO also predicted that this proposal could severely limit the quantity and quality of banks willing to accept the proposed stringent limitation on breakage fees.<sup>112</sup>

MF Global/Newedge recommended that brokered CDs remain permitted; however, if limits are to be imposed, they recommended (a) that issuers of brokered CDs meet certain capital criteria or the CDs meet certain float size thresholds, or (b) that FCMs be allowed to invest in brokered CDs up to 50 percent of their portfolio and/or 10 percent with any one issuer.<sup>113</sup> MF Global/Newedge also suggested that the Commission consider allowing brokered CDs with puts. Such an instrument may be traded in the secondary market, but also may be put back to the issuer.<sup>114</sup> Rather than restricting negotiable CDs, ADM suggested that the Commission restrict the allowable issuers of CDs using guidelines that the Commission sees fit.<sup>115</sup> Farr Financial recommended that brokered CDs be allowed as long as they generally meet the criteria of “highly liquid.”<sup>116</sup> Farr Financial also suggested that the portion of the proposed rule limiting penalties for early withdrawal to “any accrued interest earned” be modified to account for the standard practices of CD penalties. For example, Farr Financial stated that CDs with a term of one year or less have an early withdrawal penalty of up to 90 days of simple interest earned. For CDs with a term of more than one year, typically the early withdrawal penalty is up to 180 days of simple interest. CIEBA recommended eliminating investments in both brokered and non-brokered CDs, without further explanation.<sup>117</sup>

The Commission is adopting the proposed amendment to Regulation 1.25(b)(3)(v) (as amended, Regulation 1.25(b)(2)(v)) by restricting CDs to only

<sup>110</sup> MF Global/Newedge letter at 7–8.

<sup>111</sup> ADM letter at 2. According to ADM, the inactivity of the secondary market for CDs is due to the fact that most buyers hold CDs to maturity. *Id.*

<sup>112</sup> RJO letter at 6. However it should be noted that this proposal does not alter Regulation 1.25 with regard to penalties; therefore the Commission views this concern as unwarranted.

<sup>113</sup> MF Global/Newedge letter at 8.

<sup>114</sup> *Id.*

<sup>115</sup> ADM letter at 2.

<sup>116</sup> Farr Financial letter at 3.

<sup>117</sup> CIEBA letter at 3.

<sup>105</sup> FIA/ISDA letter at 3.

<sup>106</sup> *Id.*

<sup>107</sup> JAC letter at 2.

<sup>108</sup> Section 939A(a) directs each Federal agency to review their regulations for references to or requirements of credit ratings and assessments of credit-worthiness. Section 939A(b) states, in part, that “each such agency shall modify such regulation \* \* \* to remove any reference to or requirement of reliance on credit ratings and to substitute in such regulation such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations.” See 75 FR 67254 (Nov. 2, 2010).

<sup>109</sup> BlackRock letter at 2.

those instruments which can be redeemed at the issuing bank within one business day, with any penalty for early withdrawal limited to accrued interest earned according to its written terms. The preservation of customer principal and the maintenance of liquidity are the two overriding determining factors in the permissibility of a CD for purposes of Regulation 1.25.

Customer principal can be threatened by market fluctuations and early redemption penalties. Unlike a non-brokered CD, the purchaser of a brokered CD cannot, in most instances, redeem its interest from the issuing bank. Rather, an investor seeking redemption prior to a CD's maturity date must liquidate the CD in the secondary market. Depending on the brokered CD terms (interest rate and duration) and the current economic conditions, the market for a given CD can be illiquid and can result in a significant loss of principal. Penalties for early redemption may cut into customer principal unless such penalties are limited, as they are in paragraph (b)(2)(v) of Regulation 1.25, to accrued interest.<sup>118</sup>

The ability of a CD purchaser to redeem a CD at the issuing bank within one day is the second key factor in determining whether a CD is acceptable as a Regulation 1.25 investment. As noted above, the purchaser of a brokered CD cannot, in most instances, redeem its interest from the issuing bank. If the secondary market for a brokered CD is illiquid, it can prevent FCMs and DCOs from retrieving customer funds for the purpose of making margin calls.

In response to MF Global/Newedge's request for clarification, the Commission notes that a brokered CD with a put option back to the issuing bank is an acceptable investment, assuming that the issuing bank obligates itself to redeem within one business day and that the strike price for the put is not less than the original principal amount of the CD.

#### 4. Concentration Limits

Regulation 1.25(b)(4) currently sets forth issuer-based concentration limits for direct investments, other than MMMFs, and securities subject to repurchase or reverse repurchase agreements and in-house transactions. In the NPRM, the Commission proposed to adopt asset-based concentration limits for direct investments and a counterparty concentration limit for reverse repurchase agreements in addition to amending its issuer-based concentration limits and rescinding

concentration limits applied to in-house transactions.

(a) **Asset-Based Concentration Limits**  
The Commission's proposed asset-based concentration limits would restrict the amount of customer funds an FCM or DCO could hold in any one class of investments, expressed as a percentage of total assets held in segregation.

In the NPRM, the Commission proposed the following asset-based limits: No concentration limit (100 percent) for U.S. government securities; a 50 percent concentration limit for U.S. agency obligations fully guaranteed as to principal and interest by the United States; a 25 percent concentration limit for TLGP guaranteed commercial paper and corporate notes or bonds; a 25 percent concentration limit for non-negotiable CDs; a 10 percent concentration limit for municipal securities; and a 10 percent concentration limit for interests in MMMFs.

The Commission requested comment on whether asset-based concentration limits are an effective means for facilitating investment portfolio diversification and whether there are other methods that should be considered. The Commission, in particular, sought opinions on what alternative asset-based concentration limit might be appropriate for MMMFs and, if such asset-based concentration limit is higher than 10 percent, what corresponding issuer-based concentration limit should be adopted. The Commission also solicited comment on whether MMMFs should be eliminated as a permitted investment.<sup>119</sup> In discussing whether MMMF investments satisfy the overall objective of preserving principal and maintaining liquidity, the Commission specifically requested comment on whether changes in the settlement mechanisms for the tri-party repo market might impact an MMMF's ability to meet the requirements of Regulation 1.25.<sup>120</sup> The Commission requested comment on whether MMMF investments should be limited to Treasury MMMFs, or to those MMMFs that have portfolios consisting only of permitted investments under Regulation 1.25.<sup>121</sup>

Eighteen comment letters discussed MMMFs. The overwhelming majority of comments focused on the proposed limitations on MMMFs, which many in the industry believed to be "arbitrary

and unduly severe."<sup>122</sup> According to Federated, the Dodd-Frank Act "represents the collective effort of Congress and the executive branch to prevent a repetition of the activities largely confined to the financial services sector that precipitated the domino effect of the failure of a large systemically risky company, such as Lehman Brothers, that led to the events at the Reserve Primary Fund."<sup>123</sup> Federated further asserted that unless the Commission does not believe that Congress' "efforts were successful, the proposed limitations on [MMMFs] are unduly restrictive and unwarranted."<sup>124</sup> Commenters discussed a variety of topics including the safety of MMMFs, the recent enhancements to SEC Rule 2a-7, a comparison of the safety of MMMFs to other permitted investments, the appropriate concentration limits for MMMFs, and potential problems that would arise as a result of a 10 percent concentration limit, among other comments.

First, commenters stressed that MMMFs are safe, liquid investments, comprising roughly \$3-4 trillion in assets<sup>125</sup> and representing approximately 25 percent of the total assets in registered investment companies in the United States. Commenters noted that only two funds in the 40-year history of MMMFs have failed to return \$1 per share to investors (and those funds returned more than 99 cents and 96 cents on the dollar, respectively).<sup>126</sup>

According to many of the comment letters, the recent enhancements to SEC Rule 2a-7 have made MMMFs even safer and more prepared to withstand heavy redemption requests during a crisis. In this regard, heightened credit quality and shortened maturity limits increase liquidity,<sup>127</sup> as does a requirement that 10 percent of assets be in cash, Treasuries or securities that

<sup>122</sup> ICI letter at 2.

<sup>123</sup> Federated I letter at 6. The Commission notes that the Reserve Primary Fund (Reserve Primary) was an MMMF that satisfied the enumerated requirements of Regulation 1.25 and at one point was a \$63 billion fund. Reserve Primary's "breaking the buck," in September 2008, called attention to the risk to principal and potential lack of sufficient liquidity of any MMMF investment.

<sup>124</sup> Federate I letter at 6.

<sup>125</sup> Federated estimated \$2.8 trillion. Federated I letter at 2. UBS noted a figure of \$3.8 trillion as of May 2009. UBS letter at 6.

<sup>126</sup> Federated I letter at 1, CME letter at 4-5, J.P. Morgan letter at 1-2, Farr Financial letter at 1, UBS letter at 2.

<sup>127</sup> ICI letter at 4. ICI noted that the weighted average maturity (WAM) for MMMFs has been reduced from 90 to 60 days. As a result 60 percent of MMMFs have a WAM of 45 days or less. In contrast, more than half of all MMMFs had a WAM of greater than 45 days prior to the SEC's amendments to its Rule 2a-7.

<sup>118</sup> 17 CFR 1.25(b)(2)(v).

<sup>119</sup> Comment request appears in section II.A of the NPRM. See 75 FR at 67646.

<sup>120</sup> *Id.*

<sup>121</sup> Comment request appears in section II.C of the NPRM. See 75 FR at 67649.

convert into cash within one day. The SEC has increased the transparency of MMMFs by requiring that MMMFs provide portfolio information, updated monthly, on their Web sites. In addition, MMMFs are now required to conduct periodic stress tests, which examine an MMMF's ability to maintain a stable net asset value under hypothetical market conditions.<sup>128</sup>

Second, many commenters compared the safety of MMMFs to that of one or more other permitted investments. Six commenters averred that MMMFs are safer than Treasuries.<sup>129</sup> One commenter argued that municipal bonds are less liquid than MMMFs.<sup>130</sup> Two commenters argued that MMMFs were better investments than TLGP debt.<sup>131</sup> Five commenters wrote that MMMFs compared favorably with CDs.<sup>132</sup>

Third, many commenters suggested that a 10 percent MMMF limitation would cause some inconsonant and unintended results. CME stated that, in theory, Regulation 1.25 as proposed would permit over 50 percent of a customer funds portfolio to be invested in TLGP securities, municipal securities and non-negotiable CDs. In practice, however, FCMs' use of these investment categories is limited.<sup>133</sup> ICI wrote that an incongruity exists where an FCM may invest all of its assets in a self-managed portfolio of Treasuries, but may only invest 10 percent of its assets in an MMMF consisting of the same securities.<sup>134</sup> Federated expressed views similar to those of ICI, writing that investments in government funds should not be subject to any concentration limits. Federated also recommended that the Commission require that MMMFs maintain certain minimum financial thresholds in order to qualify as a Regulation 1.25 investment. Federated suggested, as thresholds, that an MMMF should manage assets of at least \$10 billion and that the MMMF's management company should manage assets of at least \$50 billion.<sup>135</sup> Dreyfus noted that, under the proposal, an FCM may construct a pool

of individual securities outside the constraints of SEC Rule 2a-7 which would have maturities of longer than those required of MMMFs. Therefore, greater interest rate risk might be associated with a self-managed portfolio than with the portfolio in an MMMF.<sup>136</sup> The decrease in MMMF investment might lead more funds to be held in cash in banks (with only \$250,000 FDIC insurance).<sup>137</sup> According to Farr Financial, another possible result of a 10 percent limitation on MMMFs is that FCMs and DCOs would hold a large amount of Treasuries, and, in the event that an FCM or DCO would need to liquidate such Treasuries, would experience potential loss in the secondary market.<sup>138</sup> BlackRock wrote that an overreliance on Treasuries and government securities would place portfolios in greater danger due to changes to interest rates. For example, a sudden rise in interest rates may negatively impact the principal valuation of Treasuries.<sup>139</sup> If liquidation is required during such a circumstance, FCMs may experience a loss in principal.<sup>140</sup>

