Federated Investors, Inc.

Comment Letter
on
Securities Exchange Act
Release No. 55431

Dechert LLP

May 1, 2007

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May 1, 2007

SUBMITTED ELECTRONICALLY

Ms. Nancy M. Morris
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: File Number S7-08-07

Dear Ms. Morris:

On behalf of our client, Federated Investors, Inc. ("Federated")[1] we are pleased to comment on Securities Exchange Act Release 55431.[2] Federated commends the Securities and Exchange Commission (the "Commission" or the "SEC") for proposing

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1 Federated is one of the nation's largest investment managers and one of the largest institutional money market fund managers. As of December 31, 2006, it had:

- 148 equity, fixed-income, and money market mutual funds;
- $237.4 billion assets under management, of which $40.9 billion were equity assets; and
- $173.6 billion in money market assets

Federated has a diversified client base including banks, broker-dealers, insurance companies, corporations, pension funds, and government entities. Federated is listed on the New York Stock Exchange (Symbol: FII). For additional information, *see* http://www.federatedinvestors.com/daf/pdf/25621.pdf

2 March 9, 2007; 72 FR 12899 (March 19, 2007) (the "Release").

changes to the financial responsibility rules.[3] We also appreciate that the Commission has sought comment in the Release on some of the specific issues that Federated raised in its amended rule petition to the Commission.[4]

Unfortunately, we believe that the proposed changes to Rule 15c3-3[5] and Rule 15c3-1[6] under the Exchange Act fall short of the needs of the marketplace. For the reasons discussed below and as set forth in our Amended Petition, we respectfully urge the Commission to permit broker-dealers to use money market funds that have received the highest rating ("AAA-rated money market funds") from a nationally recognized statistical rating organization ("NRSRO") in the following ways:

i. As "qualified securities" that are eligible for deposit in the Special Reserve Account under Rule 15c3-3;

ii. As collateral for fully-paid or excess margin securities under Rule 15c3-3;

iii. As capital eligible to receive a zero percent haircut under Rule 15c3-1; and

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3 *Cf.* Section 3(a)(40) of the Securities Exchange Act of 1934 (the "Exchange Act"), which provides that "the term 'financial responsibility rules' means the rules and regulations of the Commission or the rules and regulations prescribed by any self-regulatory organization relating to financial responsibility and related practices which are designated by the Commission, by rule or regulation, to be financial responsibility rules." We refer to Rule 15c3-1 and Rule 15c3-3 collectively as the "financial responsibility rules." *See* notes 5 and 6, *infra.*

4 Federated Amended Rule Petition, submitted to Jonathan G. Katz, Secretary, SEC, from Stuart J. Kaswell, Partner, and David J. Harris, Partner, Dechert LLP, April 4, 2005, http://www.sec.gov/rules/petitions/petn4-478a.pdf (the "Amended Petition") included as Attachment I. For convenience, we have included the current text of Federated's proposed amendments to Rule 15c3-1 and Rule 15c3-3 as an Exhibit to this letter. *See also* letter from Florence E. Harmon, Deputy Secretary, SEC, to Stuart J. Kaswell, Partner, Dechert LLP, March 14, 2007 regarding the status of the Amended Petition.

5 17 CFR §240.15c3-3 (sometimes referred to as the "customer protection rule").

6 17 CFR §240.15c3-1 (sometimes referred to as the "net capital rule").

iv. As securities eligible to be held in a separate or escrow account in accordance with Rule 15c2-4.[7]

We explain our reasons below.

Introduction and Executive Summary

Federated has sought the relief outlined above because it wishes to meet the needs of its broker-dealer customers. Federated has sought changes to the SEC's financial responsibility rules and to Rule 15c2-4 because its customers have said that they would prefer to satisfy certain of their legal obligations by using AAA-rated money market funds, rather than by using the limited financial choices that are available to them today.

As discussed in its Amended Petition, Federated believes that AAA-rated money market funds are among the safest investment vehicles available today. They have a remarkable record for safety, stability, and liquidity. The Commission itself regulates money market funds and should be proud of the legal framework it has created and which has fostered such a successful financial product. Federated believes that AAA-rated money market funds offer an extremely attractive alternative to the existing financial choices currently available to broker-dealers. They offer less operational risk than buying and selling individual U.S. Treasury securities and provide financial integrity that is at least as good as, or better than, a bank's balance sheet or its letter of credit, which are permitted for one or more purposes under Rule 15c3-3.

The Commission has proposed only limited changes to its rules that the marketplace has already deemed inadequate. Broker-dealers have already rejected the Commission's proposal to permit broker-dealers to use "Treasury-only" money market funds. Federated originally proposed such a change to the Commission in 2003, but later altered its proposal because broker-dealers indicated that they were no longer interested in purchasing Treasury-only money market funds. Accordingly, Federated amended its rule petition and asked the Commission to approve AAA-rated money market funds with comparable (or even greater) safety. The proposal to reduce the haircut under Rule 15c3-1 from 2% to 1% is not responsive to the needs of the marketplace. It is our view, which has been confirmed in conversations with potential clients, that broker-dealers will not be

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[7] 17 CFR §240.15c2-4.

interested in using money market funds for net capital purposes at such a cost. Federated has sought change through legislation. Federated hopes that either Congress or the SEC will be able to provide an effective solution and to make expeditiously the changes that we seek.

General Comments on the Safety of Money Market Funds

The basic premise underlying Federated's position is that money market funds in general, and AAA-rated money market funds in particular, are among the safest private sector investments ever created. Because of the extraordinarily high level of safety and dependability, we think that the Commission should be willing to move beyond its excessively cautious proposal and endorse Federated's recommendations. We do not wish to reiterate all of the arguments Federated has made to the Commission and its Staff over the past several years. However, we will highlight our points in this letter, and incorporate our longer statements by reference.

a. **Regulatory Framework** – The Commission should be justifiably proud of the regulatory framework that it created and has been in place since 1983. The Commission's adoption of Rule 2a-7 under the Investment Company Act of 1940 ("Rule 2a-7") has fostered an environment that has allowed money market funds to flourish. The Commission has facilitated the development of a financial product that provides safety, convenience, and market rates of return, at low cost to individuals and businesses. The Commission has modernized the rule from time to time, and has the ability to do so in the future.

As detailed in our Amended Petition, under Rule 2a-7, money market funds offer:

1. *Broad Portfolio Diversification* – taxable money market funds must limit their investment in the securities of any one issuer, other than Government securities, to five percent of funds assets.

2. *High Portfolio Quality* – money market funds may only purchase "eligible securities" as defined in Rule 2a-7(c)(3)(i). The rule further limits money market funds to portfolio securities determined to present minimal credit risks.

3. *Short Portfolio Maturity* – money market funds may not acquire any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days.

4. *High Portfolio Liquidity* – a money market fund may not have more than ten percent of its assets in illiquid securities.

5. *Reduced Operational Risk* – investors in money market funds avoid the operational risks of buying and selling individual Treasury securities. Even the largest broker-dealers, with active government securities trading desks, have indicated that they would prefer to replace their purchasing and selling of individual U.S. Treasury securities with AAA-rated money market funds.

These benefits are available from an investment in any money market fund. As described below, the higher standards required for a money market fund to receive a AAA rating from an NRSRO provide yet additional benefits.

b. **Track Record** – Since their inception, money market funds have grown to be an extremely successful investment vehicle for individual investors and large businesses. The Investment Company Institute reports that total money market funds investments for the week ended April 4, 2007 were $2.451 trillion.[8] Investors purchase and redeem millions of shares of money market funds on a continuous basis. They treat them as cash-equivalents and with good reason.

c. **AAA Rating** – Federated recommends that the SEC approve money market funds with a AAA rating for the various purposes outlined above. That standard would afford investor protection that is even higher than the current high standards of Rule 2a-7. For example, to qualify for Standard & Poor's ("S&P") top rating of AAAm, a money market fund must meet extremely rigorous standards that exceed the very high requirements of

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8 http://www.ici.org/home/mm_04_05_07.html#TopOfPage

Rule 2a-7. Among these higher standards, is the requirement that the money market fund have a weighted average maturity that does not exceed 60 days. S&P treats investments in short-term U.S. Treasuries the same as investments in short-term A-1 rated investments. Thus a Treasury-only money market fund with a weighted average portfolio of between 60 and 90 days would not qualify for the AAAm rating. The shorter weighted average maturity requirement means that the portfolio assets are subject to much less interest rate risk, and therefore provide a greater degree of investor protection.

d. **Broad Acceptance** – As detailed extensively in our Amended Petition, federal and state regulators of every stripe have approved the use of money market funds for an enormous variety of purposes. Examples of such circumstances include investment of the assets of national banks (Office of the Comptroller of the Currency), state-chartered banks (Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation), and federal credit unions (National Credit Union Administration); customer funds held in custody by futures commission merchants and futures clearing organizations (Commodity Futures Trading Commission); margin collateral (Board of Trade Clearing Corporation, New York Mercantile Exchange, Chicago Mercantile Exchange, and the Options Clearing Corporation); assets of state and municipal entities, assets subject to trust indentures, and trust and other fiduciary assets (numerous state laws). The Commission staff has authorized the pre-funded portion of an asset-backed issuance to be invested in money market mutual funds as an alternative to eligible financial assets that convert to cash. We also note that the Commission has approved a rule change submitted by the Options Clearing Corporation, which permits clearing firms to use money market funds for margin purposes.[9]

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9 Exchange Act Release 47599 (March 31, 2003); 66 FR 16849, (April 7 2003). See also Exchange Act Release No. 51289 (March 2, 2005); 70 FR 11291 (March 8, 2005) Exchange Act Release 51290 (March 2, 2005); 70 FR 11290 (March 8, 2005). The Options Clearing Corporation is also registered with the Commodity Futures Trading Commission ("CFTC") as a derivatives clearing organization. The CFTC notes that "as a registered DCO, OCC will now be able to provide clearing and settlement services for transactions in commodity futures contracts and options on

e. **Compares Favorably to Alternatives** – In support of our Amended Petition, Federated has retained Treasury Strategies, Inc. ("Treasury Strategies"), a respected consulting firm that provides financial management advice to many of the world's largest broker-dealers, banks, and mutual fund firms. Treasury Strategies prepared a study that compares AAAm rated money market funds with the assets currently eligible for deposit in the special reserve account or approved as collateral. Treasury Strategies concludes that AAAm rated money market funds are equivalent or superior to other eligible assets. For example, Treasury Strategies believes that broker-dealers usually place funds in the special reserve account in money market deposit accounts, which become subject to the risks of the bank's balance sheet. Treasury Strategies notes that:

1. *Financial Strength* – [Money Market Mutual Funds or "MMMFs"] with a AAAm rating have the highest credit rating awarded. No large commercial bank has been able to maintain a AAA rating and very few even achieve AA status.

2. *Risk of Failure* – Over the past fifteen years, there have been no failures among AAAm rated MMMFs. Among all MMMFs, there has been only one failure of a very small fund and a small number of assisted transactions. During that same period, there have been 350 commercial bank failures and an undisclosed number of assisted transactions.

3. *Quality of Underlying Investments* – The minimum credit quality of an underlying investment by an AAAm rated fund is A1. [One hundred percent] of assets meet or exceed that level of credit

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commodity futures contracts."
http://www.cftc.gov/dea/dearegistered_dco.htm?from=home&page=epclearingcontent

> quality. In contrast, only about 30% of commercial bank assets are in securities of that quality.[10]

The Release itself acknowledges the great safety of money market funds. The Commission notes "broker-dealers have on occasion changed the product to which a customer's free credit balances are swept—most frequently from a money market fund product to an interest bearing bank account." The Release then discusses the advantages and disadvantages of money market accounts and bank deposits:

> There are differences in these two types of products, including the type of protection afforded the customer in the event of an insolvency. The money market shares—as securities—would receive up to $500,000 in [Securities Investor Protection Act] protection in the event the broker-dealer failed. The bank deposits—as cash— would receive $100,000 in protection from the Federal Deposit Insurance Corporation (''FDIC'') in the event the bank failed. On the other hand, the money market fund as a security **theoretically** could lose its principal; whereas the bank deposit would be guaranteed up to the FDIC's $100,000 limit. There also may be differences in the amount of interest earned from the two products. **[emphasis added]**.[11]

It is telling that the Commission itself has concluded that investors in money market funds only face a "theoretical" risk of losing principal. It is

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10 Treasury Strategies, Assessing the Risks of Rule 15c3-3 Investment Options, submitted to Dr. Erik R. Sirri, Director, Division of Market Regulation, SEC, October 26, 2006. A copy of the study is included as Attachment II.

11 Release at 12866. The Commission notes that it is not judging the appropriateness of either option, but believes that here are consequences to the choice. Accordingly, the Commission is proposing to amend Rule 15c3-3 by adding a new paragraph (j) that would make it unlawful for a broker-dealer to convert, invest or otherwise transfer free credit balances except under circumstances that give investors more informed choices. *Id.*

our experience that the Commission rarely describes an investment in a security in such terms.[12] We think that by this choice of words, the Commission is confirming our view that money funds enjoy a stellar reputation for safety and stability. We also note that the risk of investing in a bank deposit increases significantly when the amount is in excess of $100,000, while the theoretical risk of losing any principal from an investment in money market fund shares does not increase whether the amount invested is less than $100,000 or greatly in excess of such amount.

f. **Comparison to Futures Regulation** – The securities and futures markets have been converging for many years, and in some instances, the Commission has been in the forefront of efforts to adopt regulations that harmonize the two regimes. Nonetheless, we believe that the Commission's rules substantially depart from the futures rules with regard to broker-dealer financing and money market funds. This disparity works at cross-purposes to some extent with general congressional policy and with the Commission's own goals in certain respects.

1. *CFTC Segregation Rules* – We have explained in a memorandum that the Commodity Futures Trading Commission ("CFTC") permits the use of money market funds in conjunction with the CFTC's rules regarding segregation of customers' funds.[13] Yet the

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12 For example, in the investor education portion of the SEC's website, it advises that:

> When you "invest," you have a greater chance of losing your money than when you "save." Unlike FDIC-insured deposits, the money you invest in securities, mutual funds, and other similar investments are not federally insured. You could lose your "principal," which is the amount you've invested.

http://www.sec.gov/investor/pubs/roadmap/risk.htm

See also discussion of proposed reduction of the "haircut" under Rule 15c3-1, *infra.*

13 *See* letter to Michael A. Macchiaroli, SEC, from Stuart J. Kaswell, Dechert, July 5, 2006 and accompanying memorandum, "Money Market Shares as Eligible Customer Fund Investments Under the Commodity Exchange Act," July 5, 2006, included as Attachment III. As discussed in this memorandum, the CFTC does not require that money market funds have any rating from an NRSRO.

CFTC's customer protection rules depend more heavily on segregation of customers' funds than do the SEC's rules. Briefly, the Commodity Exchange Act and CFTC rules require futures commission merchants ("FCMs") to have in their segregated funds accounts sufficient funds to meet 100% of their obligations to their customers.

In many instances, CFTC rules are more rigorous than the SEC's:

(i) there is no analog to the Securities Investor Protection Corporation;

(ii) an FCM may not borrow customers' funds or property (unlike Rule 15c3-3(b)(3), which allows broker-dealers to borrow customers' fully-paid and excess margin securities); and

(iii) the FCM must segregate funds necessary to satisfy 100% of its obligations to customers at the close of each day (unlike rule 15c3-3(e)(3), which allows broker-dealers to calculate the amount due to their special reserve accounts weekly or monthly).

The CFTC permits FCMs to meet the segregation requirements by holding funds in money market funds that meet the requirements of Rule 2a-7. The CFTC has permitted the FCMs to use money market funds in full recognition of the critical role that its segregation rules play in protecting customers.

2. *Security Futures Rules* – As we noted in our Amended Petition, the SEC and the CFTC have adopted joint final rules to establish margin requirements for securities futures. In accordance with Section 7(c)(2) of the Exchange Act, the two agencies jointly adopted margin regulations for security futures. The final rules

permit a security futures intermediary to use a money market fund as margin.[14]

It also is instructive to consider Congress's mandate to the SEC and CFTC regarding the financial responsibility rules concerning security futures. The SEC has adopted its financial responsibility rules under the authority of Section 15(c)(3)(A) of the Exchange Act.[15] By way of contrast, Congress subsequently enacted Section 15(c)(3)(B) of the Exchange Act, which directs the SEC and the CFTC to coordinate their regulations regarding financial responsibility rules regarding security futures.[16]

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14 17 CFR §41.46. *See also* Exchange Act Release 46292 (Aug. 1, 2002); 67 FR 53146 (Aug. 14, 2002).

15 Subsection (A) of Section 15(c)(3) of the Exchange Act has its origins in the Securities Acts Amendments of 1975 and the Securities Investor Protection Act of 1970.

16 Congress added subsection (B) of Section 15(c)(3) of the Exchange Act as part of its enactment of Commodity Futures Modernization Act of 2000, which lifted the ban on single stock and narrow-based stock index futures. That subsection provides, in part:

> Consistent with this title, the [Securities and Exchange] Commission, in consultation with the Commodity Futures Trading Commission, shall issue such rules, regulations, or orders as are necessary to avoid duplicative or conflicting regulations applicable to any broker or dealer registered with the Commission pursuant to section 15(b) … that is also registered with the Commodity Futures Trading Commission pursuant to section 6f(a) of Title 7 … , with respect to the application of: (i) the provisions of section 8, **section 15(c)(3)**, and section 17 and the rules and regulations thereunder related to the **treatment of customer funds, securities, or property**, maintenance of books and records, **financial reporting, or other financial responsibility rules**, involving security futures products; and (ii) similar provisions of the Commodity Exchange Act and rules and regulations thereunder involving security futures products **[emphasis added]**.

Act of December 21, 2000, (Commodity Futures Modernization Act of 2000, which was incorporated into the Consolidated Appropriations Act, 2001), H.R. 5660 (incorporated into and signed into law as H.R. 4577) Sec. 206, Pub. Law 106-554, 114 Stat. 2763, re-designated Exchange Act Sec. 15(c)(3) as Sec. 15(c)(3)(A) and added Sec. 15(c)(3)(B). Fed. Sec. L Rep (CCH) ¶25,125.

It is true that only subsection (B) directs the SEC and the CFTC to coordinate their policies and to adopt rules jointly regarding, among other things the treatment of customer funds, securities, or property, and financial responsibility. Congress enacted what is now subsection (A) before the development of security futures and so there is no explicit directive in subsection (A) for coordination between the SEC and the CFTC. Nonetheless, we think that Congress's goals are clear: to encourage the SEC and the CFTC to coordinate policy. Even if not bound to do so by Congress, we think it would be eminently sensible for the SEC to coordinate its policy with regard to the use of money market funds in the context of each agency's financial responsibility rules. Because the CFTC has permitted FCMs to use money market funds for segregation purposes and, to our knowledge, has not identified any problems as a consequence of their use, and since the SEC itself regulates money market funds, we think the SEC should be willing to approve the use of money markets funds under Rule 15c3-3 for the special reserve account and for collateral.

3. *Portfolio Margin Rules* – The SEC has been working with many interested parties to develop portfolio margining. As the Commission is well-aware, portfolio margin enhances investor protection at lower cost by allowing broker-dealers to collect margin on a basis tied more closely to risk, in comparison to conventional margin. The SEC has approved portfolio margin rules for the New York Stock Exchange ("NYSE"),[17] the Chicago Board Options Exchange ("CBOE")[18], and the National Association of Securities Dealers, Inc. ("NASD").[19]

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17 Exchange Act Release No. 54918 (Dec. 12. 2006); 71 FR 75790 (Dec. 18, 2006) ("NYSE Release")

18 Exchange Act Release No. 54919 (Dec. 12, 2006);71 FR 75781 (Dec. 18, 2006).

19 Exchange Act Release No. 55471 (March 14, 2007); 72 FR 13149 (March 20, 2007). Federated notes that the rules of these SROs all permit the use of money market funds as collateral for portfolio margin purposes. The Commission itself has issued an order that facilitates the use of

Recent amendments to these rules would facilitate cross-margining – margining securities positions and futures positions together. For example, in a recent SEC order approving changes to the NYSE's portfolio margin rules, the Commission noted:

> The proposed rule change would eliminate the requirement that portfolios with futures positions be held in a separate cross-margin account. Under the proposal, a customer would be permitted to use a single securities margin account for all eligible products. The Exchange and commenters have indicated that maintaining and monitoring two separate margin accounts would be operationally difficult and that it would be more efficient to hold all positions in one securities account.[20]

The Release itself proposes changes to the customer protection rule to better coordinate securities and futures regulation. The Release notes that:

> Under the Portfolio Margin Rules, a broker-dealer can combine securities and futures positions into the portfolio margin account. SIPA, however, only protects customer claims for securities and cash and specifically excludes from protection futures contracts that are not also securities. This raises a question as to how futures positions in a portfolio margin account would be treated in a SIPA

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money market funds for portfolio margin purposes. Letter from Catherine McGuire, Chief Counsel, Division of Market Regulation, SEC, pursuant to delegated authority, to Michael D. Udoff, Securities Industry Association, June 8, 2006, at note 1. Federated appreciates the assistance that the Commission and its Staff have provided in furthering the use of money market funds in conjunction with portfolio margin.

20 NYSE Release, at 75792.

> liquidation. Consequently, we are proposing amendments to Rules 15c3–3 and 15c3–3a that are designed to provide the protections of Rule 15c3–3 and SIPA to futures positions in a securities account under the Portfolio Margin Rules.

The Commission is proposing to:

- Amend the definition of "free credit balance" to include:
  - funds resulting from margin deposits and daily marks to market related to, and proceeds from the liquidation of, futures on stock indices and options thereon carried in a securities account pursuant to a portfolio margining rule of an SRO.
  - the market value of futures options in a portfolio margin account as of the SIPA ''filing date.''
- Amend Rule 15c3-a Item 14 to permit the broker-dealer to include as a debit item the amount of customer margin required and on deposit at a futures clearing organization related to futures positions carried in a securities account pursuant to an SRO portfolio margin rule.[21]

Without intending to comment on the specifics of these changes, the Commission is clearly taking careful steps to eliminate disparate treatment of futures and securities products, in furtherance of its goals of facilitating an effective cross and portfolio margining system. Federated respectfully suggests that if the SEC were to permit AAA-rated money market funds as "qualified securities" and eligible for deposit in the special reserve account, it also would more closely align the segregation rules of

21 Release at 12868-9.

broker-dealers and FCMs, and therefore serve the broader purpose of better coordinating securities and futures regulation.

g. **Gramm-Leach-Bliley**

Federated believes that the Commission's current policy provides an undue advantage in the marketplace to bank products and puts capital markets products at a competitive disadvantage. We believe that such a policy is both antiquated and inconsistent with the policies underlying the Gramm-Leach-Bliley Act.[22] As noted above, since the financial responsibility rules make it difficult or impossible for broker-dealers to use money market funds in conjunction with their operations, they typically use bank products, such as money market deposit accounts or other demand deposit accounts. As noted, AAA-rated money market funds are at least as safe, or safer, than many of these products. Congress enacted the Gramm-Leach-Bliley Act, in part, to level the playing field among competing financial institutions and to enhance competition. Accordingly, we do not believe that it is appropriate for the Commission to retain restrictions on the use of money market funds that have the effect of favoring banking products over capital market products.

* * * *

Based on the foregoing discussion, we believe that AAA-rated money market funds satisfy every reasonable standard of investor protection, convenience, broad acceptance, history of safety, and reduced operational risk that the Commission could reasonably expect.[23] We now turn to our specific comments with regard to the rule proposal.

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22 Public Law No. 106-102 (Nov. 12, 1999). The purpose of the Act includes enhancing "competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers…."

23 *Cf.* SEC, Study of Unsafe and Unsound Practices of Broker-Dealers, H. Doc. 92-231 (92d. Cong., 1st Sess.) (Dec. 1971).

Specific Comments

Customer Protection Rule

1. Money Market Funds and the Special Reserve Account

The Release discusses proposed changes to the customer protection rule.[24] Rule 15c3-3(e)(1) provides that:

> Every broker or dealer shall maintain with a bank or banks at all times when deposits are required or hereinafter specified a "Special Reserve Bank Account for the Exclusive Benefit of Customers" (hereinafter referred to as the "Reserve Bank Account"), and it shall be separate from any other bank account of the broker or dealer. Such broker or dealer shall at all times maintain in such Reserve Bank Account, through deposits made therein, cash and/or **qualified securities** in an amount not less than the amount computed in accordance with the formula set forth in Rule 15c3-3a **[emphasis added]**.[25]

As the Release notes:

> Paragraph (a)(6) of Rule 15c3–3 defines ''qualified securities'' as securities issued by the United States or guaranteed by the United States with respect to principal and interest ("US Treasury securities"). These strict limitations on the types of assets that can be used to fund a broker-dealer's customer reserve account are designed to further the purpose of Rule 15c3–3; namely, that customer assets be segregated and held in a manner that makes them readily available to be returned to the customer [footnote omitted].[26]

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24 Release at 12865.

25 *Id.*

26 *Id.* We have quoted the proposed revision to the definition of "qualified security" at note 49.

The Commission then indicates that:

> We believe expanding the definition to include money market funds that only invest in securities meeting the definition of ''qualified security'' in Rule 15c3–3 would be appropriate. The assets held by such a money market fund would be same as those a broker-dealer can hold directly in its customer reserve account.[[27]] Consequently, a broker-dealer might choose to deposit qualifying money market fund shares into the customer reserve account based on operational considerations such as avoiding the need to actively manage a portfolio of U.S. Treasury securities.[28]

The Commission explains:

> This operational benefit also could decrease burdens on those broker-dealers that would be impacted by our proposed amendments ... [regarding] customer reserve account cash deposits into affiliate and non-affiliate banks.[29] A broker-dealer that deposits cash into the customer reserve account to avoid the operational aspects of holding and managing U.S. Treasury securities would have the option of depositing a qualifying money market fund to replace the cash deposit.[30]

The Release then states that Federated "has filed a petition with the Commission requesting that Rule 15c3–3 be amended to include certain types of money market funds in the definition of qualified securities." The Release includes a footnote with a reference to the Amended Petition. As the Commission is aware, the Amended Petition recommends amending the definition of "qualified security" in Rule 15c3-3(a)(6) to

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27 We refer to such money market funds as "Treasury-Only Money Market Funds."

28 Release at 12865.

29 *See* discussion, *infra*, regarding limitations of bank accounts.

30 *Id.*

include "a redeemable security issued by a Designated Fund" and would add a new subparagraph (a)(16) to Rule 15c3-3 as follows:

> 16. The term "Designated Fund" shall mean an open-end management investment company registered under the Investment Company Act of 1940 which assets consist of cash or money market instruments and which is generally known as a "money market fund", and which:
>
> i. has received the highest money market fund rating from a nationally recognized statistical rating organization;
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> ii. has agreed to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, except in the event of an unscheduled closing of Federal Reserve Banks or the New York Stock Exchange; and
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> iii. has adopted a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.[31]

Since submitting the Amended Petition, Congress has enacted the Credit Rating Agency Reform Act of 2006[32] to empower the Commission to register NRSROs.[33]

Federated respectfully believes that the Commission's proposed change to this aspect of Rule 15c3-3, is insufficient, and the Commission should adopt Federated's suggestion that the Commission approve AAA-rated money market funds for the special reserve account. We commend the Commission for taking a small step – proposing that a

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31 *See* Amended Petition, at Exhibit A and Exhibt to this letter. *Cf.* H.R. 1171 (110th Cong. 1st Sess.).

32 Public Law No: 109-291.

33 The Commission has proposed rules to implement this act. Exchange Act No. Release 55231 (Feb. 2, 2007).

money market fund, even if it only a Treasury-only Money Market Fund, should constitute a "qualified security." To our knowledge, it is the first time that the Commission has proposed permitting broker-dealers to deposit in the special reserve account any security, other than a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States.

We also commend the Commission for recognizing in the Release that by depositing shares of a Treasury-only Money Market Fund, the broker-dealer would "avoid the operational aspects of holding and managing U.S. Treasury securities…."[34] Implicit in that statement is the recognition that large and small broker-dealers that wish to deposit qualified securities in the special reserve account have the operational risk of buying and selling individual U.S. Treasury securities and ensuring that they have deposited adequate amounts into the account. It is vastly easier and safer for a broker-dealer to pledge a AAA-rated money market fund to the special reserve account, than it is to manage and deposit a portfolio of Treasury securities.

As we have noted in our Amended Petition, we believe that a AAA-rated money market fund is at least as safe as some of the securities that the Commission will allow for the special reserve account. For example, under Rule 15c3-3(a)(6), the term "qualified security" shall mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States." The Staff has elaborated on the types of securities that constitute a qualified security.[35] The Staff also has indicated that the broker-dealer must mark the value of securities to market, but need not impose a haircut, as required under the net capital rule. [36] A thirty-year U.S.

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34 Release at 12865.

35 NYSE Interpretation Handbook, vol. I at 484, *et seq.*

36 According to the NASD's website:

> SEC Rule 15c3-3(a)(6) defines "qualified securities" as a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. "Qualified securities" are not subject to securities haircuts when valued for Reserve deposit purposes. Also, if the market value of securities on deposit in the "Special Reserve Bank Account for the Exclusive Benefit of Customers" falls below the reserve requirement, an additional deposit should be made to maintain an amount not less than the amount computed in the prior reserve computation.

Treasury security is of unimpeachable credit quality, but is subject to wide swings in market value depending on changes in interest rates over the course of its thirty year term. By comparison, a AAA-rated money market fund with a weighted average maturity not exceeding sixty days is subject to vastly less fluctuation because of changes in interest rates. Combined with the very high credit quality standards outlined above, we believe that the case to approve AAA-rated money market funds as "qualified securities" is compelling.

2. Collateral

The Release does not address a second aspect of Federated's Amended Petition, *i.e.*, our request that the Commission approve AAA-rated money market funds as collateral for fully-paid or excess margin securities. Although on previous occasions the Commission has expanded the types of securities that it permits broker-dealers to use collateral under Rule 15c3-3(b)(iii)(A), it has not take any action with regard to money market funds.[37] As noted, our Amended Petition recommends that the Commission further expand the types of collateral permitted under this rule to include AAA-rated money market funds. It is Federated's view that a AAA-rated money market fund is as safe or safer than other forms of collateral that the Commission has already approved. For example, we believe that a AAA-rated money market fund is substantially safer collateral than an irrevocable letter of credit issued by a bank for which the Commission has established no standards.

We understand that, pursuant to delegated authority, the Commission may issue an order that permits broker-dealers to use money market funds for collateral under Rule 15c3-3. We urge to the Commission or its Staff to act expeditiously in this regard.

Additionally, pursuant to SEC Rule 15c3-1(c)(2)(vi), qualified securities held on deposit in the "Special Reserve Bank Account for the Exclusive Benefit of Customers" would be subject to security haircut deductions when computing net capital.

SEC Staff of DMR to NASD, September 1983
SEC Staff of DMR to NASD, November 1993

37 *See also* Exchange Act Release No. 47480 (March 11, 2003); 68 FR 12780 (March 17, 2003); and Exchange Act Release 46783 (April 16, 2003); 68 FR 19864 (April 22, 2003).

3. Affiliated and Non-Affiliated Banks

The Commission has proposed restrictions on the banks at which a broker-dealer may maintain its special reserve account.

> Under the proposal, a paragraph (e)(5) would be added to Rule 15c3–3. This new paragraph would provide that—in determining whether the broker-dealer maintains the minimum reserve deposits required (customer and PAB) — the broker-dealer would be required to exclude a cash deposit at an affiliated bank. With respect to unaffiliated banks, the broker-dealer would be required to exclude the deposit to the extent that it exceeded (1) 50% of the broker-dealer's excess net capital (based on the most recently filed FOCUS Report), or (2) 10% of the bank's equity capital (based on the bank's most recently filed Call Report or Thrift Financial Report). The goal is to limit cash reserve account deposits to reasonably safe amounts as measured against the capitalization of the broker-dealer and the bank [footnote omitted].[38]

It is important to note that the broker-dealer is merely a general creditor of the bank. However, the proposal does not establish minimum standards for the solvency of the bank itself. Although the proposal would limit the amount of the losses, it would not protect the assets in the special reserve account if the bank was about to fail. Contrast this situation with the high standards of Rule 2-a7, which requires segregation of portfolio securities supporting the money market fund. Also, as noted, the standards for obtaining a AAA rating mean that the money market fund's portfolio assets will be of extremely high quality.

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38 Release at 12864. This aspect of the Release appears substantially similar to a position that the Staff took previously. SEC Staff to NYSE, *Information Memo* No. 023-3, April 2003, available on the NASD website: http://www.nasd.com/RulesRegulation/PublicationsGuidance/InterpretationsofFinancialOperationalRules/CustomerProtectionRule_SECRule15c3-3/NASDW_016813.

The Commission proposes to define "PAB" as a "proprietary securities account of a broker or dealer…." Release at 12895.

We respectfully suggest that the Commission's proposal regarding affiliated and unaffiliated banks reveals as much about AAA-rated money market funds as it does about special reserve account assets held at a bank. By proposing to add some limitations to broker-dealer's use of banks for the special reserve account, the Commission is acknowledging that bank deposits entail some measure of risk. Money market funds, and particularly AAA-rated funds, afford great safety and are as safe as or safer than bank deposits. Accordingly, we urge the Commission to alter its proposal to permit the special reserve account to hold AAA-rated money market funds.

Net Capital Rule

The Commission has proposed reducing the "haircut" on money market funds from 2% to 1%. The Commission also seeks to "clarify that a money market fund, for the purposes of paragraph (c)(2)(vi)(D)(*1*), is a fund described in Rule 2a–7."[39] The Commission states that:

> Based on the enhancements to Rule 2a–7, as well as the historical stability of money market funds as investments, we are proposing to amend paragraph (c)(2)(vi)(D)(*1*) of Rule 15c3–1 to reduce the

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39 The Revised language would provide:

> (D)(*1*) In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is described in § 270.2a–7 of this Chapter, the deduction shall be 1% of the market value of the greater of the long or short position.

We commend the Commission for making this change, because it has been our experience that some broker-dealers were not sure if they should apply the lower haircut under subsection (D)(1) or the higher haircut under (D)(3), which provides:

> In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi)(A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

By adding the reference to Rule 2a-7, we believe that the Commission will eliminate any ambiguity.

> haircut on such funds from 2% to 1%. This amendment is designed to better align the net capital charge with the risk associated with holding a money market fund.
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> ***
>
> We request comment on all aspects of this amendment, including on whether it is appropriate to reduce the haircut to 1% and, alternatively, whether the haircut for certain types of money market funds should be reduced to 0% as suggested by Federated in its petition to the Commission.[40]

We commend the Commission for proposing to reduce the haircut on money market funds. We appreciate that the Commission has requested comment on Federated's proposal. Unfortunately, we do not believe that a reduction in the haircut to 1% is sufficient.

First, for the reasons that we have discussed above, we believe that the safety record of money market funds – and in particular AAA-rated money market funds – do not justify such a significant haircut. We continue to believe that the appropriate haircut for AAA-rated money market funds is 0%. To our knowledge, the failure rate of AAA-rated money market funds (including "breaking the buck") is 0%. No one has ever lost a penny in a AAA-rated money market fund. Accordingly, we believe that the appropriate haircut is zero. By the standard the Commission has articulated in the Release, *i.e.*, "to better align the net capital charge with the risk associated with holding a money market fund," we believe the correct haircut should be zero percent.

We also have compared the proposed haircut of money market funds to other haircuts for other asset classes. Based on that comparison, we believe that a 0% haircut is justified and proportionate to other haircuts. For example, the Rule 15c3-1 imposes a 1/8 of 1% haircut on certain municipal securities and commercial paper, bankers' acceptances, and certificates of deposit. Rule 15c3-1(c)(2)(vi)(B) provides:

40 Release at 12874.

> 1. In the case of any municipal security which has a scheduled maturity at date of issue of 731 days or less and which is issued at par value and pays interest at maturity, or which is issued at a discount, and which is not traded flat or in default as to principal or interest, the applicable percentages of the market value on the greater of the long or short position in each of the categories specified below are:
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> ***
>
> ii 30 days but less than 91 days to maturity--1/8 of 1%.

We believe that the liquidity of both the money market fund shares and the portfolio securities is at least as good or superior to municipal securities. We also note that S&P requires a AAAm money market fund to have a weighted average maturity that does not exceed 60 days, as opposed to "less than 91 days" as permitted by the rule.

Similarly, the SEC also imposes a 1/8 of 1% haircut on commercial paper, bankers' acceptances, and certificates of deposit. Rule 15c3-1(c)(2)(vi)(E) provides:

> In the case of any short term promissory note or evidence of indebtedness which has a fixed rate of interest or is sold at a discount, and which has a maturity date at date of issuance not exceeding nine months exclusive of days of grace, or any renewal thereof, the maturity of which is likewise limited and is rated in one of the three highest categories by at least two of the nationally recognized statistical rating organizations ***, or in the case of any negotiable certificates of deposit or bankers acceptance or similar type of instrument issued or guaranteed by any bank as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, the applicable percentage of the market value of the greater of the long or short position in each of the categories specified below are:
>
> ***
>
> 2. 30 days but less than 91 days to maturity [--] 1/8 of 1 percent.

As noted, Federated proposes that a money market fund that receives a AAA rating, *i.e.* the **top rating**, from an NRSRO should be eligible for a 0% haircut. By comparison, this provision requires at least two NRSROs to rate a promissory note or evidence of indebtedness in **one of the three** highest categories. With regard to certificates of deposit or bankers acceptances, the rule includes no explicit limitations on the credit-worthiness of the bank.[41] Indeed, a Staff interpretive letter specifically allows marketable certificates of deposit issued by federal savings and loan associations.[42] Finally, the 1/8 of 1% haircut is available for instruments with a maturity of 30 to less than 91 days. Again, we also note that S&P requires a AAAm money market fund to have a weighted average maturity that does not exceed 60 days.

Second, we do not believe that broker-dealers will be willing to use money market funds for net capital purposes if the haircut is 1%. Broker-dealers, like all investors, treat money market funds as cash equivalents. Broker-dealers will view a 1% haircut as a significant cost and will tend to avoid using money market funds as a consequence.

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41 We believe that neither the Commission nor the Staff has imposed any standards for domestic banks. *See* NYSE Interpretation Handbook at Rule 15c3-1(c)(2)(iv)(E)/061. *See also* discussion *supra* at note 38 and accompanying text regarding the standards for banks.

42 As indicated on the NASD website:

> **Certificates of Deposit Issued by Federal Savings and Loan Associations and State Chartered Insured Institutions**
> The haircut provisions of subparagraph (c)(2)(vi)(E) of SEC Rule 15c3-1 apply to marketable certificates of deposit issued by federal savings and loan associations and certain state chartered insured institutions, as authorized by the Federal Home Loan Bank Board.
>
> *Letter from SEC staff of DMR to A.G. Becker & Co., Inc., March 10, 1976*

http://www.nasd.com/RulesRegulation/PublicationsGuidance/InterpretationsofFinancialOperationalRules/NetCapitalRule_SECRule15c3-1/NASDW_012875

The SEC Staff issued this interpretation approximately thirty years before Congress amended the definition of bank in Section 3(a)(6) of the Exchange Act to include certain savings and loan institutions. *See* n. 45 *infra.*

In short, when compared with other asset classes and other haircuts, imposing a 1% haircut on AAA-rated money market funds is disproportionate. We believe that a 0% haircut for AAA-rated money market funds is commensurate with its risk and is in proportion to other haircuts under Rule 15c3-1. We also believe that a haircut higher than 0% will unduly discourage broker-dealers from using money market funds for net capital purposes.

Separate Account / Escrow Rule

In a companion request to the Staff, Federated has sought no action or interpretive relief under Rule 15c2-4[43] to allow broker-dealers to use AAA-rated money market funds for separate bank accounts or escrow accounts under Rule 15c2-4.[44] In 1984, the Staff took the position that the money must be deposited in, or transmitted to, a bank.[45] The NTM indicates that "therefore, bank accounts, including saving accounts and bank money market accounts, are the types of investments permitted under Rule 15c2-4." It further indicates that the bank escrow agent may invest the funds in short term bank certificates of deposit, or short term U.S. Government-backed securities, provided the maturity date does not exceed the time of the anticipated contingency. However, the Staff indicated that money market funds are not a "permissible investment" for purposes of this rule.[46]

When the Staff took the positions articulated in this NTM, money market funds were still in their infancy. The Commission had adopted Rule 2a-7 only six months

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43 17 CFR §240.15c2-4.

44 Draft request to James A. Brigagliano, Assistant Director, Division of Market Regulation, SEC, draft March 2005 ("Draft Request") included as Attachment IV.

45 NASD Notice to Members 84-7 (Jan. 30, 1984) ("NTM"). The NTM indicates that the "definition of a "bank" is contained in Section 3(a)(6) of the [Exchange] Act and does not, for example, include a savings and loan association. However, the Financial Services Regulatory Relief Act of 2006, Pub. Law No. 109-371 amended Section 3(a)(6) of the Exchange Act and added the words ''or a Federal savings association, as defined in section 2(5) of the Home Owners' Loan Act''. This change alone may warrant the Commission's revisiting the substance of the NTM.

46 *Id.*

earlier, *i.e.,* July 11, 1983.[47] Again, as noted above, in the intervening years, money market funds in general, and AAA-rated money market funds in particular, have earned an extraordinary reputation for safety. We think the Staff's interpretation from 1984 is no longer warranted because of the outstanding safety record of AAA-rated money market funds. Moreover, the current disparity with bank product perpetuates an un-level playing field that is not defensible.

We wish to underscore that we do not seek any change to the fundamental structure of Rule 15c2-4, which requires the funds to be held in a separate bank account or in an escrow account. We only request that the Commission allow the separate account or bank escrow account holding the funds, in turn, to invest the funds in the shares of a AAA-rated money market fund.[48]

Additional Requirements

The Release proposes that money funds eligible for deposit into the special reserve account should meet several additional requirements.[49] We address two of these proposed standards.

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47 Release IC-13380, (July 11, 1983).

48 Draft Request, at 2.

49 Release at 12865. The proposed text of the definition of Rule 15c3-3(a)(6) would provide:

> (6) The term *qualified security* shall mean:
>
> > (i) A security issued by the United States or guaranteed by the United States with respect to principal or interest; and
> >
> > (ii) A redeemable security of an unaffiliated investment company registered under the Investment Company Act of 1940 and described in § 270.2a–7 of this chapter that:
> >
> > > (A) Has assets consisting solely of cash and securities issued by the United States or guaranteed by the United States with respect to principal and interest;

1. **Redemption Period** – The Release states that "our proposal would require the broker-dealer to use a fund that agrees to redeem fund shares in cash on the next business day. There should be no ability of the fund to delay redemption beyond one day or to require a multi-day redemption notification period."

We agree with this proposal. Federated's Amended Petition recommends that a money market fund that would qualify for the special reserve account (as well as for the other purposes we have outlined), among other things, should have:

- agreed to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, except in the event of an unscheduled closing of Federal Reserve Banks or the New York Stock Exchange; and

- adopted a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

We also note that the Options Clearing Corporation has a similar provision in its margin rule.[50] The NASD,[51] NYSE,[52] and CBOE[53], all have similar (although less specific) provisions in the portfolio margin rules.

(B) Agrees to redeem fund shares in cash no later than the business day following a redemption request by a shareholder; and

(C) Has net assets (assets net of liabilities) equal to at least 10 times the value of the fund shares held by the broker-dealer in the customer reserve account required under paragraph (e) of this section.

50 OCC Rule 604 (b)(3)(F) provides that the fund must agree to waive:

Although we endorse the idea of having a short redemption period, we respectfully suggest that the SEC include exceptions during periods when there are unscheduled closings of Federal Reserve Banks or of registered securities exchanges.[54]

2. **Ten Percent Asset Limitation** – The Release proposes that

> [O]ur proposal would require that the money market fund have an amount of net assets (assets net of liabilities) that is at least 10 times the value of the fund's shares held by the broker-dealer in its customer reserve account. This is designed to prevent a broker-dealer from holding too concentrated a position in a single fund. It also limits a potential redemption request by the broker-dealer to 10% or less of the fund's assets. While a redemption request that equaled 10% of a fund's net assets would be very substantial, we believe it is a reasonable threshold between a request that could be handled promptly and one that could have the potential to cause the fund some degree of difficulty in meeting the request within one business day. We seek comment on this threshold, particularly with

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> any right it may otherwise have to postpone the payment of redemption proceeds and the right to redeem shares in kind and agrees to redeem MMF Shares in cash not later than the business day following a redemption request by the Corporation except when such redemptions cannot be effected because of unscheduled closings of the Federal Reserve Banks or the New York Stock Exchange.

51 NASD Rule 2521(g)(7)(D)(iii) provides that "the fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request..."

52 NYSE Rule 431 (g)(7)(D)(3).

53 CBOE Rule 12.4(d)(4)(iii) (SR-CBOE-2006-14).

54 *See also* H.R. 1171, §2(c).

> respect to whether it should be smaller (*e.g.*, 5% or 2%) or higher (*e.g.*, 15% or 25%).[55]

Federated respectfully objects to this condition and believes that it is not warranted. The Commission has not offered any meaningful rationale for such a limitation. As the Commission is well aware, Rule 2a-7 establishes extensive requirements for money market funds, including requirements for portfolio diversification and quality. The standards for a AAA rating are more stringent than the Commission's own requirements. A AAA-rated money market fund's portfolio assets would be diverse, of high quality, and highly liquid. The Commission has presented no justification to limit the size of the broker-dealer's investment, since a money market fund would be able to redeem shares (including by selling assets in the fund's underlying portfolio, if necessary). Accordingly, Federated believes that the proposed 10% limitation has no basis in protecting the broker-dealer against risk, and therefore is arbitrary.

Cost Benefit Analysis and Other Considerations

The Release requests comment on the costs and benefits of permitting broker-dealer to use money market funds for the special reserve account under Rule 15c3-3.[56]

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[55] Release at 12865.

[56] The Release provides at 12881:

> The proposed amendment to Rule 15c3–3 would permit broker-dealers to deposit certain money market funds in the customer reserve account. This would benefit broker-dealers subject to the customer reserve requirements in Rule 15c3–3 by creating a deposit alternative to cash and United States Treasury securities. It would not result in any additional costs to broker-dealers.
>
> We request comment on available metrics to quantify these benefits and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.
>
> In addition, while we do not believe the proposal would result in costs to broker-dealers, we request comment on whether it would result in costs to other market participants, including broker-dealer customers, and banks. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

We believe that the costs of allowing broker-dealers to use money market funds for Rule 15c3-3 purposes will be minimal. For example, broker-dealers could use existing pledge mechanisms at Depository Trust Company to pledge shares of money market funds to their special reserve accounts.

Unfortunately, we believe that the benefits of the current proposal are virtually nil. As noted, Federated's initial rule petition, filed in 2003, asked the Commission to permit broker-dealers to use Treasury-only money market funds for the special reserve account under Rule 15c3-3. As noted in the Amended Petition, as interest rates began to rise, Federated's potential customers indicated that they no longer had any interest in using Treasury-only money market funds for the special reserve accounts. Federated's potential customers indicated that the rates of interest that Treasury-only funds would pay them would be too low to be attractive. In the two years that have elapsed since Federated filed its Amended Petition, we continue to hold the view that a Treasury-only money market fund has little attraction for most broker-dealers. Accordingly, without altering the proposal to allow higher yielding (but very safe) AAA-rated money market funds, any benefits from this proposal will be illusory.[57]

Similarly, the Commission seeks comment on the reduction of the haircut from 2% to 1%.[58] We agree that the proposal will not impose any additional costs. But based on our experience with our potential customers, we do not agree with the Commission's

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57 Our comments also apply to using a Treasury-only money market fund as collateral under Rule 15c3-3. *Cf.* discussion *supra* regarding Rule 15c2-4.

58 The Release provides at 12887:

> Reducing the money market funds haircut from 2% to 1% would benefit all broker-dealers in that it will make it less costly, in terms of capital allocation, to hold these investments. We do not believe the proposed amendment would result in any costs.
>
> We request comment on available metrics to quantify the benefits identified above and any other benefits the commenter may identify. Commenters are requested to identify sources of empirical data that could be used for the metrics they propose.
>
> In addition, we request comment on whether the proposal would result in costs. Commenters should identify the metrics and sources of any empirical data that support their costs estimates.

statement that "reducing the money market funds haircut from 2% to 1% would benefit all broker-dealers in that it will make it less costly, in terms of capital allocation, to hold these investments."[59] We believe that the reduction in haircut from 2% to 1% will not make money market funds meaningfully more attractive to broker-dealers. In our judgment, broker-dealers will not be willing to use money market funds if they must incur a 1% haircut.

In our view, the Commission has proposed changes to its financial responsibility rules that misperceive the marketplace.[60] We note that Section (3)(f) of the Exchange Act provides that:

> Whenever pursuant to this title the Commission is engaged in rulemaking, ..., and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

As noted, *supra*, Section 15(c)(3)(A), which directs the Commission to adopt financial responsibility rules, includes such a "public interest" standard. The Commission has requested comment on whether the proposed amendments are likely to promote efficiency, competition, and capital formation."[61]

We do not believe that the Commission's proposal will in any meaningful way promote efficiency, competition, and capital formation. We believe that the Commission's proposal is wide of the mark. We respectfully suggest that in fulfilling its obligations under Section 3(f) of the Exchange Act, the Commission should recognize that its proposal will not promote efficiency, competition, and capital formation, and

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59 Release at 12888.

60 We limit our comments to those aspects of the Release that we have discussed in our letter. We do not intend to comment on the entire Release.

