

deposited by customers subject to certain conditions and to modify the portfolio time-to-maturity requirements for securities deposited in connection with certain collateral management programs of DCOs pursuant to certain conditions. The Commission also is requesting comment on several other provisions of the rule: Whether the portfolio time-to-maturity requirement should be modified for portfolios consisting exclusively of Treasury securities; whether the restriction on embedded derivatives should be modified; whether the list of permitted benchmarks for variable rate securities should be expanded; and whether the concentration limitations on reverse repurchase agreements should be changed. The Commission is proposing these rule amendments and requesting comment as part of its continuing efforts to facilitate the safe and efficient handling of customer funds, and in response to inquiries received as firms gain experience implementing the revisions adopted in December 2000.

DATES: Comments must be received on or before July 30, 2003.

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

FOR FURTHER INFORMATION CONTACT: John C. Lawton, Deputy Director and Chief Counsel, or Lois Gregory, Special Counsel, Division of Clearing and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW., Washington, DC 20581. Telephone (202) 418-5450.

SUPPLEMENTARY INFORMATION:

I. Background

Commission Regulation 1.25 (17 CFR 1.25) sets forth the types of instruments in which FCMs and DCOs are permitted to invest customer segregated funds. Regulation 1.25 was substantially amended in December 2000 to expand the list of permitted investments.¹ In connection with the expansion, the Commission added several provisions intended to minimize the credit, liquidity, and volatility risk associated with the additional investments. The Commission is proposing to modify some of those provisions. The

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II. Proposed Amendments

A. Repurchase Agreements Involving Collateral Deposited by Customers

CFTC Interpretative Letter 84-24 ("84-24") permits FCMs to engage in repurchase agreements ("repos") with collateral deposited by customers ("customer collateral") subject to certain terms and conditions.² When the Commission adopted the amendments to Regulation 1.25 in December 2000, it included provisions governing repos and reverse repos involving investments purchased with customer funds ("permitted investments") subject to terms and conditions that differ in a number of ways from those in 84-24.³ The Commission did not address 84-24 at that time.

Various market participants have suggested that repos involving customer collateral should be permitted under the terms and conditions applicable to permitted investments. They believe that increased use of repos could enhance yield. They also note that certain types of collateral, while permissible as margin at the FCM level, are not acceptable at the clearinghouse level. Permitting repos of such collateral could ease cash flow problems that sometimes arise from this circumstance.

The Commission is proposing to amend Regulation 1.25(a)(2) to permit FCMs and DCOs to engage in repos of customer-deposited securities subject to certain terms and conditions. The proposal would eliminate the requirement currently set forth in 84-24 that the FCM provide written disclosure of the mechanics of the transaction and obtain written authorization from the customer. If the Commission adopted the proposal, 84-24 would be superseded.

Proposed paragraph (a)(2)(ii)(A) would provide that, to be eligible, securities must meet the marketability requirements of Regulation 1.25(b)(1). This is intended to ensure that, if a repo counterparty should default, the FCM or DCO could use the cash proceeds from the repo to buy the securities elsewhere.

Proposed paragraph (a)(2)(ii)(B) would provide that securities subject to repurchase agreements must not be "specifically identifiable property" as defined in section 190.01(kk) of the Commission's rules. Such property is generally not eligible for repo.

² CFTC Staff Letter No. 84-24, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,449 (Dec. 5, 1984).

³ Regulation 1.25(a)(2) and 1.25(d).

Proposed paragraph (a)(2)(ii)(C) would provide that the terms and conditions of such a repo must be in accordance with the requirements of Rule 1.25(d). The Commission believes that these safeguards, currently applicable to repos for permitted investments, are appropriate to apply to customer-deposited securities as well.

Proposed paragraph (a)(2)(ii)(D) would provide that, in the unlikely event of a default by a counterparty to a repurchase agreement, the FCM must take steps to ensure that the default does not result in any cost or expense to the customer. The Commission believes that this requirement is appropriate in light of the proposal to eliminate the disclosure and consent requirements of 84-24. Given this lack of express authorization, any risk of loss created by the transaction should be borne by the FCM. The Commission believes that although the standards set forth in paragraph (a)(2)(ii)(C) should minimize the risk of default, nonetheless, if there is such a default, the FCM must make the customer whole.

The Commission requests comment on all aspects of this proposal. In particular, the Commission requests comment on whether it is appropriate to permit repos of customer collateral without prior written consent, and, if so, whether the limitations set forth in the proposal are appropriate. In this regard, the Commission specifically requests comment on whether a one-way notice disclosure to the customer should be required and whether a mechanism should be provided under which a customer could instruct the FCM that repos of its collateral would not be permitted. The Commission also requests comment on how an FCM may fulfill its obligations to its customer in the event a repo counterparty fails to perform. Is it sufficient if the FCM gives the customer the cash equivalent of the securities plus any transaction costs that might be incurred in replacing the securities? Or, should the FCM replace the securities? Would cash compensation be insufficient, for example, if a customer needed the particular security to maintain the risk profile of its portfolio?

The Commission further requests comment on whether the terms and conditions applicable to DCOs engaging in repos should differ in any way from those applicable to FCMs. The Commission also requests comment on whether customer collateral that is subject to repo should be treated for concentration purposes like permitted investments under paragraph (b)(4)(ii) or continue to be treated under paragraph (b)(4)(v). Finally, the

¹ 65 FR 77993 (December 13, 2000).