Fourth, several commenters highlighted other potential difficulties that could result from the proposed 10 percent concentration limit, including issues of diversification, self-management and liquidity. The NFA warned that by limiting investment in MMMFs and other instruments, the Commission risks decreasing diversification rather than increasing it.<sup>141</sup> Along similar lines, ICI stated that the average MMMF is more diversified than the portfolio of bank CDs or municipal securities that FCMs or DCOs would be permitted to hold under the proposed amendments.<sup>142</sup>

Three commenters discussed the problems that arise from self-managed accounts. ICI, Dreyfus and BNYM suggest that by limiting MMMFs to 10 percent, the Commission would be forcing FCMs and DCOs to manage 90 percent of their portfolios themselves. Investments in TLGP debt, CDs and municipals require asset management skills that FCMs and DCOs might not have without hiring an investment adviser. While some FCMs and DCOs may be large enough to do this, many are not—and requiring FCMs to “go it alone” will cause customer funds to be

at greater risk.<sup>143</sup> ADM wrote that because intraday settlements from clearing organizations are not known until 12 noon CST or later, it would be difficult to maintain sufficient liquid assets without the use of MMMFs.<sup>144</sup>

In response to the Commission's request for comment on the proposed changes in the tri-party repo market, which have not been fully implemented, ICI wrote that the changes would allow sellers in tri-party repurchase agreements to repurchase the underlying securities later in the afternoon. Previously, such sellers would repurchase securities in the morning using funds borrowed from their clearing banks. The proposed changes should not, according to ICI, adversely affect an MMMF's ability to pay redemptions by the end of each day. Because the repurchases would occur while the Fedwire system is open, MMMFs can transfer the proceeds to their transfer agents to cover daily redemptions.<sup>145</sup>

The NPRM also requested comment on whether, or to what extent, MMMFs ought to be limited to Treasury funds. Dreyfus stated that it would not support such a limitation, as it believes that Government, prime, and municipal MMMFs are subject to sufficient risk-limiting constraints that merit their availability to FCMs and DCOs.<sup>146</sup> Treasury funds are traditionally smaller in size and less liquid than prime MMMFs, according to FIA/ISDA.<sup>147</sup> RJO wrote that because Treasury funds lag interest rate movements for significant periods of time, they are likely not viable options for FCMs in upward interest rate environments or over long periods of time.<sup>148</sup> Taking a different position, BlackRock suggested that Treasury MMMFs should be exempt from any asset-based limitations instituted by the Commission.<sup>149</sup> In addition, BlackRock recommended that the Commission require investment decision-makers at FCMs to perform periodic assessments of their MMMF providers.<sup>150</sup>

CIEBA would support limiting MMMFs to only those funds which invest in securities that would be permitted investments under Regulation 1.25.<sup>151</sup> CIEBA did not include further discussion or explanation.

<sup>128</sup> CME letter at 4–5, Federated I letter at 1, FIA/ISDA letter at 6–8, MF Global/Newedge letter at 6, J.P. Morgan letter at 1–2, UBS letter at 2–4, Dreyfus letter at 2, RJO letter at 7–8, INTL/FCStone letter at 2, BlackRock letter at 2–4, ADM letter at 1, BNYM letter at 2–3, BLS letter at 2.

<sup>129</sup> CME letter at 6, Farr Financial letter at 2, ICI letter at 7, Dreyfus letter at 4, ADM letter at 3, Federated II letter (Bilson essay at 8).

<sup>130</sup> Dreyfus letter at 4.

<sup>131</sup> UBS letter at 6, Dreyfus letter at 4.

<sup>132</sup> Federated I letter at 1, CME letter at 4–5, MF Global/Newedge letter at 6, UBS letter at 5, 7, Dreyfus letter at 4.

<sup>133</sup> CME letter at 6.

<sup>134</sup> ICI letter at 8.

<sup>135</sup> Federated III letter at 2–3.

<sup>136</sup> Dreyfus letter at 2.

<sup>137</sup> As pointed out by Farr Financial, FDIC insurance passes through to an FCM's customers. See Farr Financial letter at 2–3.

<sup>138</sup> Farr Financial letter at 2.

<sup>139</sup> BlackRock letter at 2, 5.

<sup>140</sup> *Id.*

<sup>141</sup> NFA letter at 2.

<sup>142</sup> ICI letter at 10.

<sup>143</sup> ICI letter at 6–8, Dreyfus letter at 4, BNYM letter at 2–3.

<sup>144</sup> ADM letter at 1.

<sup>145</sup> ICI letter at 12.

<sup>146</sup> Dreyfus letter at 2.

<sup>147</sup> FIA/ISDA letter at 8.

<sup>148</sup> RJO letter at 8.

<sup>149</sup> BlackRock letter at 4.

<sup>150</sup> BlackRock letter at 2, 5.

<sup>151</sup> CIEBA letter at 3.

As noted above, the Commission proposed a 10 percent asset-based concentration limit for investments in MMMFs. In response to comments, the Commission has decided to revise the rule language that was proposed. Specifically, the Commission will impose different concentration limits for investments in Treasury-only funds than for investments in all other MMMFs. The Commission also will distinguish between funds that do not have both \$1 billion in assets and a management company that has at least \$25 billion in MMMF assets under management (small MMMFs) and those that do (large MMMFs). Federated, as noted above, recommended that asset thresholds for MMMFs be set at \$10 billion and \$50 billion, respectively. However, the Commission believes, at this time, that such thresholds may needlessly constrain the pool of MMMFs available for investment and result in an unsafe concentration of customer funds in a limited number of MMMFs. The modifications to the proposed rule text discussed below reflect the Commission's consideration of the comments received on the proposed concentration limit for investments in MMMFs, in light of the overarching objective of preserving principal and maintaining liquidity of customer funds.

First, an FCM or DCO may invest all of its customer segregated funds in Treasury-only MMMFs, subject to the limitation on investment in small MMMFs discussed below. The Commission agrees with commenters that since an FCM or DCO may invest all of its funds in Treasuries directly, an FCM or DCO therefore should be able to make the same investment indirectly via an MMMF.

Second, for all other MMMFs, the Commission believes that a 50 percent asset-based concentration limit is appropriate, subject to the limitation on investment in small MMMFs discussed below. After considering the views presented by market participants, Commission staff and other regulators, the Commission has determined that a 50 percent asset-based concentration limit strikes the right balance between providing FCMs and DCOs with sufficient Regulation 1.25 investment options and, at the same time, encouraging adequate portfolio diversification.

MMMFs' portfolio diversification, administrative ease, and the heightened prudential standards recently imposed by the SEC, continue to make them an attractive investment option. However, their volatility during the 2008 financial crisis, which culminated in one fund

"breaking the buck" and many more funds requiring infusions of capital, underscores the fact that investments in MMMFs are not without risk. The Commission is persuaded to increase the proposed asset-based concentration limit for MMMFs, other than Treasury-only MMMFs, from 10 percent to 50 percent in part by commenters who noted that MMMFs are safe and liquid relative to other permitted investments.<sup>152</sup> Commenters were persistent in reminding the Commission that, aside from Reserve Primary, no MMMFs had "broken the buck" during the 2008 financial crisis and aftermath. The Commission is also cognizant that decreasing the number of investment options might have the unintended consequence of over-concentrating customer funds into a small universe of viable investments. Further, these concentration limits provide FCMs and DCOs with the ability to delegate investment decisions for their entire portfolio of customer segregated funds to MMMFs, should the FCMs and DCOs not wish to make such decisions on their own.

To the extent that an FCM or DCO invests customer segregated funds in an MMMF, subject to the asset-based concentration limits outlined above, the FCM or DCO may only invest up to 10 percent of its segregated funds in small MMMFs. The Commission believes that distinguishing between small MMMFs and large MMMFs is a necessary corollary to increasing the concentration limits proposed in the NPRM, since large MMMFs have capital bases better capable of handling a high volume of redemption requests in the event of a market event. To the extent that an FCM or DCO invests customer segregated funds in small MMMFs, the 10 percent asset-based concentration limit in the final rule is unchanged from the concentration limit set forth in the NPRM. However, having considered the comments received on this issue, the Commission has determined it appropriate to elevate the asset-based concentration limits from what had been proposed—both for Treasury-only MMMFs and for all other MMMFs—to the extent that an FCM or DCO invests in large MMMFs.

Accordingly, the Commission is amending Regulation 1.25 by adding new paragraphs (b)(3)(i)(E)–(G), which

<sup>152</sup> Although MMMFs allow FCMs and DCOs to indirectly invest in instruments which would not be permitted under Regulation 1.25 as direct investments, the Commission believes that the credit quality, maturity limitations and liquidity required by the SEC make prime MMMFs acceptable investments, subject to the concentration limits imposed by paragraph (b)(3).

implement the changes described above. The addition of these paragraphs enables the Commission to increase the concentration limits originally proposed without undermining the protection of customer funds and reduction of systemic risk, while addressing the concerns specifically raised in the comments.

The Commission has concluded that all other asset-based concentration limits remain as proposed in the NPRM. The 50 percent asset-based limitation on U.S. agency obligations<sup>153</sup> and the 25 percent asset-based limitation on each of TLGP corporate notes or bonds and TLGP commercial paper,<sup>154</sup> are consistent with commenter recommendations. Therefore, the Commission is amending Regulation 1.25(b)(3)(i), as proposed, to reflect the asset-based concentration limits described above.

With respect to the calculation of concentration limits, ADM wrote that concentration limits should be calculated by aggregating Regulation 1.25 funds and 30.7 funds.<sup>155</sup> ADM explained, by way of example, that if there is a 50 percent concentration limit for investment X, along with \$5 billion in the segregated account and \$1 billion in the 30.7 account, that the maximum amount that could be invested in X would be \$3 billion. From this comment, the Commission concludes that ADM would like the choice of investing up to 60 percent of its segregated account funds in investment X, as long as that amount, when combined with the size of the 30.7 account, does not exceed 50 percent of the cumulative size of the segregated and 30.7 account. However, the Commission has determined that concentration limits are to be calculated on a fund-by-fund basis. In the example above, the maximum amount of segregated funds that could be invested in X would be \$2.5 billion, and the maximum amount of 30.7 funds that could be invested in X would be \$0.5 billion. ADM presented no compelling argument as to why the aggregation of

<sup>153</sup> See Section II.A.1. CME recommended 25 percent, BlackRock recommended 30 percent, and FIA/ISDA and MF Global/Newedge both recommended 50 percent.

<sup>154</sup> See Section II.A.2. MF Global/Newedge recommended 25 percent and BlackRock recommended 25 percent–50 percent. The Commission is aware that MF Global/Newedge's recommendation was for all corporate notes or bonds and commercial paper—not merely those which are TLGP debt. Regardless, such a recommendation is helpful in establishing a percentage that will allow for ample investment in instrument categories while still promoting diversification.

<sup>155</sup> ADM letter at 2.

funds held in Regulation 1.25 and 30.7 accounts should be permitted.