61 Release at 12887.

therefore the Commission should adopt final rules in accordance with Federated's recommendations, which would further those goals.[62]

Similarly, for the reasons outlined above, we believe that the Commission's proposals are not consistent with Section 23(a)(2) of the Exchange Act, which directs the Commission to consider, among other matters, the impact that any proposed rule or regulation would have on competition. The provision states in part that "the Commission ... shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of this title." For the reasons discussed above, Federated believes the proposal would not provide for effective competition among financial service providers and would be unduly restrictive. Finally, Federated believes that if adopted as proposed, the changes would be inconsistent with the requirements of the Administrative Procedures Act.[63]

Congressional Action

Congressman Gregory Meeks (D-NY) has introduced H.R. 1171, the Money Market Fund Parity Act of 2007.[64] If enacted, this legislation would direct the SEC to amend its rules and permit broker-dealers to use AAA-rated money market funds for: (i) net capital purposes with a 0% haircut; (ii) collateral for fully-paid or excess margin securities; (iii) for deposit to the special reserve account; and (iv) a separate bank or escrow account in accordance with Rule 15c2-4. H.R. 1171 would modernize U.S. financial services requirements and would help level the financial services "playing field."

We remain hopeful that after more than four years, the Commission will promptly adopt the changes the we have suggested in this letter, in our Amended Petition, and in our request for no-action/interpretive relief. Nonetheless, Federated strongly supports H.R. 1171.

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62 Chamber of Commerce of the United States of America v. SEC, No.04-1300, US Court of Appeals for the District of Columbia, Fed. Sec. L. Rep. (CCH) ¶ 93,279.

63 5 USC §553(b) and §706. *See* Chevron v. Natural Resources Defense Council, 467 US 837(1984) and Pierce, Administrative Law Treatise at vol. I, at 139 and 326

64 Congressman Patrick Tiberi (R-OH) is an original co-sponsor of the legislation.

Conclusion

Federated has sought changes to the financial responsibility rules and to Rule 15c2-4 in an effort to meet the needs of its customers, large and small broker-dealers. It has sought these changes from the Commission in a way designed to level the playing field between banks and sponsors of money market funds. It also has proposed changes that would create a level playing field for Federated and its competitors. We have proposed generic changes that would allow any money market sponsor to compete for this business, provided that it could meet the objective standards of Rule 2a-7 and to receive a AAA rating. We also believe that our proposed changes are prudent and consistent with the protection of investors and the public.

* * * * *

We appreciate the consideration of our comments and would be pleased to discuss them in greater detail.

Sincerely yours,

Stuart J. Kaswell David J. Harris

cc: The Honorable Christopher Cox, Chairman
The Honorable Paul S. Atkins, Commissioner
The Honorable Roel C. Campos, Commissioner
The Honorable Annette L. Nazareth, Commissioner
The Honorable Kathleen L. Casey, Commissioner
Erik R. Sirri, Ph.D., Director, Division of Market Regulation
Andrew Donohue, Director, Division of Investment Management
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Michael A Macchiaroli, Associate Director, Division of Market Regulation
Robert E. Plaze, Associate Director, Division of Investment Management
James A. Brigagliano, Associate Director, Division of Market Regulation
Thomas McGowan, Assistant Director, Division of Market Regulation

The Honorable Gregory W. Meeks, U.S. House of Representatives
The Honorable Patrick J. Tiberi, U.S. House of Representatives

Eugene F. Maloney, Executive Vice President, Federated Investors Management Company, Inc., Vice President and Corporate Counsel of Federated Investors, Inc. and member of the Executive Committee.

Exhibit – Federated's Proposed Amendments to Rules 15c3-1 and 15c3-3.

Attachments

I. Federated Amended Rule Petition
II. Treasury Strategies Memorandum to the Division of Market Regulation, SEC, October 2006.
III. Letter to Michael Macchiaroli, Associate Director, Division of Market Regulation, SEC, from Stuart J. Kaswell, Dechert LLP, July 5, 2006, and Memorandum to Eugene F. Maloney, Federated Investors, re Money Market Fund Shares as Eligible Customer Fund Investments Under the Commodity Exchange Act, July 5, 2006.
IV. No-Action/Interpretive Request 15c2-4 – Draft Request to James A. Brigagliano, Division of Market Regulation, SEC, March 5, 2005.

EXHIBIT

TEXT OF PROPOSED AMENDMENTS TO RULES 15c3-1 AND 15c3-3

1. Add new subparagraph (c)(13) to Rule 15c3-1:

    13. The term "Designated Fund" shall mean an open-end management investment company registered under the Investment Company Act of 1940 which assets consist of cash or money market instruments and which is generally known as a "money market fund", and which:

        (i) has received the highest money market fund rating from a nationally recognized statistical rating organization;

        (ii) has agreed to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, except in the event of an unscheduled closing of Federal Reserve Banks or the New York Stock Exchange; and

        (iii) has adopted a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

2. Add new paragraph (c)(2)(vi)(D)(1) to Rule 15c3-1; revise and redesignate current paragraphs (c)(2)(vi)(D)(1) - (3) as paragraphs (c)(2)(vi)(D)(2) - (4):

Certain Municipal Bond Trusts and Liquid Asset Funds

D.

1. In the case of redeemable securities of a Designated Fund, there shall be no deduction.

2. In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is generally known as a "money market fund," other than a Designated Fund, the deduction shall be 2% of the market value of the greater of the long or short position.

3. In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which are described in paragraph (c)(2)(vi)(A) through (C) or (E) of this section, the deduction shall be 7% of the market value of the greater of the long or short positions.

4. In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments which are described in paragraphs (c)(2)(vi)(A) through (C) or (E) and (F) of this section, the deduction shall be 9% of the market value of the long or short position.

3. Revise paragraph (a)(6) of Rule 15c3-3 to read as follows:

a. *Definitions.*

* * *

6. The term *qualified security* shall mean a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States, or a redeemable security issued by a Designated Fund.

4. Add new subparagraph (a)(16) to Rule 15c3-3:

16. The term "Designated Fund" shall mean an open-end management investment company registered under the Investment Company Act of

1940 which assets consist of cash or money market instruments and which is generally known as a "money market fund", and which:

(i) has received the highest money market fund rating from a nationally recognized statistical rating organization;

(ii) has agreed to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, except in the event of an unscheduled closing of Federal Reserve Banks or the New York Stock Exchange; and

(iii) has adopted a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

5. Revise paragraph (b)(3)(iii)(A) to read as follows:

b. *Physical possession or control of securities.*

* * *

3. A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed from any person, provided that the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum;

* * *

iii. Specifies that the broker or dealer

A. must provide to the lender, upon the execution of the agreement or by the close of the business day of the

Dechert LLP

loan if the loan occurs subsequent to the execution of the agreement, collateral, consisting exclusively of cash or United States Treasury bills and Treasury notes or redeemable securities issued by one or more Designated Funds or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A) through (C) of the Securities Exchange Act which fully secures the loan of securities.

<u>Attachment I</u>:

Federated Amended Rule Petition

SEC MAIL PROCESSING
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SECTION

PETITION FOR RULEMAKING AND EXHIBITS

Federated®

FEDERATED INVESTORS, INC.

Dechert LLP

April 4, 2005, amending original petition dated April 3, 2003.

April 4, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0609

BOSTON
BRUSSELS
CHARLOTTE
FRANKFURT
HARRISBURG
HARTFORD
LONDON
LUXEMBOURG
MUNICH
NEW YORK
NEWPORT BEACH
PALO ALTO
PARIS
PHILADELPHIA
PRINCETON
SAN FRANCISCO
WASHINGTON

Re: Petition for Rulemaking

Dear Mr. Katz:

On behalf of Federated Investors, Inc. ("Federated" or "Petitioner"),[1] Dechert LLP hereby petitions the Securities and Exchange Commission ("Commission" or the "SEC") to amend: (i) Rule 15c3-1 under the Securities Exchange Act of 1934, as amended ("1934 Act") to provide the same net capital treatment to broker-dealers' investments in shares of certain investment companies registered under the Investment Company Act of 1940, as amended ("1940 Act") as is currently provided to direct investments in securities issued or guaranteed as to principal or interest by the United States government or any agency thereof ("Government securities") with maturities of less than three months; and (ii) Rule 15c3-3 under the 1934 Act to: (a) provide the same collateral treatment to such investment company shares as is provided to cash, United States Treasury bills, United States Treasury notes, irrevocable letters of credit issued by banks and such other collateral as the Commission designates by order after giving consideration to the collateral's liquidity, volatility, market depth and location, and the issuer's creditworthiness (collectively, "Rule 15c3-3 collateral"); and (b) treat such investment company shares as "qualified securities" that may be deposited into a broker-dealer's Special Reserve Bank Account for the Exclusive Benefit of Customers ("Special Reserve Account").[2]

To qualify for equivalent treatment under Rule 15c3-1 and Rule 15c3-3, the shares would have to be issued by a registered investment company that: (i) meets the conditions of paragraphs (c)(2), (c)(3) and (c)(4) of Rule 2a-7 under the 1940 Act ("money market fund") <u>and</u> (ii) has received the highest money market fund rating

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1 Federated is one of the largest investment management organizations in the United States, with total assets under management of approximately $179.3 billion as of December 31, 2004. Federated's money market assets in both funds and separate accounts totaled $124.3 billion at December 31, 2004. Average money market assets were $125.3 billion for the quarter ended December 31, 2004. Federated's money market funds are used for cash management and short-term investment by a wide array of institutions, including banks, corporate fiduciaries, broker-dealers, business organizations and public entities.

2 This petition amends Federated's original petition, as filed on April 3, 2003.

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1775 I Street, N.W. • Washington, DC 20006-2401 • Tel: 202.261.3300 • Fax: 202.261.3333 • www.dechert.com

from a nationally recognized statistical rating organization ("NRSRO") (a "Designated Fund" or "AAA rated MMF"). Federated's Prime Obligation Fund and Prime Cash Obligations Fund have both received the highest rating from Standard & Poor's (AAAm) and thus would both qualify as Designated Funds under this standard.[3]

The text of the proposed amendments are set forth in Exhibit A to this petition.

Numerous financial regulators, self-regulatory organizations, and state legislatures have approved the use of money market funds similar to Designated Funds for use by institutional investors as a safe and efficient alternative to direct investments in Government securities.[4] Petitioner submits that the Commission should amend Rules 15c3-1 and 15c3-3 to recognize that investments in Designated Funds serve as functional equivalents of investments in Government securities, Rule 15c3-3 collateral or qualified securities for purposes of those rules as well.

SUMMARY

Rule 15c3-1 seeks to ensure that broker-dealers maintain sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.[5] When calculating the value of their assets for the purposes of establishing their net capital under Rule 15c3-1, broker-dealers must reduce the market value of the securities and commodities they own by certain percentages – so-called "haircuts".[6] The applicable percentage haircut is designed to provide protection from the market risk, credit risk, and other risks inherent in particular positions. Discounting the value of a broker-dealer's proprietary positions provides a capital cushion in case the portfolio value of the broker-dealer's positions decline.[7]

Rule 15c3-3, the Commission's customer protection rule, governs a broker-dealer's acceptance, custody and use of a customer's securities.[8] The Commission adopted

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3 Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004 are included as Exhibit D for your reference.

4 Exhibit B lists those federal and state financial regulators and state legislatures that have recognized investments in shares of money market funds as safe alternatives to direct investments.

5 *Net Capital Rule*, Securities Exchange Act Rel. No. 39455 (Dec. 17, 1997), 62 FR 67996 (Dec. 30, 1997).

6 *Id.*

7 *Net Capital Rule*, Securities Exchange Act Rel. No. 39456 (Dec. 17, 1997), 62 FR 68011, 68012 (Dec. 30, 1997).

8 *Customer Protection--Reserves and Custody of Securities*, Securities Exchange Act Rel. No. 47480 (March 11, 2003), 68 FR 12779, 12780 (March 17, 2003) ("*Reserves and Custody Adopting Release*"); *Customer Protection--Reserves and Custody of Securities*, Securities Exchange Act Rel. No. 46019 (June 3, 2002), 67 FR 39642 (June 10, 2002) ("*Reserves and Custody Proposing Release*").

Rule 15c3-3 in 1972, in part, to ensure that a broker-dealer in possession of customers' funds either deployed those funds "in safe areas of the broker-dealer's business related to servicing its customers" or, if not deployed in such areas, deposited the funds in a reserve bank account to prevent commingling of customer and firm funds.[9] Rule 15c3-3 seeks to inhibit a broker-dealer's use of customer assets in its business by prohibiting the use of those assets except for designated purposes.[10] The Rule also aims to protect customers involved in a broker-dealer liquidation.[11] If a broker-dealer holding customer property fails, Rule 15c3-3 seeks to ensure that the firm has sufficient reserves and possesses sufficient securities so that customers promptly receive their property and there is no need to use the Securities Investor Protection Corporation fund.[12]

Rule 15c3-3 currently permits broker-dealers to borrow customers' fully paid or excess margin securities only if, among other things, the loan is fully collateralized with Rule 15c3-3 collateral.[13] The Commission recently has adopted amendments to Rule 15c3-3 that will allow the Commission to designate by order new categories of broker-dealer assets as permissible Rule 15c3-3 collateral.[14] For these purposes, the Commission will consider the quality and liquidity of a particular instrument, including the creditworthiness of the issuer of the instrument, the depth of the instrument's market, the locations where the instrument is traded, and the historical volatility of the instrument's price, before designating it as permissible Rule 15c3-3 collateral.[15]

The Commission also adopted a companion rule that delegates to the Director of the Division of Market Regulation the authority to issue exemptive orders permitting broker-dealers to use additional types of collateral not currently specified in Rule 15c3-3, provided the collateral has characteristics similar to those of collateral previously permitted by the Commission.[16] The Commission stated that it intends to issue an order designating as Rule 15c3-3 collateral:

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9 *Rule 15c3-3 Reserve Requirements for Margin Related to Security Futures Products*, Securities Exchange Act Rel. No. 46492 (Sept. 12, 2002), 67 FR 59747, 59748 (Sept. 23, 2002) ("*Security Futures Reserve Release*").

10 *Id.*

11 *Id.*

12 *Id. See also* SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H. Doc. 92-231 (92d. Cong., 1st Sess.) (Dec. 1971), at 30 *et seq.*

13 *Reserves and Custody Proposing Release*, *supra* note 8, 67 FR at 39643.

14 *Reserves and Custody Adopting Release*, *supra* note 8, 68 FR at 12781.

15 *Id.*

16 *Id.*

(i) "government securities" as defined in Sections 3(a)(42)(A) and (B) of the 1934 Act;

(ii) certain "government securities" meeting the definition in Section 3(a)(42)(C) of the 1934 Act;

(iii) securities issued or guaranteed by certain Multilateral Development banks;

(iv) "mortgage related securities" as defined in Section 3(a)(41) of the 1934 Act;

(v) certain negotiable certificates of deposit and bankers acceptances;

(vi) foreign sovereign debt securities;

(vii) foreign currency; and

(viii) certain corporate debt securities.[17]

The Commission did not indicate, however, that it had considered or would be willing to issue an order designating money market fund shares as Rule 15c3-3 collateral.

In addition to imposing collateral requirements upon broker-dealers' borrowings of customers' fully paid or excess margin securities, Rule 15c3-3 requires a broker-dealer to calculate what amount, if any, it must deposit on behalf of customers in the Special Reserve Account, according to the formula set forth in Rule 15c3-3a ("Reserve Formula").[18] Generally, under the Reserve Formula, a broker-dealer must calculate any amounts it owes to its customers and the amount of funds generated through the use of customer securities, called credits, and compare this amount to any amounts its customers owe it, called debits.[19] If customer credits exceed customer debits, the broker-dealer must deposit the net amount of customer credits in the Special Reserve Account.[20] Under Rule 15c3-3(e)(1), only cash or "qualified securities" may be deposited into a Special Reserve Account. Rule 15c3-3(a)(6) defines a "qualified security" as a "security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States."

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17 *Id.*

18 *Security Futures Reserve Release*, *supra* note 8, 67 FR at 59748.

19 *Id.*

20 *Id.*

Petitioner submits that shares of Designated Funds do not present any increased market risk, credit risk or other risks relative to direct holdings of Government securities or other approved Rule 15c3-3 collateral. Similarly, the quality and liquidity of shares of Designated Funds are equivalent to the quality and liquidity of current Rule 15c3-3 collateral, and may exceed the quality and liquidity of certain of the types of collateral that the Commission has stated that it will designate by order as permissible Rule 15c3-3 collateral. Moreover, the deposit of shares of Designated Funds into Special Reserve Accounts does not present any increased risk that if a broker-dealer holding customer property fails, the broker-dealer will not have sufficient reserves to ensure that customers promptly receive their property.

It should be noted that Designated Funds attempt to maintain a stable net asset value per share of $1.00, and permit shareholders to purchase and sell in precise dollar amounts, whereas transactions in Government securities take place only in large denominations and may cause a broker-dealer to incur a loss when selling a Government security. Consequently, the use of Designated Funds will facilitate a broker-dealer's ability to meet its cash management needs by providing high daily liquidity at par, which will assist a broker-dealer in managing its changing liquidity requirements over time. We understand that the need for broker-dealers to manage their cash efficiently and in a highly cost-effective manner has increased markedly over the past few years, because the condition of the securities markets during this time period has prompted investors to hold more cash in their accounts. Consequently, we expect that if the Commission adopted the amendments to Rule 15c3-1 and Rule 15c3-3 proposed in this petition, broker-dealers would use shares of Designated Funds in the manner permitted by the amendments. We believe that broker-dealers and the securities markets would benefit in many respects from the use of Designated Fund shares in the manners proposed in this petition.

For example, if Designated Fund shares were acceptable Rule 15c3-3 collateral, it could be expected that liquidity would be added to the securities lending markets and borrowing costs for broker-dealers would be lowered.[21] The proposed amendments to Rule 15c3-1 and Rule 15c3-3 would conform the treatment of money market fund shares under these rules to their treatment by other financial regulators, self-regulatory organizations and state legislatures. Furthermore, the use of Designated Fund shares, which may be traded in precise increments, will enable broker-dealers to manage their cash requirements more effectively than the use of Treasury securities, which must be traded in increments of $1,000.

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21 *See Reserves and Custody Adopting Release, supra* note 8, 68 FR at 12781.

PROPOSED RULE AMENDMENTS

Attached to this petition as Exhibit A is the text of proposed amendments to Rule 15c3-1 and Rule 15c3-3. The proposed amendments would permit shares of Designated Funds to be treated as the functional equivalent of Government securities, Rule 15c3-3 collateral and qualified securities for purposes of those rules. The amendments thus would eliminate undue restrictions under the Commission's current regulations, which provide disparate treatment for instruments with the same risk/reward characteristics. The amendments are intended to facilitate the ability of broker-dealers to comply with the Commission's financial responsibility and customer protection rules through investments in Designated Funds.

DISCUSSION

Rule 15c3-1 and Risks of Broker-Dealers

Rule 15c3-1 generally requires every registered broker-dealer to maintain certain specified minimum levels of liquid assets, or net capital, to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal legal proceeding.[22] The Rule is designed to protect the customers of a broker-dealer from losses that can be incurred upon a broker-dealer's failure.[23] The Rule prescribes different required minimum levels of capital based upon the nature of the broker-dealer's business and whether the firm handles customer funds or securities.[24]

When calculating its net capital, a broker-dealer must reduce its capital by certain percentage amounts, or haircuts, based on the market value of the securities it owns.[25] The haircuts were designed to cover:

- **market risk** – the risk that prices or rates will adversely change due to economic forces, including adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices;
- **credit risk** – risk of loss resulting from counterparty default on loans, swaps, options, and other similar financial instruments during settlement;
- **liquidity risk** – the risk that a firm will not be able to unwind or hedge a position; and
- **operational risk** – the risk of loss due to the breakdown of controls within the firm including, but not limited to, unidentified limit excesses, unauthorized trading, fraud in trading or in back office functions,

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22 *OTC Derivatives Dealers*, Securities Exchange Act Rel. No. 39454 (Dec. 17, 1997), 62 FR 67939, 67946 (Dec. 30, 1997).
23 *Id.*
24 *Id.*
25 *Id.*

inexperienced personnel, and unstable and easily accessed computer systems.[26]

Rule 15c3-3 and Risks of Broker-Dealers

The collateral requirements of Rule 15c3-3 are intended to prevent customer losses due to, among other things, the credit risks and liquidity risks associated with particular types of collateral.[27] The asset requirements applicable to Special Reserve Accounts are intended to prevent customer losses due to the operational risks of a broker-dealer.[28]

Petitioner submits that the use of shares of Designated Funds in the manner contemplated in this petition would not give rise to any increased market risk, liquidity risk, credit risk or operational risk as compared to the use of Government securities, Rule 15c3-3 collateral, or qualified securities.

Money Market Funds – Background

Money market funds are open-end management investment companies registered under the 1940 Act that have as their investment objective generation of income and preservation of capital and liquidity through investment in short-term, high quality securities.[29] Money market funds were first introduced in 1972.[30] Total money market fund assets stood at $ 1.906 trillion for the week ended Wednesday, March 24, 2005.[31]

Money market funds generally seek to maintain a stable share price, typically $1.00 per share, in reliance upon Rule 2a-7 under the 1940 Act.[32] This stable share price of $1.00 has encouraged investors to view investments in money market funds as an alternative to bank deposits or checking accounts, even though money market funds lack federal deposit insurance, and there is no guarantee that money market funds

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26 *OTC Derivatives Dealers*, Securities Exchange Act Rel. No. 40594 (Oct. 23, 1998), 63 FR 59361, 59383, 59388 nn. 262-264 (Nov. 3, 1998); *see Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Placement of Highly Leveraged Members on Surveillance Status*, Securities Exchange Act Rel. No. 44995 (Oct. 26, 2001), 66 FR 55724 (Nov. 2, 2001) (publishing notice of filing and immediate effectiveness of SR-GSCC-2001-06).

27 *See Reserves and Custody Proposing Release*, *supra* note 8, 67 FR at 39643.

28 *See Security Futures Reserve Release*, *supra* note 9, 67 FR at 59748.

29 *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (Mar. 21, 1996), 61 FR 13955, 13957 (Mar. 28, 1996) ("*Money Market Rule Revisions*").

30 Source: Investment Company Institute Mutual Fund Fact Book at inside front cover (42nd ed. 2002).

31 Source: Investment Company Institute, http://www.ici.org/home/mm_03_24_05.html#TopOfPage.

32 *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13957.

will maintain a stable share price.[33] Indeed, the Commission has observed that "investors generally treat money market funds as cash investments."[34]

Money market funds have been widely accepted by both retail and institutional investors. Institutional investors have been attracted to money market funds for various reasons. The Investment Company Institute has noted that "[t]he growth in business holdings of money funds is partly due to corporations' preference to outsource cash management to mutual funds rather than holding liquid securities directly."[35] Corporations that purchase money market shares are able to obtain daily liquidity at par, together with true daily choice, flexibility and economies of scale that are unavailable through internal management of their liquid assets.[36]

Money Market Funds and their Regulation

To maintain a stable share price, the vast majority of money market funds use the amortized cost method of valuation or the penny-rounding method of pricing permitted by Rule 2a-7 under the 1940 Act. The 1940 Act and applicable rules generally require investment companies to calculate current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by, or under the direction of, the board of directors. Rule 2a-7 exempts money market funds from these provisions, but contains conditions designed to minimize the deviation between a fund's stabilized share price and the market value of its portfolio. In particular, Rule 2a-7's conditions relating to portfolio diversification (paragraph (c)(4)), quality (paragraph (c)(3)), and maturity (paragraph (c)(2)) (collectively, the "risk-limiting conditions") are intended to reduce the likelihood of significant deviations between a fund's share price and its market based per share net asset value by requiring funds to invest in eligible quality instruments that are not significantly affected by changes in interest rates.[37]

Portfolio Diversification

Rule 2a-7 subjects a money market fund to diversification requirements designed to limit the fund's exposure to the credit risk of any single issuer. The applicability of the diversification requirements will depend on whether the fund is taxable, such as

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33 *Id.*

34 *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Investment Company Act Rel. No. 25870 (Dec. 18, 2002), 68 FR 160, 165 (Jan. 2, 2003).

35 Investment Company Institute Mutual Fund Fact Book at 30 (42nd ed. 2002).

36 *See id.*

37 *Proposed Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 17589 (July 17, 1990), 55 FR 30239 (July 25, 1990). *See generally* Jack W. Murphy & Douglas P. Dick, *Money Market Funds, in* FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS, Ch. 9 (Clifford E. Kirsch ed., 2001).

a Designated Fund, or tax-exempt. The issuer diversification requirements do not apply with respect to a money market fund's holdings of Government securities, because the Commission does not consider holdings of Government securities to present significant credit risk.[38] Taxable funds must limit their investments in the securities of any one issuer other than Government securities to five percent of fund assets.

Portfolio Quality

Money market funds may purchase only securities that are denominated in United States dollars,[39] pose minimal credit risk to the fund, and are "Eligible Securities" as defined in Rule 2a-7(c)(3)(i). "Eligible Securities" are defined generally as: (i) securities that are rated in one of the highest two short-term rating categories by the "Requisite NRSROs"[40]; or (ii) comparable unrated securities. Taxable funds must limit aggregate fund investments in so-called second tier securities[41] to no more than five percent of fund assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars.

Rule 2a-7(c)(3) further requires money market funds to limit portfolio investments to Eligible Securities determined to present minimal credit risks. This determination must be based on factors affecting the credit quality of the issuer in addition to any ratings assigned to the securities by an NRSRO. Accordingly, it is not sufficient for the board of directors of a money market fund simply to rely on the ratings assigned

38 Rule 2a-7(c)(4)(i). The Rule's treatment of Government securities is derived from Section 5(b)(1) of the 1940 Act, which excludes investments in Government securities from the limitations imposed upon diversified investment companies with respect to investments in a single issuer.

39 The Commission staff has issued two no-action letters permitting funds to hold themselves out as money market funds if they invested solely in debt securities denominated in a specified foreign currency, provided that the funds otherwise complied with the terms of Rule 2a-7. *SsgA International Liquidity Fund* (pub. avail. Dec. 2, 1998); *Five Arrows Short-Term Investment Trust* (pub. avail. Sept. 26, 1997). These funds seek to maintain a constant net asset value in their designated currency and accept purchases and effect redemptions only in that currency.

40 The term "Requisite NRSROs" is defined in Rule 5b-3(c)(6) under the 1940 Act as any two nationally recognized statistical rating organizations ("NRSROs"), or, if only one NRSRO has issued a rating at the time the fund acquires the security, that NRSRO. "NRSRO" is defined in Rule 5b-3(c)(5) as any nationally recognized statistical rating organization, as that term is used in paragraphs (c)(2)(vi)(E), (F) and (H) of Rule 15c3-1 under the 1934 Act, that is not an "affiliated person," as defined in section 2(a)(3)(C) of the 1940 Act, of the issuer of, or any insurer or provider of credit support for, the security.

41 Rule 2a-7(a)(20) defines a "second tier security" as an Eligible Security that is not a "first tier security." Rule 2a-7(a)(11) generally defines a first tier security as a security that is rated by the Requisite NRSROs in the highest rating category for short-term debt obligations, and comparable unrated securities.

to securities by an NRSRO.[42] Rather, the investment adviser must assemble and maintain a credit file for each issuer sufficient to support the determination that the security presents a minimal credit risk to the fund. Rule 2a-7 permits the responsibility for the minimal credit risk determination to be delegated by the fund's board of directors,[43] and as a matter of practice money market funds take advantage of this flexibility. Nonetheless, the fund's board of directors remains ultimately responsible for the minimal credit risk determination and has responsibility for overseeing the determination.

A money market fund's board of directors must reassess promptly whether a security presents minimal credit risks when the fund's investment adviser becomes aware that an unrated security or a second tier security has been given a rating by any NRSRO below the NRSRO's second highest rating category. A money market fund must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.[44]

Portfolio Maturity

A money market fund is required to maintain a dollar-weighted average portfolio maturity appropriate to the objective of maintaining a stable net asset value per share. In addition, Rule 2a-7 provides that a money market fund may not acquire[45] any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days. The Commission has stated that the purpose of Rule 2a-7's maturity provisions is to limit a money market fund's exposure to interest rate risk.[46]

When Rule 2a-7 was first adopted, the Rule limited the maximum remaining maturity of any portfolio instrument to one year.[47] The Commission amended the Rule to permit any money market fund using the amortized cost method to value its portfolio instruments to invest in securities with a remaining maturity of no more than thirteen months (397 days).[48] The Commission made this change in order to

42 *See Money Market Rule Revisions*, *supra* note 27, 61 FR at 13964 n. 88.

43 *Id.*, 61 FR at 13973.

44 *Id.*, 61 FR at 13961 n. 44.

45 Rule 2a-7(a)(1) defines "acquire" to mean any purchase or subsequent rollover, but does not include the failure to exercise a demand feature.

46 *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13971.

47 *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 18005 (Feb. 20, 1991), 56 FR 8113, 8120 (Feb. 27, 1991). Rule 2a-7 defined "one year" as 365 days, but provided that in the case of an instrument that was issued as a one year instrument, but had up to 375 days until maturity, one year meant 375 days. *Id.*, 56 FR at 8120 n. 53.

48 *Id.*, 56 FR at 8120.

accommodate funds purchasing annual tender bonds, and funds purchasing securities on a when-issued or delayed delivery basis.[49] These securities often are not delivered for a period of up to one month after the purchaser has made a commitment to purchase them.[50] Because the purchaser must "book" the security on the day it agrees to purchase it, the maturity period begins on that day.[51]

The Rule provides that the maturity of a portfolio security generally will be equal to the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made (the "final maturity").[52] A money market fund, however, may measure the maturity of a "variable rate security" or a "floating rate security" (collectively, "adjustable rate securities") by reference to a date that is earlier than the final maturity date.

Rule 2a-7 defines a "variable rate security" as an instrument, the terms of which provide for the adjustment of the interest rate on specified dates and that, upon adjustment, can reasonably be expected to have a market value that approximates par value. A "floating rate" security is defined as an instrument, the terms of which provide for the adjustment of its interest rate whenever a specified benchmark changes and that, at any time, can reasonably be expected to have a market value that approximates par value. Under Rule 2a-7, the maturity of an adjustable rate Government security is determined with reference to the interest readjustment date if, upon readjustment, the security can reasonably be expected to have a market value that approximates its par value.[53]

Portfolio Liquidity

Money market funds are also subject to stringent portfolio liquidity standards. A money market fund is limited to investing no more than ten percent of its assets in illiquid securities.[54] The Commission considers a security to be illiquid if it cannot

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49 *Id.*

50 *Id.*

51 *Id.* For instruments such as "when issued" or "delayed delivery" securities, if the commitment to purchase is based upon either a set price or yield, then the maturity will be calculated based upon the commitment date. 56 FR at 8120 n. 53. *See* Rule 2a-7(d).

52 A security that is subject to a "mandatory tender feature" – *i.e.*, a feature providing that the principal amount of the security will be paid off on a specified date unless the holder elects to remain invested – can be treated as having its maturity measured by reference to the payment date of the tender feature. *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13970 n. 151.

53 *Money Market Rule Revisions*, *supra* note 27, 61 FR at 13971.

54 Investment Company Act Rel. No. 13380 (July 11, 1983), 48 FR 32555 (July 18, 1983) (adopting Rule 2a-7), at nn. 37-38.

be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.[55] The Commission, however, has reiterated its staff's observation that, because a broker-dealer is normally required to settle securities transactions not later than three business days after the trade date ("T+3"), many money market funds must meet redemption requests within three days because a broker or dealer will be involved in the redemption process.[56] The Commission cautioned money market funds to assess the mix of their portfolio holdings to determine whether, under normal circumstances, they will be able to facilitate compliance with T+3 by brokers or dealers.[57] The Commission advised money market funds to consider factors such as the percentage of the portfolio that would settle in three days or less, the level of cash reserves, and the availability of lines of credit or interfund lending facilities when conducting their assessment.[58] The Commission urged money market funds to monitor carefully their liquidity needs.[59]

Safety Record of Money Market Funds Generally

General-purpose money market funds[60] have amassed an impressive record of safety over a period of 33 years. The vast majority of those funds have never invested in any money market instrument that did not pay off at maturity. There have been relatively isolated circumstances which a money market fund has experienced the potential for deviations between its stabilized share price and its market based per share net asset value by virtue of its investments in: (a) second-tier commercial paper; or (b) adjustable rate securities in which the interest rate readjustment formulas resulted in the market values of the securities not returning to par at the time of an interest rate readjustment. In all but one such instance, however, to maintain their funds' stable net asset values, the funds' investment advisers purchased the distressed or defaulted securities from their money market funds at their amortized cost value (plus accrued interest), or contributed capital to the funds, to preserve the fund's $1.00 share price.[61] Subsequent Commission amendments to

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55 *Money Market Rule Revisions, supra* note 27, 61 FR at 13966.

56 *See id., citing Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute* (May 26, 1995)

57 *See id.*

58 *See id.*

59 *Id.*

60 The term "general purpose money market funds" refers to money market funds that may invest in the full panoply of instruments permitted by Rule 2a-7.

61 *Id.*, 61 FR at 13972 n. 162. One institutional money market fund holding adjustable rates notes, a series of Community Bankers Mutual Fund, Inc., liquidated in September 1994 at 96 cents per share. Press reports generally treated this liquidation as the first instance in which a money market fund had "broken a dollar." *Id.*

In a subsequent enforcement action, the Commission found that the fund's two portfolio managers had not assessed adequately the risks of investing a large portion of the fund's

Rule 2a-7 have greatly limited the ability of a money market fund to invest in second-tier commercial paper, and have prohibited a money market fund from investing in an adjustable rate security if its interest rate readjustment formula does not ensure that the market value of the security will return to par once a readjustment occurs.

Petitioner believes that the record of money market funds amply demonstrates that Rule 2a-7 has operated and does operate successfully to minimize any credit, interest rate or liquidity risk created by an investment even in a general-purpose money market fund. As compared to these funds, however, concerns about credit, interest rate or liquidity risks are minimized still further in the context of Designated Funds because to qualify as a Designated Fund, the money market fund must meet the more stringent requirements necessary to receive the highest rating from an NRSRO. The conditions that a money market fund must satisfy to meet the definition of a Designated Fund should provide yet additional assurance that an investment in shares of a Designated Fund does not present any market, credit, liquidity, or operational risk not presented by a direct investment in Government securities, Rule 15c3-3 collateral, or qualified securities.

Additional Requirements for AAA-rated Money Market Funds

This fundamental point can be most readily understood through a quick review of the basic S&P criteria for a AAAm rating[62] and a comparison of those criteria to the characteristics of investments that are currently permitted under Rules 15c3-1 and 15c3-3. While the other NRSROs follow similar approaches, this discussion will focus on S&P's ratings criteria.

S&P engages in an extremely sophisticated analysis of a money market fund before granting its AAAm rating. S&P examines credit risk, market price risk, pricing policies, operating scenarios, and controls for the money market fund. S&P will not designate a money market fund as AAAm rated unless the fund meets and maintains those very high standards.

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portfolio in such derivatives, in an environment of rising short-term interest rates. *In the Matter of Craig S. Vanucci and Brian K. Andrew,* Securities Act Rel. No. 7625 (Jan. 11, 1999). In a related enforcement action, the Commission also found that the fund's board authorized the fund to sell its shares while omitting to disclose, or while making false and misleading disclosure of, material facts concerning the percentage of illiquid securities in the Fund's portfolio; and the value of the Fund's shares being sold. *In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey,* Securities Act Rel. No. 7626 (Jan. 11, 1999).

62 These are discussed in great detail in S&P's 2003 publication *Money Market Funds Ratings Criteria*, a copy of which is included as Exhibit C for your reference ("*S&P MMF Ratings Criteria*"). Other NRSROs follow generally similar approaches to rating money market funds, but have not published as detailed a discussion of their criteria.

S&P's AAAm rating is defined to mean that:

> Safety is excellent. Fund provides superior capacity to maintain principal value and limit exposure to loss.[63]

The criteria that must be met to qualify for such a rating are as follows:

> (i) at least 50% of the money market fund's investments must have a short-term rating of A-1+ (which is the highest gradation of the highest S&P short-term rating);
>
> (ii) no more than 50% of the money market fund's investments may have a short-term rating of A-1;
>
> (iii) none of the fund's investments may have a short-term rating of A-2 (which is S&P's second highest short-term rating category);
>
> (iv) the money market fund's weighted average maturity must not exceed 60 days; and
>
> (v) the maximum final maturity for floating rate notes in which the money market fund invests must not exceed two years.[64]

Significantly, for purposes of these ratings, S&P treats investments in short-term U.S. Treasury securities the same as investments in short-term A-1 rated investments. Thus, a money market fund which does not invest in U.S. Treasury securities, but whose investments meet the A-1 rating criteria and which maintains a weighted average maturity of 60 days or less will receive the AAAm rating just as would a Treasury MMF that maintains a weighted average maturity of 60 days or less. By contrast, a Treasury MMF or any other money market fund that maintains a weighted average portfolio maturity of between 60 and 90 days will not qualify for the AAAm rating.

Based on the foregoing, one can fairly conclude that under some circumstances AAA-rated money market funds may be safer than direct investment in U.S. Government securities. Rule 15c3-1 provides that a broker-dealer may take a zero percent haircut on investments in U.S. Government securities with less than 90 days to maturity.[65] According to S&P, in the case of a money market fund whose sole asset was a 90-day U.S. Treasury bill, it would require an overnight interest rate movement of 205 basis points or more for the fund's net asset value ("NAV") to move by more than $0.005. By contrast, S&P believes that it would take a 306

63 *See S&P MMF Ratings Criteria* at p. 3.
64 *See id.*
65 Rule 15c3-1(c)(2)(vi)(A).

basis point movement (*i.e.*, an additional 50%) to cause a similar NAV movement for a money market fund whose weighted average portfolio maturity was 60 days. Accordingly, a AAA-rated money market fund offers protections to the broker-dealer that are at least as great as direct investments in Treasury securities that qualify for a zero percent haircut.

Moreover, Rule 15c3-1 also provides a zero percent haircut for investments in commercial paper, bankers acceptances and certificates of deposit with less than 30 days to maturity, provided that, in the case of commercial paper, the investment is rated in the top 3 rating categories by at least two NRSROs; no rating requirement applies to bankers acceptances and certificates of deposit issued or guaranteed by a bank.[66] Again a AAAm-rated money market fund compares very favorably. Notwithstanding that the maturity of these instruments must be 30 days or less to qualify for the zero haircut (as opposed to the 60-day weighted average maturity permitted by S&P), S&P's credit standards for a AAAm-rated money market fund are higher, requiring at least 50% of the fund's investments to be in the highest gradation (A-1+) of S&P's highest short-term rating category with the balance in the second highest gradation of that category (A-1), and permitting none of the fund's assets to be in S&P's second highest short-term rating category (A-2).

A similar analysis applies under Rule 15c3-3 with respect to other forms of collateral permissible for securities lending arrangements.

- Letters of Credit -- Rule 15c3-3(b)(3)((iii)(A) provides that a broker-dealer may loan securities against, among other things "an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A)-(C) of the [1934] Act." The rule does not impose minimum characteristics for the letter of credit or the bank that issues it. In our view, a AAAm-rated MMF compares favorably to a letter of credit issued by an unrated or lower-rated bank.

- U.S. Treasury Securities -- Rule 15c3-3(b)(3)((iii)(A) provides that a broker-dealer may loan securities against collateral that fully secures the loan of securities consisting among other things of "cash or United States Treasury bills and Treasury notes." But as we noted above, a single Treasury bill may have greater interest rate risk than a AAAm rated money market fund with its weighted average maturity of 60 days or less.

Similarly, with respect to the Special Reserve Account, Rule 15c3-3 only permits cash or "qualified securities," defined as securities issued or guaranteed as to principal and interest by the United States, to be deposited, but does not limit the

66 Rule 15c3-1(c)(2)(vi)(E).

maturity of the qualified securities. Accordingly, AAA-rated MMFs compare favorably in that the weighted average maturity limitations would have less interest rate exposure than many qualified securities.

Finally, we note that there is nothing new about the Commission employing NRSRO ratings for net capital purposes. Chairman Donaldson recently noted in testimony before the Senate "the Commission originally used the term "Nationally Recognized Statistical Rating Organization" or "NRSRO" with respect to credit rating agencies in 1975 solely to differentiate between grades of debt securities held by broker-dealers as capital to meet Commission capital requirements."[67] Accordingly, Petitioner believes that it would be appropriate for the Commission to use the AAAm or equivalent rating as a criterion for Designated Funds.

Other Benefits of Proposed Rule Amendments

In addition, the proposed rule amendments would facilitate broker-dealers' ability to manage their cash and collateral by allowing them to delegate that responsibility to firms such as Petitioner, whose core business is to operate MMFs and to participate actively and expertly in the Treasury securities market. The Treasury securities market is widely recognized as the largest and most liquid securities market in the world.[68] Secondary market trading for Treasury securities takes place in the over-the- counter ("OTC") market. Trading activity in the OTC market takes place between primary dealers, non-primary dealers, and customers of these dealers, including financial institutions, non-financial institutions and individuals. The primary dealers are among the most active participants in the secondary market for Treasury securities. The primary dealers and other large market participants frequently trade with each other, and most of these transactions occur through an interdealer broker. The interdealer brokers provide primary dealers and other large participants in the Treasury market with electronic screens that display the bid and offer prices among dealers and allow trades to be consummated.

Smaller institutions do not have the same degree of access to the OTC market as do primary dealers and other large market participants. These institutions must use intermediaries, such as the primary dealers, to purchase and sell Treasury securities. The use of these intermediaries can be expected to result in increased transaction costs for these institutions. Permitting broker-dealers to use shares of Designated Funds in lieu of direct holdings of Government securities, Rule 15c3-3 collateral or

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67 The Honorable William H. Donaldson, Chairman, SEC, Testimony Concerning The State of the Securities Industry, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 9, 2005. http://www.sec.gov/news/testimony/ts030905whd.htm. *See also* Rule 15c3-1(c)(2)(vi)(E).

68 *See* The Treasury Securities Market: Overview and Recent Developments, The Federal Reserve Bulletin, December 1999, available at http://www.federalrserve.gov/pubs /bulletin/1999/1299lead.pdf.

qualified securities can be expected to enable such broker-dealers to manage their cash and collateral needs in a more cost-effective manner than any currently available alternative, such as by the direct purchase and sale of Treasury securities.

Similarly, even several large broker-dealers have advised Petitioner that they would prefer to delegate this responsibility to sponsors of high quality MMFs. Notwithstanding their access to the Treasury securities markets, large broker-dealers have indicated that they would rather use high quality MMFs, such as a Designated Fund, to manage their cash balances and collateral, rather than have to engage in the purchase and sale of individual Treasury securities.

Institutional Use of Money Market Funds

Money market funds now are used by institutional investors in a wide variety of applications as an efficient alternative to direct investment in Government securities. In particular, as is summarized in Exhibit B, numerous federal and state financial regulators (including the Commission), self-regulatory organizations, and state legislatures have recognized investments in shares of such funds as a fully acceptable alternative to investing in Government securities for many purposes.

Examples of such circumstances include investment of the assets of national banks (Office of the Comptroller of the Currency), state-chartered banks (Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation), and federal credit unions (National Credit Union Administration); customer funds held in custody by futures commission merchants and futures clearing organizations (Commodity Futures Trading Commission); margin collateral (Board of Trade Clearing Corporation, New York Mercantile Exchange, Chicago Mercantile Exchange, and the Options Clearing Corporation); assets of state and municipal entities, assets subject to trust indentures, and trust and other fiduciary assets (numerous state laws). The Commission staff has authorized the pre-funded portion of an asset-backed issuance to be invested in money market mutual funds as an alternative to eligible financial assets that convert to cash.

Most recently, the Commission and the Commodity Futures Trading Commission issued joint final rules to establish margin requirements for security futures ("Final Rules").[69] The Final Rules are intended to preserve the financial integrity of markets trading security futures, prevent systemic risk, and assure that the margin requirements for security futures are consistent with the margin requirements for comparable exchange-traded option contracts.[70] The Final Rules permit the use of money market fund shares to satisfy the required margin for security futures and

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69 *Customer Margin Rules Relating to Security Futures*, Securities Exchange Act Rel. No. 46292 (Aug. 1, 2002), 67 FR 53145 (Aug. 14, 2002).

70 *Id.*, 67 FR at 53146.

related positions carried in a securities account or futures account, subject to certain conditions.[71] These conditions are intended to facilitate a security futures intermediary's hypothecation or liquidation of money market fund shares deposited as margin for security futures, as necessary to meet a customer's clearing obligations.[72] Under the Final Rules, a security futures intermediary may accept money market fund shares as margin if the following conditions are met:

- the customer must waive any right to redeem the fund shares without the consent of the security futures intermediary and must instruct the fund or its transfer agent accordingly;
- the security futures intermediary (or clearing agency or derivatives clearing organization with which the security is deposited as margin) must obtain the right to redeem the shares in cash, promptly upon request; and
- the fund must agree to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.[73]

The ability under the Final Rules to use money market fund shares as collateral reflects a recognition by the Commission that the use of money market fund shares as collateral is consistent with the preservation of the financial integrity of markets trading security futures, and that it will not create or exacerbate systemic risk.

In addition, the Options Clearing Corporation ("OCC") has amended its rules to permit the use of money market fund shares as a form of margin collateral, provided that the fund meets specified criteria.[74] The OCC noted that it regularly reviews the forms of collateral that may be deposited as margin for suitability in order to address clearing members' desire to use a diverse combination of readily available and cost-effective forms of collateral while ensuring that collateral is limited to instruments that are relatively stable in value and are easily converted to cash.[75] The OCC expressed its belief that shares in certain money market funds meet these criteria and that it is appropriate for the OCC to expand its categories of acceptable collateral to include such instruments.[76] The OCC's view is predicated on the notion that the professional asset management, liquidity, and stable principal value typically associated with money market funds make shares in such funds an

71 *Id.*, 67 FR at 53162.
72 *Id.*
73 *Id.*
74 *Notice of Filing of a Proposed Rule Change Relating to Money Market Funds as Margin Collateral*, Securities Exchange Act Rel. No. 47146 (Jan. 9, 2003), 68 FR 2385 (Jan. 16, 2003) (publishing notice of filing of SR-OCC-2002-04) ("OCC Proposal").
75 *Id.*, 68 FR at 2386.
76 *Id.*

attractive collateral alternative for all OCC clearing accounts.[77] The Commission approved the OCC's proposal in March 2003.[78]

To minimize credit risk, the OCC accepts only shares of money market funds that limit their investments to first tier securities.[79] In addition, a money market fund must make certain other agreements intended to further ensure the OCC's ability to convert fund shares promptly to cash if necessary.[80] The OCC requires a money market fund to waive its rights under the 1940 Act to delay redemption or to redeem shares in kind.[81] Instead, a money market fund must agree to redeem fund shares in cash no later than the business day following a redemption request by the OCC with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.[82] These waivers of redemption restrictions along with the next day payment requirement have been established to maintain adequate liquidity of margin collateral and are also intended to be consistent with the redemption conditions contained in CFTC Rule 1.25.[83]

The treatment accorded holdings of shares of money market funds in these circumstances recognizes that such funds offer institutions a highly efficient and convenient mechanism for managing cash balances under circumstances that offer extreme safety with infinitesimal risk.

DESCRIPTION OF PROPOSED RULE AMENDMENTS

The proposed rule amendments would extend to shares of Designated Funds the net capital treatment provided to Government securities with maturities of less than three months and the collateral treatment provided to Rule 15c3-3 collateral, and would deem Designated Fund shares to be qualified securities. A Designated Fund would be defined as a money market fund (under Rule 2a-7) that meets the following conditions:

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77 *Id.*

78 Rel. 34-47599, 68 FR 16849 (April 7, 2003) ("OCC Approval Order"). *See also* Rel. 34-51290 approving SR-DTC-2005-02 (accelerated approval of proposed rule change to establish a setup fee for open-ended mutual funds); and Rel. 34-51289 approving SR-DTC-2005-01 (filing and immediate effectiveness of proposed rule change to make open-ended funds depository eligible).

79 OCC Proposal.

80 *Id.*

81 *Id.*

82 *Id.*, 68 FR at 2386-87. *See also* Approval Order at 68 FR at 16849.

83 *Id.*, 68 FR at 2387. *See also* Approval Order at 68 FR at 16850

- the fund must have received the highest rating for a money market fund from at least one NRSRO;
- the fund would have to agree to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange; and
- the fund would be required to adopt a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

The foregoing conditions are intended to ensure that shares of Designated Funds do not present any increased market risk, credit risk or other risks relative to direct holdings of Government securities and that the quality and liquidity of shares of Designated Funds are equivalent to the quality and liquidity of Rule 15c3-3 collateral or qualified securities.

CONCLUSION

Funds like the Prime Obligation Fund and Prime Cash Obligations Fund now have been widely approved by financial regulators, self-regulatory organizations and state legislatures for use by institutional investors as a safe and efficient alternative to direct investments in Treasury securities. Money market funds permit institutions to benefit from economies of scale that are not available when institutions attempt to manage their liquid assets directly. Money market funds, especially those that meet the definitional conditions of a Designated Fund, represent a safe, highly liquid asset with a stable value. Therefore, Petitioner respectfully requests that the Commission adopt the amendments set forth in Exhibit A that would extend to Designated Funds the same net capital treatment provided to Government securities with maturities of less than three months, the same collateral treatment provided to Rule 15c3-3 collateral, and the same Special Reserve Account treatment currently provided to qualified securities.

* * * * *

Should you have further questions or require additional information, please do not hesitate to contact Stuart J. Kaswell at 202-261-3314 or David J. Harris at 202-261-3385.

