

Commission requests comment on whether there are tax implications that should be considered in connection with this proposal.

#### *B. Time-to-Maturity Requirements for Certain Collateral*

Rule 1.25(b)(5) establishes a time-to-maturity requirement for the portfolio of permitted investments. Certain industry participants have requested limited relief from this provision. In particular, a DCO is developing a program whereby FCMs could deposit certain collateral on an overnight basis to meet certain special margin charges. Absent amendment of the rule, the deposit of such collateral could cause the FCM's portfolio to exceed the time-to-maturity limits of Rule 1.25(b)(5).

In order to encourage development of such innovative collateral management programs, and thereby facilitate the efficient use of capital, the Commission is proposing to amend Rule 1.25(b)(5). Under the proposal, certain instruments may be treated as if they had a time-to-maturity of one day if certain terms and conditions are satisfied. First, the instrument must be deposited with a DCO solely on an overnight basis. Second, the instrument must be one that the FCM owns or has the unqualified right to pledge, and free of any lien.<sup>4</sup> Third, the instrument must be used for the purpose of meeting concentration margin or other similar charges that are in addition to the basic margin requirement established by the DCO. Fourth, the DCO must price the instrument each day based on a current mark-to-market value. Fifth, the DCO must haircut the instrument by at least 2 percent. The Commission understands that 2 percent is the standard haircut generally used in the repo market.

The time-to-maturity requirement in 1.25(b)(5) is intended to limit the market risk of permitted investments. The Commission believes that it is appropriate to provide some additional flexibility under the circumstances and with the safeguards described above. That is, when instruments are held at a

DCO solely on an overnight basis, subject to a haircut, and for the purpose of satisfying a margin cushion over and above the basic performance bond requirement, a modified treatment is appropriate. This treatment could increase capital efficiency at the FCM level by permitting additional instruments to be used for margin while enhancing systemic security at the DCO level by increasing the amount of collateral held to support positions.

The Commission requests comment on the appropriateness of the proposed terms and conditions. In particular, the Commission requests comment on whether the haircut is appropriate and whether the relief should be limited to instruments deposited to meet concentration and similar margin requirements, as proposed or whether the modified treatment should be extended to apply to initial margin generally. If the latter, should alternative safeguards be developed? For example, would it be appropriate to apply the relief to the extent that an FCM holds excess funds in segregation?

#### *C. Time to Maturity—Treasury Portfolio*

As noted above, current Rule 1.25(b)(5) limits the dollar weighted average of the time-to-maturity for permitted investments to no longer than 24 months. In expanding the range of permissible investments in December 2000, the Commission added this requirement.

One FCM has informed a self-regulatory organization that the FCM invests exclusively in obligations of the U.S. Treasury. This FCM believes that because Treasury instruments do not pose the same risks that other permitted investments pose, the time-to-maturity limitation should not apply.

The Commission requests comment on whether an alternate safeguard to limit risk, such as appropriate haircuts, would be more appropriate than the time-to-maturity requirement of Rule 1.25(b)(5) with respect to a portfolio consisting exclusively of U.S. Treasury securities.

#### *D. Embedded Derivatives*

Rule 1.25(b)(3)(i) prohibits instruments with embedded derivatives. Some market participants have suggested that there are certain instruments containing embedded derivatives that have a lower level of risk than some of the other investments permitted under the rule. The Commission requests comment on whether Rule 1.25(b)(3)(i) should be amended to modify the prohibition on investments in securities that contain an embedded derivative. In this regard,

commenters are asked to describe how the level of risk of such securities could be limited.

#### *E. Variable Rate Securities—Permitted Benchmarks*

Rule 1.25(b)(3)(iv) permits investment in variable rate securities provided that they correlate to certain specified benchmarks. Industry representatives have noted that the benchmarks used in the marketplace evolve over time. They have suggested the rule should provide that the interest rate on variable rate securities may be benchmarked to any fixed rate instrument that is a permitted investment under the rule. The Commission requests comment on whether the provision on permitted benchmarks should be amended, and if so, what the applicable standard should be.

#### *F. Reverse Repos—Concentration Limits*

Rule 1.25(b)(4)(iii) establishes concentration limits for reverse repos. Industry representatives have indicated that because of the need to engage in manual processing, this investment alternative has generally proved not to be viable. They have expressed a desire to work with Commission staff to develop a proposal that would continue to address the risks of reverse repos. The Commission requests comment on market participants' experience with the current provisions relating to reverse repos and suggestions on how best to address the risks of these transactions.

### **III. Related Matters**

#### *A. Regulatory Flexibility Act*

The Regulatory Flexibility Act ("RFA"), 5 U.S.C. 601 et seq. (1994 & Supp. II 1996), requires federal agencies, in proposing rules, to consider the impact of those rules on small businesses. The rule amendments discussed herein would affect FCMs. 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>5</sup> The Commission has previously determined that registered FCMs are not small entities for the purpose of the RFA.<sup>6</sup> The amendments proposed herein would not require any registrant to change its current method of doing business. The proposed amendments should reduce, rather than increase, the regulatory requirements that apply to registered FCMs. Accordingly, pursuant to 5 U.S.C. 605(b), the Chairman, on behalf of the Commission, certifies that

<sup>4</sup> Instruments that have been given to an FCM by a customer for deposit in a segregated account currently are not subject to the time-to-maturity provisions of Rule 1.25 and this would remain the case under this proposal. Instruments that have been purchased by an FCM with customer funds and are being held in a segregated account currently are subject to those provisions and this generally would remain the case under the proposal. The proposal would provide relief with regard to instruments that had been held by an FCM in its non-segregated inventory and that were deposited on an overnight basis into a segregated account at a DCO. So long as an FCM had an unqualified right to pledge the instruments, they could include instruments obtained through reverse repurchase transactions, or otherwise.

<sup>5</sup> 47 FR 18618–18621 (April 30, 1982).

<sup>6</sup> 47 FR 18619–18620.