#### (b) Issuer-Based Concentration Limits

The Commission proposed to amend its issuer-based limits for direct investments to include a 2 percent limit for an MMMF family of funds, expressed as a percentage of total assets held in segregation. Currently, there is no concentration limit applied to MMMFs. Under the NPRM, the 25 percent issuer-based limitation for GSEs (now proposed to be encompassed within the term "U.S. agency obligations") and the 5 percent issuer-based limitation for municipal securities, commercial paper, corporate notes or bonds, and CDs would remain in place.

Commenters expressed doubts over whether issuer-based concentration limits, on individual or families of MMMFs, would have a meaningful, positive effect on the safety of customer funds. Adverse market conditions would probably affect all funds, according to ICI, and therefore issuer concentration limits would do little to mitigate these risks.<sup>156</sup>

BlackRock, ICI and Dreyfus suggested that limits on family of funds may not achieve increased safety of customer funds as each MMMF in a family is managed on an individual basis and will not necessarily share risks with other MMMFs managed by the same adviser. Dreyfus wrote that it sees "no benefit \* \* \* to requiring FCMs to have to potentially invest in a [prime MMMF] with one provider and a [government or Treasury MMMF] with another provider, on the basis that such an arrangement is safer than if the FCM invested in each of these types of funds with a single provider."<sup>157</sup> BlackRock also noted that MMMF complexes do not typically aggregate and publish consolidated family data on a daily basis.<sup>158</sup>

Commenters also questioned the effectiveness of issuer-based limitations on individual funds. Dreyfus asserted that the operations and results of one fund do not impact the operation and results of another fund.<sup>159</sup> ICI propounded that similar types of MMMFs often have common holdings. Thus, according to ICI, limiting investments in individual funds will have a marginal effect on the diversification of underlying credit risks.<sup>160</sup>

Taken as a whole, these arguments, that concentration limits will not increase the safety of customer funds, are untenable. The commenters assert that neither family-of-funds limits nor issuer-based limits will increase the diversification and safety of customer funds. If believed, this leads to the conclusion that it would be safer and more diverse (or at least as safe and diverse) for an FCM, investing the maximum amount in MMMFs, to invest all customer cash in one fund than it would be for that FCM to invest that customer cash among five funds in three families. As such, the Commission is not persuaded by the arguments.<sup>161</sup>

The Commission has considered the comments received on this issue, and is mindful of the comments and Commission analysis of the asset-based concentration limits discussed in the preceding section. Having considered the arguments raised, the Commission has decided to revise the rule language that was proposed. Specifically, the Commission has determined that there will be no family-of-funds or issuer-based concentration limit for MMMFs that consist entirely of Treasuries, and a 25 percent family of funds issuer-based limitation as well as a 10 percent individual fund issuer-based limitation for all other MMMFs. Investments in Treasury-only funds are not to be combined with investments in other MMMFs for purposes of calculating either family-of-funds or issuer-based concentration limits. The increase in the family of funds issuer-based concentration limit is related to the increase in the asset-based concentration limit and addresses the recommendations of commenters. The introduction of the 10 percent individual fund issuer-based concentration limit serves to add an additional layer of diversification and also aligns with recommendations of commenters.

#### (c) Counterparty Concentration Limits

In the NPRM, the Commission proposed a counterparty concentration limit of 5 percent of total assets held in segregation for securities subject to reverse repurchase agreements. Seven commenters discussed counterparty concentration limits. All expressed their belief that the 5 percent concentration limit was too low and that such a limit would greatly increase administrative risks and costs. Most commenters favored a 25 percent concentration

limit, in the event that a concentration limit was imposed.

FIA/ISDA, LCH, MF Global/Newedge, J.P. Morgan and RJO expressed similar views that a 5 percent concentration limit might actually decrease liquidity and increase operational and systemic risk. LCH and MF Global/Newedge wrote that a counterparty concentration limit would unnecessarily restrict a very liquid and secure investment that has provided flexibility and reasonable returns to FCMs and their customers.<sup>162</sup> According to FIA/ISDA, because clearing members are often required to execute and unwind reverse repurchase agreements intraday and within a brief period of time, and because DCOs strictly define the securities they will accept as collateral, an FCM must review the securities received under reverse repurchase transactions to ensure that they are both eligible for delivery to the DCO and in compliance with applicable concentration limits.<sup>163</sup> Several commenters observed that requiring an FCM to effect reverse repurchase transactions with multiple counterparties under tight time frames will substantially increase an FCM's operational risk and invite errors.<sup>164</sup> By way of example, INTL/FCStone noted that it currently has one counterparty and would potentially need to open 20 reverse repurchase accounts were the proposed rule enacted.<sup>165</sup> Further, two commenters wrote that a critical factor to consider is that, in the event of a counterparty's default, all amounts are collateralized with permitted investments under Regulation 1.25.<sup>166</sup>

INTL/FCStone<sup>167</sup> and FIA/ISDA<sup>168</sup> recommended a 25 percent counterparty concentration limit. RJO wrote that limits are unnecessary—however if a limit were imposed, RJO recommended 25 percent.<sup>169</sup> LCH suggested a 10 percent–20 percent limitation.<sup>170</sup> MF Global/Newedge recommended having no counterparty limits; however to the extent that there must be, it recommended (a) limiting FCM repurchase and reverse repurchase transactions to those external counterparties maintaining a certain level of capital (such as \$50 or \$100

<sup>162</sup> LCH letter at 3, MF Global/Newedge letter at 6.

<sup>163</sup> FIA/ISDA letter at 9–10.

<sup>164</sup> FIA/ISDA letter at 9–10, MF Global/Newedge letter at 7, J.P. Morgan letter at 2, LCH letter at 3, RJO letter at 3.

<sup>165</sup> INTL/FCStone at 2.

<sup>166</sup> LCH letter at 3, MF Global/Newedge letter at 7.

<sup>167</sup> INTL/FCStone at 2.

<sup>168</sup> FIA/ISDA letter at 10.

<sup>169</sup> RJO letter at 3.

<sup>170</sup> LCH letter at 3.

<sup>156</sup> ICI letter at 11.

<sup>157</sup> Dreyfus letter at 5. See also ICI letter at 10.

<sup>158</sup> BlackRock letter at 4.

<sup>159</sup> Dreyfus letter at 5.

<sup>160</sup> ICI letter at 10–11.

<sup>161</sup> In response to Dreyfus and ICI's comment regarding limits on family of funds, the Commission believes that a failure of, or a run on, an individual fund would likely cause a run on other funds in the family due to investors' reputational concerns.

million) or (b) setting counterparty concentration limits at 25 percent.<sup>171</sup> ADM wrote that it does not believe any concentration limit is necessary due to the collateralized nature of the loans.<sup>172</sup> However, ADM stated that it would support only allowing certain collateral, such as Treasuries and GSEs, in repurchase transactions.<sup>173</sup>

As noted above, the Commission proposed a 5 percent counterparty concentration limit in the NPRM. Having considered the comments submitted in response to the proposal, the Commission has determined that a 25 percent counterparty concentration limit is appropriate.

The Commission continues to believe that counterparty concentration limits are necessary for safeguarding customer funds. Under current rules, an FCM or DCO could have 100 percent of its segregated funds subject to one reverse repurchase agreement. The obvious concern in such a scenario is the credit risk of the counterparty. This credit risk, while concentrated, is significantly mitigated by the fact that in exchange for cash, the FCM or DCO is holding Regulation 1.25-permitted securities of equivalent or greater value. However, a default by the counterparty would put pressure on the FCM or DCO to convert such securities into cash immediately and would exacerbate the market risk to the FCM or DCO, given that a decrease in the value of the security or an increase in interest rates could result in the FCM or DCO realizing a loss. Even though the market risk would be mitigated by asset-based and issuer-based concentration limits, a situation of this type could seriously jeopardize an FCM or DCO's overall ability to preserve principal and maintain liquidity with respect to customer funds.

The Commission is persuaded to increase the limit, from the proposed level of 5 percent in the NPRM to 25 percent, primarily due to comments expressing concern about the administrative costs and burdens of a low counterparty concentration limit. Whereas a 5 percent limitation would require an FCM reverse-repurchasing all of its customer cash to have 20 counterparties, a 25 percent limitation decreases the number of counterparties to four. Further, 25 percent is in line with commenter recommendations, which ranged from 10 to 25 percent.<sup>174</sup>

### C. Money Market Mutual Funds

The Commission has decided to make two technical amendments to paragraph (c) of Regulation 1.25. First, the Commission is clarifying the acknowledgment letter requirement under paragraph (c)(3); and second, the Commission is revising and clarifying the exceptions to the next-day redemption requirement under paragraph (c)(5)(ii).

#### 1. Acknowledgment Letters

In the NPRM, the Commission sought to clarify that the intent of Regulation 1.25(c)(3) is to require that an FCM or DCO obtain an acknowledgment letter from a party that has substantial control over a fund's assets and has the knowledge and authority to facilitate redemption and payment or transfer of the customer segregated funds invested in shares of the MMMF. The Commission concluded that in many circumstances, the fund sponsor, the investment adviser, or fund manager would satisfy this requirement. The Commission also proposed to remove the current language in Regulation 1.25(c)(3) relating to the issuer of the acknowledgment letter when the shares of the fund are held by the fund's shareholder servicing agent. This revision was designed to eliminate any confusion as to whether the acknowledgment letter requirement is applied differently based on the presence or absence of a shareholder servicing agent.

The Commission requested comment on whether the proposed standard for entities that may sign an acknowledgment letter is appropriate and whether there are other entities that could serve as examples. The Commission requested comment on whether removal of the "shareholder servicing agent" language helps clarify the intent of Regulation 1.25(c)(3).

Three commenters discussed this proposal. CME, BBH and FIA/ISDA support the proposal, and FIA/ISDA and BBH had additional comments and suggested changes as well.<sup>175</sup>

BBH and FIA/ISDA requested that the Commission confirm that, in those circumstances in which an FCM deposits customer funds with a bank or other depository and thereafter instructs the bank to invest such customer funds in an MMMF, the bank is the appropriate entity from which the FCM should obtain the acknowledgment letter.<sup>176</sup> BBH explained that such settlement banks are "universally

recognized, both by regulation and standard contractual terms, as an entity that exercises legitimate control and authority over assets deposited both directly with it or held in an account at a third party depository or fund."<sup>177</sup>

The Commission is amending Regulation 1.25(c)(3) to reflect that an FCM or DCO must obtain an acknowledgment letter from a party that has substantial control over MMMF shares purchased with customer segregated funds and has the knowledge and authority to facilitate redemption and payment or transfer of the customer segregated funds invested in shares of the MMMF and is removing the current language in Regulation 1.25(c)(3) relating to the issuer of the acknowledgment letter when the shares of the fund are held by the fund's shareholder servicing agent. In response to FIA/ISDA and BBH, the Commission agrees that when an FCM deposits customer funds in a bank or other depository and thereafter instructs the depository to invest such customer funds in an MMMF, the acknowledgment letter may come from the depository if it is acting as a custodian for the fund shares owned by the FCM or DCO. The Commission therefore clarifies in the rule text that a "depository acting as custodian for fund shares" is an appropriate entity to issue an acknowledgment letter.

#### 2. Next-Day Redemption Requirement

Regulation 1.25(c) requires that "[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."<sup>178</sup> This "next-day redemption" requirement is a significant feature of Regulation 1.25 and is meant to ensure adequate liquidity.<sup>179</sup> Regulation 1.25(c)(5)(ii) lists four exceptions to the next-day redemption requirement, and incorporates by reference the emergency conditions listed in Section 22(e) of the Investment Company Act (Section 22(e)).<sup>180</sup> The Commission has, on occasion, fielded questions from FCMs regarding Regulation 1.25(c)(5), particularly because the exceptions listed in paragraph (c)(5)(ii) overlap with some of those appearing in Section 22(e).