Respectfully submitted,

Stuart J. Kaswell /zlp

Stuart J. Kaswell
Partner

David J. Harris/zlp

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Dechert LLP

Exhibits	
Letter	**Description**
A	Text of Proposed Amendments to Rules 15c3-1 and 15c3-3
B	Examples of when federal and state financial regulators (including the Commission), self-regulatory organizations, and state legislatures have recognized investments in money market shares as a fully acceptable alternative to investing in Government securities
C	S&P MMF Ratings Criteria.
D	Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004

cc: Hon. William H. Donaldson, Chairman
Hon. Cynthia A. Glassman, Commissioner
Hon. Harvey J. Goldschmid, Commissioner
Hon. Paul S. Atkins, Commissioner
Hon. Roel C. Campos, Commissioner

Giovanni P. Prezioso, General Counsel,
Office of General Counsel

Annette L. Nazareth, Director,
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Robert L.D. Colby, Deputy Director,
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Meyer Eisenberg, Acting Director,
Division of Investment Management
Robert E. Plaze, Associate Director,
Division of Investment Management

Eugene F. Maloney, Esq.
Executive Vice President and Corporate Counsel
Federated Investors, Inc.

Exhibit A

Text of Proposed Amendments to Rules 15c3-1 and 15c3-3

EXHIBIT A

<u>TEXT OF PROPOSED AMENDMENTS TO RULES 15c3-1 AND 15c3-3</u>

1. add new subparagraph (c)(13) to Rule 15c3-1

13. The term "Designated Fund" shall mean an open-end management investment company registered under the Investment Company Act of 1940 which assets consist of cash or money market instruments and which is generally known as a "money market fund", and which:

    (i) has received the highest money market fund rating from a nationally recognized statistical rating organization;

    (ii) has agreed to redeem fund shares in cash, with payment being made no later than the business day following a redemption request by a shareholder, except in the event of an unscheduled closing of Federal Reserve Banks or the New York Stock Exchange; and

    (iii) has adopted a policy that it will notify its shareholders (a) of any change in its rating; or (b) 60 days prior to any change in its policy to redeem fund shares in cash no later than the business day following a redemption request by a shareholder, with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange.

2. add new paragraph (c)(2)(vi)(D)(1) to Rule 15c3-1; revise and redesignate current paragraphs (c)(2)(vi)(D)(1) - (3) as paragraphs (c)(2)(vi)(D)(2) - (4)

Certain Municipal Bond Trusts and Liquid Asset Funds

D.

1. In the case of redeemable securities of a Designated Fund, there shall be no deduction.

2. In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets consist of cash or money market instruments and which is generally known as a "money market fund," <u>other than a Designated Fund</u>, the deduction shall be 2% of the market value of the greater of the long or short position.

3. In the case of redeemable securities of an investment company registered under the Investment Company Act of 1940, which assets are in the form of cash or securities or money market instruments of any maturity which

5. paragraph (b)(3)(iii)(A) is revised to read as follows:

b. *Physical possession or control of securities.*

* * *

3. A broker or dealer shall not be deemed to be in violation of the provisions of paragraph (b)(1) of this section regarding physical possession or control of fully-paid or excess margin securities borrowed from any person, provided that the broker or dealer and the lender, at or before the time of the loan, enter into a written agreement that, at a minimum;

* * *

iii. Specifies that the broker or dealer

A. must provide to the lender, upon the execution of the agreement or by the close of the business day of the loan if the loan occurs subsequent to the execution of the agreement, collateral, consisting exclusively of cash or United States Treasury bills and Treasury notes <u>or redeemable securities issued by one or more Designated Funds</u> or an irrevocable letter of credit issued by a bank as defined in section 3(a)(6)(A) through (C) of the Securities Exchange Act which fully secures the loan of securities.

* * * * *

EXHIBIT B

Money Market Mutual Funds as Functional Equivalents of Underlying Portfolio Investments

#	Authority	Application	Date
1.	Office of the Comptroller of the Currency	Permits national banks to purchase, for their own account, mutual funds with portfolios limited to assets national banks can acquire directly.	Banking circular issued November 21, 1986. Rules adopted December 1996.
2.	Board of Governors of the Federal Reserve System	Same with respect to state-chartered member banks.	Adopted the OCC approach by rule in 1998 (codifying earlier Fed interpretations).
3.	Federal Deposit Insurance Commission	Same with respect to state-chartered non-member banks.	Adopted the OCC approach in 1992.
4.	National Credit Union Administration	Same with respect to federal credit unions.	Rule adopted in 1997.
5.	Securities and Exchange Commission	Pre-funded portion of an asset-backed issuance may be invested in money market mutual funds as an alternative to eligible financial assets that convert to cash.	No-action letter, 1997.
6.	Commodity Futures Trading Commission	Customer funds in custody of futures commission merchants and futures clearing organizations may be invested in money market mutual funds as well as US Government securities and approved investments.	Rule amended December 2000.
7.	Securities and Exchange Commission; Commodity Futures Trading Commission	Money market fund shares may be used to satisfy the required margin for security futures and related positions carried in a securities account or futures account.	Rules adopted August 2002.
8.	Board of Trade Clearing Corporation	In lieu of depositing original margins in cash and government securities, bylaws permit deposits of certain functionally equivalent investments, including approved money market mutual funds.	Bylaws amended July 2001.
9.	New York Mercantile Exchange	Clearing members may meet original margin calls by depositing cash and government securities or certain functionally equivalent investments, including approved money market mutual funds.	Rule adopted June 2001 and amended in January 2002.
10.	Chicago Mercantile Exchange ("CME")	Clearing members may accept both cash and government securities as performance bond, as well as certain functionally equivalent investments, including approved money market mutual funds.	Rule revised October 2001.
11.	Options Clearing Corporation	Amendments to margin rules to include shares of money market mutual funds holding shares of "first tier" securities.	SEC approved on March 31, 2003. *See also* SEC orders approving DTC rule changes.
12.	State Laws	Authorize investment in Government-only money funds as an alternative to direct investment in US Government securities for investments of: • public funds by municipalities and other public entities; • trust and other fiduciary assets; • indenture trustees; • miscellaneous entities	Various

section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), that is rated investment grade in one of the two highest investment grade rating categories, and that represents ownership of a promissory note or certificate of interest or participation that is directly secured by a first lien on one or more parcels of real estate upon which one or more commercial structures are located and that is fully secured by interests in a pool of loans to numerous obligors.

(3) A residential mortgage-related security that is offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that is rated investment grade or is the credit equivalent thereof, or a residential mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41)), that is rated investment grade in one of the two highest investment grade rating categories, and that does not otherwise qualify as a Type I security.

(n) *Type V security* means a security that is:

(1) Rated investment grade;

(2) Marketable;

(3) Not a Type IV security; and

(4) Fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly.

[61 FR 63982, Dec. 2, 1996, as amended at 66 FR 34791, July 2, 2001]

§ 1.3 Limitations on dealing in, underwriting, and purchase and sale of securities.

(a) *Type I securities.* A national bank may deal in, underwrite, purchase, and sell Type I securities for its own account. The amount of Type I securities that the bank may deal in, underwrite, purchase, and sell is not limited to a specified percentage of the bank's capital and surplus.

(b) *Type II securities.* A national bank may deal in, underwrite, purchase, and sell Type II securities for its own account, provided the aggregate par value of Type II securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type II securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(c) *Type III securities.* A national bank may purchase and sell Type III securities for its own account, provided the aggregate par value of Type III securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type III securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(d) *Type II and III securities; other investment securities limitations.* A national bank may not hold Type II and III securities issued by any one obligor with an aggregate par value exceeding 10 percent of the bank's capital and surplus. However, if the proceeds of each issue are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and if each issue is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases, the bank may apply the 10 percent investment limitation separately to each issue of a single obligor.

(e) *Type IV securities*—(1) *General.* A national bank may purchase and sell Type IV securities for its own account. Except as described in paragraph (e)(2) of this section, the amount of the Type IV securities that a bank may purchase and sell is not limited to a specified percentage of the bank's capital and surplus.

(2) *Limitation on small business-related securities rated in the third and fourth highest rating categories by an NRSRO.* A national bank may hold small business-related securities, as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), of any one issuer with an aggregate par value not exceeding 25 percent of the bank's capital and surplus if those securities are rated investment grade in the third or fourth highest investment grade rating categories. In applying this limitation, a

national bank shall take account of securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings. No percentage of capital and surplus limit applies to small business related securities rated investment grade in the highest two investment grade rating categories.

(f) *Type V securities.* A national bank may purchase and sell Type V securities for its own account provided that the aggregate par value of Type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type V securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(g) *Securitization.* A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus.

(h) *Investment company shares*—(1) *General.* A national bank may purchase and sell for its own account investment company shares provided that:

(i) The portfolio of the investment company consists exclusively of assets that the national bank may purchase and sell for its own account under this part; and

(ii) The bank's holdings of investment company shares do not exceed the limitations in § 1.4(e).

(2) *Other issuers.* The OCC may determine that a national bank may invest in an entity that is exempt from registration as an investment company under section 3(c)(1) of the Investment Company Act of 1940, provided that the portfolio of the entity consists exclusively of assets that a national bank may purchase and sell for its own account under this part.

(i) *Securities held based on estimates of obligor's performance.* (1) Notwithstanding §§ 1.2(d) and (e), a national bank may treat a debt security as an investment security for purposes of this part if the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security, and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(2) The aggregate par value of securities treated as investment securities under paragraph (i)(1) of this section may not exceed 5 percent of the bank's capital and surplus.

[61 FR 63982, Dec. 2, 1996, as amended at 64 FR 60098, Nov. 4, 1999]

§ 1.4 Calculation of limits.

(a) *Calculation date.* For purposes of determining compliance with 12 U.S.C. 24 (Seventh) and this part, a bank shall determine its investment limitations as of the most recent of the following dates:

(1) The last day of the preceding calendar quarter; or

(2) The date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

(b) *Effective date.* (1) A bank's investment limit calculated in accordance with paragraph (a)(1) of this section will be effective on the earlier of the following dates:

(i) The date on which the bank's Consolidated Report of Condition and Income (Call Report) is submitted; or

(ii) The date on which the bank's Consolidated Report of Condition and Income is required to be submitted.

(2) A bank's investment limit calculated in accordance with paragraph (a)(2) of this section will be effective on the date that the limit is to be calculated.

(c) *Authority of OCC to require more frequent calculations.* If the OCC determines for safety and soundness reasons that a bank should calculate its investment limits more frequently than required by paragraph (a) of this section, the OCC may provide written notice to the bank directing the bank to calculate its investment limitations at a more frequent interval. The bank shall thereafter calculate its investment limits at that interval until further notice.

(d) *Calculation of Type III and Type V securities holdings*—(1) *General.* In calculating the amount of its investment in Type III or Type V securities issued by any one obligor, a bank shall aggregate:

(i) Obligations issued by obligors that are related directly or indirectly through common control; and

(ii) Securities that are credit enhanced by the same entity.

(2) *Aggregation by type*. The aggregation requirement in paragraph (d)(1) of this section applies separately to the Type III and Type V securities held by a bank.

(e) *Limit on investment company holdings*—(1) *General*. In calculating the amount of its investment in investment company shares under this part, a bank shall use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each investment company with the bank's direct holdings of that security. The bank's direct holdings of the particular security and the bank's pro rata interest in the same security in the investment company's portfolio may not, in the aggregate, exceed the investment limitation that would apply to that security.

(2) *Alternate limit for diversified investment companies*. A national bank may elect not to combine its pro rata interest in a particular security in an investment company with the bank's direct holdings of that security if:

(i) The investment company's holdings of the securities of any one issuer do not exceed 5 percent of its total portfolio; and

(ii) The bank's total holdings of the investment company's shares do not exceed the most stringent investment limitation that would apply to any of the securities in the company's portfolio if those securities were purchased directly by the bank.

§ 1.5 Safe and sound banking practices; credit information required.

(a) A national bank shall adhere to safe and sound banking practices and the specific requirements of this part in conducting the activities described in § 1.3. The bank shall consider, as appropriate, the interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks presented by a proposed activity, and the particular activities undertaken by the bank must be appropriate for that bank.

(b) In conducting these activities, the bank shall determine that there is adequate evidence that an obligor possesses resources sufficient to provide for all required payments on its obligations, or, in the case of securities deemed to be investment securities on the basis of reliable estimates of an obligor's performance, that the bank reasonably believes that the obligor will be able to satisfy the obligation.

(c) Each bank shall maintain records available for examination purposes adequate to demonstrate that it meets the requirements of this part. The bank may store the information in any manner that can be readily retrieved and reproduced in a readable form.

§ 1.6 Convertible securities.

A national bank may not purchase securities convertible into stock at the option of the issuer.

§ 1.7 Securities held in satisfaction of debts previously contracted; holding period; disposal; accounting treatment; non-speculative purpose.

(a) *Securities held in satisfaction of debts previously contracted*. The restrictions and limitations of this part, other than those set forth in paragraphs (b),(c), and (d) of this section, do not apply to securities acquired:

(1) Through foreclosure on collateral;

(2) In good faith by way of compromise of a doubtful claim; or

(3) To avoid loss in connection with a debt previously contracted.

(b) *Holding period*. A national bank holding securities pursuant to paragraph (a) of this section may do so for a period not to exceed five years from the date that ownership of the securities was originally transferred to the bank. The OCC may extend the holding period for up to an additional five years if a bank provides a clearly convincing demonstration as to why an additional holding period is needed.

(c) *Accounting treatment*. A bank shall account for securities held pursuant to paragraph (a) of this section in accordance with Generally Accepted Accounting Principles.

(d) *Non-speculative purpose*. A bank may not hold securities pursuant to

federal register

Monday
December 2, 1996

Part VI

Department of the Treasury

Office of the Comptroller of the Currency

12 CFR Parts 1 and 7
Investment Securities; Final Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Parts 1 and 7

[Docket No. 96–26]

RIN 1557–AB37

Investment Securities

AGENCY: Office of the Comptroller of the Currency, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency (OCC) is clarifying and updating its rules that prescribe the standards under which national banks may purchase and sell, deal in, and underwrite securities. This final rule is another component of the OCC's Regulation Review Program, a project designed to review, modernize, and simplify OCC regulations and reduce unnecessary regulatory burdens on national banks. The final rule reorganizes the regulation by placing related subjects together, clarifies certain areas, and updates various provisions to address market developments and to incorporate significant OCC interpretations, judicial decisions, and statutory amendments.

EFFECTIVE DATE: December 31, 1996.

FOR FURTHER INFORMATION CONTACT: Lee Walzer, Senior Attorney, Securities and Corporate Practices Division, 202–874–5210; Kurt Wilhelm, Senior Investment Advisor, Capital Markets, 202–874–5070; Daniel L. Cooke, Attorney, and Stuart E. Feldstein, Assistant Director, Legislative and Regulatory Activities Division, 202–874–5090. Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20009.

SUPPLEMENTARY INFORMATION:

Background

Part 1 has historically prescribed the limitations and restrictions on a national bank's purchase of investment securities for its own account. Part 1 also addresses a national bank's ability to purchase and sell, deal in, and underwrite certain investment securities. The part 1 limitations on these activities are based on the Banking Act of 1933, section 16, Pub. L. 73–66, 48 Stat. 184 (codified as amended at 12 U.S.C. 24(Seventh)), and vary according to the characteristics of the security.

In the past, part 1 grouped the securities identified in 12 U.S.C. 24(Seventh) into three categories, Types I, II, and III securities. More recently, the Secondary Mortgage Market Enhancement Act of 1984, (SMMEA)[1] and the Riegle Community Development and Regulatory Improvement Act of 1994 (CDRI)[2] amended 12 U.S.C. 24(Seventh) and removed quantitative limits on national banks" purchases of certain types of mortgage- and small business-related securities, subject to regulations prescribed by the OCC.

On December 21, 1995, the OCC published a notice of proposed rulemaking (60 FR 66152) (proposal) to revise part 1 and implement the changes required by CDRI and SMMEA. The proposal sought to implement the goals of the OCC's Regulation Review Program by updating and streamlining the regulation and eliminating requirements that imposed inefficient and costly regulatory burdens on national banks. The proposal also sought to implement the amendments made by SMMEA and CDRI and to update various provisions to address market developments and to incorporate significant OCC interpretations and judicial decisions.

In the proposal, the OCC added two new classifications of securities to characterize the changes made by SMMEA and CDRI and to reflect developments in national banks" treatment of their assets. Specifically, the proposal added a new category of securities, Type IV securities, that are defined as certain types of asset-backed securities identified in SMMEA and CDRI, which are exempt from the 10 percent investment limitation of 12 U.S.C. 24(Seventh). Type IV securities are: (1) residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933 (Securities Act), 15 U.S.C. 77d(5); (2) residential and commercial mortgage-related securities described in section 3(a)(41) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78c(a)(41); and (3) small business-related securities as defined in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A).

The proposal also added Type V securities, which are investment grade securities that are backed by pools of assets composed of obligations in which a national bank may invest directly.

In addition to adding Type IV and Type V securities, the proposal refined the definitions and limitations imposed on the three existing types of securities. Finally, the proposal restructured part 1 to make it easier to read and apply.

[1] Sec. 105(c), Pub. L. 98–440, Title I, 98 Stat. 1691 (codified as amended at 12 U.S.C. 24(Seventh) (1984)).

[2] Pub. L. 103–325, 108 Stat. 2160 (1994).

Comments and OCC Action

The OCC received 19 comment letters in response to the proposal. The commenters included eight trade associations, one professional association, six banks, two law firms, one private business, and one unaffiliated individual. The commenters generally supported the proposal but also recommended a number of specific modifications. Many of the commenters offered reasons why the OCC should remove or lessen structural limitations on investment in Type IV and Type V securities, particularly aspects of the proposed diversification requirements.

In the final rule, the OCC has addressed many of the concerns of the commenters and, in particular, has concluded that some of the proposal's definitional restrictions on Type IV and Type V securities are not necessary.

The final rule's structure is based on three core sections. Section 1.2 defines the five types of securities as well as other significant terms such as "investment grade," "investment security," and "marketable." Section 1.3 prescribes limitations on dealing in, underwriting, purchasing, and selling each of the five types of securities defined in § 1.2, investment company shares, and securities held based on estimates of an obligor's performance. Section 1.3 prescribes special provisions on aggregation of securities with a common issuer and calculation of investment company holdings. Section 1.4 prescribes how a national bank must calculate the limits imposed by § 1.3.

The final rule also makes minor clarifying and technical changes. The following section-by-section analysis discusses the comments and substantive changes made by the final rule:

Authority, Purpose, and Scope (§ 1.1)

The proposal consolidated the former "Scope and application" section (§ 1.2) with the "Authority" section (§ 1.1). The proposal also clarified that the limitations set forth in part 1 apply to national banks, federal branches of foreign banks, District of Columbia banks, and state banks that are members of the Federal Reserve System.

The OCC received no comments on this section, which is adopted as proposed with minor clarifying changes.

Definitions (§ 1.2)

The proposal substantially revised the definitions section to add several new definitions and to update others. The proposal revised the definitions of Type I, II, and III securities to define the securities by their characteristics rather than by the statutory limitations on the extent to which national banks may deal in, underwrite, purchase, or sell them. The proposal also defined two new types of securities, Type IV and Type V securities, and added a definition of "investment company."

The final rule adds a new defined term, "NRSRO." The final rule changes the paragraph letter designations for each definition accordingly. Of particular note, the final rule makes the following substantive changes:

Capital and Surplus (§ 1.2(a))

The proposal defined "capital and surplus" as the sum of Tier 1 and Tier 2 capital includable in risk-based capital under the Minimum Capital Ratios in 12 CFR part 3 appendix A, plus the balance of a bank's allowance for loan and lease losses that is not included in Tier 2 capital.

The OCC received three comments on this definition. The commenters noted that, because part 1 applies to state banks that are members of the Federal Reserve System, the OCC should adopt a definition of "capital and surplus" that applies the Board of Governors of the Federal Reserve System's (FRB's) definition of "capital and surplus" to state member banks. The OCC agrees with these commenters and has, therefore, changed the final rule to incorporate technical changes and to provide that banks must use the appropriate Federal banking agencies" guidelines defining "capital and surplus."

Investment Grade (§ 1.2(d))

In many instances in the final rule, a security must be "investment grade" to be a permissible investment for a national bank. The proposal defined a security as "investment grade" when *each* nationally recognized statistical rating organization (NRSRO) that has rated the security has given it a rating in one of the top four rating categories. Thus, for purposes of this definition, if a security were given different ratings by different NRSROs, the lowest rating would govern. For example, if two NRSROs rated a security in one of their top four categories, but a third NRSRO did not give the security a top four rating (a so-called "split- rated" security), the security would not qualify as "investment grade."

The OCC received ten comments on this section. Seven commenters recommended that the OCC change the proposed definition to recognize a security as "investment grade" if only one NRSRO rates the security in one of the top four categories. These commenters asserted that otherwise any one NRSRO could render a particular security non-investment grade and, therefore, not permissible for a national bank to purchase. One commenter recommended that, at a minimum, the OCC should deem a security "investment grade" if a majority of the NRSROs that rate the security rate it in one of the top four categories.

The OCC agrees that giving a single NRSRO the ability to deem an investment impermissible for a national bank may be unnecessarily restrictive. Thus, the final rule defines the term "investment grade" to mean a security that receives a top four rating from either: (a) Two or more NRSROs; or (b) one NRSRO if the security has been rated by only one NRSRO. This approach assures that a security is sufficiently creditworthy while also allowing for some diversity in the evaluations produced by different NRSROs.

Some commenters requested that the OCC exclude unsolicited ratings from the definition. Under the proposal, an unsolicited non-investment grade rating would have rendered the security an impermissible investment for a national bank. However, the final rule recognizes unsolicited ratings, but no longer will permit a single unsolicited rating to render a security automatically ineligible for national bank investment.

Investment Security (§ 1.2(e))

The proposal defined "investment security" as a security that is: (1) An investment grade marketable debt obligation; or (2) the credit equivalent of an investment grade marketable debt obligation if the security is not rated. The OCC requested comment on whether to describe more specifically the characteristics of securities that are the credit equivalent of investment grade. The OCC also asked commenters to address whether other securities with characteristics functionally equivalent to a debt obligation might be classified as "investment securities."

The OCC received four comments on this section. The commenters generally supported the definition of "investment security." Most commenters felt that defining "credit equivalency" by identifying specific characteristics would sacrifice flexibility.

The OCC agrees with the commenters and believes that to adopt specific identifiable characteristics of credit equivalency would unduly restrict flexibility in this area. Therefore, the OCC adopts the final rule as proposed.

Marketable (§ 1.2(f))

At § 1.5(a), the former rule defined a "marketable" security as one that may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. The proposal replaced this definition with a more objective test that lists particular indicators of a ready market for a security. The proposal defined marketable as: (1) Securities registered under the Securities Act; (2) certain government securities exempt from Securities Act registration; (3) municipal revenue bonds exempt from Securities Act registration; and (4) securities that are investment grade and sold pursuant to Securities Exchange Commission (SEC) Rule 144A (17 CFR 230.144A), which exempts certain private resales of securities to institutional investors from Securities Act registration.

The OCC requested comment on whether the proposed definition of "marketable" is sufficiently inclusive, particularly regarding other exemptions under the Securities Act and whether the definition is appropriately inclusive of foreign sovereign debt. The OCC also asked commenters to suggest alternative definitions of marketable that would address the OCC's concerns about liquidity.

The OCC received 12 comments on this issue. A majority of the commenters recommended that the OCC expand the proposed definition or retain the former definition of marketable. These commenters asserted that the proposed definition was too restrictive and did not include certain securities that are included within the definition in the former regulation. For example, the commenters noted that foreign sovereign debt, bank and savings and loan debt securities (which are exempt from registration under the Securities Act), and commercial paper were not identified in the proposed definition even though they may have been included within the former marketability test.

The OCC did not intend to prescribe a marketability test that, through its objectivity, eliminates flexibility available under the former rule and unnecessarily excludes a broad range of securities. Therefore, the final rule retains the list of marketable securities contained in the proposal and adds to that list the definition of marketable contained in the former regulation, *i.e.*, a security that may be sold with reasonable promptness at a price that corresponds reasonably to its fair value. Thus, certain foreign sovereign debt and other securities may qualify under the revised definition of marketable. This approach also provides additional flexibility for the OCC to review the permissibility of national bank investment in particular securities on a case-by-case basis.

Several commenters also asked the OCC to remove the requirement that Securities Exchange Commission Rule 144A, 17 CFR 230.144A (Rule 144A) securities be rated investment grade in order to fall within the definition of "marketable." These commenters stated that many privately-placed securities are not rated. One commenter advocated that the OCC should not adopt the proposal, because Rule 144A provides no assurance of marketability.

The OCC agrees that a Rule 144A security need not be rated investment grade to be marketable; but, if it is not rated investment grade, it must be the credit equivalent of investment grade. The final rule therefore does not adopt the proposed requirement that an NRSRO rate a Rule 144A security investment grade in order for the security to be marketable. Instead, consistent with other investment securities under this part, a Rule 144A security may qualify as investment grade, when not rated, and therefore qualify as marketable, if the bank determines that it is the credit equivalent of an investment grade security. The OCC expects that, as a matter of safe and sound banking practices, a bank will conduct a thorough analysis of a security's creditworthiness in order to satisfy itself that a particular security is the credit equivalent of investment grade.

The OCC has also determined that proposed § 1.2(f)(2) is unnecessary. That provision listed as one component of the definition of marketability each of the securities that is included in the definition of a Type I security. Because Type I securities are not required to satisfy a marketability test under section 24(Seventh), it is unnecessary for the rule to include these Type I securities in the definition of marketable. Therefore, the final rule is adopted without proposed § 1.2(f)(2). The remainder of paragraph § 1.2(f) is renumbered accordingly.

NRSRO (§ 1.2(g))

The OCC did not use the term "NRSRO" in the proposal. In making changes to the final rule's definition of, and limitations on, Type IV securities, the OCC found that referring to nationally recognized statistical rating organizations (NRSROs) was the most direct and clear means of drafting the rule. The final rule, therefore, adds "NRSRO" as a defined term.

The OCC has not listed the rating organizations that qualify as NRSROs in this definition. The OCC generally follows the assessment of the SEC in acknowledging the organizations that are currently NRSROs. The SEC recognizes NRSROs through no-action letters. The most recent SEC no action letter in which the SEC expressed no opposition to the recognition of an NRSRO is Thomson Bankwatch, Inc., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) paragraph 79,800 (August 6, 1991). *See* also 59 FR 46314 (September 7, 1994) (publishing an SEC "Concept release" on NRSROs).[3]

Several commenters suggested that the OCC recognize foreign rating organizations. The OCC finds that most significant foreign debt securities are rated by the NRSROs to which the SEC has expressed no objection and, at this time, sees no need to depart from the SEC's assessment of the rating organizations that are nationally recognized.

Type I Security (§ 1.2(i))

The proposal used language similar to that in the former rule to define "Type I security" to mean any one of specified government securities. The former rule and the proposal also incorporated key elements of an OCC interpretation regarding securities backed by the full faith and credit of the U.S. Government.

The OCC received four comments on this definition. Three commenters recommended that, consistent with 12 U.S.C. 24(Seventh), the OCC should add qualified Canadian government obligations to the definition of a Type I security. The OCC received one comment recommending that the OCC add the debt securities of certain developed foreign sovereigns to the list of Type I securities.

In accordance with 12 U.S.C. 24(Seventh), the final rule adds qualified Canadian government obligations to the list of Type I securities. The OCC acknowledges that, in the future, other securities may fulfill the definitional requirements of a Type I security, and the OCC will review securities, as appropriate, to determine if they meet the statutory requirements.

Type II Security (§ 1.2(j))

The proposal redefined a "Type II security" to mean an investment security that is issued by certain state, international, or multilateral organizations or that is otherwise listed or described in 12 U.S.C. 24(Seventh). In contrast, the former rule defined a Type II security by identifying the investment limits that apply to it and by listing examples of qualifying types of issuers.

The OCC received no comments on this definition, which is adopted as proposed. The OCC notes that the definition of Type II security also includes other securities that the OCC deems eligible as Type II securities in accordance with 12 U.S.C. 24(Seventh). This provision gives the OCC flexibility, consistent with the authorizing statute, to review securities that may fulfill the definitional requirements of a Type II security but are not listed in the definition.

Type III Security (§ 1.2(k))

The former rule defined a Type III security as a security that a bank may purchase and sell for its own account, subject to the 10 percent limitation in 12 U.S.C. 24(Seventh). The proposal redefined a Type III security as an investment security that does not qualify as a Type I, II, IV, or V security. The proposal listed corporate bonds and municipal revenue bonds as examples of Type III securities.

The OCC requested comment on whether to reference specifically other examples of Type III securities in addition to corporate bonds and municipal revenue bonds. In particular, the OCC requested comment on whether to include as Type III securities foreign securities that are eligible for investment by foreign branches of U.S. banks.

The OCC received seven comments on the definition of a Type III security. The majority of these commenters recommended that the OCC include in the list of examples that qualify as Type III securities foreign securities that are eligible for investment by foreign branches of national banks and mortgage backed securities (MBSs) that do not qualify as Type IV or Type V securities. One commenter also recommended that the OCC permit national banks to underwrite and deal in municipal revenue bonds.

The OCC has determined that the proposed definition of a Type III security provides appropriate examples of the scope of qualifying Type III securities. While certain mortgage backed securities and foreign securities eligible for investment by foreign branches of national banks will qualify as investment securities and are, therefore, Type III securities, others may not. The OCC has not concluded that all foreign securities eligible for investment by foreign branches of national banks qualify as a Type III investment security. Nor does the OCC want to imply that banks are precluded from purchasing other classes of securities,

[3] Currently, the NRSROs recognized by the SEC are: Duff and Phelps, Inc.; Fitch Investors Service, Inc.; IBCA Limited (and its subsidiary, IBCA Inc.); Moody's Investors Services Incorporated; Standard and Poor's Corporation; and Thomson Bankwatch, Inc.

which may meet the definition of "investment security" but are not specifically listed as a Type III security. This may be the case if, for example, the OCC were to add further to the list of examples, thereby appearing to create an exhaustive list of Type III securities. The OCC does not intend to create an exclusive list of Type III securities.

Type IV Security (§ 1.2(l))

The proposal added a new category of securities, Type IV securities, which SMMEA and CDRI made eligible for purchase by national banks in unlimited amounts. In 1984, the SMMEA amended 12 U.S.C. 24(Seventh) to permit national banks to purchase residential and commercial mortgage-related securities offered and sold pursuant to section 4(5) of the Securities Act of 1933 Act (Securities Act), 15 U.S.C. 77d(5), or residential mortgage-related securities as defined in section 3(a)(41) of the Exchange Act, 15 U.S.C. 78c(a)(41). The final rule incorporates the SMMEA amendments.

CDRI defined a new type of small business-related security in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A), and added a class of commercial mortgage-related securities to section 3(a)(41) of the Exchange Act, 15 U.S.C. 78c(a)(41). CDRI's amendments to 12 U.S.C. 24(Seventh) removed limitations on purchases by national banks of certain small business-related and commercial mortgage-related securities. However, CDRI requires that certain residential and commercial mortgage-related securities must receive a rating from an NRSRO in one of the top *two* rating categories. Small business-related securities must receive a rating in one of the top *four* rating categories.

CDRI also authorized the OCC to prescribe regulations to ensure that acquisitions of statutorily defined residential and commercial mortgage-related securities and small business-related securities are conducted in a manner consistent with safe and sound banking practices. In its proposed definition of a Type IV security, the OCC sought to guard against undue concentration of risk that could arise were a bank to invest in a security backed by a small number of loans or if a small number of loans represents a large percentage of the assets in the pool. Therefore, the proposal required Type IV securities that are small business- or commercial mortgage-related securities to be fully secured by interests in a pool of homogeneous loans of numerous obligors.

To assure diversification, the proposal also provided that, for small business-related securities and commercial mortgage-related securities, the aggregate amount of collateral from loans of any one obligor could not exceed 5 percent of the total amount of the loans in the pool collateralizing the security (the "5 percent collateral concentration limit").

The OCC requested specific comment on whether to define the term "homogeneous loans" and whether the 5 percent collateral concentration limit was appropriate to assure adequate diversification of the collateral.

The OCC received 17 comments on the proposed definition of a Type IV security, particularly on the 5 percent collateral concentration limit and the homogeneity and numerous obligor requirements. Most commenters opposed the "homogenous," "numerous," and 5 percent collateral concentration restrictions, stating that they were impractical. Commenters opposing both the "homogeneous" and "numerous obligor" requirements asserted that those terms are vague and difficult to apply because they are not defined. In particular, the commenters asserted that the homogeneity requirement conflicts with the diversification objective of pooling commercial loans. These commenters stated that commercial loans, by their nature, are seldom homogeneous.

Most commenters also recommended that the OCC eliminate the 5 percent collateral concentration limit on loans of any one obligor in Type IV security loan pools. The commenters emphasized that the plain language of CDRI permits unlimited investment in commercial mortgage-related and small business-related securities. These commenters asserted that NRSROs consider concentration risk when they rate a particular security, thereby making the 5 percent collateral concentration limit unnecessary. They also asserted that the limit fails to consider compensating factors such as credit enhancements, stable cash flow, prime location of mortgage properties, construction quality of mortgaged property, and barriers to competition, which are all considered by rating agencies.

The commenters also cited the following reasons for their opposition to the 5 percent collateral concentration limit: (1) The 5 percent collateral concentration limit mistakenly focuses solely on the obligor, does not focus on the collateral for the security, and therefore fails to ensure diversification of collateral. A collateral pool that satisfies the 5 percent collateral concentration limit will not necessarily contain diverse collateral; however, a single borrower/obligor can produce a commercial mortgage-backed security pool that has diverse collateral. (2) The majority of commercial mortgage loans are nonrecourse to the borrower and, therefore, borrower diversity is less relevant than tenant creditworthiness. (3) The 5 percent collateral concentration limit will be unnecessarily burdensome and costly relative to any benefits it provides because it will require a transaction-by-transaction analysis and the production and maintenance of voluminous reports regarding the make-up of each commercial mortgage-related security pool.

Some commenters recommended raising the 5 percent collateral concentration limit to a 20 percent limit. One commenter recommended that the OCC use existing authority to assess a risk-based capital surcharge when holdings of a Type IV security exceed the aggregate amount of the appropriate percentage of capital and surplus.

The OCC agrees with many of the reasons cited by the commenters and has not adopted the homogeneity and 5 percent collateral concentration limit. In particular, the OCC believes that the statutory requirements for residential and commercial mortgage-related securities defined in 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), to have an NRSRO rating in one of the top two categories and for small business-related securities to receive a rating in one of the top four rating categories provide sufficient safeguards against investment risks. NRSRO ratings reduce the risk of investment posed to banks because of the NRSROs' resources and ability to analyze such factors as cash flow treatments, credit facilities, and collateral diversification. To ensure that banks do not purchase, in unlimited amounts, commercial and residential mortgage-related securities that are offered or sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that are predominantly speculative in nature, the final rule requires that these securities at least be investment grade.

In addition, the final *retains* the requirement that the securities be composed of interests in a pool of loans to "numerous" obligors. The OCC believes that this requirement reflects an essential diversified risk characteristic of a mortgage-related or small business-related security and does not unduly limit a national bank's ability to invest in these asset-backed securities.

Type V Security (§ 1.2(m))

The proposal created a new category of securities, Type V, that are *investment grade* securities composed of loans in which a bank may invest directly. This definition reflected the OCC's long-standing interpretations that, in addition to the investments described in 12 U.S.C. 24(Seventh), a national bank may hold securitized forms of assets in which it may invest directly.[4]

Under the proposal, the definition of a Type V security included the same limitations that were included in the definition of a Type IV security (*i.e.*, "homogeneous loans" from "numerous obligors" with the obligations of any one obligor composing no more than 5 percent of the pool). In order to assure the high quality of this type of asset-backed security, the proposal also required that a Type V security be rated investment grade.

The commenters recommended that the OCC eliminate these requirements, citing many of the same reasons stated in their comments on the definition of a Type IV security. For the same reasons discussed in relation to Type IV securities previously, the OCC agrees with the commenters. Thus, the final rule does not include the proposed "homogeneity" and 5 percent collateral concentration limits but does *retain* the requirement that the securities be composed of a pool of loans to "numerous" obligors.

In addition, in order to ensure safe and sound investment in these securities, the final rule requires a Type V security to be "marketable" as defined in § 1.2(f). The marketability requirement is in addition to the investment grade requirement for a Type V security and further ensures that national banks do not acquire asset-backed securities that have speculative characteristics.

Limitations on Dealing in, Underwriting, and Purchasing and Selling Securities (§ 1.3)

The proposal consolidated the part 1 provisions that limit dealing in, underwriting, purchasing, and selling different types of securities. The proposal limited "the aggregate par value of the obligations of any one obligor" of a Type II, III, or V security that a bank may hold to a specific percentage limit. For example, the proposal restricted the aggregate par value of the obligations of any one Type II obligor held by the bank to no more than 10 percent of the bank's capital and surplus. The proposal also imposed a 10 percent limit on Type III securities and a 15 percent limit on Type V securities.

The OCC requested specific comment on whether using the aggregate par value of obligations of any one obligor is an appropriate measure of value.

Four commenters recommended that the OCC replace "par value" with "market value," asserting that par value does not account for obligations acquired either at a discount or premium.

The OCC has determined, however, that par value is the practical and objective gauge by which to measure value in this context, and the final rule therefore uses par value.

Some commenters also recommended that the OCC permit banks to use a netting approach in calculating limitations by which a bank could reduce its ownership exposure (long position) in a security by taking a short position in that same security. The commenters suggested that the OCC authorize banks to net their long and short positions in a security because the investment limitations in part 1 apply not only to amounts held by a bank but also to obligations that a bank is "legally committed to purchase and sell." These commenters assert that banks should be able to exclude from their investment limit calculations any securities for which there is both a commitment by a bank to sell and by a third party to buy.

The OCC agrees that a netting of long and short position in a particular security may be appropriate for purposes of calculations under part 1, and the language of the final rule, noted above, will accommodate this approach. However, the OCC's responses on this issue are likely to be more detailed than is appropriate for a regulation, and will be based on the transaction at issue. Therefore, specific issues on this point will be addressed by the OCC on a case-by-case basis.

The final rule also makes several minor clarifying changes to § 1.3.

Type II and III Securities; Other Investment Securities Limitations (§ 1.3(d))

The proposal provided that a national bank may not hold Type II and Type III securities of any one obligor that have a combined aggregate par value exceeding 10 percent of the bank's capital and surplus. However, the proposal did not require aggregation with respect to industrial development bonds. Instead, the proposal applied the 10 percent limitation separately to each security issue of a single obligor when the proceeds of that issuance are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and the issuance is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases.

The OCC received no comments on this section, which is adopted as proposed.

Type IV Securities (§ 1.3(e))

The proposal provided that national banks could purchase, without limitation, securities that meet the definition of a Type IV security. This proposal relied on the authority granted to national banks by SMMEA and CDRI to purchase and sell certain mortgage- and small business-related securities in unlimited amounts.

The proposal also incorporated OCC interpretations concerning the authority of a national bank to deal in obligations that are fully secured by Type I securities.[5] These interpretations reflect the OCC's consistent approach of looking to the underlying substance of an instrument to determine whether a bank may deal in, underwrite, purchase, or sell the instrument. In the case of a Type IV security that is fully secured by Type I securities, the ultimate source of repayment is Type I securities. The proposal did not limit the categories of Type IV securities in which banks may deal, if the securities are fully collateralized by Type I securities. Thus, under the proposal, a bank's authority to deal in these securities would be determined with reference to the standards that apply to Type I securities. (The ability of a bank to

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[4] *Securities Industry Ass'n v. Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) (national bank authority to securitize assets); Interpretive Letter No. 540 (December 12, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (securitized credit card receivables); Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218 (securitized mortgages); Investment Securities Letter No. 29 (August 3, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,899 (investment limits for asset-backed securities consisting of GMAC receivables); Interpretive Letter No. 416 (February 16, 1988), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,640 (securitized automobile loans); No Objection Letter No. 87–9 (December 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitization of commercial loans originated by the bank); Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988–1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (mortgage-backed pass-through certificates); Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532 (bonds collateralized by mortgages).

[5] *See* Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990–1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218; Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985–1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532.

securitize and sell loans and other obligations it holds, including loans that qualify as collateral for Type IV securities, is addressed in § 1.3(g).)

Congress made clear that it intended the OCC and other bank regulatory agencies to have authority to limit or restrict bank purchases of securities in order to ensure the safety and soundness of insured depository institutions. See H.R. Conf. Rep. No. 652, 103rd Cong., 2nd Sess. sec. 347, at 184 (1994). The OCC believes that it can ensure safe and sound investments involving purchases of small business-related securities, as defined in section 3(a)(53)(A) of the Exchange Act, 15 U.S.C. 78c(a)(53)(A), if the OCC permits purchases in unlimited amounts only if the small business-related securities are rated in one of the top two rating categories by an NRSRO. In addition, however, the final rule permits a national bank to purchase small business-related securities that an NRSRO has rated in the top third or fourth rating category, provided the bank may not hold small business-related securities from a single issuer if the aggregate par value of the security exceeds 25 percent of the bank's capital and surplus. The OCC has imposed this 25 percent limit as a safety and soundness-based prudential limit.

Type V Securities (§ 1.3(f))

The proposal limited a national bank's holding of Type V securities from any one obligor (or certain related issuers) to 15 percent of the bank's capital and surplus. The OCC requested specific comment on whether a higher limit, such as 25 percent, would be sufficient to prevent excess concentration.

Four commenters questioned whether the OCC intended the term "obligor," in this context, to mean the underlying borrowers whose notes comprise a security. The OCC did not intend that result. The 15 percent limit applied to the entity that was issuer of the security, not to each obligor on the loans that back a particular security. The final rule clarifies this point by substituting the word "issuer" for "obligor."

One of these commenters noted that the OCC used the terms obligor and issuer interchangeably in other sections of the rule and recommended that the OCC clarify the terms. To address this concern, the text of the final rule has been revised to use the two terms in a more precise fashion and rephrase certain sections to enhance clarity.

Many commenters recommended that the OCC raise the capital limitation for Type V securities from 15 percent to 25 percent. These commenters asserted that Type V securities are analogous to secured loans and therefore should be eligible for the 25 percent limit of 12 U.S.C. 84.

The OCC has carefully considered these comments, and the final rule replaces the proposed 15 percent limitation with a 25 percent of capital limitation. The OCC believes the 25 percent of capital limit is a prudential limit that provides sufficient protection against undue risk concentrations. This limit parallels the 25 percent credit concentration benchmark in the Comptroller's Handbook for National Bank Examiners. The Handbook identifies credit concentrations in excess of 25 percent of a bank's capital as raising potential safety and soundness concerns. For this purpose, the Handbook guidance aggregates direct and indirect obligations of an obligor or issuer and also specifically contemplates application of the 25 percent benchmark to concentrations that may result from an acquisition of a volume of loans from a *single source*, regardless of the diversity of the individual borrowers. *See* Comptroller's Handbook § 215. Accordingly, national banks are urged to monitor carefully their aggregate credit exposure to any single obligor or issuer in order to avoid imprudent concentrations of credit.

This provision is otherwise adopted as proposed.

Securitization (§ 1.3(g))

The proposal added this section to incorporate the OCC's long-standing position that a national bank may securitize and sell loan assets that it holds. The ability of a bank to sell loans and other obligations through the issuance and sale of certificates evidencing interests in pools of the assets provides flexibility that can enhance bank safety and soundness.[6] The provision is adopted substantially as proposed and reflects the OCC's long-standing treatment of national banks' securitization activities as affirmed by case law.[7] National banks engaging in securitization activities should consult OCC Bulletin 96-52 (September 25, 1996), which provides guidelines for national banks on their securitization activities.

Investment Company Shares (§ 1.3(h))

The proposal incorporated OCC interpretations concerning the authority of a national bank to hold instruments representing indirect interests in assets in which the bank could invest directly.[8] Former part 1 did not address a national bank's investment in an investment company. The proposal permitted a national bank to purchase and sell for its own account shares of a

[6] *See, e.g.*, Remarks by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System before the American Bankers Association (October 8, 1994). *See also* Statement by Donald G. Coonley, Chief National Bank Examiner, OCC, *Asset Securitization and Secondary Markets: Hearings Before the Subcomm. on Policy, Research, and Insurance of the Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. 2-4 (1991), *reprinted in OCC Quarterly Journal* (December 1991); and Joint Statement by Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, and Donald H. Wilson, Financial Markets Officer, Federal Reserve Bank of Chicago, *Secondary Market for Commercial Real Estate Loans: Hearings Before the Subcomm. on Policy, Research, and Insurance of the Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 2d Sess. 16-19 (1992), *reprinted in* 78 *Fed. Res. Bull.* 492 (1992).

[7] *See, e.g.*, Interpretive Letter No. 585 (June 8, 1992), *reprinted in* [1992-1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,406 (securitized motor vehicle retail installment sales contracts purchased from automobile dealers); Interpretive Letter No. 540 (December 12, 1990), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,252 (securitized credit card receivables originated by bank or purchased from others); Interpretive Letter No. 514 (May 5, 1990), *reprinted in* [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,218 (securitized mortgages); Interpretive Letter No. 416 (February 16, 1988), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,640 (securitized automobile loans); Interpretive Letter No. 388 (June 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,612 (sale of mortgage-backed pass-through certificates); No Objection Letter No. 87-9 (December 16, 1987), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,038 (securitization of commercial loans originated by the bank); Interpretive Letter No. 362 (May 22, 1986), *reprinted in* [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,532 (sales of bonds collateralized by mortgages). Regarding sales of participations in pools of loans, *see* Letter from Billy C. Wood, Deputy Comptroller, Multinational Banking (May 29, 1981), *reprinted in* [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,275; Letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision (February 1, 1980), *reprinted in* [1981-82 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,213; Letter from John M. Miller, Deputy Chief Counsel (July 31, 1979), *reprinted in* [1978-79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,182; Letter from Paul M. Homan, Senior Deputy Comptroller for Bank Supervision (April 20, 1979), *reprinted in* [1978-79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,167; Letter from H. Joe Selby, Deputy Comptroller for Operations (October 17, 1978), *reprinted in* [1978-79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,144; Letter from John G. Heimann, Comptroller of the Currency (May 18, 1978), *reprinted in* [1978-79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,116; Letter from Charles B. Hall, Deputy Comptroller for Banking Operations (February 14, 1978), *reprinted in* [1978-79 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,100; Letter from Robert Bloom, Acting Comptroller of the Currency (March 30, 1977), *reprinted in* [1973-78 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 97,093. Regarding national bank authority to securitize assets, *see Security Pacific* v. *Clarke*, 885 F.2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990).

[8] Banking Circular 220 (November 21, 1986); An Examiner's Guide to Investment Products and Practices at 23 (December 1992).

registered investment company, subject to two requirements: First, the investment company's portfolio must be composed entirely of assets in which the bank could invest directly. Second, the amount of the bank's investment in shares of any one investment company is subject to the most stringent investment limitations applicable to the underlying securities and loans that compose that investment company's portfolio.

The proposal permitted banks to purchase shares in investment companies, including mutual funds, that are registered under section 8 of the Investment Company Act of 1940 ('40 Act), 15 U.S.C. 80a-8. *See* § 1.2(c) (defining "investment company"). The OCC requested comment on whether the OCC should permit banks to purchase shares of limited partnerships with fewer than 100 investors, *i.e.*, a partnership that would not qualify as an investment company within the meaning of section 3(c)(1) of the '40 Act, if the partnerships' portfolios consist solely of Type I securities that the bank may purchase and sell for its own account. The '40 Act's definition of "investment company" excludes issuers whose outstanding securities are beneficially owned by 100 or fewer persons and who are not making, or do not presently propose to make, a public offering of their securities.

Several commenters recommended that the OCC permit banks to purchase shares in entities with 100 or fewer investors, although these entities would not be subject to '40 Act regulation. The commenters asserted that so long as the pass-through entity allows a bank to invest solely in investments that the bank could purchase directly for its own account, the number of investors should not matter.

One commenter opposed expanding the proposed definition asserting that the '40 Act establishes a regulatory framework for investment companies that addresses the unique risks posed by pooled investment vehicles. The commenter asserted that to allow national banks to invest in entities not subject to the '40 Act, for their own accounts, could leave bank capital open to substantial risk.

The OCC agrees with this commenter that the absence of a regulatory scheme, such as the '40 Act, could pose additional risk for national banks. Therefore, the final rule adopts the definition of "investment company" as proposed in § 1.2(c). Further, the final rule does not expressly permit banks to purchase shares from entities with 100 or fewer investors that are exempt from '40 Act registration.

However, the OCC recognizes that there may be circumstances in which a bank's purchase of interests in a certain exempt investment fund would be acceptable. Therefore, the final rule provides that, on a case-by-case basis, the OCC may determine that interests in other entities, the portfolios of which consist exclusively of investments eligible for national banks to hold directly, also are permissible for national banks.

The final rule also relocates the provision that limited the amount of the bank's investment in shares of any one investment company to the most stringent investment limitations applicable to the underlying securities that compose that investment company's portfolio. The OCC has determined that, for clarity, this limitation belongs in § 1.4, which governs the calculation of limits. As discussed later, the final rule also changes this limitation.

Securities Held Based on Estimates of Obligor's Performance (§ 1.3(i))

The proposal retained the flexibility contained in the former rule that permitted a bank, notwithstanding the general definition of an investment security in § 1.2(e), to treat certain debt securities, (such as pools of mortgage or business loans in moderate and low-income areas or community development loans), as investment securities when the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to meet its obligations under that security.

The OCC requested comment on whether it should provide further clarification of the standards applicable to securities held based on estimates of obligor's performance and, if so, what clarification is needed.

The majority of the commenters on this section asserted that it would not be helpful for the OCC to provide further clarification of the standards applicable to securities held based on estimates of an obligor's performance. Therefore, the OCC adopts the final rule as proposed.

Calculation of Limits (§ 1.4)

The proposal added a section that consolidated the calculation of limits requirements of part 1.