<sup>177</sup> BBH letter at 2.

<sup>178</sup> 17 CFR 1.25(c)(5)(i).

<sup>179</sup> See 70 FR 5585 (noting that "[t]he 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").

<sup>180</sup> 15 U.S.C. 80a-22(e).

<sup>171</sup> MF Global/Newedge letter at 7.

<sup>172</sup> ADM letter at 2.

<sup>173</sup> *Id.*

<sup>174</sup> As noted above, certain commenters wished to have no counterparty concentration limits, a position with which the Commission does not agree.

<sup>175</sup> CME letter at 7, FIA/ISDA letter at 13, BBH letter at 2.

<sup>176</sup> BBH letter at 2, FIA/ISDA letter at 13.

In order to expressly incorporate SEC Rule 22e-3 into the permitted exceptions for purposes of clarity, and to otherwise clarify the existing exceptions to the next-day redemption requirement, the Commission proposed to amend paragraph (c)(5)(ii) of Regulation 1.25 by more closely aligning the language of that paragraph with the language in Section 22(e) and specifically including a reference to Rule 22e-3. The Commission proposed to include, as an appendix to the rule text (Regulation 1.25 Appendix), safe harbor language that could be used by MMMFs to ensure that their prospectuses comply with Regulation 1.25(c)(5).

The Commission requested comment on all aspects of its proposed amendments to the provisions regarding MMMFs in paragraph (c) of Regulation 1.25. The Commission sought comment specifically on any proposed regulatory language that commenters believe requires further clarification. In addition, commenters were invited to submit views on the usefulness and substance of the proposed safe harbor language contained in the proposed Regulation 1.25 Appendix.

Only one commenter, ICI, mentioned this aspect of the NPRM. ICI supported this proposal to clarify exemptions from next-day redemption and to include safe harbor language.<sup>181</sup> Therefore, the Commission amends paragraph (c)(5)(ii) of Regulation 1.25 by more closely aligning the language of that paragraph with the language in Section 22(e) and specifically including a reference to Rule 22e-3. The Commission is also adding the Regulation 1.25 Appendix to the rule text, in order to provide MMMFs with safe harbor language to ensure that their prospectuses comply with Regulation 1.25(c)(5).

#### *D. Repurchase and Reverse Repurchase Agreements*

The Commission proposed specifically eliminating repurchase and reverse repurchase transactions with affiliate counterparties. Repurchase and reverse repurchase transactions are functionally similar to collateralized loans, whereby cash is exchanged for unencumbered collateral. In the NPRM, the Commission explained its view that the concentration of credit risk increases the likelihood that the default of one party could exacerbate financial strains and lead to the default of its affiliate. The Commission used the example of Bear Stearns Companies, Inc. (Bear

Stearns) in 2008<sup>182</sup> to illustrate that even possession and control of liquid securities may be insufficient to alleviate concerns relating to transactions with financially troubled affiliated counterparties.

The Commission received four comment letters discussing this topic. CME and FIA/ISDA both suggested that FCMs have much greater certainty and are exposed to substantially less counterparty risk to the extent that they enter into transactions with affiliates.<sup>183</sup> FIA/ISDA stated that funds held in affiliate accounts are at no greater risk in the event of a default than they would be in the event of a default of a non-affiliate. In both cases, the requirements of Regulation 1.25(d) are the same. Further, FIA/ISDA wrote that the Bear Stearns example used by the Commission in the NPRM relates to Bear Stearns' abilities to enter into agreements with third parties, not its affiliates.<sup>184</sup> RJO noted that affiliates should be judged as acceptable if the affiliate meets or exceeds the capital base or some other methodology deemed satisfactory for adding an arms-length counterparty.<sup>185</sup> MF Global/Newedge wrote that removing repurchase agreements with affiliates would not reduce FCM risk, "since FCMs would be unable to enter into and execute such transactions with and through entities and personnel with whom they have created an effective, efficient and liquid settlement framework."<sup>186</sup>

The Commission is not persuaded by these comments. In particular, while the Commission acknowledges that affiliates have a legal status that may distinguish such transactions from in-house transactions, the concentration of credit risk and the potential for conflicts of interest during times of crisis remain significant concerns. Indeed, the Commission's reference to Bear Stearns in the preamble was intended to serve as an illustration of how an elevated concentration of credit risk may produce broad, unforeseen consequences.

<sup>182</sup> See SEC Press Release No. 2008-46, "Answers to Frequently Asked Investor Questions Regarding the Bear Stearns Companies, Inc." (Mar. 18, 2008), available at <http://www.sec.gov/news/press/2008/2008-46.htm> (noting that rumors of liquidity problems at Bear Stearns caused their counterparties to become concerned, creating a "crisis of confidence" which led to the counterparties' "unwilling[ness] to make secured funding available to Bear Stearns on customary terms").

<sup>183</sup> CME letter at 3, FIA/ISDA letter at 9-11.

<sup>184</sup> FIA/ISDA letter at 10-11.

<sup>185</sup> RJO letter at 4.

<sup>186</sup> MF Global/Newedge letter at 7.

Further, as discussed in the NPRM, the interest of consistency of the regulation weighs in favor of disallowing repurchase agreements between affiliates. The Commission finds it incongruous that an investment in the debt instrument of an affiliate (effectively a collateralized loan between affiliates) could be prohibited by paragraph (b)(6) while a repurchase agreement between affiliates (which is the functional equivalent of a short-term collateralized loan between affiliates) could be allowed.

Finally, the Commission believes that firms engage in repurchase agreements with affiliates for purposes of balance sheet maintenance. Repurchase agreements with affiliates may cause a consolidated balance sheet to appear smaller than it would if the same transaction occurred with an unaffiliated third party because such transactions, while they may appear on sub-ledgers, are typically eliminated on the consolidated balance sheet. While FCMs and DCOs may prefer to use such transactions to manage their balance sheets, as mentioned in the context of in-house transactions in Section II.A.4 of this release, the purpose of Regulation 1.25 is not to assist FCMs and DCOs with managing their balance sheets. Rather, the purpose of Regulation 1.25 is to permit FCMs and DCOs to invest customer funds in a manner that preserves principal and maintains liquidity. Because of the concerns expressed above, particularly with respect to the potential for conflicts of interest, the Commission believes that the interests of protecting customer funds are best served by eliminating repurchase agreements with affiliates. Therefore, the Commission is amending paragraph (d) as proposed.<sup>187</sup>

#### *E. Regulation 30.7*

##### *1. Harmonization*

In the NPRM, the Commission proposed to harmonize Regulation 30.7 with the investment limitations of Regulation 1.25 by adding new paragraph (g) to Regulation 30.7. As noted above, the Commission had not previously restricted investments of 30.7 funds to the permitted investments under Regulation 1.25, although Regulation 1.25 limitations can be used as a safe harbor for such investments.<sup>188</sup>

<sup>187</sup> See supra n. 100 (discussing petition procedures set forth in Regulation 13.2, 17 CFR 13.2).

<sup>188</sup> See Commission Form 1-FR-FCM Instructions at 12-9 (Mar. 2010) ("In investing funds required to be maintained in separate section 30.7 account(s), FCMs are bound by their fiduciary obligations to customers and the requirement that the secured amount required to be set aside be at

<sup>181</sup> ICI letter at 11.

The Commission now believes that it is appropriate to align the investment standards of Regulation 30.7 with those of Regulation 1.25 because many of the same prudential concerns arise with respect to both segregated customer funds and 30.7 funds. Such a limitation should increase the safety of 30.7 funds and provide clarity for the FCMs, DCOs, and designated self-regulatory organizations. Two comment letters, from JAC and FIA/ISDA discussed this subject and both supported the amendment.

## 2. Ratings

In the NPRM, the Commission proposed to remove all rating requirements from Regulation 30.7. This amendment is required by Section 939A of the Dodd-Frank Act and further reflects the Commission's views on the unreliability of ratings as currently administered and its interest in aligning Regulation 30.7 with Regulation 1.25.<sup>189</sup> The Commission requested comment on this proposal including whether there existed any sound alternatives to credit ratings.

One comment letter, from FIA/ISDA, discussed the topic and supported the proposal. No comments provided an alternative to credit ratings. As proposed, the Commission is removing paragraph (c)(1)(ii)(B) of Regulation 30.7 as it views a nationally recognized statistical rating organization (NRSRO) rating as unreliable to gauge the safety of a depository institution for 30.7 funds. This change also serves to align Regulation 30.7 with Regulation 1.25 on the topic of NRSROs.

## 3. Designation as a Depository for 30.7 Funds

As proposed, the Commission will no longer allow a customer to request that a bank or trust company located outside the United States be designated as a depository for 30.7 funds. Previously, under Regulation 30.7(c)(1)(ii)(C), a bank or trust company that did not otherwise meet the requirements of paragraph (c)(1)(ii) could still be designated as an acceptable depository by request of its customer and with the approval of the Commission. However, the Commission never allowed a bank or trust company located outside the United States to be a depository through

all times liquid and sufficient to cover all obligations to such customers. Regulation 1.25 investments would be appropriate, as would investments in any other readily marketable securities.”).

<sup>189</sup> See *supra* Section II.B.2 regarding the Commission's policy decision to remove references to credit ratings from Regulation 1.25 and other regulations.

these means, and has decided that it is appropriate to require that all depositories meet the regulatory capital requirement under paragraph (c)(1)(ii)(A).

FIA/ISDA and ADM both supported this amendment in their comment letters. Based on the foregoing, the Commission is amending Regulation 30.7, as proposed, by deleting paragraph (c)(1)(ii)(C).

## 4. Technical Amendments

JAC recommended reinserting “foreign board of trade” in Regulation 30.7(c)(1), believing it was inadvertently omitted in February of 2003.<sup>190</sup> The Commission agrees that the February 2003 **Federal Register** final rule notice contained a clear administrative error, and to address that administrative error, the Commission is reinserting “[t]he clearing organization of any foreign board of trade” in the rule text as new paragraph (c)(1)(v) and renumbering subsequent paragraphs accordingly.<sup>191</sup>

## F. Implementation.

RJO, FIA/ISDA, CME, JAC and NFA suggest a phased implementation period of 180 days.<sup>192</sup> The Commission has determined to allow an implementation period of 180 days following the publication of the final rules.

## III. Cost Benefit Considerations

Section 15(a) of the Act requires the Commission to consider the costs and benefits of its action before promulgating a regulation.<sup>193</sup> In particular, costs and benefits must be evaluated in light of five broad areas of market and public concern: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity

<sup>190</sup> JAC letter at 2.

<sup>191</sup> Prior to 2003, Regulation 30.7(c) permitted an FCM to maintain 30.7 funds in, among other depositories, “[t]he clearing organization of any foreign board of trade.” “Foreign Futures and Foreign Options Transactions,” 52 FR 28980, 29000 (Aug. 5, 1987). In 2002, the Commission requested comment, in an NPRM, on whether the list of depositories enumerated in Regulation 30.7(c) should be expanded. “Denomination of Customer Funds and Location of Depositories,” 67 FR 52641, 52645 (Aug. 13, 2002). The Commission determined it appropriate to expand the list; however, in publishing the final rule, the Commission inadvertently failed to include “[t]he clearing organization of any foreign board of trade” on the list. See “Denomination of Customer Funds and Location of Depositories,” 68 FR 5545, 5550 (Feb. 4, 2003) (“Rule 30.7 will be amended to provide that the funds of foreign futures or options customers may, in addition to those depositories already enumerated \* \* \*.” (emphasis added)). The technical amendment set forth in this notice corrects that administrative error.