Proposed paragraphs (a) and (b) § 1.4 prescribed the dates for calculating capital and surplus and stated the OCC's authority to require more frequent calculations. The proposal required a bank to calculate its investment limitations as of the most recent of: (1) The date on which the bank's Consolidated Report of Condition and Income (call report) is properly signed and submitted; (2) the date on which the bank's call report is required to be submitted; or (3) the date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

The OCC received no significant comments on these paragraphs. The final rule makes the following changes to the proposal to conform to the OCC's recently proposed changes to its lending limit regulation, 12 CFR part 32. *See* 61 FR 37227 (July 17, 1996). The final rule requires a bank to determine its investment limitations as of the most recent of: (1) The last day of the preceding calendar quarter; or (2) the date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

The final rule prescribes an effective date for a bank's investment limit. The final rule provides that an investment limit that is calculated as of the last day of the preceding calendar quarter becomes effective on the earlier of the date on which the bank's call report is submitted or the date on which the bank's call report is required to be submitted. An investment limit calculated as of the date on which there is a change in the bank's capital category becomes effective on that day.

The effective date requirements are added in a new paragraph § 1.4(b). The final rule moves proposed paragraph § 1.4(b), which stated the OCC's authority to require more frequent calculations, to § 1.4(c), to accommodate the insertion of new paragraph § 1.4(b) and otherwise adopts that paragraph § 1.4(c) as it was proposed.

Calculation of Type III and Type V Securities Holdings (§ 1.4(d))

Proposed § 1.4(c) limited a national bank's holdings of Type III investment securities of any one issuer/obligor (or certain related issuer/obligors) to 10 percent of the bank's capital and surplus. The proposal limited a national bank's holdings of Type V securities of any one issuer/obligor to 15 percent of the bank's capital and surplus. In calculating these capital limits, the proposal required a bank to combine: (1) Obligations of issuer/obligors that are related directly or indirectly through common control; and (2) securities of issuer/obligors that are credit-enhanced by the same entity.

The OCC requested comment on other bases upon which a bank should combine its holdings when calculating its investment in Type III or Type V securities of any one issuer/obligor. Specifically, the OCC asked whether a bank should combine obligations that are predominately collateralized by loans made by the same originator or by originators that are related directly or indirectly through common control. In addition, commenters were asked to address whether and under what circumstances an issuer or affiliate of the issuer would provide a guarantee or other form of credit enhancement for Type V securities that could be a source of credit exposure of the investing bank to the issuer or its affiliate. Comment was also invited on whether the 15 percent investment limitation or a lower limitation is appropriate under these circumstances.

Five commenters stated that the OCC should not require banks to combine obligations of issuer/obligors of Type V securities that are related through common control. These commenters asserted that the risk assessment for the securities is based on the creditworthiness of the underlying borrowers whose loans collateralize the issuance, and on the credit enhancement rather than on the creditworthiness of the Type V issuer/obligor. They stated that, if the parent company provides no guarantee, there is no common source of risk and that applying a limitation on common sources of credit enhancement is sufficient to safeguard against risk concentrations. Similarly, a few commenters also recommended that the OCC remove the requirement to aggregate holdings of entities under direct or indirect common control for Type III securities. They asserted that the requirement would be unduly burdensome for banks.

The OCC continues to believe that combining obligations of issuer/obligors that are related through common control represents a prudent supervisory response, given the effect of common control on underwriting standards and servicing effectiveness, and especially in light of other burden reducing changes the OCC has made to the final rule. Thus, the final rule retains the requirement that banks aggregate issuer/obligors of Type III and Type V securities, respectively, that are under common ownership or control.

The comments demonstrate that the proposal left unclear whether it required banks to aggregate Type III and Type V securities issued by the same issuer/obligor. The final rule adds a new provision to clarify that the aggregation requirement applies separately to Type III and Type V securities. The OCC emphasizes, however, that the Comptroller's Handbook for National Bank Examiners identifies credit concentrations in excess of 25 percent of a bank's capital as raising potential safety and soundness concerns. For this purpose, the Handbook guidance does aggregate direct and indirect obligations of an issuer/obligor. Thus, if a bank's aggregate holdings of Type III and Type V securities issued by the same issuer/obligor exceed 25 percent of the bank's capital, the bank, as a matter of safety and soundness, should have carefully considered whether, and be able to demonstrate why, the characteristics of the Type III and Type V securities it holds do not entail an undue concentration.[9]

As noted in the earlier discussion of § 1.3(f), the final rule changes the Type V limitation from 15 percent to 25 percent of capital and surplus. The final rule also changes proposed paragraph § 1.3(c) to paragraph § 1.3(d) to accommodate the insertion of new paragraph § 1.3(b).

Calculation of Investment Company Holdings (§ 1.4(e))

In § 1.4(d), the proposal required a bank to use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each investment company with the bank's direct holdings of securities of that issuer. In § 1.3(h), the proposal required the bank to apply the most stringent investment limit that would apply to the underlying securities in the investment company's portfolio.

For example, if the investment company holds a Type III security, the proposal limited the bank's holdings of shares of that investment company to 10 percent of the bank's capital and surplus. The proposal would thereby have codified Banking Circular 220 (BC 220) (Nov. 21, 1986), which authorizes national banks to purchase the shares of investment companies whose portfolios are comprised entirely of bank-eligible securities.

One commenter asserted that application of the most restrictive limit at the investment company level unnecessarily constrains a national bank's ability to buy investment company shares, especially when the company's portfolio contains only a proportionately small amount of securities subject to an investment limit. As the commenter noted, the treatment prescribed by the proposal would restrict the bank's purchase of the shares of the hypothetical mutual fund described above to 10 percent of capital and surplus even if the fund's portfolio was not evenly divided between Type I and Type III securities but contained 95 percent Type I and 5 percent Type III securities.

The commenter recommended that the OCC permit banks to use a "pass-through" analysis instead, that is, that the OCC permit banks to disregard the investment company level for purposes of applying the investment limits and allow banks to apply the applicable limit only to the pro rata portion of the underlying securities. This commenter also noted that allowing pass-through treatment is more consistent with the requirement in proposed § 1.4(d), by which banks must make "reasonable efforts" to aggregate their direct and indirect holdings of a security.

The final rule consolidates the two investment limit requirements set forth in §§ 1.3(h) and 1.4(d) into a single investment limit calculation provision, paragraph § 1.4(e). The final rule also modifies these provisions significantly in consideration of the comment received.

The OCC agrees that the OCC should give banks the flexibility to apply a pass-through analysis to determine the applicable investment limit if the bank aggregates its pro rata holdings of a security in an investment company with the bank's direct and other indirect holdings of that security. Therefore, the final rule permits banks to look through to the securities in the portfolio of an investment company and apply the appropriate limitation to the aggregate of the bank's pro rata interest in securities of a particular issuer that are held in an investment company's portfolio and the bank's direct holdings of the same securities.

The OCC recognizes that some institutions may prefer the method set forth in proposed § 1.3(h), which implemented BC 220 and required banks to apply the most stringent applicable investment limit to the bank's entire holdings of a particular investment company. Because calculating *pro rata* holdings of securities that the bank holds through an investment company may be burdensome for some institutions, the final rule gives a bank the option to apply the most stringent investment limit to the bank's entire holdings of a

[9] Similarly, a bank may acquire debt obligations of an issuer/obligor pursuant to the bank's authority to make loans, (provided appropriate underwriting standards are met) rather than under its authority to hold investment securities. *See* OCC Interpretive Letter No. 663, *reprinted in* [1994–1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,611 (June 8, 1995); OCC Interpretive Letter No. 600, *reprinted in* [1992–1993 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,427 (July 31, 1992); OCC Banking Circular 181 (Rev) (Purchase of loans in whole or in part-participations) (August 2, 1984). In such a case, the holding would be permissible under a separate authority of the bank, but the credit concentration standards described in the Comptroller's Handbook would still be applicable and could curtail the amount of the bank's holdings under the two different sources of authority.

particular investment company if the investment company is diversified. An investment company is diversified if its holdings of the securities of any one issuer do not exceed 5 percent of the investment company's total portfolio.

For institutions that choose to calculate an investment limit using the most stringent applicable limit, the final rule does not require a bank to aggregate the investment company's holdings of a security with the bank's direct holdings of the security. The OCC believes that the 5 percent diversification requirement applicable to diversified investment companies provides sufficient protection against risk concentrations when a bank elects to apply the most stringent investment limit to the bank's investment in the investment company.

Safe and Sound Banking Practices; Credit Information Required (§ 1.5)

The proposal changed the requirement that, in addition to the specific requirements of part 1, a bank must exercise "prudent banking judgment" to a requirement that a bank must adhere to "safe and sound banking practices," and identified certain risks that a bank should consider as part of safe and sound banking. The proposal also required each bank to obtain credit information that demonstrates the ability of issuer/obligors to satisfy their obligations and to maintain records that document the bank's compliance with this section.

The OCC received no comments on this section. The proposal required banks to consider market, interest rate, liquidity, legal, and operations and systems risks, as well as credit risk. The final rule conforms the list of risks identified by the proposal to the risks that are now specified in the OCC's risk-based supervision approach. The final rule requires banks to consider interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks. The final rule also makes minor stylistic changes to this section.

Convertible Securities (§ 1.6)

The proposal set forth the restrictions on investment in certain convertible securities. The proposal required a bank to write down the carrying value of a convertible security to an amount that represents the value of the security considered independently of the conversion feature or attached stock purchase warrant. The proposal also prohibited a bank from purchasing securities convertible into stock at the option of the issuer.

The OCC received no comments on this section. However, the OCC has determined that requiring a bank to write down the carrying value of a security independently of the conversion feature is not consistent with generally accepted accounting principles (GAAP). Therefore, the final rule eliminates this requirement. While the final rule does not specifically state that a bank must account for convertible securities in accordance with GAAP, it is the OCC's policy that if the OCC is silent on accounting treatment, the OCC requires banks to conform with GAAP.

The final rule adopts as proposed the provision prohibiting national banks from purchasing securities convertible into stock at the option of the issuer.

Securities Held in Satisfaction of Debts Previously Contracted; Holding Period; Disposal; Accounting Treatment; Non-Speculative Purpose (§ 1.7)

The proposal added new provisions to clarify how a bank must treat securities held in satisfaction of debts previously contracted (DPC). These provisions embodied standards prescribed in the OCC's regulation on other real estate owned (OREO), 12 CFR part 34, and the OCC's related interpretation, *see* Interpretive Letter No. 604 (October 8, 1992). The proposal provided that a national bank holding securities in satisfaction of DPC may do so for a period of five years from the date that ownership of the securities was originally transferred to the bank, plus, if permitted by the OCC, an additional five years. The proposal also required a bank to mark-to-market securities held in satisfaction of DPC.

The OCC received one comment on this section. The commenter suggested that the OCC should avoid specifying an accounting treatment in the rule. Instead, the commenter recommended that a reference be made to the call report instructions.

The OCC agrees that it is unnecessary to specify the accounting treatment for DPC securities in the regulation. Accordingly, the final rule removes the reference to mark-to-market accounting and simply says that banks should account for DPC securities consistent with GAAP. In addition, the OCC emphasizes that extensions of the five-year holding period for shares acquired DPC are not automatic. While the five year holding period, plus extensions up to an additional five years, is based on the OCC's OREO standards, the OCC expects that a bank should, in general, be able to dispose of DPC securities more quickly than real estate. Accordingly, the OCC will require a clearly convincing demonstration of why any additional holding period is needed for securities acquired DPC.

Nonconforming Investments (§ 1.8)

The proposal clarified that a bank does not violate an applicable investment limitation when an investment in securities that was legal when made becomes nonconforming as a result of certain enumerated events, if the bank exercises reasonable efforts to bring the investment into conformity with applicable limitations.

The OCC asked commenters to address whether: (1) the phrase "reasonable efforts" needs additional clarification; (2) the OCC should require a bank to make "reasonable efforts" to bring into conformity an investment where the quality of a security deteriorates so that the security is no longer an investment security; and (3) any other events should be added to the list of circumstances that may cause an investment in securities to become nonconforming.

Two commenters recommended that the OCC eliminate the requirement that a bank must make reasonable efforts to conform an asset to the appropriate investment limit. The commenters stated that the requirement should not apply because the factor that caused nonconformity is beyond the bank's ability to control. One commenter noted that the reasonable efforts language might require a bank to sell securities at an exaggerated loss. Similarly, two commenters asked the OCC to clarify that a bank will have a substantial period of time before it is required to sell a non-conforming investment if the sale would result in a loss to the bank.

The OCC does not intend "reasonable efforts" to mean that a bank should sell a nonconforming investment at an exaggerated or unnecessary loss. The OCC intends a bank to use sound banking judgment to determine when it would be inappropriate to sell or reduce its holdings of a nonconforming investment. In the final rule, the OCC adopts the requirement that a bank must use reasonable efforts to bring an investment into conformity with the understanding that "reasonable efforts" should not pose significant harm to the bank if a reasonable probability exists that a loss can be avoided in the foreseeable future. The final rule makes minor clarifying changes to this section.

Amortization of Premiums (Former § 1.10)

The proposal removed former § 1.10 because the OCC believes that GAAP appropriately governs the treatment of premiums. GAAP requires that a bank defer recognition of a premium paid for an investment security and amortize the premium over the period to maturity of the security. In contrast, former § 1.10 permitted a bank to charge off the entire premium at the time of purchase or to amortize the premium in any manner the bank considers appropriate as long as the premium is extinguished entirely at or before the maturity of the security.

The OCC received no comments on the removal of this section, which is therefore removed in the final rule.

Interpretations

Indirect General Obligations (§ 1.100)

The proposal clarified and shortened former § 1.120 and renumbered it § 1.100. The proposal removed former paragraphs (f) "Tax anticipation notes," and (g) "Bond anticipation notes" as unnecessary.

The OCC received no significant comments on this section, which is adopted as proposed.

Eligibility of Securities for Purchase, Dealing in, and Underwriting by National Banks; General Guidelines (Former § 1.100)

The proposal removed former § 1.100, which contained introductory and explanatory comments that the OCC believes are unnecessary in light of other proposed changes to part 1.

The OCC received no comments on the proposal's removal of this section.

Taxing Powers of a State or a Political Subdivision (§ 1.110)

The proposal shortened former § 1.130, removed portions that are no longer necessary, and renumbered it § 1.110. The proposal added new text to provide standards for determining when obligations that are expressly or implicitly dependent upon voter or legislative authorization of appropriations are considered supported by the full faith and credit of a State or political subdivision.

The OCC received no significant comments on this section, which is adopted as proposed.

Prerefunded or Escrowed Bonds and Obligations Secured by Type I Securities (§ 1.120)

The proposal made former § 1.120(e) proposed § 1.120. The OCC proposed no substantive changes to this provision.

The OCC received no comments on this section, which is adopted as proposed.

Type II Securities; Guidelines for Obligations Issued for University and Housing Purposes (§ 1.130)

The proposal streamlined former § 1.140, clarified the types of issuers whose obligations qualify as Type II securities, and renumbered the section § 1.130.

The OCC received no comments on this section, which is adopted as proposed.

Effective Date

The final rule takes effect on December 31, 1996. The OCC finds good cause for prescribing this year-end effective date in that it will enable national banks to adjust their practices to conform with the regulation at the beginning of a calendar quarter, which also marks the beginning of a reporting period for purposes of the Consolidated Report of Condition and Income (Call Report). 5 U.S.C. 553(d)(3).

DERIVATION TABLE

[Only substantive modifications, additions and changes are indicated]

Revised provision	Original provision	Comments
§ 1.1	§§ 1.1, 1.2	Modified.
§ 1.2(a)		Added.
§ 1.2(b)	§ 1.3(g)	Modified.
§ 1.2(c)	—	Added.
§ 1.2(d)	—	Added.
§ 1.2(e)	§ 1.3(b)	Modified.
§ 1.2(f)	§ 1.5(a)	Significant change.
§ 1.2(g)	—	Added.
§ 1.2(h)	§ 1.3(f)	
§ 1.2(i)	§§ 1.3(c), 1.110	Modified.
§ 1.2(j)	§ 1.3(d)	Modified.
§ 1.2(k)	§ 1.3(e)	Modified.
§ 1.2(l)	—	Added.
§ 1.2(m)	—	Added.
	§ 1.3(a)	Removed.
§ 1.3(a)	§ 1.4	Modified.
§ 1.3(b)	§§ 1.3(d), 1.6, 1.7(a)	Modified.
§ 1.3(c)	§§ 1.3(e), 1.7(a)	Modified.
§ 1.3(d)	§ 1.7(a), 12 CFR 7.1021	Modified.
§ 1.3(e)	—	Added.
§ 1.3(f)	—	Added.
§ 1.3(g)	—	Added.
§ 1.3(h)	—	Added.
§ 1.3(i)	§§ 1.5(b), 1.7(b)	Modified.
§ 1.4	—	Added.
§ 1.5	§ 1.8	Significant change.
§ 1.6	§ 1.9	Modified.
§ 1.7(a)	§ 1.11	
§ 1.7(b)	—	Added.
	§ 1.7(c)	Removed.
	§ 1.7(d)	Added.
§ 1.7(c)	—	Added.
§ 1.8	—	Added.
	§ 1.10	Removed.
	§ 1.100	Removed.
§ 1.100(a)	§ 1.120	

DERIVATION TABLE—Continued

[Only substantive modifications, additions and changes are indicated]

Revised provision	Original provision	Comments
§ 1.100(b)(1)	§ 1.120(a)	
§ 1.100(b)(2)	§ 1.120(b)	
§ 1.100(b)(3)	§ 1.120(c)	
§ 1.100(b)(4)	§ 1.120(d)	
§ 1.110	§ 1.130	Modified.
	§ 1.120(f)	Removed.
	§ 1.120(g)	Removed.
§ 1.120	§ 1.120(e)	
§ 1.130(a)	§ 1.140(a)	Modified.
§ 1.130(b)	§ 1.140(b)	
§ 1.130(c)	§ 1.140(c)	Modified.

Regulatory Flexibility Act

It is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This regulation will reduce the regulatory burden on national banks, regardless of size, by simplifying and clarifying existing regulatory requirements.

Paperwork Reduction Act of 1995

The OCC invites comments on:

(1) Whether the collections of information contained in this notice of final rule are necessary for the proper performance of OCC functions, including whether the information has practical utility;

(2) The accuracy of the estimate of the burden of the information collections;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected;

(4) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(5) Estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

Respondents/recordkeepers are not required to respond to these collections of information unless this displays a currently valid OMB control number.

The collection of information requirements contained in this final rule have been approved by the Office of Management and Budget under OMB control number 1557–0205 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Paperwork Reduction Project (1557–0205), Washington, DC 20503, with copies to the Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

The collection of information requirements in this final rule are found in 12 CFR 1.3 and 1.7. This information is required to enable the OCC to make determinations as to the safety and soundness of activities. The likely respondents/recordkeepers are national banks.

Estimated average annual burden hours per respondent/recordkeeper: 18.4 hours.

Estimated number of respondents and/or recordkeepers: 25.

Estimated total annual reporting and recordkeeping burden: 460 hours.

Start-up costs to respondents: None.

Executive Order 12866

The OCC has determined that this final rule is not a significant regulatory action.

Unfunded Mandates Act of 1995

Section 202 of the Unfunded Mandates Reform Act of 1995 (Unfunded Mandates Act) (signed into law on March 22, 1995) requires that an agency prepare a budgetary impact statement before promulgating a rule that includes a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more in any one year. If a budgetary impact statement is required, Section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. Because the OCC has determined that this final rule will not result in expenditures by State, local, and tribal governments or by the private sector of $100 million or more in any one year, the OCC has not prepared a budgetary impact statement or specifically addressed the regulatory alternatives considered. Nevertheless, as discussed in the preamble, the final rule has the effect of reducing burden and increasing the discretion of national banks regarding their sound investment activities.

List of Subjects

12 CFR Part 1

Banks, banking, National banks, Reporting and recordkeeping requirements, Securities.

12 CFR Part 7

Credit, Insurance, Investments, National banks, Reporting and recordkeeping requirements, Securities, Surety bonds.

Authority and Issuance

For the reasons set out in the preamble, chapter I of title 12 of the Code of Federal Regulations is amended as set forth below:

1. Part 1 is revised to read as follows:

PART 1—INVESTMENT SECURITIES

Sec.

1.1 Authority, purpose, and scope.
1.2 Definitions.
1.3 Limitations on dealing in, underwriting, and purchase and sale of securities.
1.4 Calculation of limits.
1.5 Safe and sound banking practices; credit information required.
1.6 Convertible securities.
1.7 Securities held in satisfaction of debts previously contracted; holding period; disposal; accounting treatment; non-speculative purpose.
1.8 Nonconforming investments.

Interpretations

1.100 Indirect general obligations.
1.110 Taxing powers of a State or political subdivision.
1.120 Prerefunded or escrowed bonds and obligations secured by Type I securities.
1.130 Type II securities; guidelines for obligations issued for university and housing purposes.

Authority: 12 U.S.C. 1 *et seq.*, 24 (Seventh), and 93a.

§ 1.1 Authority, purpose, and scope.

(a) *Authority*. This part is issued pursuant to 12 U.S.C. 1 *et seq.*, 12 U.S.C. 24 (Seventh), and 12 U.S.C. 93a.

(b) *Purpose* This part prescribes standards under which national banks may purchase, sell, deal in, underwrite, and hold securities, consistent with the authority contained in 12 U.S.C. 24 (Seventh) and safe and sound banking practices.

(c) *Scope*. The standards set forth in this part apply to national banks, District of Columbia banks, and federal branches of foreign banks. Further, pursuant to 12 U.S.C. 335, State banks that are members of the Federal Reserve System are subject to the same limitations and conditions that apply to national banks in connection with purchasing, selling, dealing in, and underwriting securities and stock. In addition to activities authorized under this part, foreign branches of national banks are authorized to conduct international activities and invest in securities pursuant to 12 CFR part 211.

§ 1.2 Definitions.

(a) *Capital and surplus* means:

(1) A bank's Tier 1 and Tier 2 capital calculated under the OCC's risk-based capital standards set forth in appendix A to 12 CFR part 3 (or comparable capital guidelines of the appropriate Federal banking agency) as reported in the bank's Consolidated Report of Condition and Income filed under 12 U.S.C. 161 (or under 12 U.S.C. 1817 in the case of a state member bank); plus

(2) The balance of a bank's allowance for loan and lease losses not included in the bank's Tier 2 capital, for purposes of the calculation of risk-based capital described in paragraph (a)(1) of this section, as reported in the bank's Consolidated Report of Condition and Income filed under 12 U.S.C. 161 (or under 12 U.S.C. 1817 in the case of a state member bank).

(b) *General obligation of a State or political subdivision* means:

(1) An obligation supported by the full faith and credit of an obligor possessing general powers of taxation, including property taxation; or

(2) An obligation payable from a special fund or by an obligor not possessing general powers of taxation, when an obligor possessing general powers of taxation, including property taxation, has unconditionally promised to make payments into the fund or otherwise provide funds to cover all required payments on the obligation.

(c) *Investment company* means an investment company, including a mutual fund, registered under section 8 of the Investment Company Act of 1940, 15 U.S.C. 80a–8.

(d) *Investment grade* means a security that is rated in one of the four highest rating categories by:

(1) Two or more NRSROs; or

(2) One NRSRO if the security has been rated by only one NRSRO.

(e) *Investment security* means a marketable debt obligation that is not predominantly speculative in nature. A security is not predominantly speculative in nature if it is rated investment grade. When a security is not rated, the security must be the credit equivalent of a security rated investment grade.

(f) *Marketable* means that the security:

(1) Is registered under the Securities Act of 1933, 15 U.S.C. 77a *et seq.*;

(2) Is a municipal revenue bond exempt from registration under the Securities Act of 1933, 15 U.S.C. 77c(a)(2);

(3) Is offered and sold pursuant to Securities and Exchange Commission Rule 144A, 17 CFR 230.144A, and rated investment grade or is the credit equivalent of investment grade; or

(4) Can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(g) *NRSRO* means a nationally recognized statistical rating organization.

(h) *Political subdivision* means a county, city, town, or other municipal corporation, a public authority, and generally any publicly-owned entity that is an instrumentality of a State or of a municipal corporation.

(i) *Type I security* means:

(1) Obligations of the United States;

(2) Obligations issued, insured, or guaranteed by a department or an agency of the United States Government, if the obligation, insurance, or guarantee commits the full faith and credit of the United States for the repayment of the obligation;

(3) Obligations issued by a department or agency of the United States, or an agency or political subdivision of a State of the United States, that represent an interest in a loan or a pool of loans made to third parties, if the full faith and credit of the United States has been validly pledged for the full and timely payment of interest on, and principal of, the loans in the event of non-payment by the third party obligor(s);

(4) General obligations of a State of the United States or any political subdivision;

(5) Obligations authorized under 12 U.S.C. 24 (Seventh) as permissible for a national bank to deal in, underwrite, purchase, and sell for the bank's own account, including qualified Canadian government obligations; and

(6) Other securities the OCC determines to be eligible as Type I securities under 12 U.S.C. 24 (Seventh).

(j) *Type II security* means an investment security that represents:

(1) Obligations issued by a State, or a political subdivision or agency of a State, for housing, university, or dormitory purposes;

(2) Obligations of international and multilateral development banks and organizations listed in 12 U.S.C. 24 (Seventh);

(3) Other obligations listed in 12 U.S.C. 24 (Seventh) as permissible for a bank to deal in, underwrite, purchase, and sell for the bank's own account, subject to a limitation per obligor of 10 percent of the bank's capital and surplus; and

(4) Other securities the OCC determines to be eligible as Type II securities under 12 U.S.C. 24 (Seventh).

(k) *Type III security* means an investment security that does not qualify as a Type I, II, IV, or V security, such as corporate bonds and municipal revenue bonds.

(l) *Type IV security* means:

(1) A small business-related security as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), that is rated investment grade or is the credit equivalent thereof, that is fully secured by interests in a pool of loans to numerous obligors.

(2) A commercial mortgage-related security that is offered or sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that is rated investment grade or is the credit equivalent thereof, or a commercial mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41), that is rated investment grade in one of the two highest investment grade rating categories, and that represents ownership of a promissory note or certificate of interest or participation that is directly secured by a first lien on one or more parcels of real estate upon which one or more commercial structures are located and that is fully secured by interests in a pool of loans to numerous obligors.

(3) A residential mortgage-related security that is offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 U.S.C. 77d(5), that is rated investment grade or is the credit equivalent thereof, or a residential mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(41)), that is rated investment

grade in one of the two highest investment grade rating categories, and that does not otherwise qualify as a Type I security.

(m) *Type V security* means a security that is:

(1) Rated investment grade;

(2) Marketable;

(3) Not a Type IV security; and

(4) Fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly.

§ 1.3 Limitations on dealing in, underwriting, and purchase and sale of securities.

(a) *Type I securities.* A national bank may deal in, underwrite, purchase, and sell Type I securities for its own account. The amount of Type I securities that the bank may deal in, underwrite, purchase, and sell is not limited to a specified percentage of the bank's capital and surplus.

(b) *Type II securities.* A national bank may deal in, underwrite, purchase, and sell Type II securities for its own account, provided the aggregate par value of Type II securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type II securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(c) *Type III securities.* A national bank may purchase and sell Type III securities for its own account, provided the aggregate par value of Type III securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type III securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(d) *Type II and III securities; other investment securities limitations.* A national bank may not hold Type II and III securities issued by any one obligor with an aggregate par value exceeding 10 percent of the bank's capital and surplus. However, if the proceeds of each issue are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and if each issue is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases, the bank may apply the 10 percent investment limitation separately to each issue of a single obligor.

(e) *Type IV securities*—(1) *General.* A national bank may purchase and sell Type IV securities for its own account. A national bank may deal in Type IV securities that are fully secured by Type I securities. Except as described in paragraph (e)(2) of this section, the amount of the Type IV securities that a bank may purchase and sell is not limited to a specified percentage of the bank's capital and surplus.

(2) *Limitation on small business-related securities rated in the third and fourth highest rating categories by an NRSRO.* A national bank may hold small business-related securities, as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(53)(A), of any one issuer with an aggregate par value not exceeding 25 percent of the bank's capital and surplus if those securities are rated investment grade in the third or fourth highest investment grade rating categories. In applying this limitation, a national bank shall take account of securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings. No percentage of capital and surplus limit applies to small business related securities rated investment grade in the highest two investment grade rating categories.

(f) *Type V securities.* A national bank may purchase and sell Type V securities for its own account provided that the aggregate par value of Type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type V securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

(g) *Securitization.* A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus.

(h) *Investment company shares*—(1) *General.* A national bank may purchase and sell for its own account investment company shares provided that:

(i) The portfolio of the investment company consists exclusively of assets that the national bank may purchase and sell for its own account under this part; and

(ii) The bank's holdings of investment company shares do not exceed the limitations in § 1.4(e).

(2) *Other issuers.* The OCC may determine that a national bank may invest in an entity that is exempt from registration as an investment company under section 3(c)(1) of the Investment Company Act of 1940, provided that the portfolio of the entity consists exclusively of assets that a national bank may purchase and sell for its own account under this part.

(i) *Securities held based on estimates of obligor's performance.* (1) Notwithstanding §§ 1.2(d) and (e), a national bank may treat a debt security as an investment security for purposes of this part if the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security, and the bank believes that the security may be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

(2) The aggregate par value of securities treated as investment securities under paragraph (i)(1) of this section may not exceed 5 percent of the bank's capital and surplus.

§ 1.4 Calculation of limits.

(a) *Calculation date.* For purposes of determining compliance with 12 U.S.C. 24 (Seventh) and this part, a bank shall determine its investment limitations as of the most recent of the following dates:

(1) The last day of the preceding calendar quarter; or

(2) The date on which there is a change in the bank's capital category for purposes of 12 U.S.C. 1831o and 12 CFR 6.3.

(b) *Effective date.* (1) A bank's investment limit calculated in accordance with paragraph (a)(1) of this section will be effective on the earlier of the following dates:

(i) The date on which the bank's Consolidated Report of Condition and Income (Call Report) is submitted; or

(ii) The date on which the bank's Consolidated Report of Condition and Income is required to be submitted.

(2) A bank's investment limit calculated in accordance with paragraph (a)(2) of this section will be effective on the date that the limit is to be calculated.

(c) *Authority of OCC to require more frequent calculations.* If the OCC determines for safety and soundness reasons that a bank should calculate its investment limits more frequently than required by paragraph (a) of this section, the OCC may provide written notice to the bank directing the bank to calculate its investment limitations at a more frequent interval. The bank shall thereafter calculate its investment limits at that interval until further notice.

(d) *Calculation of Type III and Type V securities holdings*—(1) *General.* In calculating the amount of its investment in Type III or Type V securities issued by any one obligor, a bank shall aggregate:

(i) Obligations issued by obligors that are related directly or indirectly through common control; and

(ii) Securities that are credit enhanced by the same entity.

(2) *Aggregation by type.* The aggregation requirement in paragraph (d)(1) of this section applies separately to the Type III and Type V securities held by a bank.

(e) *Limit on investment company holdings*—(1) *General.* In calculating the amount of its investment in investment company shares under this part, a bank shall use reasonable efforts to calculate and combine its pro rata share of a particular security in the portfolio of each investment company with the bank's direct holdings of that security. The bank's direct holdings of the particular security and the bank's pro rata interest in the same security in the investment company's portfolio may not, in the aggregate, exceed the investment limitation that would apply to that security.

(2) *Alternate limit for diversified investment companies.* A national bank may elect not to combine its pro rata interest in a particular security in an investment company with the bank's direct holdings of that security if:

(i) The investment company's holdings of the securities of any one issuer do not exceed 5 percent of its total portfolio; and

(ii) The bank's total holdings of the investment company's shares do not exceed the most stringent investment limitation that would apply to any of the securities in the company's portfolio if those securities were purchased directly by the bank.

§ 1.5 Safe and sound banking practices; credit information required.

(a) A national bank shall adhere to safe and sound banking practices and the specific requirements of this part in conducting the activities described in § 1.3. The bank shall consider, as appropriate, the interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks presented by a proposed activity, and the particular activities undertaken by the bank must be appropriate for that bank.

(b) In conducting these activities, the bank shall determine that there is adequate evidence that an obligor possesses resources sufficient to provide for all required payments on its obligations, or, in the case of securities deemed to be investment securities on the basis of reliable estimates of an obligor's performance, that the bank reasonably believes that the obligor will be able to satisfy the obligation.

(c) Each bank shall maintain records available for examination purposes adequate to demonstrate that it meets the requirements of this part. The bank may store the information in any manner that can be readily retrieved and reproduced in a readable form.

§ 1.6 Convertible securities.

A national bank may not purchase securities convertible into stock at the option of the issuer.

§ 1.7 Securities held in satisfaction of debts previously contracted; holding period; disposal; accounting treatment; non-speculative purpose.

(a) *Securities held in satisfaction of debts previously contracted.* The restrictions and limitations of this part, other than those set forth in paragraphs (b), (c), and (d) of this section, do not apply to securities acquired:

(1) Through foreclosure on collateral;

(2) In good faith by way of compromise of a doubtful claim; or

(3) To avoid loss in connection with a debt previously contracted.

(b) *Holding period.* A national bank holding securities pursuant to paragraph (a) of this section may do so for a period not to exceed five years from the date that ownership of the securities was originally transferred to the bank. The OCC may extend the holding period for up to an additional five years if a bank provides a clearly convincing demonstration as to why an additional holding period is needed.

(c) *Accounting treatment.* A bank shall account for securities held pursuant to paragraph (a) of this section in accordance with Generally Accepted Accounting Principles.

(d) *Non-speculative purpose.* A bank may not hold securities pursuant to paragraph (a) of this section for speculative purposes.

§ 1.8 Nonconforming investments.

(a) A national bank's investment in securities that no longer conform to this part but conformed when made will not be deemed in violation but instead will be treated as nonconforming if the reason why the investment no longer conforms to this part is because:

(1) The bank's capital declines;

(2) Issuers, obligors, or credit-enhancers merge;

(3) Issuers become related directly or indirectly through common control;

(4) The investment securities rules change;

(5) The security no longer qualifies as an investment security; or

(6) Other events identified by the OCC occur.

(b) A bank shall exercise reasonable efforts to bring an investment that is nonconforming as a result of events described in paragraph (a) of this section into conformity with this part unless to do so would be inconsistent with safe and sound banking practices.

Interpretations

§ 1.100 Indirect general obligations.

(a) *Obligation issued by an obligor not possessing general powers of taxation.* Pursuant to § 1.2(b), an obligation issued by an obligor not possessing general powers of taxation qualifies as a general obligation of a State or political subdivision for the purposes of 12 U.S.C. 24 (Seventh), if a party possessing general powers of taxation unconditionally promises to make sufficient funds available for all required payments in connection with the obligation.

(b) *Indirect commitment of full faith and credit.* The indirect commitment of the full faith and credit of a State or political subdivision (that possesses general powers of taxation) in support of an obligation may be demonstrated by any of the following methods, alone or in combination, when the State or political subdivision pledges its full faith and credit in support of the obligation.

(1) *Lease/rental agreement.* The lease agreement must be valid and binding on the State or the political subdivision, and the State or political subdivision must unconditionally promise to pay rentals that, together with any other available funds, are sufficient for the timely payment of interest on, and principal of, the obligation. These lease/rental agreement may, for instance, provide support for obligations financing the acquisition or operation of public projects in the areas of education, medical care, transportation, recreation, public buildings, and facilities.

(2) *Service/purchase agreement.* The agreement must be valid and binding on the State or the political subdivision, and the State or political subdivision must unconditionally promise in the agreement to make payments for services or resources provided through or by the issuer of the obligation. These payments, together with any other available funds, must be sufficient for the timely payment of interest on, and principal of, the obligation. An agreement to purchase municipal sewer, water, waste disposal, or electric services may, for instance, provide support for obligations financing the construction or acquisition of facilities supplying those services.

(3) *Refillable debt service reserve fund.* The reserve fund must at least equal the amount necessary to meet the annual payment of interest on, and principal of, the obligation as required by applicable law. The maintenance of a refillable reserve fund may be provided, for instance, by statutory direction for an appropriation, or by statutory automatic apportionment and payment from the State funds of amounts necessary to restore the fund to the required level.

(4) *Other grants or support.* A statutory provision or agreement must unconditionally commit the State or the political subdivision to provide funds which, together with other available funds, are sufficient for the timely payment of interest on, and principal of, the obligation. Those funds may, for instance, be supplied in the form of annual grants or may be advanced whenever the other available revenues are not sufficient for the payment of principal and interest.

§ 1.110 Taxing powers of a State or political subdivision.

(a) An obligation is considered supported by the full faith and credit of a State or political subdivision possessing general powers of taxation when the promise or other commitment of the State or the political subdivision will produce funds, which (together with any other funds available for the purpose) will be sufficient to provide for all required payments on the obligation. In order to evaluate whether a commitment of a State or political subdivision is likely to generate sufficient funds, a bank shall consider the impact of any possible limitations regarding the State's or political subdivision's taxing powers, as well as the availability of funds in view of the projected revenues and expenditures. Quantitative restrictions on the general powers of taxation of the State or political subdivision do not necessarily mean that an obligation is not supported by the full faith and credit of the State or political subdivision. In such case, the bank shall determine the eligibility of obligations by reviewing, on a case-by-case basis, whether tax revenues available under the limited taxing powers are sufficient for the full and timely payment of interest on, and principal of, the obligation. The bank shall use current and reasonable financial projections in calculating the availability of the revenues. An obligation expressly or implicitly dependent upon voter or legislative authorization of appropriations may be considered supported by the full faith and credit of a State or political subdivision if the bank determines, on the basis of past actions by the voters or legislative body in similar situations involving similar types of projects, that it is reasonably probable that the obligor will obtain all necessary appropriations.

(b) An obligation supported exclusively by excise taxes or license fees is not a general obligation for the purposes of 12 U.S.C. 24 (Seventh). Nevertheless, an obligation that is primarily payable from a fund consisting of excise taxes or other pledged revenues qualifies as a "general obligation," if, in the event of a deficiency of those revenues, the obligation is also supported by the general revenues of a State or a political subdivision possessing general powers of taxation.

§ 1.120 Prerefunded or escrowed bonds and obligations secured by Type I securities.

(a) An obligation qualifies as a Type I security if it is secured by an escrow fund consisting of obligations of the United States or general obligations of a State or a political subdivision, and the escrowed obligations produce interest earnings sufficient for the full and timely payment of interest on, and principal of, the obligation.

(b) If the interest earnings from the escrowed Type I securities alone are not sufficient to guarantee the full repayment of an obligation, a promise of a State or a political subdivision possessing general powers of taxation to maintain a reserve fund for the timely payment of interest on, and principal of, the obligation may further support a guarantee of the full repayment of an obligation.

(c) An obligation issued to refund an indirect general obligation may be supported in a number of ways that, in combination, are sufficient at all times to support the obligation with the full faith and credit of the United States or a State or a political subdivision possessing general powers of taxation. During the period following its issuance, the proceeds of the refunding obligation may be invested in U.S. obligations or municipal general obligations that will produce sufficient interest income for payment of principal and interest. Upon the retirement of the outstanding indirect general obligation bonds, the same indirect commitment, such as a lease agreement or a reserve fund, that supported the prior issue, may support the refunding obligation.

§ 1.130 Type II securities; guidelines for obligations issued for university and housing purposes.

(a) *Investment quality.* An obligation issued for housing, university, or dormitory purposes is a Type II security only if it:

(1) Qualifies as an investment security, as defined in § 1.2(e); and

(2) Is issued for the appropriate purpose and by a qualifying issuer.

(b) *Obligation issued for university purposes.* (1) An obligation issued by a State or political subdivision or agency of a State or political subdivision for the purpose of financing the construction or improvement of facilities at or used by a university or a degree-granting college-level institution, or financing loans for studies at such institutions, qualifies as a Type II security. Facilities financed in this manner may include student buildings, classrooms, university utility buildings, cafeterias, stadiums, and university parking lots.

(2) An obligation that finances the construction or improvement of facilities used by a hospital may be eligible as a Type II security, if the hospital is a department or a division of a university, or otherwise provides a nexus with university purposes, such as an affiliation agreement between the university and the hospital, faculty positions of the hospital staff, and training of medical students, interns, residents, and nurses (*e.g.*, a "teaching hospital").

(c) *Obligation issued for housing purposes.* An obligation issued for housing purposes may qualify as a Type II security if the security otherwise meets the criteria for a Type II security.

PART 7—INTERPRETIVE RULINGS

2. The authority citation for part 7 continues to read as follows:

Authority: 12 U.S.C. 1 *et seq.* and 93a.

§ 7.1021 [Removed]

3. Section 7.1021 is removed.

Dated: November 22, 1996.

Eugene A. Ludwig,

Comptroller of the Currency.

[FR Doc. 96-30779 Filed 11-29-96; 8:45 am]

BILLING CODE 4810-33-P

information on prudent management of securities lending arrangements.

Liquidity

In addition to considering the types of instruments used by each investment company and applicable investment limits, national bank portfolio managers shall consider the practical liquidity of holdings of investment company shares. Securities issued by investment companies are generally less marketable than many types of "investment securities", particularly U.S. government and federal agency securities. Indeed, certain investment company fee structures such as "deferred contingency" fees (declining rear-end load fees) may actually serve as an impediment to marketability. Shares in investment companies may not be acceptable on the same basis as U.S. government or federal agency obligations as collateral for pledge against uninsured public deposits or for other pledging purposes. Shares of closed-end funds may present particular liquidity problems because they may not be readily redeemable and they may not have a secondary market.

Regulatory Reporting and Accounting

Existing instructions for the quarterly Reports of Condition require bank holdings of investment company shares to be reported at the lower of the aggregate cost or market value in Schedule RC-B SECURITIES, Item No. 4(b)(3) (see the instructions for the Report of Condition, glossary entry for "marketable equity securities" and Statement of Financial Accounting Standards No. 12, Accounting for Certain Marketable Securities, ("FAS 12")). For reporting purposes market value of "open-end" investment companies should be based on net asset value rather than offering price; shares in "closed-end" investment companies should be marked to the bid price. In no case should the carrying value of investment company holdings be increased above their aggregate cost as a result of net unrealized gains. Net unrealized losses on marketable equity securities and subsequent recoveries of net unrealized losses should be excluded from Schedule RI-INCOME STATEMENT and instead be reported (reduced by applicable income tax effect) in Schedule RI-A CHANGES IN EQUITY CAPITAL as an adjustment to "Undivided Profits and Capital Reserves". A loss on an individual investment which is other than temporary should be charged to noninterest expense on Schedule RI-INCOME STATEMENT.

As part of the market value determination referred to above, mutual fund sales fees, both "front end load" and "deferred contingency", must be deducted in calculating market value to more accurately reflect the current value of fund shares. Consequently, unless the market value of such shares increases sufficiently to offset these fees, the amount of these fees will be reflected as unrealized losses and effectively charged against "Undivided Profits and Capital Reserves".

SUMMARY

In summary, the approval of this Office for the investment of bank portfolio funds in the shares of investment companies is conditioned as follows:

1. The investment company must be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and Securities Act of 1933 or be a privately offered fund sponsored by an affiliated commercial bank.

2. When an investment company's assets consist solely of and are limited to obligations that are eligible for unlimited investment by a national bank, there is no limit on the bank's investment. But where the investment company portfolio contains securities subject to the bank's investment or lending limitations, investment by the bank must be limited to 10% of capital and surplus.

3. When the investment company makes use of futures, forwards, options, repurchase agreements and securities lending arrangements, their use must be consistent with standards established for use of such instruments in a national bank's investment portfolio.

4. The shareholder has a proportionate undivided interest in the underlying assets of the investment company.

5. Shareholders are shielded from personal liability for acts or obligations of the investment company.

6. The bank's investment policy, as formally approved by its board of directors, specifically provides for such investments; prior approval of the board of directors is

obtained for initial investments in specific investment companies and recorded in the official board minutes; and procedures, standards, and controls for managing such investments are implemented prior to the investment being made.

7. The bank conducts reviews at least quarterly of its holdings of investment company shares to ensure that such investments are in accordance with the foregoing principles.

8. Regulatory reporting of holdings in investment companies is consistent with established standards for "marketable equity securities".

ORIGINATING OFFICE

Questions may be referred to the Investment Securities Division, (202) 447-1901.

Robert J. Herrmann

Robert J. Herrmann
Deputy Comptroller of the Currency

issued by the Board of Governors of the Federal Reserve System under 12 U.S.C. 24; sections 9, 11 and 21 of the Federal Reserve Act (12 U.S.C. 321–338a, 248(a), 248(c), and 481–486); sections 1814, 1816, 1818, 1823(j), 1831o, 1831p–1 and 1831r–1 of the FDI Act (12 U.S.C. 1814, 1816, 1818, 1823(j), 1831o, 1831p–1 and 1831r–1); and the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973, as amended (42 U.S.C. 4001–4129).

(b) *Purpose and scope.* This subpart B describes certain investment limitations on member banks, statutory requirements for amortizing losses on agricultural loans and extending credit in areas having special flood hazards, as well as the requirements for issuing letters of credit and acceptances.

§208.21 Investments in premises and securities.

(a) *Investment in bank premises.* No state member bank shall invest in bank premises, or in the stock, bonds, debentures, or other such obligations of any corporation holding the premises of such bank, or make loans to or upon the security of any such corporation unless:

(1) The bank notifies the appropriate Reserve Bank at least fifteen days prior to such investment and has not received notice that the investment is subject to further review by the end of the fifteen day notice period;

(2) The aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation that is an affiliate of the bank (as defined in section 2 of the Banking Act of 1933, as amended, 12 U.S.C. 221a), is less than or equal to the bank's perpetual preferred stock and related surplus plus common stock plus surplus, as those terms are defined in the FFIEC Consolidated Reports of Condition and Income; or

(3)(i) The aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any such corporation that is an affiliate of the bank, is less than or equal to 150 percent of the bank's perpetual preferred stock and related surplus plus common stock plus surplus, as those terms are defined in the FFIEC Consolidated Reports of Condition and Income; and

(ii) The bank:

(A) Has a CAMELS composite rating of 1 or 2 under the Uniform Interagency Bank Rating System[5] (or an equivalent rating under a comparable rating system) as of the most recent examination of the bank; and

(B) Is well capitalized and will continue to be well capitalized, in accordance with subpart D of this part, after the investment or loan.

(b) *Investments in securities.* Member banks are subject to the same limitations and conditions with respect to purchasing, selling, underwriting, and holding investment securities and stocks as are national banks under 12 U.S.C. 24, ¶7th. To determine whether an obligation qualifies as an investment security for the purposes of 12 U.S.C. 24, ¶7th, and to calculate the limits with respect to the purchase of such obligations, a state member bank may look to part 1 of the rules of the Comptroller of the Currency (12 CFR part 1) and interpretations thereunder. A state member bank may consult the Board for a determination with respect to the application of 12 U.S.C. 24, ¶7th, with respect to issues not addressed in 12 CFR part 1. The provisions of 12 CFR part 1 do not provide authority for a state member bank to purchase securities of a type or amount that the bank is not authorized to purchase under applicable state law.

§208.22 Community development and public welfare investments.

(a) *Definitions.* For purposes of this section:

(1) *Low- or moderate-income area* means:

(i) One or more census tracts in a Metropolitan Statistical Area where the median family income adjusted for family size in each census tract is less than 80 percent of the median family income adjusted for family size of the Metropolitan Statistical Area; or

(ii) If not in a Metropolitan Statistical Area, one or more census tracts

[5] *See* FRRS 3–1575 for an explanation of the Uniform Interagency Bank Rating System. (For availability, see 12 CFR 261.10(f).)

recent examination of the bank, and that are, and continue to be, well capitalized, to make investments in bank premises of less than or equal to 150 percent of the bank's perpetual preferred stock and related surplus plus common stock plus surplus without providing the Board with after-the-fact notice of such investments.

Investments in Securities. The proposal incorporated a new § 208.21(b) which provided guidance to banks regarding permissible investments in securities. For the reasons outlined below under the discussion of the Board's interpretation on Investments in Shares of an Investment Company, the Board is amending § 208.21(b) to clarify generally that, with respect to certain investment company shares and investment securities, a State member bank may look to the OCC's Part 1 rules and interpretations to determine whether a security qualifies as an investment security for the purpose of section 24, paragraph 7th, and for the calculations of the limitations applicable to such investments. Section 208.21(b) is also being amended to clarify that a State member bank should consult the Board for determinations with respect to issues concerning investment securities that have not been addressed by the OCC rules and interpretations.

Voting Stock in a Fiduciary Capacity. The proposed rule contained a footnote, footnote four, which several commenters stated would prevent banks from voting shares of stock in a fiduciary capacity. Footnote four was derived from, and was intended to update, a Board interpretation located at 12 CFR 250.220, which was to be removed. The Board is not including footnote four in the final rule and is retaining the Board interpretation found at 12 CFR 250.220 which states that banks may vote shares of stock if they are acting in a fiduciary capacity.

Subpart C—Bank Securities and Securities-Related Activities

Section 208.34 Recordkeeping and Confirmation of Certain Securities Transactions

Effected by State Member Banks. The final rule includes the text of existing § 208.24, as issued in final by the Board on March 5, 1997 (62 FR 9909), with an effective date of April 1, 1997. Existing § 208.24 remains unchanged except that it is being renumbered from § 208.24 to § 208.34.

Section 208.35 Qualification Requirements for the Recommendation or Sale of Certain Securities

The final rule includes a place holder for proposed new § 208.35. The Board is seeking public comment on proposed § 208.35 separately.

Section 208.37 Government Securities Sales Practices

The final rule includes the text of existing § 208.25, as issued in final by the Board on March 19, 1997 (62 FR 13275) with an effective date of July 1, 1997. Existing § 208.25 remains unchanged except that it is being renumbered from § 208.25 to § 208.37.

Subpart D—Prompt Corrective Action

The proposed rule did not significantly amend the terms of prior Subpart B other than to redesignate it as Subpart D and to amend § 208.41 to provide the Federal Reserve with the option of using period-end total assets rather than average total assets for purposes of defining *total assets.* The Board received two comments regarding Subpart D. The first commenter inquired as to whether other governmental agencies allow the option of using period-end total assets rather than average total assets for purposes of defining *total assets.* In this regard the Board notes that the OCC's definition of total assets, for purposes of its prompt corrective action rule, is the same as the Board's.[5]

The second commenter stated that § 208.43(c)(2) should be updated to reflect all applicable CAMELS components. The Board has added "sensitivity to market risk" as the final CAMELS component.

Subpart F—Miscellaneous Requirements

Section 208.61 Bank Security Procedures

Regulation P (12 CFR part 216), as amended by the Board on May 1, 1991, is being incorporated into Regulation H at § 208.61. A final rule removing 12 CFR part 216 is found elsewhere in today's Federal Register.

Section 208.64 Frequency of Examination

The final rule includes the text of existing § 208.26, as issued in final by the Board on April 2, 1998 (63 FR 16378), also effective on April 2, 1998). Existing § 208.26 remains unchanged except that it is being renumbered from § 208.26 to § 208.64.

[5] 12 CFR 6.2(j).

Subpart G—Interpretations

Proposed § 208.101 Investments in Federal Agricultural Mortgage Corporation (Farmer Mac) Stock

This proposed interpretation restated an existing staff opinion[6] regarding the permissibility of banks investing in the stock of the Federal Agricultural Mortgage Corporation (Farmer Mac), which is a government agency. One commenter stated that the Board should either provide a complete list of permissible investments in stocks of governmental agencies or provide no list.

In general, banks are prohibited from owning stock pursuant to paragraph seventh of section 5136 of the Revised Statutes (12 U.S.C. 24 ¶ 7th), which was made applicable to State member banks under paragraph 20 of § 9 of the Federal Reserve Act (12 U.S.C. 335). Although State member banks are generally prohibited from owning stock, the Board has, in the past, allowed banks to own the stock of certain governmental agencies where Congress has evidenced a clear intention that banks be allowed to hold such stock in order to achieve a legislative purpose. Since decisions regarding permissible stock investments in governmental agencies must be made on a case-by-case basis, the Board has decided not to include proposed § 208.101 in the final rule. However, the Board will retain the existing staff opinion regarding investments in Farmer Mac stock in the Federal Reserve Regulatory Service.

Proposed Section 208.102 Investments in Shares of an Investment Company

The Board proposed to retain its existing interpretation, entitled "Purchase of investment company stock by a State member bank," and rename it "Investments in Shares of an Investment Company," and renumber it from § 208.124 to § 208.102. In addition, the Board requested comment as to whether the existing interpretation should be amended to provide an alternative limit for certain diversified investment companies. Under the alternative limit, a bank could elect not to combine its pro rata interest in a particular security held by an investment company with the bank's direct holdings of the security where: (a) the investment company's holdings of the securities of any one issuer do not exceed 5 percent of its total portfolio; and (b) the bank's total holdings of the investment company's shares do not exceed the most stringent limit applicable to any of the securities in the

[6] F.R.R.S. 3–447.13 (July 26, 1988).

company's portfolio if those securities were purchased directly by the bank. This alternative limit is currently available to national banks under OCC rules.

Several commenters pointed to conflicts between the Board's interpretation and the provisions of the OCC's Part 1 concerning investment company shares and recommended that the Board withdraw its interpretation in order to avoid a conflict with the OCC rules. Alternatively, these commenters supported efforts to conform the Board's interpretation to the OCC's current provisions concerning investment companies, including adoption of the alternative limit and other conforming amendments.

In addition to differences concerning calculation of limits, the commenters pointed out that the Board's interpretation generally permits investment only in investment companies that are registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and the Securities Act of 1933, while the OCC rule provides for case-by-case consideration of investment companies that are exempt from registration where the portfolio of the investment companies consist entirely of assets that a national bank may purchase and sell for its own account. Commenters also pointed out that the OCC's rule requires only that the portfolio of the investment company consist exclusively of assets that a national bank could purchase directly. The Board's interpretation, on the other hand, requires that limits on the investment company's authority be included in the investment company's prospectus, which one commenter argued prevented State member banks from being able to "seed" start-up investment companies where funds were initially invested only in bank eligible securities. The Board's interpretation also differs from the OCC rule in other technical respects and includes requirements that relate to safety and soundness, rather than investment authority.

The Board believes that State member banks should be permitted to use the alternative method of calculating investment limits available under the OCC's rules for diversified investment companies. Additionally, although the circumstances under which a State member bank may provide funds to "seed" an investment company are limited, the Board believes that State member banks should be permitted to do so where the activity is consistent with the Glass-Steagall Act. The Board also notes that its interpretation was not intended to preclude the consideration on a case-by-case basis of investments not covered by its interpretation, including unregistered investment companies.

With respect to the provisions of the interpretation concerning internal procedures for approval and management of investments in investment companies, guidance issued by Board staff concerning risk management practices related to investment and end-user activities provides more thorough guidance concerning appropriate risk management practices than was available at the time the interpretation was adopted.[7] Further, internal procedures and practices discussed in current guidance cover the bank's investment activities generally and are not limited to a particular area. The Board therefore believes that the specific internal procedures required under the Board's interpretation are no longer necessary.

Based on the above considerations, the Board has concluded that its existing interpretation, § 208.124 (proposed § 208.102), no longer serves a useful purpose and is rescinding it. The Board is adding language to the § 208.21(b) on investments in securities to clarify generally that, with respect to certain investment company shares and investment securities, a State member bank may look to the OCC's Part 1 rules and interpretations to determine whether a security qualifies as an investment security for the purpose of section 24, paragraph 7th, and for the calculations of the limitations applicable to such investments. Regulation H also is being amended to clarify that a State member bank should consult the Board for determinations with respect to issues concerning investment securities that have not been addressed by the OCC rules and interpretations.

Section 208.101 Obligations Concerning Institutional Customers

The final rule includes the text of existing § 208.129, as issued in final by the Board on March 19, 1997 (62 FR 13275). Existing § 208.129 remains unchanged except that it is being renumbered from § 208.129 to § 208.101.

Investments in operating subsidiaries. Several commenters recommended that the Board rescind its 1968 interpretation concerning "operations subsidiaries," published at 12 CFR 250.141, noting that this interpretation was obsolete. The interpretation states that a State member bank may invest in the shares of a wholly owned "operations subsidiary" without violating the provisions of the Glass-Steagall Act concerning the purchase of stock by member banks. At the present time the Board is retaining the existing interpretation regarding "operations subsidiaries."

Miscellaneous. Financial Condition. The Board proposed eliminating existing § 208.17, entitled Disclosure of Financial Information by State member banks, from the proposed Regulation H on the basis that call report information for banks is now available through the internet. In response to this proposal the Board received three comments from Federal Reserve Banks which stated that it was premature to eliminate § 208.17 because a large segment of the public does not have access to the internet. The Board has decided to rescind § 208.17 despite these objections. The Board believes that § 208.17 places a burden on banks by requiring them to make available a potentially unlimited number of copies of statements regarding their financial condition to the public. This burden has been justified in the past because it was the only effective means for the public to obtain information concerning a bank's financial condition. However, now that many private institutions, as well as many public institutions, such as public libraries, offer access to the internet, where such financial information concerning banks can be obtained, the Board does not believe the burden on banks of providing such information continues to be justified, and therefore, is removing existing § 208.17 from the final rule.

Final Regulatory Flexibility Analysis

Two of the three requirements of a final regulatory flexibility analysis (5 U.S.C. 604), (1) a succinct statement of the need for and the objectives of the rule and (2) a summary of the issues raised by the public comments, the agency's assessment of the issues, and a statement of the changes made in the final rule in response to the comments, are discussed above. The third requirement of a final regulatory flexibility analysis is a description of significant alternatives to the rule that would minimize the rule's economic impact on small entities and reasons why the alternatives were rejected.

The final amendments will apply to all State member banks, which numbered approximately 997 as of February 1998, regardless of size, and represent changes to the existing rules that should reduce burden for those institutions by reducing regulatory filings, reducing the paperwork burden

[7] See SR 95-17 (SUP), March 28, 1995.

(n) *Residents of the state* includes individuals living in the State, individuals employed in the State, any person to whom the company provided insurance as principal without interruption since such person resided in or was employed in the State, and companies or partnerships incorporated in, organized under the laws of, licensed to do business in, or having an office in the State.

(o) *Security* has the same meaning as it has in part 344 of this chapter.

(p) *Significant risk to the deposit insurance fund* shall be understood to be present whenever the FDIC determines there is a high probability that any insurance fund administered by the FDIC may suffer a loss. Such risk may be present either when an activity contributes or may contribute to the decline in condition of a particular state-chartered depository institution or when a type of activity is found by the FDIC to contribute or potentially contribute to the deterioration of the overall condition of the banking system.

(q) *State-chartered depository institution* means any State bank or State savings association insured by the FDIC.

(r) *Subsidiary* means any company that is owned or controlled directly or indirectly by one or more insured depository institutions.

(s) *Tier one capital* has the same meaning as set forth in part 325 of this chapter for an insured State nonmember bank. For other state-chartered depository institutions, the term "tier one capital" has the same meaning as set forth in the capital regulations adopted by the appropriate Federal banking agency.

(t) *Well-capitalized* has the same meaning set forth in part 325 of this chapter for an insured State nonmember bank. For other state-chartered depository institutions, the term "well-capitalized" has the same meaning as set forth in the capital regulations adopted by the appropriate Federal banking agency.

[63 FR 66326, Dec. 1, 1998, as amended at 66 FR 1028, Jan. 5, 2001]

§ 362.3 Activities of insured State banks.

(a) *Equity investments.* (1) *Prohibited equity investments.* No insured State bank may directly or indirectly acquire or retain as principal any equity investment of a type that is not permissible for a national bank unless one of the exceptions in paragraph (a)(2) of this section applies.

(2) *Exceptions.* (i) *Equity investment in majority-owned subsidiaries.* An insured State bank may acquire or retain an equity investment in a subsidiary of which the bank is a majority owner, provided that the subsidiary is engaging in activities that are allowed pursuant to the provisions of or by application under § 362.4(b).

(ii) *Investments in qualified housing projects.* An insured State bank may invest as a limited partner in a partnership, or as a noncontrolling interest holder of a limited liability company, the sole purpose of which is to invest in the acquisition, rehabilitation, or new construction of a qualified housing project, provided that the bank's aggregate investment (including legally binding commitments) does not exceed, when made, 2 percent of total assets as of the date of the bank's most recent consolidated report of condition prior to making the investment. For the purposes of this paragraph (a)(2)(ii), *Aggregate investment* means the total book value of the bank's investment in the real estate calculated in accordance with the instructions for the preparation of the consolidated report of condition. *Qualified housing project* means residential real estate intended to primarily benefit lower income persons throughout the period of the bank's investment including any project that has received an award of low income housing tax credits under section 42 of the Internal Revenue Code (26 U.S.C. 42) (such as a reservation or allocation of credits) from a State or local housing credit agency. A residential real estate project that does not qualify for the tax credit under section 42 of the Internal Revenue Code will qualify under this exception if 50 percent or more of the housing units are to be occupied by lower income persons. A project will be considered residential despite the fact that some portion of the total square footage of the project is utilized for commercial purposes, provided that such commercial use is not the primary purpose of the project. *Lower income* has the same meaning as "low income" and "moderate income" as defined for the purposes of § 345.12(n) (1) and (2) of this chapter.

(iii) *Grandfathered investments in common or preferred stock; shares of investment companies.* (A) *General.* An insured State bank that is located in a State which as of September 30, 1991, authorized investment in:

(*1*)(*i*) Common or preferred stock listed on a national securities exchange (listed stock); or

(*ii*) Shares of an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 *et seq.*) (registered shares); and

(*2*) Which during the period beginning on September 30, 1990, and ending on November 26, 1991, made or maintained an investment in listed stock or registered shares, may retain whatever lawfully acquired listed stock or registered shares it held and may continue to acquire listed stock and/or registered shares, provided that the bank files a notice in accordance with section 24(f)(6) of the Federal Deposit Insurance Act in compliance with § 303.121 of this chapter and the FDIC processes the notice without objection under § 303.122 of this chapter. Approval will be granted only if the FDIC determines that acquiring or retaining the stock or shares does not pose a significant risk to the appropriate deposit insurance fund. Approval may be subject to whatever conditions or restrictions the FDIC determines are necessary or appropriate.

(B) *Loss of grandfather exception.* The exception for grandfathered investments under paragraph (a)(2)(iii)(A) of this section shall no longer apply if the bank converts its charter or the bank or its parent holding company undergoes a change in control. If any of these events occur, the bank may retain its existing investments unless directed by the FDIC or other applicable authority to divest the listed stock or registered shares.

(C) *Maximum permissible investment.* A bank's aggregate investment in listed stock and registered shares under paragraph (a)(2)(iii)(A) of this section shall in no event exceed, when made, 100 percent of the bank's tier one capital as measured on the bank's most recent consolidated report of condition (call report) prior to making any such investment. The lower of the bank's cost as determined in accordance with call report instructions or the market value of the listed stock and shares shall be used to determine compliance. The FDIC may determine when acting upon a notice filed in accordance with paragraph (a)(2)(iii)(A)(*2*) of this section that the permissible limit for any particular insured State bank is something less than 100 percent of tier one capital.

(iv) *Stock investment in insured depository institutions owned exclusively by other banks and savings associations.* An insured State bank may acquire or retain the stock of an insured depository institution if the insured depository institution engages only in activities permissible for national banks; the insured depository institution is subject to examination and regulation by a State bank supervisor; the voting stock is owned by 20 or more insured depository institutions, but no one institution owns more than 15 percent of the voting stock; and the insured depository institution's stock (other than directors' qualifying shares or shares held under or acquired through a plan established for the benefit of the officers and employees) is owned only by insured depository institutions.

(v) *Stock investment in insurance companies*—(A) *Stock of director and officer liability insurance company.* An insured State bank may acquire and retain up to 10 percent of the outstanding stock of a corporation that solely provides or reinsures directors', trustees', and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions.

(B) *Stock of savings bank life insurance company.* An insured State bank located in Massachusetts, New York, or Connecticut may own stock in a savings bank life insurance company, provided that the savings bank life insurance company provides written disclosures to purchasers or potential purchasers of life insurance policies, other insurance products, and annuities that are consistent with the disclosures described in the Interagency Statement on the Retail Sale of Nondeposit Investment Products (FIL–9–94,[1] February 17, 1994) or any successor requirement which indicates that the policies, products, and annuities are not FDIC insured deposits, are not guaranteed by the bank and are subject to investment risks, including possible loss of the principal amount invested.

(b) *Activities other than equity investments*—(1) *Prohibited activities.* An insured State bank may not directly or indirectly engage as principal in any activity, that is not an equity investment, and is of a type not permissible for a national bank unless one of the exceptions in paragraph (b)(2) of this section applies.

(2) *Exceptions*—(i) *Consent obtained through application.* An insured State bank that meets and continues to meet the applicable capital standards set by the appropriate Federal banking agency may conduct activities prohibited by paragraph (b)(1) of this section if the bank obtains the FDIC's prior written consent. Consent will be given only if the FDIC determines that the activity poses no significant risk to the affected deposit insurance fund. Applications for consent should be filed in accordance with § 303.121 of this chapter and will be processed under § 303.122(b) of this chapter. Approvals granted under § 303.122(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from risk, to prevent unsafe or unsound banking practices, and/or to ensure that the activity is consistent with the purposes of Federal deposit insurance and other applicable law.

(ii) *Insurance underwriting*—(A) *Savings bank life insurance.* An insured State bank that is located in Massachusetts, New York or Connecticut may provide as principal savings bank life insurance through a department of the bank, provided that the department meets the core standards of paragraph (c) of this section or submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter, and the department provides purchasers or potential purchasers of life insurance policies, other insurance products and annuities written disclosures that are consistent with the disclosures described in the Interagency Statement on the Retail Sale of Nondeposit Investment Products (FIL–9–94, February 17, 1994) and any successor requirement which indicates that the policies, products and annuities are not FDIC insured deposits, are not guaranteed by the bank, and are subject to investment risks, including the possible loss of the principal amount invested.

(B) *Federal crop insurance.* Any insured State bank that was providing insurance as principal on or before September 30, 1991, which was reinsured in whole or in part by the Federal Crop Insurance Corporation, may continue to do so.

(C) *Grandfathered insurance underwriting.* A well-capitalized insured State bank that on November 21, 1991, was lawfully providing insurance as principal through a department of the bank may continue to provide the same types of insurance as principal to the residents of the State or States in which the bank did so on such date provided that the bank's department meets the core standards of paragraph (c) of this section, or submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter.

(iii) *Acquiring and retaining adjustable rate and money market preferred stock.* (A) An insured State bank's investment of up to 15 percent of the bank's tier one capital in adjustable rate preferred stock or money market (auction rate) preferred stock does not represent a significant risk to the deposit insurance funds. An insured State bank may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate Federal banking agency. The fact that prior consent is not required by this

[1] Financial institution letters (FILs) are available in the FDIC Public Information Center, room 100, 801 17th Street, N.W., Washington, D.C. 20429.

subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(B) An insured State bank may acquire or retain other instruments of a type determined by the FDIC to have the character of debt securities and not to represent a significant risk to the deposit insurance funds. Such instruments shall be included in the 15 percent of tier one capital limit imposed in paragraph (b)(2)(iii)(A) of this section. An insured State bank may conduct this activity without first obtaining the FDIC's consent, provided that the bank meets and continues to meet the applicable capital standards as prescribed by the appropriate Federal banking agency. The fact that prior consent is not required by this subpart does not preclude the FDIC from taking any appropriate action with respect to the activities if the facts and circumstances warrant such action.

(c) *Core standards.* For any insured State bank to be eligible to conduct insurance activities listed in paragraph (b)(2)(ii)(A) or (C) of this section, the bank must conduct the activities in a department that meets the following core separation and operating standards:

(1) The department is physically distinct from the remainder of the bank;

(2) The department maintains separate accounting and other records;

(3) The department has assets, liabilities, obligations and expenses that are separate and distinct from those of the remainder of the bank;

(4) The department is subject to State statute that requires its obligations, liabilities and expenses be satisfied only with the assets of the department; and

(5) The department informs its customers that only the assets of the department may be used to satisfy the obligations of the department.

§ 362.4 Subsidiaries of insured State banks.

(a) *Prohibition.* A subsidiary of an insured State bank may not engage as principal in any activity that is not of a type permissible for a subsidiary of a national bank, unless it meets one of the exceptions in paragraph (b) of this section.

(b) *Exceptions*—(1) *Consent obtained through application.* A subsidiary of an insured State bank may conduct otherwise prohibited activities if the bank obtains the FDIC's prior written consent and the insured State bank meets and continues to meet the applicable capital standards set by the appropriate Federal banking agency. Consent will be given only if the FDIC determines that the activity poses no significant risk to the affected deposit insurance fund. Applications for consent should be filed in accordance with § 303.121 of this chapter and will be processed under § 303.122(b) of this chapter. Approvals granted under § 303.122(b) of this chapter may be made subject to any conditions or restrictions found by the FDIC to be necessary to protect the deposit insurance funds from risk, to prevent unsafe or unsound banking practices, and/or to ensure that the activity is consistent with the purposes of Federal deposit insurance and other applicable law.

(2) *Grandfathered insurance underwriting subsidiaries.* A subsidiary of an insured State bank may:

(i) Engage in grandfathered insurance underwriting if the insured State bank or its subsidiary on November 21, 1991, was lawfully providing insurance as principal. The subsidiary may continue to provide the same types of insurance as principal to the residents of the State or states in which the bank or subsidiary did so on such date provided that:

(A)(*1*) The bank meets the capital requirements of paragraph (e) of this section; and

(*2*) The subsidiary is an "eligible subsidiary" as described in paragraph (c)(2) of this section; or

(B) The bank submits an application in compliance with § 303.121 of this chapter and the FDIC grants its consent under the procedures in § 303.122(b) of this chapter.

(ii) Continue to provide as principal title insurance, provided the bank was required before June 1, 1991, to provide title insurance as a condition of the bank's initial chartering under State law and neither the bank nor its parent immediately convertible at the option of the holder without payment of substantial additional consideration into such security; any security carrying any warrant or right to subscribe to or purchase any such security; and any certificate of interest or participation in, temporary or interim certificate for, or receipt for any of the foregoing unless it is acquired through foreclosure or settlement in lieu of foreclosure. The definition is the same as that used in § 303.13(a) of the FDIC's regulations.

The FDIC received 15 comments addressing the issue of whether the regulation should exclude from the definition of equity security investment grade preferred stock and other preferred stock issues that are very debt like. The comments focused on two categories of preferred stock, money market preferred stock and adjustable rate preferred stock. Adjustable rate preferred stock refers to shares for which dividends are established contractually by a formula in relation to Treasury rates or other readily available interest rate levels. Money market preferred stock refers to those issues in which dividends are established through a periodic auction process that establishes yields in relation to short term rates paid on commercial paper issued by the same or a similar company. Dividends are not declared by the issuer's board and the credit quality of the issuer determines the value of the *53219 stock. Money market preferred shares are sold at auction rather than on a national securities exchange.

The FDIC agrees after reviewing the comments that money market (auction rate) preferred stock and adjustable preferred stock are essentially substitutes for money market investments such as commercial paper and are closer in their characteristics to debt than to equity. The final regulation therefore has been amended to specifically exclude money market preferred stock and adjustable preferred stock from the definition of equity investment. As a result, such investments are not subject to the provisions of § 362.3(a) of the final regulation. Investing in such instruments will be an "activity" for the purposes of section 24. Whether or not a state bank may continue to make such investments after December 19, 1992 will depend, among other things, on whether a national bank could make a similar investment.

The FDIC received one comment urging that the definition be amended so as to not encompass any debt security that carries with it a warrant to purchase equity. The FDIC has rejected this suggestion. If the warrant is for an equity security in which a national bank could not invest (and the equity security cannot be acquired pursuant to an exception under the regulation), the bank would be prohibited from exercising the warrant in any event.

8. Equity Investment Permissible for a National Bank

The proposed regulation defined the phrase "equity investment permissible for a national bank" to mean any equity investment expressly authorized for national banks under the National Bank Act or any other federal statute, regulations issued by the Office of the Comptroller of the Currency, or any order or formal interpretation issued by the Office of the Comptroller of the Currency.

The FDIC requested comment on the propriety of including equity investments

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authorized by an order or formal interpretation of the Office of the Comptroller of the Currency as "permissible" for the purposes of the proposal and further sought comment on what the FDIC should consider to constitute a formal interpretation if it is in fact deemed appropriate to recognize formal interpretations. Insured state banks were also advised that regardless of how the FDIC defines "permissible for a national bank", they should be prepared to document to the FDIC's satisfaction that their equity investments are permissible for a national bank.

The FDIC received forty-eight comments which indicated that the definition of permissible for a national bank as proposed was too narrowly drawn. It was suggested that in order to avoid creating a competitive disadvantage for state banks, the regulation should recognize all directives and staff opinions of the Office of the Comptroller of the Currency. In short, if a national bank can rely upon an issuance of the Office of the Comptroller of the Currency then a state bank should have the same advantage regardless of how informal the issuance may be.

In response to the comments, the final regulation modifies the proposed regulation and defines a permissible equity investment by reference to the underlying statutory authorities. It provides further that any equity investment expressly authorized by statute or recognized as permissible in official bulletins or circulars issued by the OCC or in any interpretation issued in writing by the OCC will be accepted as permissible for state banks under section 24. Written staff opinions will be considered to evidence the position of the Office of the Comptroller of the Currency so long as the opinion is considered to be valid by the Office of the Comptroller of the Currency. Thus, an opinion will not be recognized if it is not the current opinion of the Comptroller's Office, i.e., it is no longer considered valid, the opinion is overruled by the Office of the Comptroller of the Currency, or the opinion is found by a court of law to be incorrect. Even though staff opinions are not necessarily binding on the Comptroller of the Currency, the FDIC is satisfied that they embody the current opinion of the Office of Comptroller of the Currency and that to not recognize them would in fact unnecessarily put state banks at a disadvantage. State banks should note that the FDIC will generally expect any conditions or restrictions set out in the Comptroller of the Currency's regulations, bulletins, circulars, and staff opinions to be met if the equity investment is to be considered permissible under part 362 when made by a state bank.

In expanding the definition the FDIC also addressed the 63 comments which stated that the regulation should recognize Banking Circular 220 issued by the Comptroller of the Currency on November 21, 1986 relating to national bank investment in investment companies composed wholly of bank eligible investments. This Circular offers the opinion that it is permissible for a national bank to purchase for its own account shares of investment companies as long as the portfolios of such companies consist solely of obligations which are eligible for purchase by national banks for their own account. By recognizing this circular and similar bulletins or circulars, the FDIC is excluding from the coverage of this regulation such investments, i.e., any investments consistent with the Circular 220 would be considered an equity investment permissible for a national bank.

Sixteen comments expressed concern that state banks do not have access to the

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Office of the Comptroller of the Currency for interpretive opinions and that these banks cannot make a determination if an investment is allowed for a national bank. Several comments suggested the establishment of a procedure in which state banks would have direct access to the Office of the Comptroller of the Currency to obtain interpretive opinions. The FDIC does not have authority to establish such a procedure and the implementing statute does not require such a response from the Office of the Comptroller of the Currency. Information on what investments are permissible for national banks is publicly available in a variety of sources, including various banking law reporters, publications of the OCC Communications Division ("Interpretations and Actions" and the Quarterly Journal), and a database on LEXIS. Recognizing that investments in addition to those addressed to date in written interpretations of the OCC may be permissible for national banks, the FDIC and the OCC are working together to develop inter-agency procedures for resolving those questions as they arise. In addition, to address the many questions about permissible national bank powers that the FDIC has received since FDICIA was enacted, the FDIC is working in conjunction with the OCC to develop basic guidance to state banks on investments and powers of national banks. It is intended that a financial institution letter containing the guidance will be sent out to state banks.

9. Lower Income

One of the exceptions to the general prohibition on acquiring equity investments not permissible for a national bank allows insured state banks to become limited partners in partnerships that develop housing projects designed to primarily benefit "lower income" persons. The proposed regulation defined "lower income" to mean an income that is less than or *53220 equal to the median income (as determined by state or federal statistics) for the area in which the housing project is located. Under the proposed definition the "area" in which a housing project is located referred to the relevant Metropolitan Statistical Area (MSA) if the project is located within an MSA. If the project is not located in an MSA, the median income of the "area" referred to the median income of the state or territory as a whole exclusive of the designated MSA's.

The FDIC invited comment generally on the issue of what state or federal statistics the FDIC should recognize for the purposes of applying this definition; how the term "area" should be construed for the purposes of applying the definition; and what federal and state statistics are readily available to insured state banks. Two comments were received, both of which expressed concern relating to the definition of "area" in rural parts of a state. These comments felt that by using statewide statistics certain depressed rural areas may be overlooked. In response to these concerns the definition as adopted in the final regulations has been amended so that statistics for the state or territory (exclusive of designated MSA's in the state) would be used for a project not located in a MSA only when no statistics for a local area are available.

10. National Securities Exchange

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unions and mature no later than the maturity of the transaction; and

(4) The Federal credit union has executed a written loan and security agreement with the borrower.

(f)(1) *Trading securities.* A Federal credit union may trade securities, including engaging in when-issued trading and pair-off transactions, so long as the Federal credit union can show that it has sufficient resources, knowledge, systems, and procedures to handle the risks.

(2) A Federal credit union must record any security it purchases or sells for trading purposes at fair value on the trade date. The trade date is the date the Federal credit union commits, orally or in writing, to purchase or sell a security.

(3) At least monthly, the Federal credit union must give its board of directors or investment-related committee a written report listing all purchase and sale transactions of trading securities and the resulting gain or loss on an individual basis.

§ 703.14 Permissible investments.

(a) *Variable rate investment.* A Federal credit union may invest in a variable rate investment, as long as the index is tied to domestic interest rates and not, for example, to foreign currencies, foreign interest rates, or domestic or foreign commodity prices, equity prices, or inflation rates. For purposes of this part, the U.S. dollar-denominated London Interbank Offered Rate (LIBOR) is a domestic interest rate.

(b) *Corporate credit union shares or deposits.* A Federal credit union may purchase shares or deposits in a corporate credit union, except where the NCUA Board has notified it that the corporate credit union is not operating in compliance with part 704 of this chapter. A Federal credit union's aggregate amount of paid-in capital and membership capital, as defined in part 704 of this chapter, in one corporate credit union is limited to two percent of its assets measured at the time of investment or adjustment. A Federal credit union's aggregate amount of paid-in capital and membership capital in all corporate credit unions is limited to four percent of its assets measured at the time of investment or adjustment.

(c) *Registered investment company.* A Federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for Federal credit unions.

(d) *Collateralized mortgage obligation/real estate mortgage investment conduit.* A Federal credit union may invest in a fixed or variable rate collateralized mortgage obligation/real estate mortgage investment conduit.

(e) *Municipal security.* A Federal credit union may purchase and hold a municipal security, as defined in Section 107(7)(K) of the Act, only if a nationally-recognized statistical rating organization has rated it in one of the four highest rating categories.

(f) *Instruments issued by institutions described in Section 107(8) of the Act.* A Federal credit union may invest in the following instruments issued by an institution described in Section 107(8) of the Act:

(1) Yankee dollar deposits;

(2) Eurodollar deposits;

(3) Banker's acceptances;

(4) Deposit notes; and

(5) Bank notes with original weighted average maturities of less than 5 years.

(g) *European financial options contract.* A Federal credit union may purchase a European financial options contract or a series of European financial options contracts only to fund the payment of dividends on member share certificates where the dividend rate is tied to an equity index provided:

(1) The option and dividend rate are based on a domestic equity index;

(2) Proceeds from the options are used only to fund dividends on the equity-linked share certificates;

(3) Dividends on the share certificates are derived solely from the change in the domestic equity index over a specified period;

(4) The options' expiration dates are no later than the maturity date of the share certificate.

(5) The certificate may be redeemed prior to the maturity date only upon the member's death or termination of the corresponding option;

(6) The total costs associated with the purchase of the option is known by the Federal credit union prior to effecting the transaction;

(7) The options are purchased at the same time the certificate is issued to the member.

(8) The counterparty to the transaction is a domestic counterparty and has been approved by the Federal credit union's board of directors;

(9) The counterparty to the transaction:

(i) Has a long-term, senior, unsecured debt rating from a nationally-recognized statistical rating organization of AA− (or equivalent) or better at the time of the transaction, and the contract between the counterparty and the Federal credit union specifies that if the long-term, senior, unsecured debt rating declines below AA− (or equivalent) then the counterparty agrees to post collateral with an independent party in an amount fully securing the value of the option; or

(ii) Posts collateral with an independent party in an amount fully securing the value of the option if the counterparty does not have a long-term, senior unsecured debt rating from a nationally-recognized statistical rating organization.

(10) Any collateral posted by the counterparty is a permissible investment for Federal credit unions and is valued daily by an independent third party along with the value of the option;

(11) The aggregate amount of equity-linked member share certificates does not exceed the credit union's net worth;

(12) The terms of the share certificate include a guarantee that there can be no loss of principal to the member regardless of changes in the value of the option unless the certificate is redeemed prior to maturity; and

(13) The Federal credit union provides its board of directors with a monthly report detailing at a minimum:

(i) The dollar amount of outstanding equity-linked share certificates;

(ii) Their maturities; and

(iii) The fair value of the options as determined by an independent third party.

[68 FR 32960, June 3, 2003, as amended at 69 FR 39831, July 1, 2004]

§ 703.15 Prohibited investment activities.

Adjusted trading or short sales. A Federal credit union may not engage in adjusted trading or short sales.

§ 703.16 Prohibited investments.

(a) *Derivatives*. A Federal credit union may not purchase or sell financial derivatives, such as futures, options, interest rate swaps, or forward rate swaps. This prohibition does not apply to:

(1) Any derivatives permitted under §§ 701.21(i) and 703.14(g) of this chapter;

(2) Embedded options not required under GAAP to be accounted for separately from the host contract; and

(3) Interest rate lock commitments or forward sales commitments made in connection with a loan originated by the Federal credit union.

(b) *Zero coupon investments*. A Federal credit union may not purchase a zero coupon investment with a maturity date that is more than 10 years from the settlement date;

(c) *Mortgage servicing rights*. A Federal credit union may not purchase mortgage servicing rights as an investment but may perform mortgage servicing functions as a financial service for a member as long as the mortgage loan is owned by a member;

(d) A Federal credit union may not purchase a commercial mortgage related security that is not otherwise permitted by Section 107(7)(E) of the Act; and

(e) *Stripped mortgage backed securities (SMBS)*. A Federal credit union may not invest in SMBS or securities that represent interests in SMBS except as described in paragraphs (1) and (3) below.

(1) A Federal credit union may invest in and hold exchangeable collateralized mortgage obligations (exchangeable CMOs) representing beneficial ownership interests in one or more interest-only classes of a CMO (IO CMOs) or principal-only classes of a CMO (PO CMOs), but only if:

PUBLIC
JUL 8 1997

ACT
SECTION
RULE 3a-7
PUBLIC AVAILABILITY July 8, 1997

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 97-75
Federated Investors, Inc.
File No. 811-699

Your letter of July 7, 1997 requests our assurance that we would not recommend enforcement action to the Commission if an issuer that does not register under the Investment Company Act of 1940 ("Investment Company Act") in reliance on the exception from the definition of investment company provided by Rule 3a-7 under that Act, purchases and holds in its "pre-funded account" shares of money market funds in the manner described in your letter.

Facts

You state that a "pre-funded account" is an account, established by an issuer of asset-backed securities, that holds highly rated, liquid, short-term investments under the control of an indenture trustee pending the purchase by the issuer of additional receivables, the cash flow of which would fund the asset-backed securities (the "pre-funding period").[1] You state that pre-funded accounts, which are prevalent in transactions in which the issuer securitizes receivables that are created on a regular and predictable basis, such as automobile loans and credit card receivables, allow sponsors to lock in financing and take advantage of market opportunities without waiting for all of the underlying receivables to be created.

You explain that in a pre-funded transaction, the issuer raises more cash from the sale of asset-backed securities than is needed to pay for the receivables that it purchases from the sponsor on the date that the securities are issued (the "closing date"). You state that the excess cash is deposited in a pre-funded account, and that the ratio of the amount deposited compared with the total offering proceeds varies depending on the size of the offering, the amount of receivables available to be purchased by the issuer on the closing date, interest rate expectations, and market demand for the securities. You state that the assets in the pre-funded account are used to purchase additional receivables that are substantially similar to those receivables purchased by the issuer on the closing date,[2] and that the sponsor determines the frequency of

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[1]You state that, as a general matter, these investments are not actively managed.

[2]You state that, when rating an asset-backed transaction with a pre-funded component, the rating agency considers the nature of the receivables being securitized, the sponsor's ability to generate the receivables on a timely basis, the sponsor, and the criteria of the underlying documents regarding the additional receivables to be purchased by the issuer during the pre-funding period. In addition, the rating agency, along with the underwriter and credit support provider (if any), examines the receivables acquired during the pre-funding period to ensure that the characteristics of these receivables are substantially similar to the characteristics of the receivables transferred on the closing date.

these purchases.[3] Any assets remaining in the pre-funded account at the end of the pre-funding period will be paid to security holders as principal prepayments. You represent that pre-funded accounts generally are terminated no later than six months after the asset-backed securities are issued, although issuers that are structured as grantor trusts must terminate these accounts no later than 90 days after issuance in order to preserve their status as a trust for tax purposes.

You state that an indenture trustee selects appropriate investments for the pre-funded account from a list, previously approved by the rating agency rating the transaction, that is set forth in the issuer's governing documents.[4] You further state that assets in pre-funded accounts typically are invested in money market instruments such as commercial paper. You maintain that permitting pre-funded accounts to invest in shares of money market funds would enhance investor protection by enabling the account to hold (1) a more diversified pool of assets, and (2) assets that are highly liquid and under continuous professional management.

Analysis

Rule 3a-7 excepts from the definition of investment company any issuer "who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets and who does not issue redeemable securities (and in activities related or incidental thereto)," provided that certain conditions are met. Paragraph (b)(1) of the rule defines "eligible assets" as "financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders."[5] Money market fund shares held in a pre-funded account are not eligible assets because (1) money market fund shares are common stock and thus do not convert into cash within a finite time period, and (2) such shares are held in a pre-funded account pending the purchase of additional receivables and are not designed to assure the servicing or timely distribution of cash flow from the receivables to security holders.

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[3]You state that if interest rates decrease after the closing date, resulting in the origination of receivables with an interest rate lower than those receivables already purchased by the issuer, the sponsor would sell these receivables to the issuer at a discount and more receivables would be purchased by the issuer in order to support the interest rate on the asset-backed securities. However, if interest rates drop so dramatically that the sponsor is unable to provide sufficient receivables at the requisite interest rates, you state that security holders would be repaid their principal from the assets held in the pre-funded account.

[4]You state that the investments are selected in a manner designed to ensure that the investment return is both secure and sufficient to help fund the asset-backed securities' interest rate until additional receivables are purchased. You also state that typically in a pre-funded account, the sponsor will self-fund a capitalized interest account that would be used to help support the securities' interest rate, because the returns of the permitted investments by themselves are usually insufficient.

The adoption of the rule implemented the recommendation made in Chapter I, "The Treatment of Structured Finance Under the Investment Company Act," of the Division of Investment Management's 1992 report, Protecting Investors: A Half Century of Investment Company Regulation (the "Report").

An important new development in the structured finance market is "pre-funding". In a pre-funded transaction, the issuer raises more cash in the offering than is needed to purchase the receivables it intends to purchase immediately. The remaining cash is placed in a "pre-funded account" under the control of the indenture trustee and is invested in highly rated, liquid short term investments pending the subsequent purchase by the issuer of other receivables during a limited pre-funding period. The additional assets must be of the same character as the initial assets and meet specific eligibility requirements.

Pre-funding is especially prevalent in the case of issuers which hold assets which are created on a regular and predictable basis, such as automobile loans and credit card receivables. The following is a more comprehensive discussion of pre-funding.

1. The Mechanics of the Pre-funded Account.

The sponsor and/or depositor ("sponsor") or one of its affiliates determines the total dollar amount of certificates which are to be issued by the issuer and the amount of receivables to be transferred to the issuer based on several variable factors. Such factors include: (a) the availability, on the date the securities are issued (the "Closing Date"), of receivables satisfying the characteristics required by the rating agencies, the underwriters and the insurers (or other credit support providers); (b) interest rate expectations; and (c) market demand.

On the Closing Date the sponsor transfers the receivables to the issuer in exchange for the securities. The securities are then sold to an underwriter for cash or to the securityholders directly if the securities are sold through a placement agent. The cash received by the sponsor from the securityholders (or the underwriter) from the sale of the securities issued by the issuer in excess of the purchase price for the receivables constitutes the cash to be deposited in the pre-funded account. Such funds are accounted for separately and are not part of the assets of the sponsor.

Generally, the receivables are transferred at par value, unless the interest rate payable by the receivables is not sufficient to service both the interest rates to be paid on the securities and the transaction fees (i.e., servicing fees, trustee fees and fees to credit support providers). In such cases, the receivables are sold to the issuer at a discount, based on a formula agreed upon in advance by the parties. For example, if the securities issued by the issuer bear interest at ten percent (10%), and assuming no transaction fees, a $100 receivable that is paying eight percent (8%) would be sold to the issuer at $80 in order to achieve the required 10% pass-through rate. Alternatively, if there are a large number of such lower interest-paying receivables, the receivables could be sold to the issuer each at par ($100) and the securityholders would receive payments from one security representing $80 of principal paying 10% interest, and the extra $20 of principal would be offered by the issuer as a "principal only" strip security. The rating agencies do not generally require any particular formula for establishing the purchase price of the receivables, provided that the parties can demonstrate that the purchase price of the receivables can support the pass-through rate to be paid to the securityholders. The proceeds payable to the sponsor from the sale of the receivables transferred to the issuer may also be reduced to the extent they are used to pay transaction costs (which typically include underwriting or placement agent fees and legal and accounting fees). In addition, the sponsor may, in certain cases, be required by the rating agencies to set up trust reserve accounts to protect the securityholders against credit losses.

The pre-funded account is invested in certain permitted investments (as defined in the governing documents). The time period during which an issuer might invest pre-funded accounts in MMFs is usually restricted by economic and tax factors and by the underlying documents. As a practical matter, the rating agencies require that the pre-funding period end after no more than six months, and the underlying documents usually require that the pre-funded account end after six months.[1]

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[1] It is our understanding that most structured financings (other than credit card receivable transactions) which meet the terms of Rule 3a-7 have qualified as grantor trusts for purposes of federal taxation. Grantor trusts are trusts organized under state law which qualify for pass-through taxation pursuant to Internal Revenue Code Section 671. Under Internal Revenue Service regulations set forth at 26 C.F.R. 301.7701-4(c) and rulings issued thereunder, a trust generally cannot make new investments after 90 days have elapsed since the inception of the trust without losing its status as a trust for tax purposes and the accompanying exemption from tax at the entity level. Such an event would be catastrophic for an asset-backed trust. Therefore, the documentation for a grantor trust with a pre-funded account provides that the balance of the account must be either securitized or returned to the security holders on a pro rata basis within this 90-day period. Accordingly, the pre-funded account of a grantor trust exists for a maximum period of 90 days.

Structured financings backed by credit card receivables generally are also organized as trusts under state law but are not trusts for tax purposes. Due to the "revolving" rather than "term" nature of credit debt, individual credit card holders are constantly repaying and reborrowing. Since purchasers of asset-backed securities require a reasonably predictable amortization schedule, the issuer must be able to acquire additional receivables (which meet defined criteria) to minimize pre-payments of the asset-backed securities. This limited power to vary prevents grantor trust status. Such issuers generally qualify for pass-through taxation as partnerships under subchapter K of the Internal Revenue Code. For a general discussion of these issues, see Peaslee, "Investment Trusts in the Age of Financial Derivatives", Tax Law Review, Any issuer relying on Rule 3a-7 must be engaged solely in the business of purchasing, or otherwise acquiring, and holding eligible assets and in activities related or incidental thereto.[5] The "related or incidental" activities permitted by Rule 3a-7 include only those activities that support or further, and therefore are secondary to, the entity's business of purchasing, or otherwise acquiring, and holding eligible assets.[6]

You maintain that holding money market fund shares in a pre-funded account may be viewed as a secondary activity that supports the issuer's business of acquiring eligible assets (*i.e.*, the receivables), and thus such an activity meets the standard of "related or incidental thereto" for purposes of Rule 3a-7. You contend that any issuer that purchases and holds in its pre-funded account shares of money market funds may rely on Rule 3a-7 if the issuer obtains an opinion of counsel concluding that it may rely on Rule 3a-7 because the issuer is engaged solely in the business of acquiring and holding eligible assets.

Based on all the facts and representations contained in your letter, we agree that, under certain circumstances, holding assets in a pre-funded account could be viewed as a related or incidental activity for purposes of Rule 3a-7, provided that such an activity will support or further, and therefore be secondary to, the issuer's business of acquiring and holding eligible assets. In reaching this determination, factors to be considered include the length of the pre-funding period, the maturity date of the asset-backed securities issued, and the cash amount deposited in the pre-funded account compared with the total offering proceeds. This analysis would be the same regardless of whether the pre-funded account held money market fund shares or any other instrument that is not an eligible asset.[7] Because of the factual nature of this determination, the staff will not express an opinion with respect to whether a particular issuer that holds assets that are not eligible assets in a pre-funded account is engaged in a related or incidental activity for purposes of Rule 3a-7.

Rochelle Kauffman Plesset

Rochelle Kauffman Plesset
Senior Counsel

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[5] *See* Investment Company Act Release No. 19105 (Nov. 19, 1992) (adopting Rule 3a-7); Investment Company Act Release No. 18736 (May 29, 1992) (proposing Rule 3a-7).

[6] Citicorp Securities, Inc. (pub. avail. Aug. 4, 1995) (no-action relief granted to an issuer that obtained an opinion of counsel that concluded that the issuer may rely on Rule 3a-7 because (1) the issuer will be engaged solely in the business of acquiring and holding eligible assets, and (2) the issuer's holding of assets that are not eligible assets is an activity related or incidental to that business).

[7] Determining whether assets held in a pre-funded account would constitute a related or incidental activity is necessary only when the assets are not eligible assets. Issuers with pre-funded accounts that hold only eligible assets meet the literal terms of Rule 3a-7.

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July 7, 1997

Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Attention: Office of Chief Counsel

Federated Investors, Inc.
<u>1940 Act Section 3(a); Rule 3a-7</u>

Ladies and Gentlemen:

On behalf of Federated Investors, Inc., we are writing in regard to issuers of asset-backed securities which do not register under the Investment Company Act of 1940 (the "1940 Act") in reliance on Rule 3a-7 thereunder. We hereby request that the Staff of the Division of Investment Management (the "Staff") confirm that under Rule 3a-7 such issuers may purchase and hold for their "pre-funded accounts" shares of registered investment companies which qualify as "money market funds" ("MMFs") under Rule 2a-7 under the circumstances described more fully below.

PRE-FUNDED ACCOUNTS

The Commission adopted Rule 3a-7 in 1992 to exclude structured financings meeting the rule's conditions from the definition of "investment company" under Section 3(a) of the 1940 Act. See Release No. IC-19105, 52 SEC Docket 2573 (November 19, 1992) (the "Issuing Release").

During the pre-funding period, the sponsor determines how frequently the receivables are to be sold to the issuer for cash. Usually the transfers are made on a periodic basis as sufficient numbers of receivables become available to make it administratively convenient to transfer them. Any amounts paid out of the pre-funded account are used solely to purchase receivables and to support the pass-through rate (as explained above). However, in the event that, after all of the requisite receivables have been transferred to the issuer, any funds remain in the pre-funded account, such funds will be paid to the certificateholders as principal prepayments.

2. Percentage of Pre-Funding.

The percentage or ratio of the amount allocated to the pre-funded account, as compared to the total offering proceeds, of issuers has usually varied from 10% to 40%, with 25% typically used. The pre-funding percentage is a function of both the size of the offering desired and the assets which are available at the time of the offering. In addition, predictions as to the rise or fall of interest rates can affect the decision as to what ratio of pre-funding is to be utilized. An expectation of higher interest rates encourages the use of pre-funding because the parties will want to issue as many certificates as possible at the current rate, rather than issue higher rate certificates in the future. Also, a high market demand encourages pre-funding in order to effectuate the transactions. There is no optimal percentage. However, the advantages for the sponsor of pre-funding must be weighed against the cost to such sponsor of funding a capitalized interest account to subsidize the interest rate on the expected gap between the pass-through rate on the securities and the return on the receivables transferred to the issuer on the Closing Date. This is a cost factor for the sponsor because the permitted investments for funds in the pre-funded account and capitalized interest account produce a lower rate of return than interest accruing on the securities.

Spring, 1994, p. 419.

In recognition of the practical difficulties posed by the grantor trust and partnership formats, Congress established a new type of tax pass-through vehicle, a "Financial Asset Securitization Investment Trust," or FASIT in the Small Business Job Protection Act passed on August 2, 1996. If an issuer satisfies the structural and operational tests provided by new Internal Revenue Code section 860L, then the issuer is not subject to income taxation, and items of income, deduction, loss and tax credit flow through to the investors pursuant to new Internal Revenue Code section 860H. One of the operational tests in the definition of a FASIT is that the issuer must invest substantially all of its assets in "permitted assets" as of the close of the third month after the day of its formation and at all times thereafter. One of the types of asset included in the definition of permitted assets is "cash equivalents," which includes MMFs. Internal Revenue Code Section 860L(c)(1)(A). Therefore, in contrast to grantor trusts, there are no tax considerations which limit the time FASITs can maintain pre-funded accounts if the account is invested in cash equivalents.

3. Changes in Interest Rates During Pre-Funding Period.

A dramatic change in interest rates which adversely affected the rates of return on the receivables held by an issuer using a pre-funded account with a ninety-day pre-funded period would be handled as follows. If the receivables had already been originated prior to the closing date, no action would be required as the fluctuations in market interest rates would not affect the receivables transferred to the issuer after the closing date. In contrast, if interest rates fall after the closing date, receivables originated after the closing date will tend to be originated at lower rates, with the possible result that the receivables will not support the pass-through rate. In such situations, the sponsor would sell the receivables to the issuer at a discount (as described in Item (1) above) and more receivables will be used to fund the issuer in order to support the pass-through rate. In a situation where interest rates drop dramatically and the sponsor is unable to provide sufficient receivables at the requisite interest rates, the pool would be closed. In this latter event, under the terms of the pooling and servicing agreement, the securityholders would get a repayment of principal from the unused cash held in the pre-funded account. In transactions where the pass-through rates are variable or adjustable, the effects of market interest rate fluctuations are mitigated. In no event will fluctuations in interest rates payable on the receivables affect the pass-through rate paid to securityholders.

As described in Item 5 below, the rating agency, the underwriter and any insurer or other credit support provider each have requirements with respect to the characteristics of the receivables to be transferred after the closing date. In addition, such parties may require the establishment of yield supplement arrangements and capitalized interest accounts. Both of these control mechanisms directly or indirectly mitigate the effect of receivable interest rate fluctuations. However, it is the sponsor who is directly obligated under the pooling and servicing agreement to take whatever actions are necessary to maintain the pass-through rate in the event of interest rate fluctuations. The sponsor has the responsibility to transfer the appropriate receivables to the issuer to support the pass-through rate. The rating agencies, underwriters, insurers or other credit support providers, servicers or trustees are not concerned about how this is accomplished, as long as the end result is that the receivables held by the issuer are able to support such pass-through rate.