<sup>192</sup> CME letter at 7, JAC letter at 3, FIA/ISDA letter at 13, NFA letter at 3, RJO letter at 3.

<sup>193</sup> 7 U.S.C. 19(a).

of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas, depending upon the nature of the regulatory action.

Section 4d of the Act<sup>194</sup> limits the investment of customer segregated funds to obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities), and general obligations of any State or of any political subdivision thereof (municipal securities). The Commission has exercised its authority to grant exempt relief under Section 4(c) of the Act to permit additional investments beyond those prescribed in Section 4d. Regulation 1.25 sets out the list of permissible investments, which the Commission has expanded substantially over the years.<sup>195</sup> As detailed in the discussion above, the final rules narrow the scope of investment choices in order to reduce risk and to increase the safety of Regulation 1.25 investments, consistent with the statute. Further, certain changes to the rule relating to the elimination of credit ratings are mandated by Section 939A of the Dodd-Frank Act.

FCMs currently hold over \$170 billion in segregated customer funds and \$40 billion in funds held subject to Regulation 30.7.<sup>196</sup> The funds are held as performance bond for the purpose of meeting margin calls and Commission regulations allow these funds to be invested by the FCMs and DCOs in enumerated investments subject to various restrictions. Through this rulemaking, the Commission has determined that certain investments are no longer permitted as they may not adequately meet the statute's paramount goal of protecting customer funds.

The Commission recognizes that restricting the type and form of permitted investments could result in certain FCMs and DCOs earning less income from their investments of customer funds. The Commission is unable to determine the magnitude of such income reduction, if any, because information was not provided to allow the Commission to estimate any such income reduction. No commenter provided information about the composition of the portfolio in which customer segregated funds are invested.

<sup>194</sup> 7 U.S.C. 6(d).

<sup>195</sup> 7 U.S.C. 6(c).

<sup>196</sup> Based on CFTC data as of April 30, 2011. See CFTC Web site, Market Reports, Financial Data for FCMs at <http://www.cftc.gov/MarketReports/FinancialDataforFCMs/index.htm>.

As noted above, the list of permitted investments under the rules, notwithstanding the restrictions instituted herein, still represent a significantly wider selection of investment options than those permitted by the Act. Further, in most cases, the amended rules allow for investment in many of the same instruments as previously permitted, subject to asset-based and issuer-based concentration limits.

In issuing these final rules, the Commission has considered the costs and benefits of each aspect of the rules, as well as alternatives to them. In addition, the Commission has evaluated comments received regarding costs and benefits in response to its proposal.<sup>197</sup> Where quantification has not been reasonably estimable due to lack of necessary underlying information, the Commission has considered the costs and benefits of the final rules in

<sup>197</sup> The commenters cost/benefit concerns fall in two categories, summarized below with the Commission's corresponding response.

- *Potentially reduced investment income may cause increases in customer fee.* Some public commenters suggested that a loss of investment income on customer segregated funds and those funds held pursuant to Regulation 30.7 potentially attributable to the rules' investment choice limitations, might incentivize FCMs and DCOs to raise customer fees to make up for reduced investment income. No objective evidence was provided to predict the likelihood of this speculated outcome. The Commission believes that the corresponding benefit—i.e., substantially reduced risk and greater protection of customer segregated funds—justifies this speculative cost, particularly given that the purpose of the segregated funds is not investment income, but customer fund protection. Moreover, as discussed herein, two factors mitigate the magnitude of concern for the significance of any such a potential income reduction. First, under the final rules, most asset classes are still available to managers and are only subject to concentration limits. All other types of investments remain permitted, including Treasuries, municipals, other U.S. agency obligations, foreign sovereign debt and MMMFs. Second, the comment letters do not specify how extensively FCMs and DCOs actually directly invest in those assets classes the rules will exclude. Rather, comments expressing that limitations on direct investments in MMMFs would occasion extra cost and additional investment expertise, suggest that FCMs and DCOs have eschewed investment in these products, at least to some degree.

- *Potentially increased portfolio management costs.* Multiple commenters focused on the additional expense FCMs and DCOs might incur to acquire additional investment staff and expertise needed to manage portfolios under the new rules. Particular areas of concern related to the investment process in light of the removal of credit ratings from that process and portfolio management subject to the percentage limitations with regard to asset-type, issuer, and counterparty. Removal of credit ratings is not within Commission discretion. Moreover, the Commission believes the burden of on-boarding and risk managing additional counterparties, as well as the tracking of investments across more issuers, are offset by the benefit of increased portfolio diversification and more limited exposure to large credit and counterparty risk profiles.

qualitative terms.<sup>198</sup> Generally, as discussed more specifically below with respect to the CEA section 15(a) factors, the Commission believes that the restrictions on segregated customer funds and Regulation 30.7 fund investments promote important benefits. These include greater security for customer funds and enhanced stability for the financial system as a whole.

A discussion of the costs and benefits of this rule and the relevant comments is set out immediately below. The remainder of this Section III considers the costs and benefits of this rule under Section 15(a) of the CEA, organized by (i) impact on each class of permitted investment, (ii) certain other limitations on permitted investments, and (iii) Regulation 30.7.

#### *Municipal Securities*

Municipal securities are permitted investments pursuant to the Act. For the reasons discussed above, the final rule restricts the percentage of total customer segregated funds that may be held by an FCM or DCO in municipal securities to 10 percent. This is in addition to the 5 percent limitation of total customer segregated funds that previously existed for the investment in the municipal securities of any individual issuer.

The Commission has determined that the overall benefits of the concentration limitations for municipal securities and the resultant portfolio risk reductions—as compared to those without such limitations—are compelling, notwithstanding any related costs.

#### (1) Protection of Market Participants and the Public

The public has a strong interest in the stability of the nation's financial system, a goal of the Dodd-Frank Act. The new asset-based concentration limitation for municipal securities will protect market participants and the public by limiting losses to customer segregated funds in the event of a crisis in the municipal bond markets.

The Commission believes that such restrictions are appropriate and will benefit the public and market participants by safeguarding customer funds.

#### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes market efficiency,

<sup>198</sup> In the NPRM, the Commission invited the public "to submit any data or other information that may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters." The Commission received no such quantitative data or information with respect to these rules.

competitiveness and financial integrity in an important way. Imposing portfolio concentration limits lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule. While there may be some potential for "forced sale" losses for FCMs and DCOs on investments that may now be subject to restrictions, the Commission cannot gauge the magnitude and believes that it has taken measures appropriate to the circumstances to mitigate any potential costs. More specifically, the Commission is not in a position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to municipal securities, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell municipal securities. Consequently, the Commission cannot quantify this cost. Further, as mentioned above, the Commission does not believe that FCMs or DCOs invest heavily in municipal securities, so "forced sales," if necessary, should be of little impact. However, to reduce any potential impact, slight though it may be, the rules allow for a 180 day phase-in period, giving FCMs and DCOs ample time to adjust their portfolios to the extent necessary to comply with the regulations. Since municipal securities remain eligible investments for FCMs and DCOs and may be held either directly or indirectly through MMMFs,<sup>199</sup> the Commission believes that any potential impact on municipal securities markets generally also should be mitigated. Accordingly, the Commission believes that the significant benefits of having portfolios less concentrated in municipal securities justify any cost, as mitigated under the rules.

#### (3) Price Discovery

The Commission has considered the restrictions on municipal securities and has determined that the final rules should not have an impact on price discovery.

#### (4) Sound Risk Management Practices

As previously noted, the rules enhance risk management practices by reducing vulnerability to municipal securities defaults by the introduction of additional investment restrictions in the

<sup>199</sup> These investments, of course, remain subject to the "highly liquid" requirement in these rules. To be a permitted investment, a municipal security must have the ability to be converted into cash within one business day, without a material discount in value.

form of asset-based concentration limits. However, given that the list of permitted investments remains relatively unchanged and that there is believed to be little investment in municipal securities at this time, there should be little or no additional resources required to comply with the final rule and the existing risk management strategies and systems should be largely unaffected.

#### (5) Other Public Interest Considerations

The greatest potential impact of this rule on public interest considerations stem from the increased stability of the financial system as a whole. The inclusion of asset-based concentration limits for municipal securities contributes to financial stability by encouraging sound investment strategies for customer segregated funds. For FCMs and DCOs, the expenses associated with managing within these limitations and the potential for reduced investment return opportunities are costs. As discussed above, municipal securities are not a widely used investment, however. Further, as a general matter, FCMs and DCOs still have a great deal of flexibility and the Commission believes that any added expense associated with a more active management of the investment portfolios should be minor relative to the benefits fostered.

#### *U.S. Agency Obligations*

U.S. agency obligations will continue to be permitted investments pursuant to the Commission's authority under Section 4(c), subject to certain restrictions under the rules. In addition to the existing 25 percent limitation on the securities of any single U.S. agency being held with customer segregated funds, the new rules limit this asset class in aggregate to 50 percent of the total customer segregated funds held by the FCM or DCO. The rules also condition investment in debt issued by Fannie Mae and Freddie Mac only while these entities are operating under the conservatorship or receivership of the FHFA.

#### (1) Protection of Market Participants and the Public

In response to concerns regarding the safety of GSE debt securities, highlighted by the 2008 failures of both Fannie Mae and Freddie Mac, these additional restrictions are designed to protect market participants and the public from the excessive risk that concentrated investment in these assets might present. The reduction of credit risk and the portfolio diversification requirements set forth by the amendment will provide greater

security for customer funds, and ultimately to the FCMs and DCOs that rely on those funds.

#### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes market efficiency, competitiveness and financial integrity in an important way. Imposing portfolio concentration limits lowers the risk the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

While there may be some potential for "forced sale" losses for FCMs and DCOs on investments that may now be subject to restrictions, the Commission cannot gauge the magnitude and believes that it has taken measures appropriate to the circumstances to mitigate any potential costs. More specifically, the Commission is not in a position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to U.S. agency obligations, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell U.S. agency obligations. Consequently, the Commission cannot quantify this cost. However, to reduce any potential cost, the rules contemplate a 180 day implementation period, giving FCMs and DCOs ample time to liquidate portfolios to the extent necessary to comply with the regulations. Since investments in U.S. agency obligations remain available for indirect investment through MMMFs, the Commission believes any impact on the markets for U.S. agency obligations generally also should be mitigated. Accordingly, the Commission believes that the significant potential benefits of having portfolios less concentrated in U.S. agency obligations justify any cost, as mitigated under the rules.

#### (3) Price Discovery

The Commission has considered the restrictions on U.S. agency obligations and has determined that the final rules should not have an impact on price discovery.

#### (4) Sound Risk Management Procedures

The greatest costs relative to sound risk management procedures have been mentioned previously. The introduction of additional investment restrictions for U.S. agency obligations in the form of asset-based and issuer-based concentration limits may require FCMs and DCOs to enhance their investment management and portfolio monitoring

resources. However, given that investments in U.S. agency obligations—including GSE debt securities—are currently permitted, the risk management strategies and systems should largely be in place already.

The Commission continues to believe that the overall benefits of the restrictions and concentration limits on U.S. agency obligations, as compared to those based on a regulatory standard without such limitations, are compelling, notwithstanding attendant costs of the restrictions and concentration limits. By limiting the concentration of an FCM's or DCO's investment in U.S. agency obligations, the Commission is encouraging a diverse portfolio that is more likely to withstand a crisis in the GSE debt securities market or a failure of one or more GSEs.

#### (5) Other Public Interest Considerations

The greatest potential effect of this rule on public interest considerations stem from the implications of these rules on the overall stability of the financial system. The inclusion of asset-based and issuer-based limits on U.S. agency obligations contributes to financial stability by reducing concentration risk for funds held in customer segregated accounts. For FCMs and DCOs, the expenses associated with administration and the potential for lost upside investment opportunities are costs. However, as discussed above, notwithstanding the limitations on U.S. agency obligations, FCMs and DCOs still have a great deal of flexibility to invest in such instruments and the added expense associated with a more active management of the investment portfolios should be minor relative to the benefits fostered.

#### *Certificates of Deposit*

CDs will continue to be permitted investments pursuant to the Commission's authority under Section 4(c), subject to certain restrictions under the rules. In addition to the current issuer-based limitation of 5 percent, the new rules impose a 25 percent asset-based limitation. The rules also condition investment in CDs to those that are redeemable at the issuing bank within one day, or are brokered CDs that have embedded put options.

#### (1) Protection of Market Participants and the Public

This rulemaking continues to allow CDs as a permitted investment for FCMs and DCOs while ensuring that such instruments adequately preserve the customers' principal and maintain liquidity. The costs of this rulemaking

include the administrative costs of moving from non-permitted CDs to permitted CDs (or other permitted investments) and potential lost upside investment opportunities from the inability to invest in non-permitted CDs. The Commission is unable to determine the reduction in income, if any, because it does not know the composition of the portfolio in which customer segregated funds are invested. The Commission believes that there is a strong benefit in creating a framework for CDs in which such instruments must be able to be redeemed, within one business day, at the issuing bank, however. The Commission believes that any cost brought about by this amendment is justified by a more diversified risk structure as a result of concentration limits. Further, given the availability of indirect investment in CDs generally through MMMFs, any income loss resulting from these limitations should be minor.

Like other asset types, FCMs and DCOs may need additional resources and expertise, and incur the related expense, to manage a portfolio subject to the percentage limitations of the rules with regard to asset-type and issuer. With sizeable allowances for MMMFs, FCMs and DCOs will be able to continue to leverage the expertise of fund managers and access indirect investment in otherwise restricted asset types.

#### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes financial integrity in an important way. Imposing portfolio concentration limits lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

While there may be some potential for “forced sale” losses for FCMs and DCOs on CDs now subject to restrictions, the Commission cannot gauge the magnitude and believes that it has taken measures appropriate to the circumstances to mitigate any potential costs. More specifically, the Commission is not in a position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to CDs, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell CDs. Consequently, the Commission cannot quantify this cost. However, to reduce any potential cost, the rules contemplate a 180 day implementation period, giving FCMs and DCOs ample time to liquidate

portfolios to the extent necessary to comply with the regulations. Since CDs remain eligible investments for FCMs and DCOs and may be held either directly or indirectly through MMMFs, the Commission believes that any potential impact on CD markets generally also should be mitigated. Accordingly, the Commission believes that the significant potential benefits of having portfolios less concentrated in CDs justify any cost, as mitigated under the rules.

#### (3) Price Discovery

The Commission has reviewed the restrictions on CDs and determined that the final rules should not have an impact on price discovery.

#### (4) Sound Risk Management Procedures

The greatest costs relative to sound risk management procedures have been mentioned previously. The introduction of additional investment restrictions to CDs in the form of asset-based concentration limits may require FCMs and DCOs to enhance their investment management and portfolio monitoring resources. However, the risk management strategies and systems should largely be in place already.

The Commission believes that the overall benefits of the concentration limitations and other restrictions on CDs and the resultant reductions in risk to portfolios, as compared to those based on a regulatory framework without such limitations, mitigate the costs.

#### (5) Other Public Interest Considerations

The greatest potential impact of this rule on public interest considerations stem from the implications of these rules on the stability of the financial system as a whole. The inclusion of asset-based limitations on CDs, as well as the restriction that all CDs must be redeemable at the issuing bank, contributes to financial stability by reducing concentration risk for funds held in customer segregated accounts. For FCMs and DCOs, the expenses associated with managing to these limitations on CDs and the potential for reduced upside investment return on CD investments are costs. However, as discussed above, notwithstanding these limitations, FCMs and DCOs may still invest directly in CDs and may invest indirectly through MMMFs. The added expense associated with a more active management of the investment portfolios should be minor relative to the benefits fostered.

#### *Commercial Paper and Corporate Debt*

Some commercial paper and corporate notes or bonds will continue

to be permitted investments pursuant to the Commission’s authority under Section 4(c), subject to certain restrictions under the rules. In addition to the existing 5 percent limitation on the securities of any single issuer of such instruments being held with customer segregated funds, the new rules limit these asset classes in aggregate to 25 percent, respectively, of the total customer segregated assets held by the FCM or DCO. The rules also restrict investment in commercial paper and corporate notes or bonds to those that are federally guaranteed as to principal and interest under the TLGP.

#### (1) Protection of Market Participants and the Public

The lack of liquidity that impacted these markets during the recent financial crisis, and which necessitated the federal guarantee under TLGP, highlights the concerns of permitting FCMs and DCOs unrestricted investment of customer funds in these assets. The limits imposed by this rule will protect customer funds from being invested in concentrated pools of unrated commercial paper and corporate notes or bonds. While the requirement that these instruments be guaranteed by TLGP may, in effect, severely limit investment in these instruments by FCMs and DCOs, the actual costs of this limitation for FCMs and DCOs are unclear, given that there is little data evidencing the extent of their use as an investment option, and the fact that indirect investment is still permitted through the use of MMMFs.

Like other asset types, FCMs and DCOs may need additional resources and expertise, and incur the related expense, to manage a portfolio of TLGP corporate notes or bonds and/or commercial paper subject to the percentage limitations of the rules and the TLGP restrictions. With sizeable allowances for MMMFs, FCMs and DCOs will be able to continue to leverage the expertise of fund managers and access indirect investment in otherwise restricted asset types.

#### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes financial integrity in an important way. Imposing portfolio concentration limits lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

While there may be some potential for “forced sale” losses for FCMs and DCOs

on commercial paper and corporate debt now subject to restrictions, the Commission cannot gauge the magnitude and believes that it has taken measures appropriate to the circumstances to mitigate any potential costs. More specifically, the Commission is not in a position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to commercial paper and corporate debt, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell commercial paper and corporate debt. Consequently, the Commission cannot quantify this cost. However, to reduce any potential cost, the rules contemplate a 180 day implementation period, giving FCMs and DCOs ample time to liquidate portfolios to the extent necessary to comply with the regulations. Since investments in commercial paper and corporate debt remain available for indirect investment through MMMFs, the Commission believes any impact on commercial paper and corporate debt markets also should be mitigated. Accordingly, the Commission believes that the significant potential benefits of having portfolios less concentrated in commercial paper and corporate debt justify any cost, as mitigated under the rule.

### (3) Price Discovery

The Commission has reviewed the restrictions on commercial paper and corporate notes or bonds and determined that the final rules should not have an impact on price discovery.

### (4) Sound Risk Management Procedures

The greatest costs relative to sound risk management procedures have been mentioned previously. The introduction of additional investment restrictions in the form of asset-based concentration limits and the TLGP restriction may require FCMs and DCOs to enhance their investment management and portfolio monitoring resources. However, the risk management strategies and systems should largely be in place already.

The Commission believes that the overall benefits of the concentration limits and TLGP restrictions on commercial paper and corporate notes or bonds, and the resultant reductions in risk to portfolios, as compared to those based on a regulatory framework without such limitations, are compelling, notwithstanding attendant costs of the restrictions and concentration limits. By adding restrictions and increasing diversification through concentration limits, customer segregated funds

should be better protected in the event of a crisis in the broader financial market.

### (5) Other Public Interest Considerations

The greatest potential impact of this rule on public interest considerations stem from the implications of these rules for the stability of the financial system as a whole. The inclusion of asset-based limits on commercial paper and corporate notes or bonds, as well as the exclusion of corporate instruments that are not guaranteed by the TLGP, will contribute to financial stability by increasing the safety of funds in customer segregated accounts. For FCMs and DCOs, the expenses associated with managing these limitations and the potential for reduced upside investment opportunities are costs. However, as discussed above, notwithstanding the limitations on commercial paper and corporate notes or bonds, FCMs and DCOs still have a great deal of flexibility and the added expense associated with a more active management of the investment portfolios should be minor relative to the benefits fostered.

### *Foreign Sovereign Debt*

Foreign sovereign debt is eliminated as a permitted investment in this rulemaking. However, the Commission invites FCMs or DCOs to request an exemption pursuant to the Commission's authority under Section 4(c), allowing them to invest in foreign sovereign debt: (1) To the extent that the FCM or DCO has balances in segregated accounts owed to its customers (or clearing member FCMs, as the case may be) in that country's currency; and (2) to the extent that investment in such foreign sovereign debt would serve to preserve principal and maintain liquidity of customer funds, as required by Regulation 1.25. Upon an appropriate demonstration, the Commission has noted that it may be amenable to granting such an exemption.

### (1) Protection of Market Participants and the Public

The recent sovereign debt crises highlight the concerns of permitting FCMs and DCOs to invest customer funds in foreign sovereign debt. The restriction of this investment class will protect customer funds from being invested in risky or illiquid foreign sovereign debt. While this rule eliminates investment in these instruments by FCMs and DCOs, the actual costs of this restriction on FCMs and DCOs are unquantifiable, in large part because the extent to which DCOs invest in foreign sovereign debt is uncertain.

Certain commenters argued that investment in foreign sovereign debt is necessary to hedge currency risk, and a prohibition on doing so may be costly. While the Commission recognizes that the restriction may impose costs, such costs are mitigated by the ability of an entity to seek an exemption from the Commission. Further, in a scenario where a market event has caused a currency devaluation and/or the illiquidity of a country's sovereign debt, the Commission believes that customers' best interests are served by an FCM holding a devalued currency, which (albeit devalued) can be delivered immediately to the customer as opposed to an illiquid foreign sovereign debt issuance, which may not be able to be exchanged for any currency in a reasonably short timeframe.

### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes financial integrity in an important way. Eliminating unpredictable and potentially risky instruments lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

While there may be some potential for "forced sale" losses for FCMs and DCOs on foreign sovereign debt now prohibited, the Commission cannot quantify any such losses and believes that through the exemption process under Section 4(c), it has mitigated any such potential costs. Moreover, the Commission is not in a position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to foreign sovereign debt, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell such instruments. Consequently, the Commission cannot quantify this cost. However, to mitigate any such potential cost, the rules contemplate a 180-day implementation period, giving FCMs and DCOs ample time to liquidate portfolios to the extent necessary to comply with the regulations and/or allowing FCMs and DCOs the opportunity to request an exemption.

### (3) Price Discovery

The Commission does not believe that the restrictions on foreign sovereign debt will have an impact on price discovery.

## (4) Sound Risk Management Procedures

The restriction on foreign sovereign debt is intended to require an FCM or DCO to protect against currency exposure in a way that fosters sound risk management, particularly the protection of customer funds.

## (5) Other Public Interest Considerations

The prohibition on investment in foreign sovereign debt will contribute to financial stability by increasing the safety of funds in customer segregated accounts. For FCMs and DCOs, any expense associated with the elimination of foreign sovereign debt is a cost. However, as discussed above, notwithstanding the elimination of this investment class, the Commission believes that the benefits to the public and market participants of this provision of the rule are significant.