4. Maintenance of the Pre-funded and Capitalized Interest Accounts.

The pre-funded and capitalized interest accounts and all other cash accounts maintained by the issuer are either kept in separate sub-accounts or are invested on a commingled basis. Where the accounts are invested on a commingled basis, precise accounting records are kept by an independent, substantial, institutional trustee in order to assure that, at all times, the assets which belong to each account can be identified and that the investment income is properly credited. The pooling and servicing agreement sets forth each account to be established, states in very specific terms what cash is to go into each account, when moneys are to be paid out and when, and in what circumstances, moneys can be transferred from or to an account. The pooling and servicing agreement also specifies the permitted investments for the cash held in these accounts.

The sponsor must fund the capitalized interest account. Funds are paid out periodically to the securityholders as needed on distribution dates to support the pass-through rate. In addition, a portion of such funds may be returned to the sponsor from time to time as the receivables are transferred to the issuer and the need for the capitalized interest account diminishes. As the sponsor has the economic burden of maintaining this account, it will sometimes negotiate with the rating agencies to allow a return of funds to the sponsor as the receivables are purchased and the funds are no longer needed. In other cases, the rating agencies may insist on maintenance of the capitalized interest account until the end of the pre-funding period.

5. Characteristics of Receivables Transferred after the Closing Date.

We understand that investors place a particularly strong reliance on the rating agency review because of the complexities of structured finance offerings. In rating an offering with a pre-funded component, the rating agencies consider the nature of the receivables, the sponsor's ability to generate the receivables on a timely basis, the sponsor, and the criteria of the underlying documents regarding additional assets.

The characteristics of the receivables transferred to the issuer after the Closing Date are substantially similar to the characteristics of those transferred on the closing date and have such characteristics as are necessary to satisfy the requirements of the rating agency, the underwriter and the insurer or other credit support provider. All of these parties examine the receivables acquired during the pre-funding period to ascertain if their characteristics are in fact substantially similar to those acquired on the closing date (based on their own criteria which may be different from each other). The factors which may be considered include the following: the range of interest rates payable on the receivables and the weighted average interest rate of such receivables; the range of the remaining term to maturity of the receivables and the weighted average of such terms; a "seasoning factor" indicating how long the receivable has been outstanding (which indicates the payment history of the debtor); the loan-to-value ratios of the receivables compared to the loan collateral; a debt service coverage ratio indicating the size of the receivable as a percentage of the borrower's monthly expenses; the geographic dispersement and concentration of the receivables; the average balance outstanding; the type of collateral and the maximum and minimum rates of variable rate receivables. Not all of the above factors are necessarily relevant to every asset type.

The emphasis on specific factors varies from transaction to transaction and may vary significantly for different types of receivable pools. For example, in automobile transactions, the loan-to-value ratios are not considered to be that significant, but for mortgage transactions, the loan-to-value ratios generally are considered quite important.

Compliance with the requirements established by the rating agencies, insurers or other credit support providers and underwriters are monitored by such parties and the sponsor's accountants. For example, the rating agencies typically review a tape setting forth the specific characteristics of the receivables to be transferred for compliance with the required criteria, and actual loan files may be spot-checked against the tape, especially for new sponsors who do not have an established performance record. Non-conforming receivables are rejected.

6. Insurer and Credit Support Provider's Right to Veto Receivables.

In certain transactions, the insurer and/or other credit support provider may have the right to veto specific receivables. This right usually takes the form of a requirement that the sponsor obtain the consent of these parties before the receivables can be transferred to the issuer. The insurer and/or credit support provider may, therefore, reject certain receivables or require that the sponsor establish certain reserve accounts as a condition of including the receivables. Virtually all issuers which have insurers or other credit support providers are structured to give such veto rights to these parties. The percentage of issuers that have insurers and/or credit support providers, and accordingly feature such veto rights, varies but we believe that a majority of transactions have some kind of credit support.

7. Permitted Investments in the Pre-funded and Capitalized Interest Accounts.

The permitted types of investments in the pre-funded account and capitalized interest account are highly rated, conservative investments as set forth in the pooling and servicing agreement and as required by the rating agencies. The investments are selected in a manner designed to insure that the return is both secure and sufficient, when combined with the amount contributed to the capitalized interest account, to fund the pass-through rate. In the unlikely event that any of these conservative investments failed to pay interest and principal at maturity, the loss would be distributed pro-rata to the securityholders in the same manner as if one of the issuer's permanent investments failed.

Investment decisions for the pre-funded account are usually made by the indenture trustee. We understand from speaking to industry participants that indenture trustees do not normally actively manage the investments of the pre-funded account. Indenture trustees tend to invest the pre-funded account at the closing of the offering for the duration of the pre-funded period according to the anticipated dates for future transfers of receivables paid for out of the pre-funded account. Any amounts in the pre-funded account which are not used to purchase additional assets must be returned to the securityholders at the end of the pre-funding period. While the issuer is often over-collateralized in some manner to provide for some default on the assets it owns, the pre-funded account is not subject to a separate over-collateralization requirement.

8. Benefits of Pre-Funding.

Pre-funding has benefits to both sponsors and investors in that it reduces the high transaction costs of securitization by spreading them over a broader base. It benefits sponsors by allowing them to lock in funding and to take timely advantage of market opportunities. It benefits investors by allowing them to purchase fixed income investments they believe are attractive for their portfolio without waiting for all of the underlying assets to be created.

An investor must consider whether the sponsor can originate sufficient additional assets during the pre-funded period for the issuer to purchase. A failure to do so results in a prepayment to the security holders of the amounts remaining in the pre-funded account, with a probable decrease in the duration and yield of the securities. We understand that the standard practice is to disclose these risks in the prospectus.[2]

Sponsors seeking regular access to the structured finance market have strong incentives to make sure that amounts in the pre-funded account are successfully invested in additional assets. There would be serious negative long term market consequences to a sponsor if (i) cash in the pre-funded account was returned to securityholders or (ii) the issuer purchased additional assets which did not meet the expectations of securityholders, even if the assets complied with the terms of the governing documents. An issuer's ability to sell securities with a pre-funded component is dependent on the market's confidence that the issuer will successfully complete the pre-funding. To the extent that the market's confidence waned in a particular issuer's ability to successfully utilize pre-funded amounts, the pricing of the securities would reflect that concern.

Issuers regularly invest servicing accounts in MMFs but are reluctant to do so with pre-funded accounts due to regulatory uncertainty. As a result, pre-funded accounts are being invested directly in money market instruments such as commercial paper. We understand that the Staff has concerns about issuers exempt from the 1940 Act investing a sizeable percentage of their assets in registered investment companies for other than short-term cash management purposes, thereby avoiding registration under the 1940 Act even though the underlying

[2] For example, see Registration Statement No.333-07249, August 12, 1996 for The CIT RV Trust 1996-B in which the issuer sought to sell securities with a face value of $240,000,000. The initial assets had a value of approximately $164,000,000, with the balance of the remaining $76,000,000 to be held in a pre-funded account for a maximum of 90 days. The risk factors segment of the prospectus had an extensive discussion of the risk of pre-payment if (i) the sponsor did not generate sufficient assets which met the eligibility criteria of the issuer within the pre-funding period or (ii) if a rating agency, after receiving prior notice of the issuer's intention to purchase certain additional assets pursuant to the governing documents, advised the issuer of its intention to modify its rating of the issuer's outstanding securities.

investments may be similar to those of a registered investment company. However, we believe these investments are permitted under Rule 3a-7 and that the Staff could adequately address its concerns in a way other than a de-facto prohibition.

If MMF investments are permitted for the servicing account, they should logically be permitted for other short-term cash management purposes. The use of MMFs allows diversification, continuous professional management, enhanced liquidity and lower costs in an entity regulated by the Commission under the 1940 Act. Prohibiting such use results in credit concentrations, management only at the time the investment is made rather than the continuous professional management of a mutual fund, liquidity which is dependent solely on the market for the securities held by the issuer, and lower returns, while depriving investors of the safeguards of the 1940 Act. This raises issuance costs and diminishes investor protection. Moreover, pre-funded accounts may in many cases be invested in the commercial paper of a single issuer, or at best a few issuers, resulting in possibly unsound credit concentrations. It seems somewhat illogical to restrict the use of MMFs in circumstances for which they are the ideal short-term money management vehicle.

BASIS FOR THE NO-ACTION REQUEST

Rule 3a-7 excludes certain issuers engaged in the business of acquiring and holding "eligible assets" from the definition of "investment company" under the 1940 Act. In drafting the rule, the Commission was careful to include certain provisions to advance its goal of allowing the rule to accommodate developments in the markets. At the same time, these provisions were carefully crafted to allow the Commission the opportunity to consider such developments in light of the intent of the rule and to act accordingly. For example, in the Issuing Release, the Commission stated that:

> "Although the definition of eligible assets is intended to be broad, it is impossible to devise a definition of eligible assets that will include all types of assets that can be securitized. Accordingly, issuers, or other parties on their behalf, may request that the Division of Investment Management take a no-action position with respect to the holding of specified assets that do not meet the definition of "eligible assets," provided such assets meet the intent of the definition." 52 SEC Docket at 2576, fn. 17.

We are of the opinion that investment of the pre-funded account by an issuer in MMFs is permissible under Rule 3a-7 and respectfully request the Staff's written concurrence in the opinion set forth herein. We recognize that given the intent of the rule, the Staff's concurrence might be contingent on limitations as to the amount of the pre-funding and the length of the pre-funding period.

Rule 3a-7(a) is available to "any issuer who is engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets... (and in activities related or incidental thereto)." [underlining added]. The underlined language was not in the Proposing Release but was added by the Issuing Release to make sure that issuers were not subject to unduly narrow restrictions on the scope of their activities. The Issuing Release states that the purpose of this added language was to provide flexibility to issuers. In Citicorp Securities Inc., (SEC April 6, 1995) the Staff provided further guidance when it stated that "[I]t is the Division's view that the 'related or incidental activities' permitted by Rule 3a-7 include only those activities that support or further, and therefore are secondary to, the entity's business of purchasing, or otherwise acquiring, and holding eligible assets." In meeting this standard, the staff relied on the opinion of counsel to the issuer that (i) the issuer was engaged solely in the business of acquiring and holding eligible assets and (ii) the related activity was an activity related to or incidental to that business.

We are of the opinion that the investing of pre-funded accounts in MMFs during the pre-funded period is a secondary activity which supports an issuer's primary activity of acquiring and holding eligible assets and that such activity meets the standard of " related to or incidental thereto" set forth in Rule 3a-7. Whether or not a particular issuer is engaged solely in the business of acquiring and holding eligible assets should be covered by an opinion issued by counsel to a particular issuer.

Pursuant to Release No. 33-6269, seven additional copies of this letter are enclosed. Please do not hesitate to contact the undersigned or Stephen Burger of this office (212-732-3200) if you require any further information concerning the matter addressed in this letter.

Sincerely,

Bernard J. Karol

BJK:slf

cc: Eugene F. Maloney, Esq.

used to carry trades or positions of the same commodity and/or option customer other than in commodities or commodity options traded throught the facilities of a contract market.

[47 FR 57007, Dec. 22, 1982]

§1.23 Interest of futures commission merchant in segregated funds; additions and withdrawals.

The provision in section 4d(2) of the Act and the provision in §1.20(c), which prohibit the commingling of customer funds with the funds of a futures commission merchant, shall not be construed to prevent a futures commission merchant from having a residual financial interest in the customer funds, segregated as required by the Act and the rules in this part and set apart for the benefit of commodity or option customers; nor shall such provisions be construed to prevent a futures commission merchant from adding to such segregated customer funds such amount or amounts of money, from its own funds or unencumbered securities from its own inventory, of the type set forth in §1.25, as it may deem necessary to ensure any and all commodity or option customers' accounts from becoming undersegregated at any time. The books and records of a futures commission merchant shall at all times accurately reflect its interest in the segregated funds. A futures commission merchant may draw upon such segregated funds to its own order, to the extent of its actual interest therein, including the withdrawal of securities held in segregated safekeeping accounts held by a bank, trust company, contract market clearing organization or other futures commission merchant. Such withdrawal shall not result in the funds of one commodity and/or option customer being used to purchase, margin or carry the trades, contracts or commodity options, or extend the credit of any other commodity customer, option customer or other person.

[62 FR 42400, Aug. 7, 1997]

§1.24 Segregated funds; exclusions therefrom.

Money held in a segregated account by a futures commission merchant shall not include: (a) Money invested in obligations or stocks of any clearing organization or in memberships in or obligations of any contract market; or (b) money held by any clearing organization which it may use for any purpose other than to purchase, margin, guarantee, secure, transfer, adjust, or settle the contracts, trades, or commodity options of the commodity or option customers of such futures commission merchant.

[46 FR 54519, Nov. 3, 1981]

§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 clearing organization may invest customer funds 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) General obligations issued by any agency sponsored by the United States (government sponsored agency securities);

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

(vi) Corporate notes;

(vii) General obligations of a sovereign nation; and

(viii) 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 (viii) 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 meet the marketability requirement of 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.

(b) *General terms and conditions.* A futures commission merchant or a 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) *Marketability.* Except for interests in money market mutual funds, investments must be "readily marketable" as defined in § 240.15c3–1 of this title.

(2) *Ratings.* (i) *Initial requirement.* Instruments that are required to be rated by this section must be rated by an NRSRO. For an investment to qualify as a permitted investment, ratings are required as follows:

(A) U.S. government securities need not be rated;

(B) Municipal securities, government sponsored agency securities, certificates of deposit, commercial paper, and corporate notes, except notes that are asset-backed, must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO;

(C) Corporate notes that are asset-backed must have the highest ratings of an NRSRO;

(D) Sovereign debt must be rated in the highest category by at least one NRSRO; and

(E) Money market mutual funds that are rated by an NRSRO must be rated at the highest rating of the NRSRO.

(ii) *Effect of downgrade.* If an NRSRO lowers the rating of an instrument that was previously a permitted investment on the basis of that rating to below the minimum rating required under this section, the value of the instrument recognized for segregation purposes will be the lesser of:

(A) The current market value of the instrument; or

(B) The market value of the instrument on the business day preceding the downgrade, reduced by 20 percent of that value for each business day that has elapsed since the downgrade.

(3) *Restrictions on instrument features.* (i) With the exception of money market mutual funds, no permitted investment may contain an embedded derivative of any kind, including but not limited to a call option, put option, or collar, cap, or floor on interest paid.

(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)(3)(iv) of this section.

(iv) Variable-rate securities are permitted, provided the interest rates paid 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, or the one-month or three-month LIBOR rate.

(v) Certificates of deposit, if negotiable, must be able to be liquidated within one business day or, if not negotiable, 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.

(4) *Concentration.* (i) *Direct investments.* (A) U.S. government securities and money market mutual funds shall not be subject to a concentration limit or other limitation.

(B) Securities of any single issuer of government sponsored agency securities held by a futures commission merchant or clearing organization may not exceed 25 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(C) Securities of any single issuer of municipal securities, certificates of deposit, commercial paper, or corporate notes held by a futures commission merchant or clearing organization may not exceed 5 percent of total assets held in segregation by the futures commission merchant or clearing organization.

(D) Sovereign debt is subject to the following limits: a futures commission merchant may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its customers denominated in that country's currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances in segregated accounts owed to its clearing member futures commission merchants denominated in that country's currency.

(ii) *Repurchase agreements*. For purposes of determining compliance with the concentration limits set forth in this section, securities sold by a futures commission merchant or clearing organization subject to agreements to repurchase shall be combined with securities held by the futures commission merchant or clearing organization as direct investments.

(iii) *Reverse repurchase agreements*. The concentration limit applicable to securities of each issuer that are held by a futures commission merchant or clearing organization subject to agreements to resell to a particular counterparty shall be as follows:

(A) For a portfolio of securities held that are subject to resale to a counterparty that has been rated single A or higher by two or more NRSROs, or whose obligation under an agreement is guaranteed by a parent or affiliate company that has been rated single A or higher by two or more NRSROs:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 50 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty, may not exceed 10 percent of the total amount of securities supplied by such counterparty; and

(B) For a portfolio of securities held that are subject to resale to a counterparty that does not have a rating or guarantee as specified in paragraph (b)(4)(iii)(A) of this section:

(*1*) Government sponsored agency debt, issued by the same issuer and supplied by the counterparty, may not exceed 25 percent of the total amount of securities supplied by such counterparty; and

(*2*) Municipal securities, certificates of deposit, commercial paper, and corporate notes, issued by the same issuer and supplied by the counterparty, may not exceed 5 percent of the total amount of securities supplied by such counterparty.

(iv) *Treatment of securities issued by affiliates*. For purposes of determining compliance with the concentration limits set forth in this section, securities issued by entities that are affiliated, as defined in paragraph (b)(6) 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.

(v) *Treatment of customer-owned securities*. For purposes of determining compliance with the 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 clearing organization are not included in total assets held in segregation by the clearing organization.

(5) *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.

(6) *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 clearing organization shall not invest customer funds in obligations of an entity affiliated with the 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 clearing organization may invest customer funds in a fund affiliated with that futures commission merchant or clearing organization.

(7) *Recordkeeping.* A futures commission merchant and a 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) Generally, 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. A fund sponsor, however, may petition the Commission for an exemption from this requirement. The Commission may grant such an exemption provided that the fund can demonstrate that it will operate in a manner designed to preserve principal and to maintain liquidity. The application for exemption must describe how the fund's structure, operations and financial reporting are expected to differ from the requirements contained in §270.2a-7 of this title and the risk-limiting provisions for direct investments contained in this section. The fund must also specify the information that the fund would make available to the Commission on an ongoing basis.

(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, except for a fund exempted in accordance with paragraph (c)(1) of this section.

(3) A futures commission merchant or 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 FCM or clearing organization in accordance with §1.26(a). If the futures commission merchant or the clearing organization holds its shares of the fund with the fund's shareholder servicing agent, the sponsor of the fund and the fund itself are required to provide the acknowledgment letter required by §1.26.

(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 clearing organization by that time.

(5) A fund must be able to redeem an interest by the business day following a redemption request by the futures commission merchant or clearing organization. Demonstration that this requirement has been met may include

either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and a futures commission merchant or clearing organization.

(6) The agreement pursuant to which the futures commission merchant or 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.

(d) *Repurchase and reverse repurchase agreements.* A futures commission merchant or clearing organization may buy and sell the permitted investments listed in paragraphs (a)(1)(i) through (viii) 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) 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) The transaction is executed in compliance with the concentration limit requirements applicable to the securities held in connection with the agreements to repurchase referred to in paragraphs (b)(4)(ii) and (iii) of this section.

(4) 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 (d)(12) of this section and which states that the parties thereto intend the transaction to be treated as a purchase and sale of securities.

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

(6) The securities transferred under the agreement are held in a safekeeping account with a bank as referred to in paragraph (d)(2) of this section, a clearing organization, or the Depository Trust Company in an account that complies with the requirements of §1.26.

(7) The futures commission merchant or the 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 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.

(8) The transfer of securities is made on a delivery versus payment basis in immediately available funds. 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 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 clearing organization's customer segregated custodial account is made simultaneously with the disbursement of funds from the futures commission merchant's or clearing organization's customer segregated cash account at the custodian bank. On the sale or resale of securities, the futures commission merchant's or 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.

(9) A written confirmation to the futures commission merchant or 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 clearing organization is issued once the transaction is reversed.

(10) 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.

(11) An actual transfer of securities 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."

(12) The agreement makes clear that, in the event of the bankruptcy of the futures commission merchant or 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 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, 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.

[65 FR 78010, Dec. 13, 2000, as amended at 65 FR 82271, Dec. 28, 2000; 69 FR 6145, Feb. 10, 2004]

§ 1.26 Deposit of instruments purchased with customer funds.

(a) Each futures commission merchant who invests customer funds in instruments described in § 1.25 shall separately account for such instruments and segregate such instruments as belonging to such commodity or option customers. Such instruments, when deposited with a bank, trust company, clearing organization or another futures commission merchant, shall be deposited under an account name which clearly shows that they belong to commodity or option customers and are segregated as required by the Act and this part. Each futures commission merchant upon opening such an account shall obtain and retain in its files an acknowledgment from such bank, trust company, clearing organization or other futures commission merchant that it was informed that the instruments belong to commodity or option customers and are being held in accordance with the provisions of the Act and this part. *Provided, however,* that an acknowledgment need not be obtained from a clearing organization that has adopted and submitted to the Commission rules that provide for the segregation as customer funds, in accordance with all relevant provisions of the Act and the rules and orders promulgated thereunder, of all funds held on behalf of customers and all instruments purchased with customer funds. Such acknowledgment shall be retained in accordance with § 1.31. Such bank, trust company, clearing organization or other futures commission proposal,[1] others took comfort in it.[2] Despite this "don't ask, don't tell" approach, DTFs all will be "recognized" by the Commission as regulated markets.[3] In turn, these DTF markets will hold themselves out to the public as markets regulated by the CFTC.

The Commission and certain commenters within the industry find the possible mix of futures and non-futures products on DTFs acceptable. They rely on Congressional report language from the 1992 legislation that, in effect, allows the Commission to exempt transactions without first determining that they are in the agency's jurisdiction.[4]

In the context of bilateral, privately negotiated transactions—such as those swaps the Commission was directed by Congress to "promptly exempt—such an exemption makes a certain amount of sense. The consequence of any performance failure or fraud is borne solely by the parties to the transaction.

However, today the Commission extends this rationale to entities that are, in fact, exchange markets. Global participants and international regulators rely on our representations that these markets are regulated. I will not be comfortable making such representations with regard to DTFs where the Commission's jurisdiction is so questionable.

As a secondary matter, I am concerned with the level of oversight that will be applied to all DTF markets. Under the new framework, DTFs generally will not be required to maintain or provide the Commission with reports of futures positions held by their customers that exceed certain thresholds. In what appears to be a nod to the need for these reports, known as "large trader reports," the Commission contemplates collecting this information only in a select, few markets. But the vast majority of markets trading at the DTF level—generally those without retail participants—will have no obligation or duty to the Commission or the public with regard to this important information.

Large trader reports are an essential tool in the Commission's effort to detect and deter market manipulations. Deterrence is important because the effects of market manipulations reach far beyond the market's participants. Consumers ultimately pay for manipulations in commodity markets: Home buyers pay higher interest rates; commuters pay higher prices for gasoline; and we all pay higher prices for heating oil and food. For these reasons, I would require large trader reports in all DTF markets, regardless of the type of commodity product or participant involved.

The Department of the Treasury identified this issue in its comment letter, stating that "large trader reporting requirements have worked well in the market for treasury futures, both for the information they reveal to regulators and their deterrent effect."[5] I could not agree more strongly with the Treasury Department on this point. While it appears that large trader reporting will attach to government securities markets, I do not understand why the Treasury's views have not provided just as compelling a rationale for other markets which are not nearly as deep or liquid.

I believe that DTF markets may prove to be very successful, commercially. They may well grow to be the commercial markets where pricing and price-basing of commodities occurs. The Commission would be wise to retain its ability to detect and deter manipulations at their incipience.

Dated: November 20, 2000.

Thomas J. Erickson,

Commissioner.

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[1] *See* Mercatus letter, Aug. 21, 2000, p. 4 ("While it may be appropriate for the CFTC to avoid such a determination in granting an exemption from regulation, it is not clear that the CFTC can exercise its antifraud authority in relation to a particular transaction without determining that the CFTC is authorized to exercise jurisdiction in the first instance.") The drafters of the Mercatus letter further note that the "broad definition of MTEF" in the proposed rules could even be read "to cover auction markets such as eBay and all other forms of B2B trading facilities, whether electronic or not." *Id.* at 5. The Commission attempts to deflect this criticism in the final rules, stating that "so long as a facility auctions instruments outside of the Commission's regulatory jurisdiction under the Act, [the] exemptions therefrom and this framework would have no application to its business." *See* Final Rules for a New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, pp. 13–14. The Commission's response misses the rudimentary point that it will be anyone's guess whether some instruments possibly traded on DTFs are within or outside the Commission's jurisdiction.

[2] *See* Lehman Brothers letter, Sept. 5, 2000, p. 2 ("[T]he Commission's jurisdiction extends solely to futures and commodity options, such that reserving anti-fraud and anti-manipulation authority over futures and commodity options merely restates the current state of law. Such a reservation of authority cannot, legally, extend to transactions other than futures and commodity options and repeating the nature of the agency's statutory jurisdiction carries no legal baggage.").

[3] The only apparent penalty for refusing to comply with Commission rules is the market's loss of recognition as a DTF. I am not comfortable with this after-the-fallout remedy, and I cannot imagine potential market participants or domestic or international regulators being any more pleased.

[4] *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, p. 11, citing H.R. Rep. No. 978, 102d Cong., 2d Sess. 82–83 (1992).

[5] *See* Department of Treasury letter, Aug. 16, 2000, p. 4.

COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 1, 3, 4, 140, 155 and 166

RIN 3038–AB56

Rules Relating to Intermediaries of Commodity Interest Transactions

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rules.

SUMMARY: As part of a comprehensive regulatory reform process, the Commodity Futures Trading Commission (CFTC or Commission) has revised its rules relating to intermediation of commodity futures and commodity options (commodity interest) transactions. These new rules and rule amendments will provide greater flexibility in several areas. For example, to ease barriers to entry for persons seeking registration as futures commission merchants (FCMs) or introducing brokers (IBs), the Commission has established a simplified registration procedure for those persons who are regulated by other federal financial regulatory agencies and who limit their customer base to institutional customers only, regardless of the type of market involved.

With respect to trading on recognized derivatives transaction facilities (DTFs), the Commission has determined to permit non-institutional customers to enter into transactions thereon, provided that such non-institutional customer business is transacted either through a registered FCM that is a clearing member of at least one designated contract market or recognized futures exchange (RFE), and that has adjusted net capital of at least $20 million or by a registered commodity trading advisor (CTA) who has discretionary authority over the non-institutional customer's account, and who has assets under management of not less than $25 million. The latter circumstance is an expansion of the proposal.

As proposed, the Commission is expanding the range of instruments in which FCMs may invest customer funds. In response to various comments concerning the expansion of permissible investments, the Commission is making certain adjustments to the proposals relating to, among other things, concentration limits as applied to securities held in connection with repurchase transactions, permissible investments in FCMs and their affiliates by money market mutual funds meeting the requirements of Rule 2a–7 under the Investment Company Act of 1940 (Investment Company Act), and investment in foreign sovereign debt. Separately, the Commission also is considering proposing risk-based capital rules for FCMs. Further, the Commission recently adopted a revised interpretation concerning the treatment of customer funds on deposit with

disclosures pursuant to Rule 4.34(h), which requires a CTA to disclose to the client if, pursuant to Rule 1.46, the CTA has instructed the FCM carrying the client account either not to close out all offsetting positions or to close out offsetting positions on other than a first-in, first-out basis. This issue is discussed in greater detail below.

2. Segregation of Funds

The Proposing Release raised two sets of questions seeking comments about whether, and under what circumstances, the Commission should permit (1) customers to opt out of segregation and (2) FCMs to maintain, in the same customer segregated account, various instruments, such as over-the-counter (OTC) derivatives, equity securities, and other cash market positions, as well as the funds used for the purpose of securing or margining such products and positions.[46] Differing views were presented on both issues, and the Commission has determined to defer action in these areas. With respect to customer opt-out of segregation, most parties commenting on the issue urged the Commission to consider thoroughly the potential implications with respect to the bankruptcy rules, *e.g.*, priority of distribution, before proceeding on the issue. (CL 22–18 at 1; CL 22–22 at 6; CL 22–25 at 7; CL 22–31 at 7–8; CL 22–32 at 14–15; CL 22–34 at 3) NFA further expressed the view that there was no current need for, or interest in, allowing institutional customers to opt out of segregation, as the FCM community is more interested in being able to provide customers with a unified account statement reflecting their holdings across all products, not just futures contracts. (CL 22–24 at 5)

In response to the Commission's query on whether the types of permissible instruments held in the same customer account should be expanded, FIA expressed the view that Section 4d(2) of the Act permits the Commission to authorize any FCM that wishes to carry a customer's cash, OTC derivatives, securities and futures positions in a single account to maintain that account as a customer segregated account. The CBT cautioned the Commission to give further consideration to bankruptcy implications before proceeding in this area. The Commission agrees that action on this issue should be deferred to allow for additional study and consultation with other regulators, including members of the President's Working Group (PWG), and in addition, that any ultimate determination must be made in conjunction with deciding the customer opt-out of segregation issue.[47]

3. Investment of Customer Funds

The Commission proposed to amend Rule 1.25, which sets forth the types of instruments in which FCMs and clearing organizations are permitted to invest customer funds pursuant to Section 4d(2) of the Act (permitted investments), by expanding the list of permitted investments.[48] Previously, an FCM or clearing organization was permitted to invest segregated funds only in obligations of the U.S., in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the U.S.

The Commission proposed, subject to specific risk-limiting features, to permit FCMs to invest customer segregated funds in the following additional instruments: (1) Obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank insured by the Federal Deposit Insurance Corporation; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds (MMMFs). In addition, an FCM or a clearing organization would also be permitted to both buy and sell the permitted investments pursuant to agreements for resale or repurchase of the instruments (repurchase transactions).[49]

The Proposing Release contained several provisions intended to minimize credit risk, market risk, and liquidity risk, including: (i) A requirement that the investments be highly-rated by a nationally-recognized statistical rating agency (NRSRO), except for U.S. government securities and those MMMFs that are not required to be rated; (ii) a requirement that the dollar-weighted average of the time remaining to maturity of the debt securities held in the segregated portfolio not exceed 24 months, excluding investment in MMMFs because MMMFs have no maturity date; (iii) concentration limits on the percentage of the portfolio that may be comprised of the securities of individual issuers; (iv) specific prohibitions against leverage, embedded derivatives, and options; and (v) a requirement that the daily value and gains and losses on each investment be included in the records of the FCM or clearing organization.[50]

In connection with the proposed revisions to Rule 1.25, the Commission also proposed to amend Rules 1.20(a) and 1.26(a) to eliminate the requirement that an FCM obtain a written acknowledgment, from each clearing organization where the FCM has deposited customer funds or instruments purchased with customer funds, that the clearing organization was informed that the customer funds or instruments purchased with customer funds and deposited therein belong to customers and are being held in accordance with the provisions of the Act and the rules and orders promulgated thereunder.[51] The elimination of the written acknowledgment requirement would be conditioned upon the clearing organization's adoption and submission to the Commission of rules that provide for the segregation as customer funds, in accordance with the Act and the Commission's rules and orders, of all funds held on behalf of customers and all instruments purchased with customer funds.[52]

In general, commenters responded favorably to the Commission's proposals to expand the permissible investments, and the Commission has determined to adopt the amendments generally as proposed.[53] Notwithstanding their overall support, however, commenters addressed several areas in which they sought additional adjustments or clarifications concerning the rule amendments. Commenters also responded to specific questions raised by the Commission in the Proposing Release.

The CBT suggested that the Commission set guidelines with regard to the marketability of the permitted investments. The CBT recommended that the guidelines limit permitted investments to those instruments for which there are available quotes or valuations and, further, that the guidelines provide that there be a likelihood that any permitted investments can be liquidated within a

[46] 65 FR at 39014.

[47] The Commission notes, however, that cross-margining arrangements are already in place with respect to trading of stock index options and stock index futures.

[48] 65 FR at 39014.

[49] *Id.*

[50] *Id.* at 39014–15.

[51] *Id.* at 39015.

[52] *Id.* This codifies a staff no-action letter issued three years ago. *See* CFTC Staff Letter No. 97–45, [1996–1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,065 (May 5, 1997).

[53] Because the Commission has determined to include MMMFs in the list of permissible investments for customer funds, subject to the limitations adopted in Rule 1.25, it is hereby rescinding Division of Trading and Markets Financial and Segregation Interpretation No. 9, which previously prohibited such investment. *See* Financial and Segregation Interpretation No. 9, 1 Comm. Fut. L. Rep. (CCH) ¶7,119 (Nov. 23, 1983).

reasonable time period. (CL 22–25 at 7) The final rule has been modified so that paragraph (b)(1) of Rule 1.25 requires that the permitted securities held in segregation be "readily marketable" consistent with SEC Rule 15c3–1 under the Securities Exchange Act of 1934.[54]

The CBT also recommended that the Commission use a simpler approach for the valuation of downgraded investments than the proposed 20 percent per day reduction. The CBT suggested instead that a set number of days be permitted for disposal of the investment and that, during that permitted time period, the firm be allowed to use the full market value of the instrument towards meeting its segregated liability. The CBT also, indicated that it thought the 20 percent per day reduction in value for a downgraded instrument could lead to errors in calculation. (CL 22–25 at 7–8) The Commission has determined not to change this provision because it believes that the 20 percent per day write-down will provide an appropriate valuation under the circumstances and that it will serve as an incentive for the firm to take action to dispose of a downgraded investment sooner. *See* Rule 1.25(b)(2)(ii).

Rosenthal Collins Group, LLC (RCG) stated that the proposed credit rating requirements were too restrictive. (CL 22–18 at 2) The Commission notes that these requirements are intended to result in the holding of "investment grade" securities only. After the new rule takes effect, the Commission plans to monitor the effectiveness of the rule on an ongoing basis. If experience shows that the required ratings are too stringent, adjustments to the rule will be considered.

RCG also stated that the Commission should not impose rating requirements on investments in municipal securities because some of these securities are not rated due to the costs associated with obtaining a rating. RCG stated further that if the rule were adopted as proposed, investments that comply with the present rules but that do not comply with the new requirements should be "grandfathered" as part of an existing portfolio. (CL 22–18 at 2) In response to this comment, the Commission will not require the disposal of investments held as of December 13, 2000, *i.e.*, such investments may be held until they mature or are liquidated in the ordinary course of business, although no new acquisitions of non-compliant investments will be permitted.

Brown Brothers Harriman (BBH) stated that the prohibition against an FCM investing in an MMMF that has investments in securities issued by a parent or affiliate of the FCM should be dropped. (CL 22–20 at 5) This recommendation was made because MMMFs are often operated independently of the sponsoring affiliated entity and, in any event, are subject to a five percent concentration limit in the securities of any single issuer. BBH also noted that many FCMs are affiliated with world-class financial enterprises and that a prohibition against MMMFs investing in securities of the FCMs' affiliates would eliminate a large and important group of instruments. The Commission finds merit in this suggestion and has modified Rule 1.25(b)(6)(ii) accordingly. The Commission also notes that Section 17 of the Investment Company Act[55] restricts investments made by MMMFs in securities issued by any entity affiliated with the MMMF or its sponsors, and that the concentration limit set forth in SEC Rule 2a–7 under the Investment Company Act[56] is similar to the concentration provision of CFTC Rule 1.25.

BBH also requested that the requirement that a fund be "SEC registered" be defined to mean registration under the Investment Company Act only and not require registration under the Securities Act of 1933. (CL 22–20 at 6) This clarification has been made to paragraph (c)(1) of Rule 1.25.

Sentinel Management Group, Inc. (Sentinel) requested clarification as to whether the concentration limits provided for in the proposed rule would apply to securities held in connection with repurchase agreements. (CL 22–41 at 1) Sentinel stated that the concentration limits should not apply because of: (1) The burden that would be imposed upon the FCMs; (2) the fact that complete information on such securities is sometimes not known until the day following entry into the repurchase transaction; (3) the fact that the duration of repurchase transactions is only one day; and (4) the fact that the obligation created pursuant to a repurchase transaction is that of the counterparty and not the issuer of the securities. Therefore, it argued, the creditworthiness of the counterparty augments the value of the securities held pursuant to the repurchase agreement. (CL 22–41 at 1–2) This same point was raised by BBH in follow-up conversations.

Taking into consideration these comments, as well as the requirement contained in the Proposing Release that counterparties for repurchase transactions must be regulated financial institutions (generally large banks or brokerage firms), the Commission has concluded that the focus of concentration should be primarily upon the counterparties and secondarily upon the securities held in connection with the repurchase agreement. Therefore, the final rule contains several clarifying or enhancing changes.

First, paragraph (b)(4)(ii) provides that securities that are held by a counterparty, *i.e.*, securities that have been "repoed out," are subject to the concentration limitations along with currently-owned direct investment securities. This clarification was made because a security that has been sold subject to repurchase at a later date presents the FCM or clearing organization with the same price risk as a security that is currently held in the portfolio. Second, paragraph (b)(4)(iii) provides concentration limit percentages for securities that are held by the FCM or clearing organization pursuant to a reverse repurchase agreement that are double those required for direct investments, provided that the counterparty has a credit rating of single A or higher from two or more NRSROs. In addition, the rule was changed to provide that the concentration percentages for such securities shall be computed using only the securities contained in the portfolio of securities supplied by each counterparty of the FCM or clearing organization. This change was made because the counterparty has the direct control over what specific securities will be supplied in a repurchase transaction. Thus, the Commission expects that an FCM or clearing organization will inform its counterparties as to the per-issuer concentration limits that must be observed, as set forth in the rule. Finally, paragraph (b)(4)(v) makes explicit that the concentration limits do not apply to securities owned by customers that have been posted by customers as collateral with the FCM. This clarification was made primarily because changes in the value of customer-owned securities accrue to the customers who posted the securities and, therefore, in a properly margined account such securities pose no direct price risk to the FCM. The Commission believes that these changes and clarifications will provide additional flexibility to FCMs and clearing

[54] 17 CFR 240.15c3–1. As a result of the addition of new Rule 1.25(b)(1), proposed paragraph (b)(6) of Rule 1.25 concerning recordkeeping is being adopted unchanged as paragraph (b)(7).

[55] 15 U.S.C. 80a–17.

[56] 17 CFR 270.2a–7.

organizations without unduly increasing associated risk.

The Investment Company Institute (ICI) suggested that MMMFs sponsored by investment advisers registered under the Investment Advisers Act of 1940 be included in the list of permitted investments. (CL 22–27 at 6) The Commission has made this suggested change. *See* Rule 1.25(c)(2).

ICI noted that the proposed rule appeared to require valuation of the investment portfolio by 9 a.m. each day and suggested, instead, that valuation not be required until after the close of the markets each day, *i.e.*, not until after 4 p.m. (CL 22–27 at 7) The Commission's intention was to require valuation by 9 a.m. the business day following the investment, so that the valuation would be available in time for the segregation calculation, which is required to be completed on a daily basis by noon the following business day. The final rule (paragraph (c)(4) of Rule 1.25) has been changed to correctly state the Commission's intention more precisely.

ICI also suggested that the proposed rule should be changed to permit MMMFs that are not rated by an NRSRO to invest in unrated securities. The proposed rule provided that only MMMFs that are rated may invest in unrated securities. ICI cited the comprehensive approach to risk control and preservation of capital contained in SEC Rule 2a–7 and noted that that rule permits an MMMF to invest in unrated securities if the MMMF determines that the securities are of comparable quality to otherwise eligible securities. (CL 22–27 at 4) The Commission has changed the final rule (Rule 1.25(b)(2)(i)(D)) to permit unrated MMMFs to invest in unrated securities because of the risk-limiting features of SEC Rule 2a–7.

ICI also recommended two revisions to paragraph (c)(3) of Rule 1.25 concerning MMMFs. First, because fund shares are usually uncertificated, ICI recommended that the first sentence be revised to provide that the ownership of fund shares must be noted (by book-entry or otherwise) in a custody account of the FCM or clearing organization. Second, to ensure that confirmations for transactions in fund shares are retained, ICI recommended that the confirmation relating to the purchase be retained in the FCM's or clearing organization's records. (CL 22–27 at 6) The Commission has made these suggested changes.

ICI further recommended that the one-day liquidity requirement applicable to MMMFs be extended to seven days, to be consistent with SEC requirements and the longer settlement time-frames associated with direct investments. (CL 22–27 at 7)

The 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. Since a material portion of an FCM's customer funds could well be invested in a single MMMF, this is an important provision of the rule. The Commission notes that, although sales of directly-owned securities settle in longer than one-day time-frames, an FCM or clearing organization could obtain liquidity by entering into a repurchase transaction. Therefore, the Commission has retained the one-day liquidity requirement imposed on investments in MMMFs and, in view of the importance of this provision, has clarified that demonstration that this requirement has been met may include either an appropriate provision in the offering memorandum of the fund or a separate side agreement between the fund and an FCM or clearing organization. *See* Rule 1.25(c)(5).

The FRBC commented that permitted investments should have either a CUSIP or ISIN number, and that permitted investments should be required to have a reasonably transparent secondary market enabling accurate and efficient valuation of the investments. (CL 22–30 at 6) The Commission has changed the final rule to include securities with ISIN numbers as permitted investments.

The FRBC also recommended that permitted investments have a reasonably transparent secondary market. As noted above, the Commission strengthened the rule in this respect by adding a requirement that all permitted securities, except for MMMFs, meet the SEC's "readily marketable" standard. The Commission intends to monitor closely for any problems concerning valuation of permitted investments, and will consider proposing further rule amendments if appropriate.

The FRBC also recommended that permitted investments should settle on a same-day or next-day basis, to ensure adequate liquidity. It pointed out that, currently in the U.S., virtually all corporate and municipal debt securities settle on a T+3 basis, which is not sufficient for futures clearing organization demands, and that this delay could deprive the FCM or clearing organization of the liquidity that is so important in times of market stress or emergency. (CL 22–30 at 5) The Commission has elected to permit investment of customer funds in investment grade corporate notes and municipal securities because FCMs have methods of obtaining liquidity other than by selling the securities, such as by entering into repurchase transactions and by establishing backup bank lines of credit using the securities as collateral.

The FRBC further recommended that CFTC rules should permit the investment of customer funds held in a foreign currency in identically-denominated sovereign debt securities. (CL 22–30 at 4–5; *see also* CL 22–31 at 9; CL 22–42 at 2) The Commission notes that, under the rule as proposed, an FCM that decided to invest deposits of foreign currencies was required to convert the foreign currencies received to a U.S. dollar-denominated asset. This would increase its exposure to foreign currency fluctuation risk, unless it incurred the additional expense of hedging. Therefore, the Commission has determined that the FRBC's suggestion should be adopted. The Commission has changed the proposed rule to permit investment in the general obligations of any country whose sovereign debt is rated in the highest category by at least one NRSRO, but limited as follows: an FCM may invest in the sovereign debt of a country to the extent it has balances owed to its customers denominated in that currency; a clearing organization may invest in the sovereign debt of a country to the extent it has balances owed to its clearing member FCMs denominated in that currency.[57] The Commission notes that foreign sovereign debt that is denominated in the Euro will qualify as a permitted investment under this rule, provided the country that issued the debt qualifies as a permitted country under the rule, the obligation is a general obligation of the country, and the balances owed to the customers or the FCMs are Euro-denominated. As with other aspects of Rule 1.25, the Commission will monitor the effect of this provision and stands ready to make additional adjustments as experience dictates.

In addition, the FRBC suggested that the CFTC expressly approve the use of certain "sweep" accounts in connection with the investment of customer funds in MMMFs or other permissible forms of investment. (CL 22–30 at 6) The Commission notes that Rule 1.25 will not preclude the use of sweep accounts and encourages this practice to enhance the efficiency of liquidity management.

The FRBC also suggested that, with respect to the concentration provision, the rule should be clarified that it applies only to the portfolio of securities

[57] As is the case for U.S. government securities and those MMMFs that are not required to be rated, permitted foreign sovereign debt will not be subject to a credit rating requirement. *See* § 1.25(b)(2)(i)(A).

purchased with customer funds, *i.e.*, the provision does not apply to customer-owned securities posted as margin. (CL 22–30 at 6) As noted previously, the Commission has made this clarification in paragraph (b)(4)(v) of Rule 1.25.

FIA suggested that the Commission clarify what is meant by the required ratings in the rule, where the "two highest ratings of an NRSRO" are specified, *i.e.*, AAA and AA. In particular, it recommended that the Commission clarify whether "AA" includes all variations included within the AA rating. (CL 22–31 at 8) The Commission confirms that this interpretation is correct.

FIA also suggested that the Commission clarify whether a security would be a permitted investment if one NRSRO gave it an acceptable rating, even though another NRSRO gave it an unacceptable rating. (CL 22–31 at 9) The Commission hereby confirms that if one NRSRO gave an acceptable rating and another did not, investment in the security would be permitted. The Commission believes that it would be rare for such differences to occur at the investment grade ratings level and, further, that any differences would probably be temporary.

FIA also suggested providing a grace period for FCMs or clearing organizations that find themselves in violation of the concentration limits. (CL 22–31 at 9) The Commission has decided against adopting this suggestion because the Commission would not expect FCMs to violate the concentration limits, except perhaps under unusual circumstances. Further, the Commission is concerned that were a formal grace period provided in the rule, it might be subject to abuse.

In addition, FIA suggested that the Commission plan to review the list of permitted investments every six months to determine whether revisions should be made. (CL 22–31 at 9) The Commission plans to review all aspects of the new rule on an ongoing basis and further changes will be proposed, if appropriate.

Two exchanges, the NYMEX and the CME, pointed out that each clearing organization would need to make its own determination as to the types of assets that would be accepted by that clearing organization. (CL 22–32 at 16; CL 22–35 at 13) The Commission recognizes that an SRO may adopt more restrictive requirements than those set forth in Rule 1.25 for its member FCMs.

E. Core Principle Four: Risk Disclosure and Account Statements

Although the Commission stated in the Proposing Release that non-institutional customers should continue to receive the risk disclosures regarding futures and options trading that are currently required,[58] it proposed to streamline the account opening process by amending Rules 1.55(d)(1) and (2) to expand the list of disclosures and consents that could be provided in a single document and acknowledged with a single signature.[59] This list includes: (1) The disclosures required by new Rule 1.33(g) (relating to electronic transmission of statements);[60] (2) the consent referenced in Rule 155.3(b)(2) (relating to customer permission for FCMs to take the opposite side of an order); and (3) a provision for preauthorization of transfers of funds from a customer's segregated account to another account of that customer. The single signature could be made electronically as provided for in recently-adopted Commission Rules 1.3(tt) and 1.4.[61] Disclosure concerning arbitration of disputes, however, would continue to require a separate signed acknowledgement by non-institutional customers, pursuant to proposed Rule 166.5 (which was modeled on, and would replace, prior Rule 180.3).[62]

All of the commenters who addressed the proposed amendments to Rule 1.55(d) responded favorably to the expansion of disclosures and consents that could be acknowledged and made by a single signature, and the Commission is adopting the amendments as proposed. (CL 22–17 at 3; CL 22–24 at 6; CL 22–25 at 8; CL 22–31 at 14; CL 22–32 at 16; CL 22–35 at 11; CL 22–44 at 2) FIA requested that the Commission confirm that an FCM may obtain an acknowledgement of receipt and understanding of the risk disclosure statement contemporaneously with opening an account. The Commission agrees that the FCM may open the customer account simultaneously with receiving the acknowledgment of receipt and understanding of the risk disclosure statement, along with margin funds and any other required account opening documents, from the customer. The FCM will remain responsible for ensuring that the risk disclosure document is furnished to the customer in such a way that the customer can review and understand the document before committing funds to the FCM.

NFA commented generally that the Commission should not dictate the specifics of how disclosures and consents are delivered and acknowledged, and that it would be willing to develop best practice guidance in this area. (CL 22–24 at 6) The Commission believes that its rules requiring risk disclosure and customer acknowledgments do not impose a significant burden in light of their important customer protections. The Commission is providing additional flexibility to the industry in this area. As the Commission noted in the Proposing Release, there would continue to be no specific disclosure requirements for institutional customers and, in addition, as provided in Rule 35.1(b), governmental entities would be included in the definition of "institutional customer," and consequently would not be required to receive and to acknowledge a disclosure statement.[63] Further, the single signature acknowledgment could be made electronically as provided for in Rules 1.3(tt) and 1.4. The Commission looks forward to working with NFA and the industry both in developing a Statement of Acceptable Practices for disclosure to non-institutional customers trading on DTFs, and in developing more streamlined disclosure requirements for domestic exchange-traded options under Rule 33.7.

As noted above, the Commission proposed to continue to require a separate signed acknowledgement by non-institutional customers with respect to disclosure concerning arbitration of disputes. Nevertheless, the Commission also solicited comment on whether to maintain this requirement.[64] FIA opposed continuing to require a separate signature from non-institutional customers if their account agreement contains a pre-dispute arbitration provision. (CL 22–31 at 14). In general, FIA expressed the opinion that the Commission should eliminate all of its rules pertaining to the use of pre-dispute arbitration agreements, as well as the Commission's reparations program. For example, FIA commented that the Commission's rule that an FCM may not require a customer to sign a pre-dispute arbitration agreement as a condition to opening an account with the FCM inhibits the ability of FCMs that are also securities broker-dealers to enter into a single agreement with their customers, because the SEC does not prohibit the use of such mandatory agreements. (CL 22–31 at 10) At the very least, FIA stated that the Commission

[58] 65 FR at 39015. There would continue to be no specific disclosure requirements for institutional customers. Id. at 39016.

[59] *Id.* at 39015–16.

[60] *See infra.*

[61] 65 FR 12466 (Mar. 9, 2000).

[62] 65 FR at 39016. This is discussed further below.

[63] *Id.*

[64] *Id.*

Federal Register

Wednesday,
August 14, 2002

Part IV

Commodity Futures Trading Commission

17 CFR Part 41

Securities and Exchange Commission

17 CFR Part 242

Customer Margin Rules Relating to Security Futures; Joint Final Rules

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 41

RIN 3038–AB71

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 242

[Release No. 34–46292; File No. S7–16–01]

RIN 3235–AI22

Customer Margin Rules Relating to Security Futures

AGENCIES: Commodity Futures Trading Commission and Securities and Exchange Commission.

ACTION: Joint final rules.

SUMMARY: The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, "Commissions") are adopting rules to establish margin requirements for security futures. The final rules preserve the financial integrity of markets trading security futures, prevent systemic risk, and require that the margin requirements for security futures be consistent with the margin requirements for comparable exchange-traded option contracts.