*Money Market Mutual Funds*

MMMF investments will continue to be permitted pursuant to the Commission's authority under Section 4(c), albeit with some restrictions. First, an FCM or DCO may invest all of its customer segregated funds in Treasury-only MMMFs, but for all other MMMFs, as discussed below, the Commission believes that a 50 percent asset-based concentration is appropriate. In addition, an FCM or DCO may invest up to 10 percent of its assets in segregation in funds that do not have both \$1 billion in assets and a management company that has at least \$25 billion in MMMF assets under management (small MMMFs), while, subject to the caveats described above, an FCM or DCO may invest up to 50 percent of its assets in segregation in funds that do (large MMMFs).

In arriving at these concentration limits, in addition to its own staff research, the Commission took into consideration information presented in meetings with the market participants, comment letters and discussions with other regulators. The Commission decided to allow investment without asset- or issuer-based limitations for Treasury-only MMMFs due to the fact that Regulation 1.25 allows direct investments entirely in Treasuries. Indirect investment in Treasuries via a Treasury-only MMMF is essentially the risk equivalent of a direct investment in Treasuries, while allowing an FCM or DCO the administrative ease of delegating the management of its portfolio to a MMMF. The Commission decided upon a 50 percent asset-based concentration limit for large prime MMMFs, as it remains concerned that, in another crisis, a run on a prime

MMMF may threaten both the liquidity and principal of customer segregated funds. After weighing the information described above, the Commission determined that a 50 percent asset-based limitation struck the right balance between providing FCMs and DCOs with sufficient Regulation 1.25 investment options and, at the same time, encouraging adequate portfolio diversification. The issuer-based limitation reflects the view that the Commission seeks to protect FCMs and DCOs from runs on particular funds and families of funds. As a necessary corollary for increasing the asset-based concentration limits, the Commission decided to implement the fund and fund family size requirements in order to ensure that MMMFs invested in heavily by FCMs and DCOs were large enough to handle a high volume of redemption requests while still allowing for limited investment in small MMMFs.

Finally, the Commission notes that these restrictions are such that an FCM could invest all of its customer funds in MMMFs, by, as examples, investing entirely in a large Treasury-only MMMF or by investing 50 percent of its funds in large prime MMMFs (spread out among five individual funds and three fund families) and 50 percent in a large Treasury-only MMMF. The Commission believes that this should alleviate the concerns of FCMs that expressed, in their comment letters, a reluctance to manage their own portfolios and instead wished to delegate those responsibilities entirely to fund managers.

## (1) Protection of Market Participants and the Public

The recent financial crisis exposed the risks attendant to MMMFs—in particular, their susceptibility to runs. Though only one fund broke the buck, many others were supported by their sponsors and/or affiliates during the crisis. In response, the SEC has made a number of changes to Rule 2a–7 to address the risks inherent in MMMFs. The changes are aimed at reducing the perceived credit and liquidity risks of the MMMFs' underlying portfolios. However, as the President's Working Group on Financial Markets has noted, systemic risks remain in the MMMF market, notwithstanding the SEC's recent reforms.<sup>200</sup> Absent further changes in the way MMMF shares are valued, redeemed and/or supported

through private or public sector guarantees, future runs on MMMFs cannot be ruled out.

The minimum \$1 billion asset requirement for individual fund and \$25 billion asset requirement for family of funds of large MMMFs are designed to ensure that customer funds are typically invested in sufficiently large funds with diversified portfolios of holdings that are better positioned to withstand unexpected redemptions requests. Limited investment in small MMMFs was retained from the NPRM in order to provide flexibility for FCMs and DCOs and to promote diversification. The new asset-based concentration limitations for non-Treasury MMMFs in aggregate, by family and by individual fund will provide additional protection for customer segregated funds in the event of both runs on MMMFs generally, and more targeted runs that may affect a specific family of funds or an individual fund. The portfolio diversification requirements set forth by the amendment will provide greater security for customer funds, and ultimately to the FCMs and DCOs that rely on those funds.

Individual FCMs and DCOs may need additional resources and expertise, and incur the related expense, to manage a portfolio subject to the percentage limitations of the rules with regard to asset-type, issuer and size. However, with sizeable allowances for MMMFs, FCMs and DCOs will be able to continue to leverage the expertise of fund managers. The Commission notes that under this rule, an FCM or DCO is able to invest all of their customer segregated funds in one or more MMMFs. Therefore, FCMs or DCOs not wishing to manage their portfolios may delegate entirely to MMMF managers.

## (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that this rule promotes financial integrity in an important way. Imposing portfolio concentration limits lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

While there may be some potential for "forced sale" losses for FCMs and DCOs on MMMFs that are above the concentration limits or not meet the asset requirements, the Commission cannot gauge the magnitude and believes that it has taken measures appropriate to the circumstances to mitigate any potential costs. More specifically, the Commission is not in a

<sup>200</sup> President's Working Group on Financial Markets, Money Market Fund Reform Options, at 16–18 (2010). The full report may be accessed at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>.

position to know, with any precision, the portfolio holdings of FCMs and DCOs with respect to MMMFs, nor can the Commission predict the prevailing market conditions if FCMs and DCOs must sell MMMFs. Consequently, the Commission cannot quantify this cost. However, to reduce any potential cost, the rules contemplate a 180 day implementation period, giving FCMs and DCOs ample time to liquidate portfolios to the extent necessary to comply with the regulations. Since investments in MMMFs remain available, the Commission believes any impact on MMMF markets generally also should be mitigated. Accordingly, the Commission believes that the significant potential benefits of having portfolios less concentrated in a small number of MMMFs justify any cost, as mitigated under the rules.

### (3) Price Discovery

The final rules should not have an impact on price discovery.

### (4) Sound Risk Management Procedures

The greatest costs relative to sound risk management procedures have been mentioned previously. The introduction of additional investment restrictions on MMMFs in the form of asset-based and issuer-based concentration limits may require FCMs and DCOs to enhance their investment management and portfolio monitoring resources. However, to the extent that FCMs and DCOs had invested in MMMFs previously, the risk management strategies and systems should largely be in place already.

### (5) Other Public Interest Considerations

The greatest potential benefit of this rule on public interest considerations stem from the implications of these rules on the stability of the financial system as a whole. The inclusion of asset-based concentration limitations on non-Treasury MMMFs, placing limitations on families of funds and on individual funds, and allowing only limited investment in funds not meeting certain asset limits contributes to financial stability by promoting the diversification of investment for funds held in customer segregated accounts. For FCMs and DCOs, the expenses associated with managing their MMMF investments and the potential for lost upside investment opportunities are costs. However, as discussed above, notwithstanding the limitations on the permitted investments, FCMs and DCOs may still invest all customer segregated funds in a portfolio of MMMFs, and the added expense associated with a more

active management of the MMMF portfolio should be minor.

### *Other Investment Limitations*

The final rules also include other limitations and restrictions on those investments that are permitted for customer segregated funds by FCMs and DCOs, including the elimination of in-house transactions and repurchase agreements with affiliates as well as a 25 percent counterparty concentration limit on repurchase agreements.

### (1) Protection of Market Participants and the Public

As stated above, the guiding investment principle for customer funds is that investments are liquid and preserve principal. The lessons of the recent financial crisis highlighted the contagion that can occur in the financial markets from a single failure or default. As such, the new rules are designed to broadly spread counterparty risk, such that customer funds are protected and may be liquidated quickly, notwithstanding select failures in the marketplace. In-house transactions and repurchase agreements with affiliates have been eliminated due to the conflicts of interest that can arise during periods of crisis, the concentration risk associated with engaging in such transactions within an FCM-broker dealer entity (in the case of an in-house transaction) and within an affiliate structure (in the case of a repurchase agreements with affiliates), among other reasons. The 25 percent counterparty-concentration limit has been introduced to ensure that an FCM or DCO does not have all of its customer funds subject to the risk profile of a single counterparty.

### (2) Efficiency, Competitiveness and Financial Integrity of the Markets

The Commission believes that these additional limitations promote financial integrity in an important way. By broadly spreading counterparty risk and enhancing customer fund protections and liquidity, the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls is decreased. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

Moreover, to the extent there are potential costs noted below, offsetting benefits justify them. Any decrease in efficiency resulting from the elimination of in-house transactions and repurchase agreements with affiliates need be considered in light of the benefits of the increased certainty of arms-length transactions between two legally distinct, unaffiliated parties. And, a

crucial benefit offsets the administrative costs associated with having five counterparties rather than one: Reduced counterparty risk.

### (3) Price Discovery

The final rules should not have an impact on price discovery.

### (4) Sound Risk Management Procedures

There may be additional expense associated with the on-boarding and risk managing additional counterparties, but the scale of this additional burden does not appear large and is justified by the benefits of improved counterparty concentration limits.

### (5) Other Public Interest Considerations

The greatest potential impact of this rule on public interest considerations stem from the increased stability of the financial system as a whole. The inclusion of counterparty concentration limits, in particular, contributes to financial stability by reducing risk for funds held in customer segregated accounts.

### *Regulation 30.7*

The Commission has decided to harmonize Regulation 30.7 with the investment limitations of Regulation 1.25. The Commission had not previously restricted investments of 30.7 funds to the permitted investments under Regulation 1.25. The Commission now believes that it is appropriate to align the investment standards given the similar prudential concerns that arise with respect to both segregated customer funds and 30.7 funds. The Commission has also removed the credit ratings requirements for depositories of 30.7 funds and eliminated the option of customers to designate, with the permission of the Commission, a depository not otherwise meeting the standards to be a depository of 30.7 funds.

### (1) Protection of Market Participants and the Public

The public has a strong interest in the stability of the nation's financial system, a goal of the Dodd-Frank Act. Applying Regulation 1.25 standards to 30.7 funds will better insulate them against the negative shocks of future financial crises, thereby enhancing protection to market participants and the public. Also, no benefit justifies applying a different standard for 30.7 funds than for segregated customer funds. FCMs and DCOs traditionally have used Regulation 1.25 as a safe harbor for 30.7 funds; accordingly, there is no basis to anticipate material additional expense

as a result of extending these requirements to 30.7 funds.

The removal of credit ratings from Regulation 30.7 was necessitated by Section 939A of the Dodd-Frank Act and is in line with the Commission's removal of credit ratings under Regulation 1.25. The removal of the designation option for depositories stemmed from the fact that the Commission had never entertained such a request and from the belief that a depository should meet the capital requirements for depositories in order to hold 30.7 funds.

(2) Efficiency, Competitiveness and Financial Integrity of the Markets

The investments made with 30.7 funds generally have been similar to those made under Regulation 1.25. Accordingly, the Commission believes that harmonization of Regulation 30.7 with Regulation 1.25 promotes financial integrity in the same important ways and relative to less significant cost as discussed in the above. Specifically, imposition of the restrictions discussed above with respect to Regulation 1.25 asset classes lowers the risk of FCMs and DCOs suffering losses and/or being unable to liquidate assets to meet margin calls. This type of liquidity loss may operate to undermine market integrity and public confidence in the absence of this rule.

The Commission does not expect the removal of credit ratings to have a significant impact on choice of depositories for 30.7 funds. The Commission expects the elimination of the designation option to have no impact, since it has never been used.

(3) Price Discovery

The final rules regarding Regulation 30.7 should not have an impact on price discovery.

(4) Sound Risk Management Procedures

As mentioned above, most FCMs and DCOs have used Regulation 1.25 as a safe harbor for 30.7 funds. As such, the incremental costs associated with applying the additional investment restrictions in the form of asset-based and issuer-based concentration limits should not be substantial. The risk management strategies and systems should largely be in place already, and will now be applied to 30.7 funds.