EFFECTIVE DATE: September 13, 2002.

FOR FURTHER INFORMATION CONTACT:
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SUPPLEMENTARY INFORMATION: The CFTC is adopting Rules 41.42 through 41.49, 17 CFR 41.42 through 41.49, and the SEC is adopting Rules 400 through 406, 17 CFR 242.400 through 242.406, (the "Final Rules") under authority delegated by the Federal Reserve Board pursuant to the Securities Exchange Act of 1934 ("Exchange Act").

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I. Background

A. Statutory Provisions

The Commodity Futures Modernization Act of 2000 ("CFMA"),[1] which became law on December 21, 2000, lifted the ban on single stock and narrow-based stock index futures ("security futures"). In addition, the CFMA established a framework for the joint regulation of security futures by the CFTC and the SEC.

As part of the statutory scheme for the regulation of security futures, the CFMA provided for the issuance of rules governing customer margin for transactions in security futures. Specifically, the CFMA added a new subsection (2) to section 7(c) of the Exchange Act,[2] which directs the Board of Governors of the Federal Reserve System ("Federal Reserve Board") to prescribe rules establishing initial and maintenance customer margin requirements imposed by brokers, dealers, and members of national securities exchanges for security futures products. In addition, section 7(c)(2)(B) provides that the Federal Reserve Board may delegate this rulemaking authority jointly to the Commissions. On March 6, 2001, the Federal Reserve Board delegated its authority under Section 7(c)(2)(B) to the Commissions.[3] Pursuant to that authority, the SEC and the CFTC have adopted customer

[1] Appendix E of Pub. L. No. 106–554, 114 Stat. 2763 (2000).

[2] 15 U.S.C. 78g(c)(2).

[3] Letter from Jennifer J. Johnson, Secretary of the Board, Federal Reserve Board, to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, SEC (March 6, 2001) ("FRB Letter").

margin requirements for security futures.[4]

Section 7(c)(2) provides that the customer margin requirements for security futures must satisfy four requirements. First, they must preserve the financial integrity of markets trading security futures products. Second, they must prevent systemic risk. Third, they must (a) be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act; and (b) provide for initial and maintenance margin levels that are not lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded options. Fourth, they must be and remain consistent with the margin requirements established by the Federal Reserve Board under Regulation T.[5]

B. Proposed Rules

On September 26, 2001, the CFTC and the SEC issued for public comment proposed rules (the "Proposed Rules") relating to customer margin requirements for security futures.[6] In response to a joint request from the Futures Industry Association ("FIA") and the Securities Industry Association ("SIA") for an extension of the public comment period, the Commissions granted a 30-day extension until December 5, 2001.[7]

C. Overview of the Comment Letters

The Commissions received a total of 19 comment letters from securities and futures industry associations,[8] exchanges,[9] a clearing organization,[10] financial services firms,[11] systems vendors,[12] a member of the academic community,[13] and two members of the public.[14] In general, the comment letters focused on three major issues raised by the Proposed Rules: the applicability of Regulation T and the desirability of an account-specific margin regime; the appropriateness of the proposed 20% margin level; and the permissibility of portfolio margining.

The majority of commenters expressed the view that Regulation T should not be applied to futures accounts. They stated their concern that application of Regulation T to security futures carried in futures accounts would impose heavy costs on carrying firms in the form of reprogramming of systems and training of staff. Some believed that it would discourage futures commission merchants ("FCMs") from trading security futures. One commenter, however, supported the application of Regulation T to security futures, regardless of the type of account in which they are carried. Several commenters identified specific provisions of Regulation T that would have to be addressed in order to accommodate carrying security futures in a securities account, *e.g.*, rules for variation margin payments.

Ten of the commenters specifically endorsed the concept that the margin rules should build on the existing regulatory infrastructure and that, to the extent possible, the rules applicable to security futures should be determined by the type of account in which the security futures are carried. Under this "account-specific" approach, for example, rules relating to acceptable collateral, collateral haircuts, timing for collection of margin, and calculations of current market value would be determined in accordance with the rules otherwise applicable to a securities account or futures account, respectively. Several commenters observed that this would be consistent with the Commissions' proposed customer funds rules[15] and would be the most prudent and cost effective approach.

Most commenters found the proposed 20% minimum margin level to be acceptable, although some thought the minimum should instead be 25%. The SIA/FIA Letter noted that "members of the Associations are divided" as to whether the minimum level of initial and maintenance margin should be 20% or 25%. Another commenter expressed the view that the 20% level could be either too high or too low depending on the circumstances, and that for certain positions 50% initial margin would be appropriate.

Eleven commenters supported the implementation of full portfolio margining for security futures, as soon as possible. Two other commenters emphasized the need for experience with a proposed pilot program.[16] One commenter supported portfolio margining only for sophisticated customers, with another commenter joining in the view that portfolio margining might not be appropriate for all customers.

After carefully considering the public comments, the Commissions have adopted Final Rules that reflect modifications to the Proposed Rules in response to the views and concerns expressed by the commenters. The Commissions believe that the Final Rules fulfill the statutory requirements and that the changes made to the

[4] Because section 6(h)(6) of the Exchange Act (15 U.S.C. 78f(h)(6)) provides that options on security futures may not be traded for at least three years after the enactment of the CFMA, the margin requirements do not address options on security futures.

[5] 12 CFR 220 *et seq.*

[6] Securities Exchange Act Release No. 44853 (September 26, 2001), 66 FR 50720 (October 4, 2001). The FRB Letter was attached as Appendix B. *See id.* at 50741.

[7] *See* Securities Exchange Act Release No. 44996 (October 29, 2001), 66 FR 55608 (November 2, 2001).

[8] *See* letters from Mark E. Lackritz, President, SIA, and John M. Damgard, President, FIA, dated December 5, 2001 ("SIA/FIA Letter"); George Ruth, Chairman, Rules and Regulations Committee, Securities Industry Association Credit Division, dated December 4, 2001 ("SIA Credit Division Letter"); Thomas W. Sexton, Vice President and General Counsel, National Futures Association, dated December 5, 2001 ("NFA Letter"); and John G. Gaine, President, Managed Funds Association, dated January 11, 2002 ("Manager Funds Letter").

[9] *See* letters from James J. McNulty, Chicago Mercantile Exchange Inc., and David J. Vitale, Board of Trade of the City of Chicago, Inc., dated December 4, 2001 ("CME/CBOT Letter"); the American Stock Exchange, Chicago Board Options Exchange, The Options Clearing Corporation, International Securities Exchange, Pacific Exchange, and Philadelphia Stock Exchange, dated December 5, 2001 ("Options Exchanges Letter"); Kathleen M. Hamm, Director of Market Regulation, Senior Vice President Regulation and Compliance, Nasdaq Liffe Markets, LLC, dated December 5, 2001 ("Nasdaq Liffe Letter"); Kenneth M. Rosenzweig, on behalf of OneChicago, LLC, dated December 6, 2001 ("OneChicago Letter"); Michael J. Ryan, Jr., Executive Vice President and General Counsel, American Stock Exchange, dated December 7, 2001 ("Amex Letter"); and William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, dated December 7, 2001 ("CBOE Letter"). The CBOE also joined in the Options Exchanges Letter.

[10] *See* letter from Susan Milligan, The Options Clearing Corporation, dated December 14, 2001 ("OCC Letter"). The OCC also joined in the Options Exchanges Letter.

[11] *See* letters from John P. Davidson III, Managing Director, Morgan Stanley, dated December 5, 2001 ("Morgan Stanley Letter"); James A. Gary, Executive Vice President, ABN AMRO Incorporated, dated December 5, 2001 ("ABN AMRO Letter"); and Russell R. Wasendorf, Sr., Chairman and Chief Executive Officer, Peregrine Financial Group, Inc., dated December 5, 2001 ("Peregrine Letter").

[12] *See* letters from John Munro, Senior Vice President, Product Design, Rolfe and Nolan Systems Inc ("Rolfe and Nolan Letter"); and Stephen P. Auerbach, Chief Operating Officer, SunGard Futures Systems, dated December 5, 2001 ("SunGard Letter").

[13] *See* letter from Frank Partnoy, Professor of Law, University of San Diego School of Law, dated October 29, 2001 ("Partnoy Letter").

[14] *See* letter from Robert Drinkard, dated September 28, 2001 ("Drinkard Letter"); and letter from Bernard E. Klein, dated December 18, 2001 ("Klein Letter").

[15] *See* Securities Exchange Act Release No. 44854 (September 26, 2001), 66 FR 50768 (October 4, 2001).

[16] *See* Securities Exchange Act Release No. 45630 (March 22, 2002), 67 FR 15263 (March 29, 2002) (notice of rules proposed by the CBOE related to customer portfolio and cross-margining requirements).

Proposed Rules will more effectively promote market efficiency and liquidity.

D. Overview of the Final Rules

The Commissions have carefully considered the commenters' views, and have modified the Proposed Rules in various respects. The Final Rules, among other things:

• Establish stand-alone requirements that are consistent with Regulation T, but do not apply Regulation T in its entirety to futures accounts.

• Establish minimum initial and maintenance margin levels for unhedged positions in security futures at 20% of their "current market value."

• Permit self-regulatory authorities to set margin levels lower than 20% of current market value for customers with certain strategy-based offset positions involving security futures and one or more related securities or futures.

• Identify the types of collateral acceptable as margin deposits and establish standards for the valuation of such collateral and other components of equity.

• Establish standards for the withdrawal of margin by customers and security futures intermediaries.

• Set forth procedures applicable to undermargined accounts.

• Set forth procedures for filing proposed rule changes with the CFTC.

II. Discussion of the Final Rules

A. Who Is Covered by the Final Rules

The Commissions are adopting the Final Rules under the authority delegated to them by the Federal Reserve Board under section 7(c)(2) of the Exchange Act, which applies to brokers, dealers, and members of national securities exchanges extending credit to or for customers, or collecting margin from customers, in connection with security futures. In the Proposed Rules, the Commissions used the term "creditor," as defined in Regulation T, to delineate those persons who would be subject to the margin rules.[17] Because FCMs that effect transactions in security future products are broker-dealers,[18] they were included in the definition of "creditor" under the Proposed Rules.

To avoid characterizing the collection of margin for a security futures contract as involving an extension of credit, the Final Rules use the term "security futures intermediary" instead of the term "creditor." [19] The term "security futures intermediary" is intended to include the same persons as are included in the Regulation T definition of "creditor," but solely with respect to their financial relations involving security futures. SEC Rule 401(a)(29) defines security futures intermediary by reference to the term creditor. For the sole purpose of clarifying the scope of the Final Rules for market participants that are not subject to Regulation T, the definition of security futures intermediary in CFTC Rule 41.43(a)(29) specifies that the term includes FCMs and enumerated affiliated persons.[20]

The Commissions believe that the term security futures intermediary is defined identically for all substantive purposes, and emphasize that the difference in the language used in the two rules to define a security futures intermediary is not intended to mean that the scope of the two rules is different.

In addition, the term "customer" is defined under the Final Rules as any person or persons acting jointly on whose behalf a security futures intermediary effects a security futures transaction or carries a security futures position, or who would be considered a customer of the security futures intermediary according to the ordinary usage of the trade.[21] The definition of customer further includes (i) any partner in a security futures intermediary that is organized as a partnership who would be considered a customer of the security futures intermediary absent the partnership relationship, and (ii) any joint venture in which a security futures intermediary participates and which would be considered a customer of the security futures intermediary if the security futures intermediary were not a participant.[22] This definition is derived from the Regulation T definition of customer.[23]

B. Exclusions From Coverage

The Final Rules include specific exclusions for certain categories of financial relations, substantially as proposed. The exclusions are described below.

1. Financial Relations between a Customer and a Security Futures Intermediary Under a Portfolio Margining System

The Proposed Rules provided an exclusion for margin calculated by a portfolio margining system that has been approved by the SEC and, as applicable, the CFTC.[24] The Commissions are adopting this exclusion substantially as proposed.[25] The Final Rules add a provision requiring that the portfolio margining system meet the criteria set forth in section 7(c)(2)(B) of the Exchange Act.[26] This addition is intended to clarify that the portfolio margining system must be consistent with a risk-based system used for comparable exchange-traded options. This requirement does not preclude the use of an existing portfolio margining system that interfaces with an FCM's bookkeeping system, so long as the portfolio margining system is modified to produce results that comply with the Final Rules.[27]

Portfolio margining establishes margin levels by assessing the market risk of a "portfolio" of positions in securities or commodities. Under a portfolio margining system, the amount of required margin is determined by analyzing the risk of each component position in a customer account (*e.g.*, a class of option with the same expiration date) and by recognizing any risk offsets in an overall portfolio of positions (*e.g.*, across options and futures on the same underlying instrument). So that adequate margin is deposited to cover extraordinary market events, one or more additional adjustments may be applied in calculating a customer's required margin. A portfolio margining system may also be used in conjunction with a risk-based margining system,

[17] Under Section 220.2 of Regulation T (17 CFR 220.2), the term "creditor" means any broker or dealer, member of a national securities exchange, or any person associated with a broker or dealer other than business entities controlling or under common control with the broker-dealer.

[18] *See* sections 3(a)(4) and 3(a)(5) of the Exchange Act, 15 U.S.C. 78c(a)(4) and 78c(a)(5).

[19] For the same reason, the Final Rules do not use the term "borrower" to refer to persons who deposit margin in connection with security futures transactions.

[20] *See* CFTC Rule 41.43(a)(29); SEC Rule 401(a)(29).

[21] *See* CFTC Rule 41.43(a)(5)(i); SEC Rule 401(a)(5)(i).

[22] *See* CFTC Rule 41.43(a)(5)(ii) and (iii); SEC Rule 401(a)(5)(ii) and (iii).

[23] *See* 12 CFR 220.2.

[24] *See* Proposed CFTC Rule 41.43(b)(3)(i); Proposed SEC Rule 400(b)(3)(i).

[25] *See* CFTC Rule 41.42(c)(2)(i); SEC Rule 400(c)(2)(i).

[26] *See* CFTC Rule 41.42(c)(2)(i); SEC Rule 400(c)(2)(i). Section 7(c)(2)(B) requires that the margin requirements for security futures (i) be consistent with the margin requirements for comparable exchange-traded security options (and that margin levels for security futures not be lower than the levels of margin required for comparable exchange-traded options), and (ii) be and remain consistent with Regulation T of the Federal Reserve Board. 15 U.S.C. 78g(c)(2)(B).

[27] Under the Final Rules, a portfolio margining system can be used to compute required initial or maintenance margin that results in margin levels that are equal to or higher than the margin levels required by the Final Rules. In this regard, for example, the minimum margin requirement for unhedged security futures positions must be 20%, and the system cannot recognize any offset for combination positions that is not permitted under self-regulatory authority rules, as provided in CFTC Rule 41.45(b)(2) and SEC Rule 403(b)(2). See discussion of margin offsets, Section II.G.3. below.

which assesses margin based on the historical performance of individual instruments, rather than as a fixed percentage of current market value. Depending upon the risks attributable to one or more positions, the amount of required margin in a portfolio margining system may be greater than or less than the margin levels currently required for securities positions in a fixed-percentage, strategy-based margining system.

The Commissions received 14 comment letters that addressed the issue of portfolio margining, all of which supported the concept of portfolio margining for security futures.[28] Ten of the commenters strongly supported the implementation of full portfolio margining for security futures as soon as possible.[29]

Five commenters observed that portfolio margining recognizes the market risk associated with a specific position more accurately than a fixed-percentage margin scheme.[30] One commenter criticized the Proposed Rules for limiting customers to an "archaic strategy-based system."[31]

One commenter stated its opinion that portfolio margining should be allowed immediately for security futures, and that the higher margin levels collected under a strategy-based approach would make it difficult for U.S. markets to attract liquidity in security futures.[32] This commenter raised concerns that strategy-based margining would disadvantage U.S. markets and would encourage investors to seek foreign markets.[33] Another commenter supported portfolio margining for security futures, securities, and securities options to promote global competitiveness.[34] It observed that portfolio margining has become the international standard for major futures markets and without it, the U.S. markets will be at a disadvantage.[35]

One commenter expressed the view that portfolio margining should not be approved for security futures before it is approved for options, and stated that it was critical that any portfolio margining system applicable to security futures apply to all related products, including options and the underlying securities.[36] Another commenter supported implementation of a portfolio margining framework under which the margin requirements for portfolios comprised of securities and security futures would be determined through a risk-based analysis.[37]

Two other commenters, while strongly supporting the concept of portfolio margining, expressed the opinion that portfolio margining was not necessarily appropriate for all investors, and that it might be appropriate to limit the use of portfolio margining for security futures to sophisticated investors.[38]

The SEC and the CFTC have approved the use of portfolio margining systems for certain purposes. The CFTC has approved portfolio margining using the SPAN system for all currently traded futures contracts, at both the clearing level and the customer level.[39] The SEC has approved portfolio margining using The Options Clearing Corporation's ("The OCC") Theoretical Intermarket Margin System ("TIMS") for margin collected by The OCC for the options positions of its clearing members.[40] The SEC and CFTC also have approved self-regulatory organization ("SRO") rules that permit the use of SPAN and TIMS in connection with certain cross-margining arrangements involving futures and securities.[41] In addition, as noted previously, on March 22, 2002, the SEC published notice of a proposed rule change filed by the CBOE to implement a portfolio margining system on a pilot basis for certain customers.[42]

Section 7(c)(2)(B)(iii) of the Exchange Act[43] provides that the margin requirements for security futures must be consistent with the margin requirements for comparable exchange-traded options, and that the initial and maintenance margin levels for security futures may not be lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded option. After considerable deliberation about the application of this standard to security futures margin, the Commissions have determined that risk-based portfolio margining for security futures will not be permitted until a similar methodology is introduced for comparable exchange-traded options.

Three commenters expressed opinions regarding the future selection and use of SPAN or TIMS as a portfolio margining system.[44] The Commissions will consider issues related to the use of any particular portfolio margining system at such time as the Commissions consider the actual implementation of portfolio margining for security futures.

The Commissions strongly encourage the efforts of market participants to develop a portfolio margining proposal for security futures, and are committed to working with these participants to resolve any outstanding issues as quickly as feasible. Such a portfolio margining system would be in keeping with current practices in the futures industry and would be responsive to the Federal Reserve Board's desire to encourage the development of more risk-sensitive, portfolio-based approaches to margining security futures products.[45]

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[28] *See* SIA Credit Division Letter; Options Exchanges Letter; CME/CBOT Letter; SunGard Letter; SIA/FIA Letter; OCC Letter; Peregrine Letter; Nasdaq Liffe Letter; NFA Letter; Morgan Stanley Letter; OneChicago Letter; ABN AMRO Letter; Rolfe and Nolan Letter; and Managed Funds Letter.

[29] *See* CME/CBOT Letter; SunGard Letter; SIA/FIA Letter; Peregrine Letter; Nasdaq Liffe Letter; NFA Letter; OneChicago Letter; ABN AMRO Letter; Rolfe and Nolan Letter; and Managed Funds Letter.

[30] *See* SIA/FIA Letter at 2; Morgan Stanley Letter at 3; OneChicago Letter at 7–8; NFA Letter at 4–5; and Nasdaq Liffe Letter at 4.

[31] CME/CBOT Letter at 5.

[32] SunGard Letter at 2.

[33] *Id.*

[34] Nasdaq Liffe Letter at 5–6.

[35] *Id.*

[36] Options Exchanges Letter at 4.

[37] SIA/FIA Letter at 11. This commenter also recommended that the Commissions permit FCMs to use the Standard Portfolio Analysis of Risk ("SPAN") system for establishing the initial and maintenance margin requirements for security futures maintained in a futures account as long as the resulting margin levels are consistent with the margin requirements for security futures held in a securities account. *Id.* at 12.

[38] *See* SIA Credit Division Letter at 2; Morgan Stanley Letter at 4.

[39] The CFTC also has approved SPAN margining for all options on futures contracts.

[40] *See* Securities Exchange Act Release No. 28928 (March 1, 1991), 56 FR 9995 (March 8, 1991); Securities Exchange Act Release No. 23167 (April 22, 1986), 51 FR 16127 (April 30, 1986).

[41] To date, the Commissions have approved cross-margining programs between The OCC and the following futures clearing organizations: The Intermarket Clearing Corporation (1988); Chicago Mercantile Exchange ("CME") (1989); Board of Trade Clearing Corporation ("BOTCC") (1991); Kansas City Board of Trade Clearing Corporation (1992); and Comex Clearing Association (1992). The Commissions also have approved cross-margining programs between the Government Securities Clearing Corporation and the following futures clearing organizations: the New York Clearing Corporation (1999); BOTCC (2001); and CME (2001).

[42] *See supra* note 16 and accompanying text.

[43] 15 U.S.C. 78g(c)(2)(B)(iii).

[44] *See* CME/CBOT Letter at 5; SIA/FIA Letter at 12–13 and Appendix I, Q 15; OCC Letter.

[45] In its delegation letter, the Federal Reserve Board requested that "the Commissions provide an assessment of progress toward adopting more risk-sensitive, portfolio-based approaches to margining security futures products." The Federal Reserve Board further stated that "[t]he Board has encouraged the development of such approaches by, for example, amending its Regulation T so that portfolio margining systems approved by the [SEC] can be used in lieu of the strategy-based system embodied in the Board's regulation. The Board anticipates that the creation of security future products will provide another opportunity to develop more risk-sensitive, portfolio based approaches for all securities, including security options and security futures products." FRB Letter at 2.

2. Financial Relations Between a Security Futures Intermediary and a Foreign Person

The Proposed Rules provided an exclusion from the margin requirements for financial relations between a foreign branch of a creditor and a foreign person involving foreign security futures.[46] This exclusion was intended to be consistent with the way Regulation T treats financial relations between a foreign branch of a creditor and a foreign person involving foreign securities.[47] The Commissions are adopting this exclusion with two modifications.[48]

First, in response to concerns raised by a commenter,[49] the scope of the exclusion is being expanded so that it applies to the U.S. offices as well as foreign branch offices of a security futures intermediary. This commenter expressed the view that the exclusion, as proposed, would create a competitive disadvantage for U.S. firms whose existing foreign futures customers would likely migrate to foreign offices or competing foreign firms to obtain the margin levels available on the foreign exchange. After considering the commenter's view, the Commissions have concluded that expanding the exclusion is appropriate and, in light of the potential competitive issues, is not inconsistent with Regulation T.

The second modification clarifies the scope of this exclusion. Because the Proposed Rules did not define the term "foreign security future," the Final Rules provide that the exclusion applies to financial relations between a security futures intermediary and a foreign person involving "security futures traded on or subject to the rules of a foreign board of trade." Thus, the exclusion applies regardless of whether the underlying security is issued in the United States or a foreign country.[50]

3. Margin Requirements Imposed by Clearing Agencies or Derivatives Clearing Organizations

The Proposed Rules provided an exclusion from the margin requirements for margin collected by registered clearing agencies from their members.[51] The Commissions received no comments relating to this provision. The text of the proposed exclusion has been revised to specify that the Final Rules exclude clearing agencies registered under section 17A of the Exchange Act and derivatives clearing organizations registered under Section 5b of the CEA.[52] These textual changes do not affect the meaning of the provision and, therefore, the Commissions have effectively adopted the provision as proposed.

Section 7(c)(2) of the Exchange Act directs the Federal Reserve Board to prescribe rules regarding customer margin for security futures products, but it does not confer authority over margin requirements for clearing agencies and derivatives clearing organizations. Accordingly, the Federal Reserve Board stated in its delegation letter that "[t]he authority delegated by the Board is limited to customer margin requirements imposed by brokers, dealers, and members of national securities exchanges. It does not cover margin requirements imposed by clearing agencies on their members." The margin rules of clearing agencies registered with the SEC are approved by the SEC pursuant to section 19(b)(2) of the Exchange Act.[53] The CFTC has authority to ensure compliance with core principles for derivatives clearing organizations registered with the CFTC under Sections 5b and 5c of the CEA.[54] This exclusion clarifies that margin requirements that clearing agencies registered with the SEC or derivatives clearing organizations registered with the CFTC impose on their members are not subject to the Final Rules.

4. Financial Relations Between Security Futures Intermediaries and Broker-Dealers, and Certain Members of National Securities Exchanges

a. *Financial Relations with an Exempted Person.* The Proposed Rules provided an exclusion from the margin requirements for credit arrangements between a creditor and a borrower that is a member of a national securities exchange or is a registered broker-dealer (including an FCM registered as a broker-dealer under section 15(b)(11) of the Exchange Act) if the creditor made a good faith determination that the borrower was an "exempted borrower" under Regulation T.[55] The Regulation T criteria for an "exempted borrower" establish standards for the exception from federal margin regulation for exchange members and registered brokers and dealers, a substantial portion of whose business consists of transactions with persons other than brokers or dealers.[56] In addition, the Proposed Rules provided that a person that ceased to qualify for the exempted borrower exclusion would be required to notify the creditor of this fact before establishing any new security futures positions.[57] Any security futures positions subsequently established by that person would be subject to the Commissions' customer margin requirements.

One commenter addressed the exclusion, asserting that an FCM or floor broker whose only securities business consists of trading security futures would not likely qualify as an exempted borrower under Regulation T.[58] The commenter asked the Commissions to clarify that the scope of the exclusion includes FCMs or floor brokers that do not have a substantial securities or security futures business, as long as they have a substantial customer futures business.

After considering the commenter's view, the Commissions have adopted the exclusion with several modifications to clarify the application of the exclusion.[59] As a preliminary matter, the Commissions are replacing the term "exempted borrower" with the new term, "exempted person," to avoid characterizing the collection of margin for a security futures contract as involving an extension of credit.

Consequently, the Commissions are also adding to the Final Rules a definition of "exempted person." The Commissions believe that the definition of exempted person is consistent with

[46] *See* Proposed CFTC Rule 41.43(b)(3)(ii); Proposed SEC Rule 400(b)(3)(ii).

[47] *See* 12 CFR 220.1(b)(3)(iv).

[48] *See* CFTC Rule 41.42(c)(2)(ii); SEC Rule 400(c)(2)(ii).

[49] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2000).

[50] This exclusion does not address the application of Section 6(h)(1) of the Exchange Act (15 U.S.C. 78f(h)(1)) to transactions in security futures that are traded on or subject to the rules of a foreign board of trade.

[51] *See* Proposed CFTC Rule 41.43(b)(3)(iii); Proposed SEC Rule 400(b)(3)(iii).

[52] *See* CFTC Rule 41.42(c)(2)(iii); SEC Rule 400(c)(2)(iii).

[53] 15 U.S.C. 78s(b)(2).

[54] 7 U.S.C. 7a–1; 7 U.S.C. 7a–2.

[55] *See* Proposed CFTC Rule 41.43(b)(3)(iv)(A); Proposed SEC Rule 400(b)(3)(iv)(A).

[56] The term "exempted borrower" is defined in Section 220.2 of Regulation T as a member of a national securities exchange or a registered broker or dealer, a substantial portion of whose business consists of transactions with persons other than brokers or dealers, and includes a borrower who: (1) Maintains at least 1,000 active accounts on an annual basis for persons other than brokers, dealers, and persons associated with a broker or dealer; (2) earns at least $10 million in gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer; or (3) earns at least 10% of its gross revenues on an annual basis from transactions with persons other than brokers, dealers, and persons associated with a broker or dealer. 12 CFR 220.2. section 7(c)(3)(A) of the Exchange Act (15 U.S.C. 78g(c)(3)(A)) provides an exception from federal margin regulation for members of national securities exchanges and registered broker-dealers, "a substantial portion of whose business consists of transactions with persons other than brokers or dealers."

[57] *See* Proposed CFTC Rule 41.45(e); Proposed SEC Rule 402(e).

[58] OneChicago Letter at 8–9.

[59] *See* CFTC Rule 41.42(c)(2)(iv); SEC Rule 400(c)(2)(iv).

the definition of exempted borrower in Regulation T. More specifically, the Final Rules define an exempted person as a member of a national securities exchange, a registered broker or dealer, or a registered futures commission merchant, a substantial portion of whose business consists of transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, futures commission merchants, floor brokers, or floor traders, including a person who:

• Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader that are effecting transactions in securities, commodity futures, or commodity options;

• Earns at least $10 million in gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader; or

• Earns at least 10 percent of its gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader.[60]

Although the commenter recommended that floor brokers as well as FCMs be permitted to qualify as exempted borrowers, the Commissions have not included floor brokers in the definition of exempted person. This is because the exemption cannot readily be applied to floor brokers given that they do not carry the type of customer accounts contemplated by the Regulation T exempted borrower provision. The Commissions note that, although floor brokers are not included in the definition of exempted person, they may still qualify for an exclusion from the security futures margin requirements if they meet the criteria for a market maker under the Final Rules, as discussed below.[61]

The Final Rules also set forth an express definition of "persons affiliated with" a futures commission merchant, floor broker, or floor trader,[62] which parallels the definition in the Exchange Act of "person associated with a broker or dealer."[63] The purpose of this definition is to establish consistency with the Regulation T definition of exempted borrower, which excludes transactions with "persons associated with a broker or dealer," as that term is defined in section 3(a)(18) of the Exchange Act.[64] The phrase "persons affiliated with" has been used in the definition with respect to transactions with FCMs, floor brokers and floor traders, and the phrase "persons associated with" has been used with respect to transactions with brokers and dealers. This is not intended to create a substantive difference in the provisions applicable to the securities and futures industries. Rather, it is intended to avoid confusion insofar as the CFTC's definition of "affiliated person" (which includes corporate affiliates)[65] more closely matches the Exchange Act definition of "persons associated with a broker or dealer," than does the CFTC definition of "associated person," which is a registration category.[66]

The Final Rules clarify that a person may qualify as an exempted person based on transactions in commodity futures and commodity options, as well as securities. For purposes of the "1000 active accounts" threshold, an FCM or broker or dealer that clears a bona fide customer omnibus account for another FCM or broker or dealer may treat that account as a single customer account. For purposes of the $10 million and 10% thresholds, the gross revenues from transactions for bona fide customer omnibus accounts may be included in the computation. An omnibus account will not be considered a bona fide customer account if it is used to clear transactions for market professionals that would otherwise be excluded from the exempted person computation. A fully disclosed customer account will be considered a single customer account of the clearing firm, as well as the introducing firm.

The exempted person provision further states that a member of a national securities exchange or a registered broker, dealer, or futures commission merchant that has been in existence for less than one year may meet the definition of exempted person based on a six-month period.[67] This incorporates the standard set forth in Regulation T.[68]

In response to one commenter's suggestion,[69] the Commissions are also defining the term "good faith," consistent with the definition of that term in Regulation T,[70] for the purposes of determining what steps a security futures intermediary must take to assure itself that a person is an exempted person.[71] The Final Rules further provide that a person who ceases to qualify as an exempted person must notify the security futures intermediary of that fact, and become subject to the provisions of the Final Rules, but only before entering into any new security futures transaction or related transaction that would require additional margin to be deposited.[72] This would permit a person to enter into new offsetting transactions that reduce the required margin in an account without triggering higher margin requirements.

b. *Margin Arrangements with a Borrower Otherwise Excluded Pursuant to section 7(c)(3) of the Exchange Act.* The Proposed Rules included an exclusion for credit extended, maintained, or arranged by a creditor to or for a registered broker-dealer, or member of a national securities exchange (including an FCM registered as a broker-dealer under section 15(b)(11) of the Exchange Act) that is otherwise excluded under section 7(c)(3) of the Exchange Act.[73] The Commissions have decided not to adopt this exclusion.

Under section 7(c)(3)(B) of the Exchange Act,[74] the financing of the market making or underwriting activities of a member of a national securities exchange or a registered broker-dealer is excluded from the scope of federal margin regulation. The Federal Reserve Board has expressed the view that floor traders on open-outcry futures exchanges act as market makers and therefore would be excluded from the margin requirements for security futures pursuant to Section 7(c)(3)(B).[75]

[60] *See* CFTC Rule 41.43(a)(9); SEC Rule 401(a)(9).

[61] *See* CFTC Rule 41.42(c)(2)(v); SEC Rule 400(c)(2)(v).

[62] *See* CFTC Rule 41.43(a)(9)(ii); SEC Rule 401(a)(9)(ii).

[63] *See* CFTC Rule 41.43(a)(23); SEC Rule 401(a)(23).

[64] 15 U.S.C. 78c(a)(18).

[65] *See* 17 CFR 155.1; Section 4f(c)(1)(i) of the CEA, 7 U.S.C. 6f(c)(1)(i).

[66] *See* 17 CFR 1.3(aa).

[67] *See* CFTC Rule 41.43(a)(9)(iii); SEC Rule 401(a)(9)(iii).

[68] *See* 12 CFR 220.3(j)(1).

[69] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2002).

[70] *See* 12 CFR 220.2.

[71] *See* CFTC Rule 41.43(a)(15); SEC Rule 401(a)(15).

[72] *See* CFTC Rule 41.44(f); SEC Rule 402(f).

[73] *See* Proposed CFTC Rule 41.43(b)(3)(iv)(B); Proposed SEC Rule 400(b)(3)(iv)(B).

[74] 15 U.S.C. 78g(c)(3)(B).

[75] In its delegation letter, the Federal Reserve Board stated that "[i]n the current open-outcry

Continued

The proposed exclusion was intended to codify this view.

One commenter addressed this exclusion and maintained that the exclusion was confusing because the Commissions did not provide any guidance as to the factors under which a broker-dealer would qualify for the exclusion.[76] The commenter asked the Commissions to clarify the circumstances under which a floor trader on an open outcry exchange qualifies for the market maker exclusion.

The Commissions have not adopted the proposed exclusion. As noted above, the Federal Reserve Board has taken the position that floor traders on open-outcry futures exchanges qualify for the statutory market maker exception. However, any further interpretation of section 7(c)(3) of the Exchange Act is within the purview of the Federal Reserve Board. As a result, the Commissions would not be able to provide specific guidance as requested by the commenter as to the circumstances under which Section 7(c)(3) applies to floor traders on an open-outcry futures exchange. The Commissions emphasize that any person excluded from federal margin regulation under section 7(c)(3) of the Exchange Act is not subject to the rules adopted by the Commissions today. The Commissions encourage market participants to seek interpretive guidance from the Federal Reserve Board regarding the circumstances in which the exception under section 7(c)(3) of the Exchange Act applies.

c. *Financial Relations between a Security Futures Intermediary and a Member of a National Securities Exchange or Association in Connection with Market Making Activities.* The Commissions proposed to exclude from the scope of the margin requirements credit extended, maintained, or arranged to or for members of a national securities exchange or a national securities association in connection with market making activities.[77] As proposed, the exclusion had two conditions. First, the borrower could not directly or indirectly accept or solicit customer orders or provide advice to any customer in connection with the trading of security futures. Second, the borrower had to be registered with the exchange or association as a security futures dealer, pursuant to regulatory authority rules that require the borrower: (a) To be registered as a floor trader or floor broker with the CFTC, or as a dealer with the SEC; (b) to comply with applicable SEC or CFTC net capital requirements; (c) to maintain records sufficient to demonstrate compliance with the exclusion and the rules of the exchange or association; (d) to hold itself out as willing to buy and sell security futures for its own account on a regular or continuous basis; and (e) to be subject to disciplinary action if it failed to comply with the Commissions' margin rules or the rules of the exchange or association.[78] The Commissions are adopting this exclusion with modifications in light of commenters' views.[79]

The Commissions received four comments on the exclusion.[80] These comments generally supported the proposed exclusion, but suggested that the Commissions clarify certain aspects of the conditions.

One commenter expressed the view that a person is a market maker in security futures if it provides liquidity on a regular basis, even if it is not under an affirmative obligation to do so.[81] Based on that view, the commenter suggested two alternatives to the Commissions' proposal to determine whether a trader is a liquidity provider. First, the commenter recommended that the Commissions consider a person to be a liquidity provider solely because that person is registered with either the SEC or the CFTC as a trading professional (*e.g.*, as a broker-dealer or FCM) and is a member of an exchange. In the alternative, the commenter recommended that the Commissions consider a trader to be a liquidity provider if that person can demonstrate through its business activity that it is a professional liquidity provider, regardless of its regulatory status or membership in an exchange.[82] This commenter further stated that the net capital requirements for persons acting as market makers in security futures should be uniform in order to prevent security futures market makers subject to CFTC financial responsibility rules from obtaining an unfair competitive advantage over security futures market makers (or security options market makers) subject to SEC financial responsibility rules.[83]

Another commenter asked the Commissions to modify the condition to the exclusion for exchange members that requires that the member "hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis."[84] The commenter maintained that market makers on a screen-based trading system either should have an enforceable obligation to provide liquidity or should meet an objective standard for supplying liquidity.[85] Specifically, the commenter suggested that the condition be narrowed further with respect to members of screen-based trading systems so that it would apply only to members of such systems that: (1) have a continuous, affirmative obligation to quote a two-sided market; or (2) effect more than two-thirds of their security futures trades on that exchange with persons other than registered market makers on that exchange.[86]

A third commenter asked the Commissions to eliminate the condition to the exclusion for exchange members that requires that the member not "directly or indirectly accept or solicit orders from any customer or provide advice to any customer in connection with the trading of security futures."[87] The commenter maintained that a broker-dealer acting as a market maker should not be precluded from also carrying out a customer securities business.

The fourth commenter asked the Commissions to confirm that registered floor brokers and floor traders would qualify for the exclusion even if they are not subject to a net capital requirement under CFTC rules.[88] In support of this request, the commenter stated that market makers in options are exempt from the SEC's net capital rule.[89]

After considering the commenters' views, the Commissions have adopted the exclusion with certain modifications. First, the Commissions are clarifying that the provision relating

environment, the Board believes that floor traders act as market makers and therefore would be exempt [under section 7(c)(3) of the Exchange Act]." FRB Letter at 2.

[76] CBOE Letter.

[77] *See* Proposed CFTC Rule 41.43(b)(3)(iv)(C); Proposed SEC Rule 400(b)(3)(iv)(C).

[78] *Id.*

[79] *See* CFTC Rule 41.42(c)(2)(v); SEC Rule 400(c)(2)(v). The Commissions note that the Final Rules include a definition of the term "member," which clarifies the applicability of that term to persons with trading privileges on an exchange, even if that exchange does not have a "membership" structure. More specifically, the term "member" has the meaning provided in section 3(a)(3) of the Exchange Act and includes persons registered under section 15(b)(11) of the Exchange Act that are permitted to effect transactions on a national securities exchange without the services of another person acting as executing broker. *See* CFTC Rule 41.43(a)(21); SEC Rule 401(a)(21).

[80] *See* Amex Letter; CBOE Letter; OneChicago Letter; SIA/FIA Letter. In addition, the ABN AMRO Letter endorsed the comments in the SIA/FIA Letter.

[81] CBOE Letter at 2–3.

[82] *Id.* at 4.

[83] *Id.* at 5–6.

[84] Amex Letter.

[85] *Id.* at 2, 4.

[86] *Id.* at 4.

[87] SIA/FIA Letter at 14, n.25; Appendix I, Q 17(a).

[88] OneChicago Letter at 9.

[89] *Id.*

to accepting or soliciting customer orders was not intended to bar a member from engaging in such activities. That provision was intended to limit the exclusion from the margin requirements to circumstances where the member was trading for its own account, not for the account of others. Accordingly, the rule has been modified to make clear that the exclusion is available to a member only with respect to trading activity for its own account.[90] Thus, the member may conduct a customer business and still qualify for the exclusion from the Commissions' margin requirements for security futures with regard to its market making activity.

The Commissions have also decided that it is unnecessary to restate the applicability of existing net capital requirements under CFTC and SEC rules, or to impose additional net capital requirements, as a condition of the exclusion for persons acting as market makers. Firms will continue to be subject to applicable CFTC or SEC net capital requirements. Further, even if a member is not subject to net capital requirements, the member's carrying firm will be subject to the treatment provided in existing SEC or CFTC net capital rules, whichever are applicable, with respect to the member's security futures transactions.

As noted above, the Commissions received several comments regarding the circumstances under which an exchange member should be considered a market maker for purposes of the margin rules, other than in circumstances that fall within the exception in Section 7(c)(3) of the Exchange Act. These comments largely refer to the requirement that the exchange member "hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis' in order to qualify for the exclusion. The Commissions do not believe that registration with the SEC or CFTC is, by itself, sufficient to show that a market participant is holding itself out as willing to buy and sell security futures. However, the Commissions believe that there are a number of different ways that an exchange member could satisfy this condition. For example, an exchange's or association's rules could require the member to effect a certain percentage of its security futures trades on that exchange or association with persons other than registered market makers on that exchange or association.[91]

Alternatively, such rules could require that a large majority of such exchange member's revenue is derived from business activities or occupations from trading listed financial-based derivatives (*i.e.*, security futures, stock index futures, stock and index options, foreign currency futures and options, and interest rate futures and options) on any exchange in the capacity of a member. As another alternative, the exchange member could be subject to rules that impose on it an affirmative obligation to quote on a regular or continuous basis in security futures.

C. Interpretations of, and Exemptions From, the Final Rules

The Commissions are adopting two provisions in the Final Rules to clarify the Commissions' authority to respond to issues that arise in connection with the implementation of the Final Rules. First, the Commissions are adding a provision regarding the interpretation of the security futures margin rules. The Final Rules provide that the Commissions shall jointly interpret the margin rules, consistent with the criteria set forth in clauses (i) through (iv) of section 7(c)(2)(B) of the Exchange Act and Regulation T.[92]

Second, the Final Rules add a provision providing that each Commission may issue an exemption from any provision of the Final Rules.[93] CFTC Rule 41.42(d) provides that the CFTC may grant an exemption with respect to any provision of CFTC Rules 41.42 through 41.49, provided that the CFTC finds that the exemption is consistent with the public interest and the protection of customers. Similarly, SEC Rule 400(d) provides that the SEC may grant an exemption with respect to any provision of SEC Rules 400 through 406, provided that the exemption is necessary or appropriate in the public interest and consistent with the protection of investors. Because financial relations involving security futures are subject to the Final Rules as adopted by both the CFTC and the SEC, any person seeking an exemption under these rules must request and obtain the same exemption from both the CFTC and SEC. The Commissions intend to work together on exemption requests to establish uniform policies for security futures trading.

D. Definitions

The definition section of the Proposed Rules has been expanded to include all applicable defined terms. Under the Proposed Rules, many of these definitions and provisions would have been incorporated through the application of Regulation T.

The terms "contract multiplier," "daily settlement price," and "Regulation T" are defined in the Final Rules as proposed.[94] The Proposed Rules defined the terms "examining authority," "initial margin," and "maintenance margin."[95] These terms are not, however, included in the Final Rules because modifications made to the Proposed Rules make them unnecessary. The Final Rules also define the term "self-regulatory authority,"[96] instead of the term "regulatory authority" as proposed,[97] and its definition has been revised to include a reference to registration under the CEA. In addition, the Final Rules define the term "current market value" with respect to a security other than a security future consistently with the Regulation T definition.[98] Some of the defined terms incorporate by reference definitions from the CEA, the Exchange Act, or CFTC or SEC rules.[99]

[90] *See* CFTC Rule 41.42(c)(2)(v); SEC Rule 400(c)(2)(v).

[91] National securities exchanges registered under section 6(a) of the Exchange Act require their options market makers to conduct at least 50% of their total contract volume in option classes to which they have been appointed. *See* Amex Rule 958; Philadelphia Stock Exchange ("Phlx") Rule 1014. In some cases, market makers are required to conduct at least 75 percent of their total contract volume in option classes to which they have been appointed. *See* CBOE Rule 8.7.03; International Securities Exchange Rule 805; Pacific Exchange ("PCX") Rule 6.37.

[92] *See* CFTC Rule 41.42(b); SEC Rule 400(b).

[93] *See* CFTC Rule 41.42(d); SEC Rule 400(d). The SEC and CFTC exemption standards contained in the Final Rules are the same as those set forth in the recently adopted rules relating to cash settlement and regulatory halt requirements for security futures products. *See* Securities Exchange Act Release No. 45956 (May 17, 2002), 67 FR 36740 (May 24, 2002). As noted in connection with those rules, the SEC version of the exemption provision refers to the protection of "investors," and the CFTC version of the provision refers to the protection of "customers." *Id.* at 36745, n.64. The difference in terminology is not intended to have any substantive significance. Rather, the terms are used for purposes of conformity with terminology used in the Exchange Act and CEA.

[94] *See* CFTC Rules 41.43(a)(3), (a)(6), and (a)(24); SEC Rules 401(a)(3), (a)(6), and (a)(24).

[95] *See* Proposed CFTC Rules 41.44(a)(3), (a)(4), and (a)(5); Proposed SEC Rules 401(a)(3), (a)(4), and (a)(5).

[96] *See* CFTC Rule 41.43(a)(30); SEC Rule 401(a)(30). The terminology was modified to eliminate confusion as to a "regulatory authority" being a governmental regulator rather than an SRO.

[97] *See* Proposed CFTC Rule 41.44(a)(7); Proposed SEC Rule 401(a)(7).

[98] *See* CFTC Rule 41.43(a)(4); SEC Rule 401(a)(4); see also 12 CFR 220.2.

[99] *See, e.g.*, definitions of "broker," CFTC Rule 41.43(a)(2) and SEC Rule 401(a)(2); "dealer," CFTC Rule 41.43(a)(7) and SEC Rule 401(a)(7); "exempted security," CFTC Rule 41.43(a)(10) and SEC Rule 401(a)(10); "futures account," CFTC Rule 41.43(a)(13) and SEC Rule 401(a)(13); "futures

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Terms that are not otherwise defined in the definition section of the Final Rules will have the meaning set forth in the margin rules applicable to the account.[100] Terms that are neither defined in the definition section nor in the margin rules applicable to the account will have the meaning set forth in the Exchange Act and the CEA.[101] If the definitions of a term in the Exchange Act and the CEA are inconsistent as applied in particular circumstances, such term shall have the meaning set forth in rules, regulations, or interpretations jointly promulgated by the SEC and the CFTC.

E. Application of Regulation T to Security Futures

Section 7(c)(2)(B)(iv) of the Exchange Act requires that the margin requirements for security futures (other than levels of margin), including the type, form, and use of collateral, must be consistent with the requirements of Regulation T.[102] To carry out that statutory mandate, the Commissions proposed that Regulation T would apply to all transactions in security futures, to the extent consistent with the Proposed Rules. Thus, under the Proposed Rules, Regulation T would have applied both to securities accounts (which are already subject to Regulation T) and to futures accounts (which are not otherwise subject to Regulation T) that carry security futures.[103] This approach also would have applied existing and future Federal Reserve Board interpretations of Regulation T to the margin requirements for security futures and kept the margin requirements consistent with Regulation T without the need for amendments to the Final Rules.

The Commissions, however, also recognized that there could be more than one approach to prescribing rules that are "consistent" with Regulation T. Accordingly, the Commissions specifically requested commenters' views on alternative approaches to establishing consistency with Regulation T. In particular, the Commissions solicited comment on the approach of issuing comprehensive "stand-alone" margin rules that would parallel Regulation T requirements for securities to the extent that such requirements are relevant to security futures. Under that approach, the stand-alone rules would apply to security futures and any related securities or futures contracts that are used to offset positions in such security futures. However, the stand-alone rules would not apply to any other securities or futures transactions.

The Commissions received a total of 12 comment letters on the application of Regulation T to security futures transactions.[104] One commenter supported the Commissions' proposed approach regarding Regulation T.[105] Nine commenters opposed general application of Regulation T to security futures carried in futures accounts,[106] and two other commenters specifically opposed applying the Regulation T account structure to FCMs.[107]

The commenter that supported application of Regulation T to all security futures transactions believed that the alternative approach of stand-alone rules would not satisfy the statutory requirement that the margin requirements for security futures (other than levels of margin) be "consistent" with those imposed on securities.[108] The commenter expressed the view that the term "consistent" should mean that there is no appreciable difference between rules applicable to exchange-traded options and rules applicable to security futures. In addition, the commenter noted that if the Commissions adopt stand-alone margin rules there is a risk that over time such rules will vary materially from Regulation T because of the difficulty of promptly incorporating the Federal Reserve Board's future interpretations of Regulation T into stand-alone rules.

Commenters opposing the general application of Regulation T to security futures did not believe that the CFMA required such application. One commenter contended that application of Regulation T to futures accounts "is impractical and unnecessary" and "not required," and that the CFMA's "consistent" standard did not necessarily require rules "identical" or "equivalent" to the rules applicable to exchange-traded options.[109] Rather, this commenter argued, Regulation T permits commodity futures to be recorded in an account other than a margin account (a "good faith" account) and, as a result, permitting security futures to be carried in a futures account (not a margin account) is "consistent" with Regulation T.[110] Another commenter observed that while "consistency requires reasonable comparability * * * [, i]f Congress had meant 'consistent' to mean 'identical,' however, it would have used that word" or would have clearly directed that Regulation T be applied to security futures.[111] Similarly, another commenter pointed out that "the CFMA did not mandate the application of Reg[ulation] T to security futures maintained in a futures account" and that the "imposition of Reg[ulation] T with respect to security futures is inconsistent with Congress's goal of facilitating trading in security futures." [112]

Commenters that disagreed with the Commissions' proposed approach generally urged the Commissions to adopt "stand-alone" margin rules for security futures.[113] All of these commenters maintained that the programming changes necessary to enable FCMs to comply with Regulation T would be overly costly.[114] Generally, those commenters believed that it would be operationally difficult or impossible to carry security futures in a standard futures account without costly and time-consuming reprogramming.[115] Commenters were concerned that this would place FCMs at a considerable disadvantage in comparison to broker-dealers and would discourage them from trading security futures. One commenter pointed out that a broker-dealer "would need to do little, relative to an FCM, to bring itself into compliance with the Proposed Rules." [116] Another commenter expressed concern that FCMs would have to undertake a substantial development project requiring 'the

commission merchant," CFTC Rule 41.43(a)(14) and SEC Rule 401(a)(14); and "securities account," CFTC Rule 41.43(a)(28) and SEC Rule 401(a)(28).