The Commission believes that the overall benefits of applying Regulation 1.25 standards to 30.7 funds, as compared to those based on a regulatory framework without such limitations, justify the less significant costs. By adding restrictions and increasing diversification through concentration

limits, 30.7 funds should be better protected in the event of a crisis in the broader financial market. The removal of credit ratings for depositories and the removal of the designation option should not have a significant impact on risk management practices because depositories must still meet the capital requirements in order to qualify under Regulation 30.7 and, as mentioned, no depositories have ever qualified through designation. The only cost associated with the former would be the administrative cost of moving funds from one depository to another, in the event that a previously qualifying depository now no longer qualifies.

(5) Other Public Interest Considerations

The greatest potential impact of this rule on public interest considerations stem from the implications of these rules for the stability of the financial system as a whole. The application of Regulation 1.25 standards to 30.7 funds will contribute to financial stability by reducing concentration risk for 30.7 funds. For FCMs and DCOs, the expenses associated with managing these limitations and the potential for lost upside investment opportunities are costs. However, as discussed above, the added expense associated with a more active management of the investment portfolios should be minor.

#### IV. Related Matters

##### A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA)<sup>201</sup> requires federal agencies, in promulgating rules, to consider the impact of those rules on small businesses. The rule amendments contained 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.<sup>202</sup> The Commission has previously determined that registered FCMs<sup>203</sup> and DCOs<sup>204</sup> are not small entities for the purpose of the RFA. Accordingly, pursuant to 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that the final rules will not have a significant economic impact on a substantial number of small entities.

##### B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) imposes certain requirements on federal agencies (including the Commission) in connection with their

conducting or sponsoring any collection of information as defined by the PRA. The final rules do not require a new collection of information on the part of any entities subject to the rule amendments. Accordingly, for purposes of the PRA, the Commission certifies that these rule amendments, promulgated in final form, do not impose any new reporting or recordkeeping requirements.

#### Lists of Subjects

##### 17 CFR Part 1

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

##### 17 CFR Part 30

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

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

#### PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

■ 1. The authority citation for part 1 is revised 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 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

■ 2. Section 1.25 is revised to read as follows:

##### § 1.25 Investment of customer funds.

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

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

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

(iii) Obligations of any United States government corporation or enterprise sponsored by the United States government (U.S. agency obligations);

(iv) Certificates of deposit issued by a bank (certificates of deposit) as defined

<sup>201</sup> 5 U.S.C. 601 *et seq.*

<sup>202</sup> 47 FR 18618 (Apr. 30, 1982).

<sup>203</sup> *Id.* at 18619.

<sup>204</sup> 66 FR 45604, 45609 (Aug. 29, 2001).

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 fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program as administered by the Federal Deposit Insurance Corporation (commercial paper);

(vi) Corporate notes or bonds fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program as administered by the Federal Deposit Insurance Corporation (corporate notes or bonds); and

(vii) 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 (vii) 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 “highly liquid” as defined in paragraph (b)(1) of this section.

(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) Obligations issued by the Federal National Mortgage Association or the Federal Home Loan Mortgage Association are permitted while these entities operate under the conservatorship or receivership of the Federal Housing Finance Authority with capital support from the United States.

(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) *Liquidity.* Investments must be “highly liquid” such that they have the ability to be converted into cash within one business day without material discount in value.

(2) *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)(2)(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)(2)(iv) of this section, and it may not otherwise constitute a derivative instrument.

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

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

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

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

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

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

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

(2) The term *floating rate security* means a security, the terms of which provide for the adjustment of its interest rate whenever a specified interest rate changes and that, at any time until the final maturity of the instrument or the period remaining until the principal amount can be recovered through demand, can reasonably be expected to have 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 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.

(vi) Commercial paper and corporate notes or bonds must meet the following criteria:

(A) The size of the issuance must be greater than \$1 billion;

(B) The instrument must be denominated in U.S. dollars; and

(C) The instrument must be fully guaranteed as to principal and interest by the United States for its entire term.

(3) *Concentration*—(i) *Asset-based concentration limits for direct investments.* (A) Investments in U.S. government securities shall not be subject to a concentration limit.

(B) Investments in U.S. agency obligations may not exceed 50 percent of the total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(C) Investments in each of commercial paper, corporate notes or bonds and certificates of deposit may not exceed 25 percent of the total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(D) Investments in municipal securities may not exceed 10 percent of the total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(E) Subject to paragraph (b)(3)(i)(G) of this section, investments in money market mutual funds comprising only

U.S. government securities shall not be subject to a concentration limit.

(F) Subject to paragraph (b)(3)(i)(G) of this section, investments in money market mutual funds, other than those described in paragraph (b)(3)(i)(E) of this section, may not exceed 50 percent of the total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(G) Investments in money market mutual funds comprising less than \$1 billion in assets and/or which have a management company comprising less than \$25 billion in assets, may not exceed 10 percent of the total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(ii) *Issuer-based concentration limits for direct investments.* (A) Securities of any single issuer of U.S. agency obligations 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.

(B) 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.

(C) Interests in any single family of money market mutual funds described in paragraph (b)(3)(i)(F) of this section may not exceed 25 percent of total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(D) Interests in any individual money market mutual fund described in paragraph (b)(3)(i)(F) of this section may not exceed 10 percent of total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(E) For purposes of determining compliance with the issuer-based concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(5) 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.

(iii) *Concentration limits for agreements to repurchase—(A) Repurchase agreements.* For purposes of determining compliance with the asset-based and issuer-based 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.

(B) *Reverse repurchase agreements.* For purposes of determining compliance with the asset-based and issuer-based 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) *Treatment of customer-owned securities.* For purposes of determining compliance with the asset-based and issuer-based 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.

(v) *Counterparty concentration limits.* Securities purchased by a futures commission merchant or derivatives clearing organization from a single counterparty, subject to an agreement to resell to that counterparty, shall not exceed 25 percent of total assets held in segregation by the futures commission merchant or derivatives clearing organization.

(4) *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.

(5) *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.

(6) *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. The futures commission merchant or the derivatives clearing organization shall obtain the acknowledgment letter required by § 1.26 from an entity that has substantial control over the fund shares purchased with customer segregated funds and has the knowledge and authority to facilitate redemption and payment or transfer of the customer segregated funds. Such entity may include the fund sponsor or depository acting as custodian for fund shares.

(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) For any period during which there is a non-routine closure of the Fedwire or applicable Federal Reserve Banks;

(B) For any period:

(1) During which the New York Stock Exchange is closed other than customary week-end and holiday closings; or

(2) During which trading on the New York Stock Exchange is restricted;

(C) For any period during which an emergency exists as a result of which:

(1) Disposal by the company of securities owned by it is not reasonably practicable; or

(2) It is not reasonably practicable for such company fairly to determine the value of its net assets;

(D) For any period as the Securities and Exchange Commission may by order permit for the protection of security holders of the company;

(E) For any period during which the Securities and Exchange Commission has, by rule or regulation, deemed that:

(1) Trading shall be restricted; or

(2) An emergency exists; or

(F) For any period during which each of the conditions of § 270.22e-3(a)(1) through (3) of this title are met.

(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.

(7) The Appendix to this section sets forth language that will satisfy the requirements of paragraph (c)(5) of this section.

(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 (vii) 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) Permitted 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) A futures commission merchant or derivatives clearing organization shall not enter into an agreement to repurchase or resell with a counterparty that is an affiliate of the futures commission merchant or derivatives clearing organization, respectively. 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.

(4) 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)(3)(iii)(A) and (B) of this section.

(5) 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 (13) of this section and which states that the parties thereto intend the transaction to be

treated as a purchase and sale of securities.

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

(7) 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.

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

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

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

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

(9) 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.

(10) 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.

(11) 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.

(12) 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."

(13) 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) *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.

#### **Appendix to § 1.25—Money Market Mutual Fund Prospectus Provisions Acceptable for Compliance With Section 1.25(c)(5)**

Upon receipt of a proper redemption request submitted in a timely manner and otherwise in accordance with the redemption procedures set forth in this prospectus, the [Name of Fund] will redeem the requested shares and make a payment to you in satisfaction thereof no later than the business day following the redemption request. The [Name of Fund] may postpone and/or suspend redemption and payment beyond one business day only as follows:

- a. For any period during which there is a non-routine closure of the Fedwire or applicable Federal Reserve Banks;
- b. For any period (1) during which the New York Stock Exchange is closed other than customary week-end and holiday closings or (2) during which trading on the New York Stock Exchange is restricted;
- c. For any period during which an emergency exists as a result of which (1) disposal of securities owned by the [Name of Fund] is not reasonably practicable or (2) it is not reasonably practicable for the [Name of Fund] to fairly determine the net asset value of shares of the [Name of Fund];
- d. For any period during which the Securities and Exchange Commission has, by rule or regulation, deemed that (1) trading shall be restricted or (2) an emergency exists;
- e. For any period that the Securities and Exchange Commission, may by order permit for your protection; or
- f. For any period during which the [Name of Fund] as part of a necessary liquidation of the fund, has properly postponed and/or suspended redemption of shares and payment in accordance with federal securities laws.

#### **PART 30—FOREIGN FUTURES AND FOREIGN OPTIONS TRANSACTIONS**

■ 3. The authority citation for part 30 continues to read as follows:

**Authority:** 7 U.S.C. 1a, 2, 6, 6c, and 12a, unless otherwise noted.

■ 4. In § 30.7, revise paragraph (c) and add paragraph (g) to read as follows:

##### **§ 30.7 Treatment of foreign futures or foreign options secured amount.**

\* \* \* \* \*

(c)(1) The separate account or accounts referred to in paragraph (a) of this section must be maintained under

an account name that clearly identifies them as such, with any of the following depositories:

- (i) A bank or trust company located in the United States;
- (ii) A bank or trust company located outside the United States that has in excess of \$1 billion of regulatory capital;
- (iii) A futures commission merchant registered as such with the Commission;
- (iv) A derivatives clearing organization;
- (v) The clearing organization of any foreign board of trade;
- (vi) A member of any foreign board of trade; or
- (vii) Such member or clearing organization's designated depositories.

(2) Each futures commission merchant must obtain and retain in its files for the period provided in § 1.31 of this chapter an acknowledgment from such depository that it was informed that such money, securities or property are held for or on behalf of foreign futures and foreign options customers and are being held in accordance with the provisions of these regulations.

\* \* \* \* \*

(g) Each futures commission merchant that invests customer funds held in the account or accounts referred to in paragraph (a) of this section must invest such funds pursuant to the requirements of § 1.25 of this chapter.

Issued in Washington, DC, on December 5, 2011 by the Commission.

**David A. Stawick,**

*Secretary of the Commission.*

#### **Appendices to Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions—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, Commissioners Sommers, Chilton, O'Malia and Wetjen voted in the affirmative; no Commissioner voted in the negative.

##### **Appendix 2—Statement of Chairman Gary Gensler**

I support the final rule to enhance customer protections regarding where derivatives clearing organizations (DCOs) and futures commission merchants (FCMs) can invest customer funds. I believe that this rule is critical for the safeguarding of customer money.

The Commodity Exchange Act in section 4d(a)(2) prescribes that customer funds can only be placed in a set list of permitted investments. From 2000 to 2005, the

Commission granted exemptions to this list, loosening the rules for the investment of customer funds. These exemptions allowed FCMs to invest customer funds in AAA-rated sovereign debt, as well as to lend customer money to another side of the firm through repurchase agreements.

This rule prevents such in-house lending through repurchase agreements. I believe there is an inherent conflict of interest between parts of a firm doing these transactions. The rule also would limit an FCM's ability to invest customer money in foreign sovereign debt.

In addition, this rule fulfills a Dodd-Frank requirement that the CFTC remove all reliance on credit ratings from its regulations.

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