[100] *See* CFTC Rule 41.43(b); SEC Rule 401(b). *See also infra* notes 125–126 and accompanying text.

[101] *See* CFTC Rule 41.43(c); SEC Rule 401(c).

[102] 15 U.S.C. 78g(c)(2)(B)(iv).

[103] *See* Proposed CFTC Rule 41.43(b)(1); Proposed SEC Rule 400(b)(1).

[104] *See* NFA Letter; SIA/FIA Letter; Nasdaq Liffe Letter; ABN AMRO Letter; CME/CBOT Letter; OneChicago Letter; Morgan Stanley Letter; Peregrine Letter; SunGard Letter; Options Exchanges Letter; Managed Funds Letter; and Rolfe and Nolan Letter.

[105] Options Exchanges Letter at 3.

[106] NFA Letter at 2–3; SIA/FIA Letter at 2, 4–7; ABN AMRO Letter at 1; CME/CBOT Letter at 2–3; OneChicago Letter at 3–7; Morgan Stanley Letter at 2, 5–6; Peregrine Letter at 2; Managed Funds Letter at 1; and Rolfe and Nolan Letter at 1–2.

[107] Nasdaq Liffe Letter at 6–7; and SunGard Letter at 2–3.

[108] Options Exchanges Letter at 3.

[109] OneChicago Letter at 3.

[110] *Id.* at 3–4.

[111] NFA Letter at 2.

[112] SIA/FIA Letter at 5.

[113] *See* NFA Letter at 2; SIA/FIA Letter at 5; Nasdaq Liffe Letter at 7; ABN AMRO Letter at 1; CME/CBOT Letter at 10; OneChicago Letter at 7; SunGard Letter at 3; and Peregrine Letter at 2.

[114] *See* NFA Letter at 3; SIA/FIA Letter at 4; Nasdaq Liffe Letter at 6; ABN AMRO Letter at 1; CME/CBOT Letter at 3; OneChicago Letter at 5; SunGard Letter at 1; and Peregrine Letter at 2.

[115] *See* NFA Letter at 2; SIA/FIA Letter at 4–5; Nasdaq Liffe Letter at 6; ABN AMRO Letter at 1; CME/CBOT Letter at 3; OneChicago Letter at 4; SunGard Letter at 1; Peregrine Letter at 2.

[116] OneChicago Letter at 5.

restructuring of FCMs' accounts and related systems changes." [117] The commenter estimated that this would result in the expenditure of "several thousands of personnel hours," [118] while another commenter believed that costs would "run well into six figures." [119]

Eight commenters recommended the adoption of an account-specific margin regime for purposes of account administration.[120] The adoption of an account-specific margin regime was effectively endorsed by two other commenters that advocated retention of specific existing practices [121] and one other that believed the imposition of Regulation T on FCMs would be highly burdensome.[122] One commenter argued against the adoption of an account-specific margin regime, stating that FCMs will have to revise a number of their operating procedures and there is no compelling reason to make an exception for margin procedures.[123]

After considering the commenters' suggestions, the Commissions have determined that it is not necessary to apply Regulation T in its entirety to security futures transactions to satisfy the requirements under section 7(c)(2) of the Exchange Act.[124] Given the relative infrequency of the Federal Reserve Board adopting amendments to Regulation T and issuing formal regulatory guidance, the Commissions do not believe that it will be unduly burdensome or impractical to amend these rules to maintain consistency with Regulation T. Accordingly, the Commissions have adopted stand-alone margin rules that include certain requirements of Regulation T. The Commissions believe that the inclusion of these requirements in the Final Rules satisfies the statutory requirement that margin requirements for security futures be and remain consistent with Regulation T.

The Commissions believe that many of the rules governing margin for positions carried in securities accounts are similar enough to the rules governing margin for positions carried in futures accounts that the differences do not, by themselves, create an incentive for customers either to trade security futures instead of options, or to hold security futures in a futures account rather than a securities account. Accordingly, the Commissions are adopting an "account-specific" approach for those aspects of account administration that need not be conformed to satisfy the requirement that the margin rules for security futures be consistent with Regulation T. Thus, the Final Rules provide that security futures held in a securities account are subject to the Final Rules, Regulation T, and to the margin requirements of the self-regulatory authorities of which the security futures intermediary is a member.[125] Security futures held in a futures account, on the other hand, will be subject to the Final Rules and the margin requirements of the self-regulatory authorities of which the security futures intermediary is a member.[126]

Notwithstanding the Commissions' determination not to apply Regulation T in its entirety to security futures, the Final Rules include certain uniform provisions that govern account administration, type, form, and use of collateral, calculation of equity, withdrawals from accounts, and treatment of undermargined accounts. The Commissions believe that the inclusion of these provisions in the Final Rules satisfies the statutory requirement that the margin rules for security futures be consistent with Regulation T.

F. Account Administration Rules

1. Separation and Consolidation of Accounts

Regulation T establishes specific types of accounts for recording different types of customer transactions (*e.g.*, a margin account, a cash account, a good faith account).[127] Regulation T generally provides that a customer can have only one margin account.[128] While a margin account may be divided into separate parts for bookkeeping purposes, as authorized by the customer, all parts must be considered as one unit in determining whether or not any transaction is permissible under Regulation T.[129] The determination as to whether an account satisfies the requirements of Regulation T, moreover, may not take into consideration items in any other account; bookkeeping entries must be made whenever cash or securities in one account are used for purposes of meeting requirements in another account.[130] Consistent with Regulation T, the Final Rules provide that the margin requirements for one account may not be met by considering items in another account, except where excess margin is transferred using appropriate bookkeeping entries.[131] To facilitate the enforcement of this general prohibition, this provision also requires that if withdrawals of cash, securities, or other assets deposited as margin are permitted under the Final Rules, a security futures intermediary must make and keep accurate bookkeeping entries when those assets are used to meet requirements in another account.[132] This provision parallels Section 220.3(b)(1) of Regulation T, and is intended to be consistent with existing futures account practices under Section 4d of the CEA,[133] CFTC Rules 1.20 and 1.22, and applicable futures exchange rules.

Currently, futures exchange rules or practices similarly recognize accounts of different types for different customer transactions (*e.g.*, customer segregated, customer secured, nonsegregated). Customers may maintain multiple accounts of the same regulatory classification or account type, although futures exchange rules provide that identically owned accounts within the same regulatory classification or account type should be combined for margin purposes.[134] Moreover, an FCM may not apply free funds in an account under identical ownership but of a different regulatory classification or account type to an account's margin deficiency.[135] As is the case under Regulation T, however, the Final Rules require the FCM to actually document through bookkeeping entries the transfer of funds from one account to satisfy the margin deficiency in another account. The Commissions do not believe that this provision will create any substantial operational burdens for FCMs carrying security futures in futures accounts.

The Final Rules provide that all futures accounts of the same regulatory

[117] SIA/FIA Letter at 4.

[118] *Id.*

[119] Rolfe and Nolan Letter at 1.

[120] *See* NFA Letter at 1–2; SIA/FIA Letter at 3–4; Nasdaq Liffe Letter at 6–7; ABN AMRO Letter at 1; OneChicago Letter at 6–7; Peregrine Letter at 2; Morgan Stanley Letter at 1; and Managed Funds Letter at 2.

[121] *See* Rolfe and Nolan Letter at 2; and CME/CBOT Letter at 10.

[122] SunGard Letter at 2.

[123] Options Exchanges Letter at 3–4.

[124] 15. U.S.C. 78g(c)(2).

[125] *See* CFTC Rule 41.44(a)(1); SEC Rule 402(a)(1).

[126] *See* CFTC Rule 41.44(a)(2); SEC Rule 402(a)(2).

[127] *See* 12 CFR 220.4(a)(1).

[128] *See* 12 CFR 220.4(a)(2).

[129] Fed. Res. Reg. Serv. § 5–634.11 (Staff Op. May 15, 1978).

[130] *See* 12 CFR 220.3(b)(1).

[131] *See* CFTC Rule 41.44(b)(1); SEC Rule 402(b)(1).

[132] *See* CFTC Rule 41.44(b)(1); SEC Rule 402(b)(1); *see also* section 17(a) of the Exchange Act (15 U.S.C. 78q–1(a)), and the rules thereunder; Section 4g of the CEA (7 U.S.C. 6g), and the rules thereunder; National Association of Securities Dealers ("NASD") Rule 3110; and NFA Rule 2–10.

[133] 7 U.S.C. 6d.

[134] *See* Joint Audit Committee Handbook, Chapter 9 (June 1999), available at *<http://www.nfa.futures.org/compliance/publications/Margins/MarginsHandbook.pdf>*.

[135] *See* id.

type or classification that carry security futures shall be considered a single account for purposes of the Regulation.[136] The Final Rules also permit a securities futures intermediary to further consolidate all futures accounts of the same regulatory classification or account type, regardless of whether they carry security futures, for purposes of determining whether the required margin for all of a customer's futures positions (including security futures) is satisfied.[137]

2. Accounts of Partners

The Final Rules provide that if a partner of a security futures intermediary (organized as a partnership) has an account with the security futures intermediary in which security futures or related positions are held, the security futures intermediary must disregard the partner's financial relations with the firm (as shown in the partner's capital and ordinary drawing accounts) in calculating the margin or equity of any such account.[138] This provision parallels Section 220.4(b)(5) of Regulation T,[139] and is consistent with current futures exchange practices. The provision is intended to reinforce the principle of "separation of accounts" with respect to partners in a security futures intermediary organized as a partnership, when a partner maintains a trading account with the firm.

3. Contribution to a Joint Venture

Under the Final Rules, if an account in which security futures or related positions are held is the account of a joint venture in which the security futures intermediary participates, any interest of the security futures intermediary in the joint account in excess of the interest which the security futures intermediary would have on the basis of its right to share in the profits must be margined in accordance with the Final Rules.[140] This provision parallels Section 220.4(b)(6) of Regulation T,[141] which is intended to prevent firms from indirectly extending credit to customers in circumstances where the customer does not deposit equity in the account corresponding to its share of the profits in the account (*e.g.*, if the customer is entitled to 90% of the profits in an account, but only deposits 40% of the equity at the outset, the broker-dealer is effectively extending credit to the customer in the amount of 50% of the equity in the account).

4. Extensions of Credit

The Final Rules prohibit any extension of credit with respect to security futures, if the extension of credit is designed to evade or circumvent the security futures margin requirements.[142] Among other things, this provision is intended to prevent security futures intermediaries from extending unsecured credit to customers, or extending credit secured by securities or other assets in excess of the value such assets would have under the Final Rules,[143] to satisfy or maintain the required margin for security futures carried in the customer's account.[144] For example, a security futures intermediary may not lend a customer $100 in cash secured by less than $200 in margin equity securities to meet a margin call for a security future. This provision does not, however, preclude a security futures intermediary from advancing funds to a customer to meet variation settlement calls on behalf of an undermargined customer account, in the ordinary course of business, provided that the security futures intermediary issues a margin call for the funds advanced.

The Final Rules permit a security futures intermediary to arrange for an extension of credit to or for a customer by a person, provided that the extension of credit would not constitute a violation of Regulations T, U, or X by such person.[145] In this connection, the Commissions believe that credit extended for the purpose of satisfying or maintaining the required margin for a security future is "purpose credit" for purposes of the Federal Reserve Board's credit regulations. For example, a security futures intermediary may not arrange for a Regulation T creditor to extend credit to a customer against securities or other assets in a nonpurpose or nonsecurities credit account to enable the customer to meet a margin requirement with respect to a security future. Likewise, a security futures intermediary may not arrange for a bank or other Regulation U lender to extend credit secured directly or indirectly by margin stock in excess of the maximum loan value of the collateral (*i.e.*, 50% of current market value) securing the credit for the purpose of purchasing or carrying a security future. Similarly, a security futures intermediary may not arrange for a Regulation X borrower to obtain an extension of credit within or from outside the United States for the purpose of effecting or carrying a security futures transaction unless the credit conforms to the Federal Reserve Board's margin regulations, as provided in Regulation X.

G. Customer Margin Levels for Security Futures

The Commissions proposed to require both the seller and the buyer of a security future to provide and maintain, on a daily basis, cash or other acceptable assets equal to a percentage of the "current market value" of the security future. The Commissions are adopting those requirements substantially as proposed.

1. Definition of Current Market Value

The Commissions proposed to define the term "current market value" of a security future as the product of the daily settlement price of the security future (as shown by any regularly published reporting or quotation service) and either the applicable number of shares per contract (when the underlying instrument is a single stock), or the applicable contract multiplier (when the underlying instrument is a narrow-based security index).[146] The Commissions also proposed to define the term "current market value" with respect to a narrow-based security index future to mean the product of the daily settlement price of such security future, as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.[147]

The Commissions received one comment on these definitions, which suggested that the pricing convention for determining current market value need not be the same for security futures held in a security account and for

[136] *See* CFTC Rule 41.44(b)(2); SEC Rule 402(b)(2).

[137] *Id.*

[138] *See* CFTC Rule 41.44(c); SEC Rule 402(c).

[139] 12 CFR 220.4(b)(5).

[140] *See* CFTC Rule 41.44(d); SEC Rule 402(d).

[141] 12 CFR 220.4(b)(6).

[142] *See* CFTC Rule 41.44(e); SEC Rule 402(e). CFTC Rule 1.30 permits FCMs to lend their own funds to customers on pledged securities; the proceeds of such loans are treated as customer funds for purposes of the CEA. 17 CFR 1.30. Extensions of credit by brokers and dealers with respect to securities are governed by Regulation T and the margin rules of the national securities exchanges and securities associations.

[143] *See* CFTC Rule 41.46(c); SEC Rule 404(c).

[144] Futures exchange rules also impose certain restrictions on the financing of futures positions. *See, e.g.*, CME Rule 930.G ("Clearing members may not extend loans to account holders for performance bond purposes unless such loans are secured as defined in [17 CFR] 1.17(c)(3)"); New York Mercantile Exchange ("NYMEX") Rule 4.03 ("Clearing Members shall not be permitted to make loans to any customers for the purpose of financing margins on NYMEX Division contracts unless such loans are secured, as such term is defined in [17 CFR] 1.17.").

[145] *See* CFTC Rule 41.44(e)(2); SEC Rule 402(e)(2).

[146] *See* Proposed CFTC Rule 41.44(a)(2)(i); Proposed SEC Rule 401(a)(2)(i).

[147] *See* Proposed CFTC Rule 41.44(a)(2)(ii); Proposed SEC Rule 401(a)(2)(ii).

security futures held in a futures account.[148] The Commissions, however, believe that a uniform definition of current market value is necessary to ensure that identical contracts are not subject to different margin requirements based on the type of account in which they are carried.

As noted above, section 7(c)(2)(B)(3)(I) of the Exchange Act[149] requires that the margin requirements for security futures be consistent with the margin requirements for comparable exchange-traded options. The Commissions believe that using the daily settlement price[150] at the end of each trading day to calculate margin requirements for security futures on that day is consistent with the use of the closing price of the option and the underlying security for determining maintenance margin for equity options.[151] In addition, the Commissions continue to believe that using the daily settlement price of a security future on the day of a transaction to calculate the initial margin (rather than the daily settlement price on the day preceding the transaction) is consistent with using the underlying stock's closing price on the preceding business day. The daily settlement price of a security future on the preceding business day, for example, may not exist if such security future were not available for trading on the preceding business day. Accordingly, the Commissions are adopting the definition of "current market value" as proposed.

2. Margin Levels for Unhedged Positions

The Commissions proposed that the minimum initial and maintenance margin levels required of customers for each security future carried in a long or short position be 20% of the current market value of such security future.[152] This proposed level was based on the requirement under section 7(c)(2) of the Exchange Act that the initial and maintenance margin levels for a security future not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act.[153]

Twelve commenters commented on this aspect of the Proposed Rules.[154] Six commenters found 20% to be an acceptable level.[155] Two commenters advocated a 25% margin level,[156] and one commenter, joined by a second, stated that its members could not reach a consensus as between 20% and 25%.[157] One commenter expressed the view 20% could be either too high or low, and suggested that for certain positions, 50% initial margin would be appropriate.[158]

One commenter considered the 20% level to be consistent with the margin requirements for exchange-traded options, but "more than adequate" in terms of preserving the financial integrity of the market and preventing systemic risk.[159] Another commenter stated that it "does not oppose" the 20% level, but favors portfolio margining.[160]

One commenter said that its members were split between recommending 20% and 25%.[161] Those supporting the 20% level believed that it was consistent with the levels applicable to exchange-traded options and consistent with the intent of the CFMA. This margin level in combination with a T+1 settlement period and the fact that the Proposed Rules permit higher margin levels, made some members conclude that 20% is a prudent minimum level.[162] Other members thought that 20% is too low, failing to take into account the varying volatility/share price profiles of equity securities and the credit risk implications of those differences. Those members favored a 25% minimum, finding this to be "consistent" with margin levels for options.[163] They further noted that a comparable option position consists of a long (short) call/short (long) put option pair struck at the forward price of the underlying security.[164]

Finally, one commenter urged the Commissions to adopt a 25% margin level, citing historical data and stating that this level is consistent with the minimum margin level applied under SRO rules to long equity positions.[165] It argued that the 20% level would create an advantage for security futures as compared to listed option put/call pairs, noting margin levels in excess of 30% for combinations based on relatively high volatility stocks, and margin levels in excess of 20% for combinations based on relatively low volatility stocks.[166]

After considering the commenters' views, the Commissions have adopted the margin levels as proposed. The Commissions believe that a security future is comparable to a short, at-the-money option, as discussed in the release accompanying the Proposed Rules ("Proposing Release").[167] Currently, the margin requirement for a short, at-the-money option, where the underlying instrument is either an equity security (such as a stock or an instrument immediately convertible into a stock) or an index, is 100% of the option proceeds plus 20% of the value of the underlying security or index.[168]

Unlike an options contract, however, a futures contract involves obligations of both parties to perform in the future: The buyer (long) to purchase the asset underlying the future, and the seller (short) to deliver the asset. As a result, both the buyer and the seller of a futures contract must post and maintain margin on a daily basis to assure contract performance and the integrity of the marketplace. In addition, all market participants pay or receive daily variation settlement as a result of all open futures positions being marked to current market value. Accordingly, the margin levels apply equally for both buyers and sellers of security futures.

The Commissions have considered the comments, and have determined that a minimum margin level of 20% satisfies the comparability standard of section 7(c)(2) of the Exchange Act.[169] In addition, the Commissions note that the Final Rules permit self-regulatory

[148] SIA/FIA Letter at Appendix I, Q 18.

[149] 15 U.S.C. 78g(c)(2)(B)(3)(I).

[150] Under the Final Rules, the term "daily settlement price" means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, as determined by the rules of the applicable exchange, clearing agency or derivatives clearing organization. *See* CFTC Rule 41.43(a)(6); SEC Rule 401(a)(6).

[151] Currently, the computation of the margin required on the sale of an uncovered option is based on the value of the security underlying the option. The initial margin on the sale of an uncovered option is based on the price at which the underlying security closed at the end of the business day before the day on which the option is sold. The maintenance margin on an uncovered short option is based on the closing price of the underlying security at the end of each business day.

[152] *See* Proposed CFTC Rule 41.45(b); Proposed SEC Rule 402(b).

[153] 15 U.S.C. 78g(c)(2)(B)(iii)(II).

[154] *See* SIA Credit Division Letter; Morgan Stanley Letter; Drinkard Letter; Partnoy Letter; Klein Letter; SIA/FIA Letter; One Chicago Letter; NFA Letter; Peregrine Letter; Options Exchanges Letter; Nasdaq Liffe Letter; and Managed Funds Letter.

[155] *See* NFA Letter at 4; Nasdaq Liffe Letter at 5; Options Exchanges Letter at 5; OneChicago Letter at 2; Peregrine Letter at 2; Managed Funds Letter at 3.

[156] *See* Morgan Stanley Letter at 6; SIA Credit Division Letter at 1.

[157] *See* SIA/FIA Letter at 2–3, 10–11; ABN AMRO Letter at 1.

[158] Partnoy Letter at 10–14.

[159] NFA Letter at 4.

[160] Nasdaq Liffe Letter at 5.

[161] SIA/FIA Letter at 2.

[162] *Id.* at 10.

[163] *Id.*

[164] *Id.*

[165] Morgan Stanley Letter at 6–8.

[166] *Id.* at 7.

[167] *See* Securities Exchange Act Release No. 44853 (September 26, 2001), 66 FR at 50776 (October 4, 2001).

[168] *See, e.g.,* Amex Rule 462; CBOE Rule 12.3; NASD Rule 2520; New York Stock Exchange ("NYSE") Rule 431; PCX Rule 2.16; and Phlx Rule 722.

[169] *See* 15 U.S.C. 78g(c)(2).

authorities and security futures intermediaries to establish higher margin levels or to take appropriate action to preserve their own financial integrity.[170] As a result, the Commissions are adopting the minimum initial and maintenance margin levels for unhedged positions, as proposed.

3. Margin Offsets

The Proposed Rules included a provision to allow national securities exchanges and national securities associations to adopt rules that reduce the margin levels below 20% of current market value for customers with certain positions in securities or futures that offset the risk of their positions in security futures.[171] The Proposed Rules provided further that the resulting margin levels could not be lower than the lowest customer margin levels required for comparable offset positions involving exchange-traded options.[172] In addition, the Commissions published a table that included offsets for security futures that the Commissions had preliminarily identified as consistent with those permitted for comparable offset positions involving options and that would qualify for reduced margin levels.[173]

The Commissions received three comments with respect to the proposed offsets.[174] One of the commenters stated that offsets involving security futures and options should be recognized only if the risk from the security future is completely offset by the option.[175] Another commenter expressed concern that the offsets would produce margin levels that did not accurately reflect the risk of the positions and suggested that the Commissions adopt general provisions regarding margin levels for offsetting positions instead of providing specific examples.[176] Finally, one commenter suggested modifying the existing strategy-based rules to put security futures on a par with cash equities in connection with offsetting strategies involving listed options and to reduce the margin requirements for certain calendar and basket spreads involving security futures.[177] This commenter also suggested that the Commissions address the treatment of spreads involving non-fungible security futures.[178]

After considering the commenters' views, the Commissions have adopted, substantially as proposed, rules that permit self-regulatory authorities to establish margin levels for offset positions involving security futures that are lower than the required margin levels for unhedged positions.[179] Under the Final Rules, a self-regulatory authority may set the required initial or maintenance margin level for an offsetting position involving security futures and related positions at a level lower than the level that would be required if the positions were margined separately. Such rules must meet the criteria set forth in section 7(c)(2)(B) of the Exchange Act[180] and must be effective in accordance with section 19(b)(2) of the Exchange Act[181] and, as applicable, Section 5c(c) of the CEA.[182]

The Commissions have retained, with certain revisions, the table of offsets that they deem to be consistent with offsets recognized for comparable exchange-traded options. In particular, the revised table of offsets reflects an adjustment in the level of margin required for certain calendar and basket spreads involving security futures to more accurately reflect the risk of such positions relative to comparable spreads involving exchange-traded options. An offset position for spreads involving non-fungible security futures also has been added to the table.

When it approved strategy-based offsets for options, the SEC found that it was appropriate for the SROs to recognize the hedged nature of certain combined options strategies and prescribe margin requirements that better reflect the risk of those strategies.[183] The SEC also found that the SROs' proposals relating to strategy-based offsets involving options contracts were carefully crafted as they were based on the SROs' experiences in monitoring the credit exposures of options strategies. In particular, the SEC noted that the SROs regularly examine the coverage of options margin as it relates to price movements in the underlying securities and index components. Moreover, the SROs' proposals were thoroughly reviewed by the NYSE Rule 431 Review Committee, which is comprised of securities industry participants who have extensive experience in margin and credit matters. As a result of these factors, the SEC was confident that the SROs' proposed margin requirements were consistent with investor protection and properly reflected the risks of the underlying options positions.

The table of offsets reflects a reduction in the minimum initial and maintenance margin requirement for calendar spreads[184] and basket spreads,[185] in response to the comment that the risk posed by certain spreads involving security futures is lower than the risk posed by comparable spreads involving exchange-traded options.[186] In light of the observation that security futures are not subject to early exercise and therefore do not exhibit the same price volatility as options, the minimum initial and maintenance margin requirement recognized for calendar spreads and basket spreads has been reduced to 5% of the current market value of the long or short position.[187] The Commissions deliberated as to whether risk-based margin computations using SPAN could be applied to these strategies, so long as the offsetting positions were the only positions included in the margin computation. The Commissions have decided not to permit risk-based margin computations for these offsets at this time.

The table of offsets, likewise, reflects a reduction in the required margin recognized for spreads involving a long or short security future and a short or long position in the same security underlying the security future, given that these spreads are economically

[170] *See* CFTC Rule 41.42(c)(1); SEC Rule 400(c)(1).

[171] *See* Proposed CFTC Rule 41.45(d); Proposed SEC Rule 402(d).

[172] *Id.*

[173] *See* Securities Exchange Act Release No. 44853 (September 26, 2001), 66 FR at 50727–29 (October 4, 2001).

[174] *See* Options Exchanges Letter; Partnoy Letter; SIA/FIA Letter.

[175] Options Exchanges Letter at 6.

[176] Partnoy Letter at 14.

[177] SIA/FIA Letter at Appendix I, Q 19.

[178] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2002).

[179] *See* CFTC Rule 41.45(b)(2); SEC Rule 403(b)(2).

[180] 15 U.S.C. 78g(c)(2)(B).

[181] 15 U.S.C. 78s(b)(2).

[182] 7 U.S.C. 7a–2(c).

[183] *See* Securities Exchange Act Release Nos. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving SR–CBOE–97–67 amending CBOE Rule 12.3); 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving SR–NYSE–99–03 amending NYSE Rule 431); 43582 (November 17, 2000), 65 FR 70854 (November 28, 2000) (order approving SR–Amex–99–27 amending Amex Rule 462); and 43581 (November 17, 2000), 65 FR 71151 (November 29, 2000) (order approving SR–NASD–00–15 amending NASD Rule 2520).

[184] A calendar spread is an offset position consisting of a long security future and short security future on the same underlying security, each contract expiring in a different month. *See* table of offsets, item 10.

[185] A basket spread is an offset consisting of a security future based on an index and a basket of security futures that replicates the index, *i.e.*, a basket that contains the same securities, and in the same proportion, as the index. *See* table of offsets, items 17 and 18.

[186] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2002).

[187] By way of comparison, the minimum margin required for offsetting long and short positions in the same security under the rules of the national securities exchanges is 5% of the current market value of the long position. *See, e.g.*, NYSE Rule 431(e)(1).

analogous to calendar spreads.[188] The Commissions intend to review the margin levels for the offsets discussed above after six months of security futures trading to determine whether the margin levels have resulted in regulatory arbitrage with comparable positions involving exchange-traded options, and may jointly undertake appropriate action.

Based on the same commenter's suggestion, the Commissions believe that an additional offset should be recognized for spreads involving identical, non-fungible security futures.[189] Because there is a possibility that certain security futures may not be fungible across markets, a customer may simultaneously hold a long security future and a short security future on the same underlying security even when those security futures have identical contract terms. As a result, the customer will be economically neutral but will be required to hold both positions to expiration and meet daily variation settlement calls with respect to each contract. The commenter expressed the view that a minimum margin level of 1% would be appropriate.[190] The Commissions recognize that the rules of a clearing agency or derivatives clearing organization may effectively net the two contracts at final settlement. However, due to potential differences in daily settlement prices across markets or other market-specific events, the Commissions have determined that such offset positions will be subject to a minimum margin requirement of 3%.

The Commissions believe that the offsets identified in the following table are consistent with the strategy-based offsets permitted for comparable offset positions involving exchange-traded options. The Commissions expect that self-regulatory authorities seeking to permit trading in security futures will submit to the Commissions proposed rules that impose levels of required margin for offsetting positions involving security futures in accordance with the minimum margin requirements identified in the following table of offsets.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
1. Long security future or short security future.	Individual stock or narrow-based security index.	20% of the current market value of the security future.	20% of the current market value of the security future.
2. Long security future (or basket of security futures representing each component of a narrow-based securities index[1]) and long put option[2] on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus pay for the long put in full.	The lower of: (1) 10% of the aggregate exercise price[3] of the put plus the aggregate put out-of-the-money[4] amount, if any; or (2) 20% of the current market value of the long security future.
3. Short security future (or basket of security futures representing each component of a narrow-based securities index[1]) and short put option on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any. Proceeds from the put. Proceeds from the put sale may be applied.	20% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any.[5]
4. Long security future and short position in the same security (or securities basket[1]) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the short stock or stocks.	5% of the current market value as defined in Regulation T of the stock or stocks underlying the security future.
5. Long security future (or basket of security futures representing each component of a narrow-based securities index[1]) and Short call option on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any.
6. Long a basket of narrow-based security futures that together tracks a broad based index[1] and short a broad-based security index call option contract on the same index.	Narrow-based security index	20% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	20% of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any.
7. Short a basket of narrow-based security futures that together tracks a broad-based security index[1] and short a broad-based security index put option contract on the same index.	Narrow-based security index	20% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	20% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any.
8. Long security a basket a narrow-based securities futures that together tracks a broad-based security index[1] and long a broad-based security index put option contract on the same index.	Narrow-based security index	20% of the current market value of the long basket of narrow-based security futures, plus pay for the long put in full.	The lower of: (1) 10% of the aggregate exercise price of the put, plus the aggregate put out-of-the-money amount, if any; or (2) 20% of the current market value of the long basket of security futures.

[188] *See* table of offsets, items 4 and 13.

[189] *See* table of offsets, item 19.

[190] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2002).

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
9. Short a basket of narrow-based security futures that together tracks a broad-based security index [1] and long a broad-based security index call option contract on the same index.	Narrow-based security index	20% of the current market value of the short basket of narrow-based security futures, plus pay for the long call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short basket of security futures
10. Long security future and short security future on the same underlying security (or index).	Individual stock or narrow-based security index.	The greater of: 5% of the current market value of the long security future; or 2) 5% of the current market value of the short security future.	The greater of: 5% of the current market value of the long security future; or (2) 5% of the current market value of the short security future.
11. Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put and call must have the same exercise price. (Conversion).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from the call sale may be applied.	10% of the aggregate exercise price, plus the aggregate call in-the-money amount, if any.
12. Long security future, long put option and short call option. The long security future, long put and short call must be on the same underlying security and the put exercise price must be below the call exercise price. (Collar).	Individual stock or narrow-based security index.	20% of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from call sale may be applied.	The lower of: (1) 10% of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any; or (2) 20% of the aggregate exercise price of the call, plus the aggregate call in-the-money amount, if any.
13. Short security future and long position in the same security (or securities basket [1]) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long stock or stocks.	5% of the current market value, as defined in Regulation T, of the long stock or stocks.
14. Short security future and long position in a security immediately convertible into the same security underlying the security future, without restriction, including the payment of money.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long security.	10% of the current market value, as defined in Regulation T, of the long security
15. Short security future (or basket of security futures representing each component of a narrow-based securities index [1]) and long call option or warrant on the same underlying security (or index).	Individual stock or narrow-based security index.	20% of the current market value of the short security future, plus pay for the call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short security future.
16. Short security future, Short put option and long call option. The short security future, short put and long call must be on the same underlying security and the put and call must have the same exercise price. (Reverse Conversion).	Individual stock of narrow-based security index.	20% of the current market value of the short security future, plus the aggregate put in-the-money amount, if any, plus pay for the call in full. Proceeds from put sale may be applied.	10% of the aggregate exercise price, plus the aggregate put in-the-money amount, if any.
17. Long (short) a basket of security futures, each based on a narrow-based security index that together tracks the broad-based index [1] and short (long) a broad based-index future.	Narrow-based security index	5% of the current market value of the long (short) basket of security futures.	5% of the current market value of the long (short) basket of security futures.
18. Long (short) a basket of security futures that together tracks a narrow-based index [1] and short (long) a narrow based index future.	Individual stock and narrow-based security index.	The greater of: (1) 5% of the current market value of the long security future(s); or (2) 5% of the current market value of the short security future(s).	The greater of: (1) 5% of the current market value of the long security future(s); or (2) 5% of the current market value of the short security future(s).
19. Long (short) a security future and short (long) an identical security future traded on a different market.[6]	Individual stock and narrow-based security index.	The greater of: (1) 3% of the current market value of the long security future(s); or (2) 3% of the current market value of the short security future(s).	The greater of: (1) 3% of the current market value of the long security future(s); or (2) 3% of the current market value of market value of the short security future(s).

[1] Baskets of securities or security futures contracts must replicate the securities that comprise the index, and in the same proportion.
[2] Generally, for the purposes of these rules, unless otherwise specified, stock index warrants shall be treated as if they were index options.

[3] "Aggregate exercise price," with respect to an option or warrant based on an underlying security, means the exercise price of an option or warrant contract multiplied by the numbers of units of the underlying security covered by the option contract or warrant. "Aggregate exercise price" with respect to an index option means the exercise price multiplied by the index multiplier. *See, e.g.*, Amex Rules 900 and 900C; CBOE Rule 12.3; and NASD Rule 2522.

[4] "Out-of-the-money" amounts must be determined as follows:

(1) For stock call options and warrants, any excess of the aggregate exercise price of the option or warrant over the current market value of the equivalent number of shares of the underlying security;

(2) for stock put options or warrants, any excess of the current market value of the equivalent number of shares of the underlying security over the aggregate exercise price of the option or warrant;

(3) for stock index call options and warrants, any excess of the aggregate exercise price of the option or warrant over the product of the current index value and the applicable index multiplier; and

(4) for stock index put options and warrants, any excess of the product of the current index value and the applicable index multiplier over the aggregate exercise price of the option or warrant. *See, e.g.*, NYSE Rule 431 (Exchange Act Release No. 42011 (October 14, 1999), 64 FR 57172 (October 22, 1999) (order approving SR–NYSE–99–03)); Amex Rule 462 (Exchange Act Release No. 43582 (November 17, 2000), 65 FR 71151 (November 29, 2000) (order approving SR–Amex–99–27)); CBOE Rule 12.3 (Exchange Act Release No. 41658 (July 27, 1999), 64 FR 42736 (August 5, 1999) (order approving SR–CBOE–97–67)); or NASD Rule 2520 (Exchange Act Release No. 43581 (November 17, 2000), 65 FR 70854 (November 28, 2000) (order approving SR–NASD–00–15)).

[5] "In the-money" amounts must be determined as follows:

(1) for stock call options and warrants, any excess of the current market value of the equivalent number of shares of the underlying security over the aggregate exercise price of the option or warrant;

(2) for stock put options or warrants, any excess of the aggregate exercise price of the option or warrant over the current market value of the equivalent number of shares of the underlying security;

(3) for stock index call options and warrants, any excess of the product of the current index value and the applicable index multiplier over the aggregate exercise price of the option or warrant; and

(4) for stock index put options and warrants, any excess of the aggregate exercise price of the option or warrant over the product of the current index value and the applicable index multiplier.

[6] Two security futures will be considered "identical" for this purpose if they are issued by the same clearing agency or cleared and guaranteed by the same derivatives clearing organization, have identical contract specifications, and would offset each other at the clearing level.

The Commissions note that positions in a securities account may not be cross-margined with positions in a futures account except in accordance with the rules of a self-regulatory authority that have become effective under section 19(b)(2) of the Exchange Act and, as applicable, section 5c(c) of the CEA. At present, the Commissions have not approved the use of a cross-margining methodology for customer securities and futures accounts. Accordingly, security futures or other positions carried in a futures account may not currently be offset against security futures or other positions carried in a securities account to reduce a customer's total margin requirement.

4. Higher Margin Levels

The Proposed Rules expressly provided that self-regulatory authorities could impose on their members initial and maintenance margin levels that are higher than the minimum levels otherwise specified in the rules.[191] The Proposed Rules also provided that self-regulatory authorities could permit their members to use a method for computing required margin that could result in margin levels that are higher than the minimum levels specified in the rules.[192]

The Commissions have decided that it is not necessary to adopt these provisions of the Proposed Rules because other provisions of the Final Rules make clear the ability of a self-regulatory authority to establish higher margin levels. The Final Rules establish minimum levels and do not set any limitations as to maximum levels. Moreover, the Final Rules expressly do not preclude a self-regulatory authority or a security futures intermediary from imposing additional margin requirements, including higher initial and maintenance margin levels, consistent with the Final Rules.[193]

As noted previously, a portfolio margining system such as SPAN may be used to compute required margin based on the parameters established in accordance with the Final Rules. Each security futures intermediary remains responsible for collecting margin in compliance with the Final Rules.

5. Procedures for Certain Margin Level Adjustments

The Commissions proposed to allow national securities exchanges registered under section 6(g) of the Exchange Act[194] and national securities associations registered under section 15A(k) of the Exchange Act[195] to raise or lower margin levels in accordance with section 19(b)(7) of the Exchange Act,[196] as long as the resulting levels satisfy the minimum level requirements.[197] The Commissions received no comments on this aspect of the proposal, and are adopting it as proposed.[198]

H. Satisfaction of Required Margin

Section 7(c)(2)(B)(iv) of the Exchange Act[199] requires that the type, form and use of collateral for security futures products be and remain consistent with the requirements of Regulation T. To fulfill this statutory requirement, the Commissions proposed to permit security futures intermediaries to accept as margin for security futures any of the types of collateral permitted under Regulation T to satisfy a margin deficiency in a margin account.[200] The Commissions also proposed to allow self-regulatory authorities to establish their own margin collateral requirements as long as those requirements were consistent with the requirements of Regulation T.[201]

The Final Rules continue to limit the type, form, and use of collateral deposits that security futures intermediaries may accept to satisfy the required margin for security futures to those permitted under Regulation T.[202] The Commissions are, however, permitting security futures intermediaries to include the net value of certain additional items—specifically, long options[203] and open trade equity[204]—in computing the equity in an account. Moreover, for purposes of determining whether the required margin in an account is satisfied, the final rules

[191] *See* Proposed CFTC Rule 41.45(b)(2)(i); Proposed SEC Rule 402(b)(2)(i).

[192] *See* Proposed CFTC Rule 41.45(b)(2)(ii); Proposed SEC Rule 402(b)(2)(ii).

[193] *See* CFTC Rule 41.42(c)(1); SEC Rule 400(c)(1).

[194] 15 U.S.C. 78f(g).

[195] 15 U.S.C. 78o–3(k).

[196] 15 U.S.C. 78s(b)(7).

[197] *See* Proposed CFTC Rule 41.45(c); Proposed SEC Rule 402(c).

[198] *See* CFTC Rule 41.45(c); SEC Rule 403(c).

[199] 15 U.S.C. 78g(c)(2)(B)(iv).

[200] *See* Proposed CFTC Rule 41.47(a)(4); Proposed SEC Rule 404(a)(4).

[201] *See* Proposed CFTC Rule 41.47(b); Proposed SEC Rule 404(b).

[202] *See* CFTC Rule 41.46(a); SEC Rule 404(a).

[203] *See* CFTC Rule 41.46(c)(1)(iv); SEC Rule 404(c)(1)(ii).

[204] *See* CFTC Rule 41.46(c)(1)(vi) and (c)(2)(iii); SEC Rule 404(c)(1)(vi) and (c)(2)(iii).

permit security futures intermediaries to compute equity in accordance with applicable self-regulatory authority rules, subject to certain adjustments to ensure consistency with Regulation T.[205]

1. Type, Form and Use of Collateral

a. *Acceptable Collateral Deposits.* The Commissions proposed to permit security futures intermediaries to accept as margin for security futures a deposit of any combination of cash, margin securities as defined in Regulation T,[206] exempted securities as defined in section 3(a)(12) of the Exchange Act,[207] and other collateral permitted under Regulation T to satisfy a margin deficiency in the margin account.[208]

The Commissions received four comments on this issue.[209] One commenter supported the Commissions' proposal with respect to permissible collateral.[210] The other three commenters suggested that the Commissions should permit security futures intermediaries to accept other forms of collateral in addition to those permitted by Regulation T.[211]

Two of these commenters suggested that the type of collateral permitted should be determined based on the type of account. Under an account-specific approach, for security futures held in futures accounts, the types of permissible collateral would be determined by SRO rules; and for security futures held in securities accounts, the types of permissible collateral would be governed by Regulation T.[212] The other commenter maintained that, unless the Commissions recognize other instruments that are commonly accepted as collateral within a futures account (*e.g.*, letters of credit), the margin requirements would disadvantage the futures community and would make it unlikely that customers would carry security futures products in a futures account.[213]

The Commissions have considered the commenters' views, and have adopted the provisions regarding acceptable collateral deposits substantially as proposed. In particular, the Commissions do not believe that it would be consistent with the requirements regarding type, form, and use of collateral under Regulation T to permit customers to satisfy the required margin for security futures in a futures account using letters of credit or other types of collateral not currently permitted under Regulation T. Any types of collateral the Federal Reserve Board may subsequently permit in a Regulation T margin account, however, may also be used to satisfy the required margin for security futures under the Final Rules.[214]

b. *Use of Money Market Mutual Funds.* The definition of "margin security" under Regulation T includes, among other securities, money market mutual funds. A number of futures exchanges currently accept money market mutual fund shares as performance bond deposits for futures and options on futures, subject to certain conditions imposed under CFTC Rule 1.25.[215] Regulation T also permits creditors to extend good faith loan value to shares in money market mutual funds and other mutual funds carried in a securities account, although the limitations on extensions of credit in connection with new issues of securities under section 11(d)(1) of the Exchange Act have limited the practicability of their use.[216]

The Final Rules permit the use of money market mutual fund shares[217] to satisfy the required margin for security futures and related positions carried in a securities account or futures account, subject to certain conditions.[218] These conditions are intended to facilitate a security futures intermediary's hypothecation or liquidation of money market mutual fund shares deposited as margin for security futures, as necessary to meet a customer's clearing obligations.

Specifically, a security futures intermediary may accept money market mutual fund shares as margin if the following conditions are met (*e.g.*, under the rules of a self-regulatory authority or pursuant to a three-way agreement among the security futures intermediary, the customer, and the money market mutual fund or its transfer agent):

(1) The customer waives any right to redeem the fund shares without the consent of the security futures intermediary and instructs the fund or its transfer agent accordingly;

(2) The security futures intermediary (or clearing agency or derivatives clearing organization with which the security is deposited as margin) obtains the right to redeem the shares in cash, promptly upon request; and

(3) The fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.

2. Computation of Equity

The Proposed Rules would have required security futures intermediaries to compute the equity in an account in accordance with Regulation T for purposes of determining whether the required margin for security futures is satisfied.[219] The Commissions received one comment on this issue.[220] The commenter expressed the opinion that the rules governing collateral haircuts in securities and futures accounts need not be identical, as long as the relevant standards do not create a material incentive for customers to carry security futures positions in a futures account rather than a securities account.[221]

The Commissions have considered this commenter's views and have determined not to require security futures intermediaries to compute equity in accordance with Regulation T. The Final Rules provide that, for purposes of determining whether the required margin for security futures carried in an account is satisfied, the equity in an account shall be computed in accordance with the margin rules

[205] *See* CFTC Rule 41.46; SEC Rule 404.

[206] Under Section 202.2 of Regulation T (12 CFR 220.2), margin securities include: (1) Any security registered or having unlisted trading privileges on a national securities exchange; (2) any security listed on the Nasdaq Stock Market; (3) any nonequity security; (4) any security issued by either an open-end investment company or unit investment trust which is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8); (5) any foreign margin stock; and (6) any debt security convertible into a margin security.

[207] 15 U.S.C. 78c(a)(12).

[208] *See* Proposed CFTC Rule 41.47(a)(4); Proposed SEC Rule 404(a)(4).

[209] *See* Options Exchanges Letter; NFA Letter; CME/CBOT Letter; SIA/FIA Letter.

[210] Options Exchanges Letter at 6–7.

[211] *See* NFA Letter at 6–7; CME/CBOT Letter at 3–4; and SIA/FIA Letter 6–8.

[212] *See* NFA Letter at 7; SIA/FIA Letter at 6.

[213] CME/CBOT Letter at 4.

[214] CFTC Rule 41.46(b)(1); SEC Rule 404(b)(1).

[215] *See, e.g.*, CME Rule 930.C.

[216] In a recent interpretive release providing guidance on the application of certain provisions of the federal securities laws to trading in security futures products, the SEC expressed the view that a security future is not an extension of credit under section 11(d)(1) of the Exchange Act (15 U.S.C. 78k(d)(1)), and that margin collected in connection with a security futures transaction represents a good faith deposit against performance and not "partial payment" for the security. Securities Exchange Act Release No. 46101 (June 21, 2002), 67 FR 43234, 43245 (June 27, 2002). Accordingly, a deposit of money market mutual fund shares by a customer to satisfy the required margin for a security future does not, in the SEC's view, constitute a direct or indirect extension or maintenance of credit to or for the customer on such shares for purposes of Section 11(d)(1) (15 U.S.C. 78k(d)(1)).

[217] *See* CFTC Rule 41.43(a)(22); SEC Rule 401(a)(22).

[218] *See* CFTC Rule 41.46(b)(2); SEC Rule 404(b)(2).

[219] *See* Proposed CFTC Rule 41.43(b); Proposed SEC Rule 400(b).

[220] SIA/FIA Letter.

[221] *Id.*, at 6.

applicable to the account.[222] However, so that that collateral and other components of equity are valued consistently in securities and futures accounts, the Final Rules require security futures intermediaries to make certain adjustments to equity when determining whether the required margin for security futures carried in an account is satisfied.[223] Each of these components of equity is discussed in turn below.

a. *Security Futures.* The Proposed Rules provided that security futures would not be "margin securities" for purposes of the margin requirements and therefore would not have loan value for margin purposes.[224] One commenter addressed this provision and supported the view that security futures should not have loan value for margin purposes.[225]

The Commissions have considered the commenter's views and have adopted Final Rules that provide that security futures will have no value for purposes of determining whether the required margin in a securities or futures account is satisfied.[226] This is consistent with the treatment of other futures contracts carried in futures accounts.

To avoid confusion as to whether extensions of credit in connection with security futures are considered "purpose credit" for purposes of the Federal Reserve Board's credit regulations,[227] however, the Commissions have revised the Final Rules to eliminate the statement that security futures are not margin securities.

b. *Option Value.* The Proposed Rules did not address the question of whether the net value of options in a securities or futures account could be applied to satisfy the required margin for security futures.[228] The rules of the futures exchanges generally permit FCMs to include the value of listed options on contracts for future delivery in computing the equity in a futures account. The rules of the national securities exchanges and the NASD, however, generally deny value to options carried for a customer for the purpose of computing the equity in the customer's account.[229]

One commenter expressed concern that the exclusion of net option value from the calculation of equity in a futures account would create significant operational difficulties for security futures intermediaries that carry security futures in futures accounts.[230] Two other commenters noted, however, that recognition of option value for purposes of determining whether the required margin for security futures is satisfied in a futures account would create a significant regulatory disparity with exchange-traded options carried in securities accounts.[231]

The Commissions, having considered the commenters' concerns, are adopting Final Rules that provide that a net long or short position in a listed put or call option carried in a futures account shall be valued in accordance with the margin rules applicable to the account for purposes of determining whether the required margin for a security future in the account is satisfied.[232] For these purposes, the term "listed option" is defined to mean any put or call option that is (i) issued by a clearing agency that is registered under section 17A of the Exchange Act[233] or cleared and guaranteed by a derivatives clearing organization that is registered under Section 5b of the CEA;[234] and (ii) traded on or subject to the rules of a self-regulatory authority.[235]

The SEC is willing to entertain proposed rule changes by the national securities exchanges and the NASD to grant value to listed options in a securities account under appropriate circumstances. In addition, the Commissions intend to review their determination to grant value to long options carried in futures accounts after six months of security futures trading to determine whether it has created a material disparity between the margin requirements for security futures and the margin requirements for comparable exchange-traded options, and may jointly undertake appropriate action.

c. *Open Trade Equity.* The Proposed Rules did not address in detail how "open trade equity" (*i.e.*, the daily marked-to-market gain or loss in value of futures or other exchange-traded contracts) would be included in the equity in an account for purposes of determining whether the required margin for security futures is satisfied. However, eight commenters raised the issue and requested clarification from the Commissions.[236] Those commenters generally requested that the Commissions clarify that broker-dealers and FCMs could treat open trade equity on security futures positions as cash for purposes of margin and collateral.

One of those commenters maintained that disallowing the use of open trade equity to satisfy margin on trades and position in other markets could dampen customers' interest in security futures.[237] Another of the commenters suggested that FCMs would have to make costly systems changes if they were not allowed to recognize open trade equity for security futures as they are permitted to do for other futures positions.[238]

In light of commenters' views on this issue, the Final Rules clarify that "open trade equity" may be applied to satisfy the required margin for security futures and related positions. Specifically, the Final Rules define a new term, "variation settlement," to mean any credit or debit to a customer account, made on a daily or intraday basis, for the purpose of marking to market a security future or any other contract that is: (i) issued by a clearing agency that is registered under section 17A of the

[222] *See* CFTC Rule 41.46(c); SEC Rule 404(c). For purposes of determining whether the required margin for security futures and related positions is satisfied under the Final Rules, the equity in a futures account is defined to include the account's net liquidating equity plus the collateral value of margin securities, exempted securities, and other acceptable margin deposits. *See* Joint Audit Committee, Margins Handbook, Chapter 1 (June 1999) (definition of "margin equity"). Securities may not be combined with security futures carried in a futures account to create an offset position except pursuant to a cross-margining arrangement, as described in Section II.G.3 of this release.

[223] *See* CFTC Rule 41.46(c), (d), and (e); SEC Rule 404(c), (d), and (e).

[224] *See* Proposed CFTC Rule 41.47(c); Proposed SEC Rule 404(c).

[225] Options Exchanges Letter at 6–7.

[226] *See* CFTC Rule 41.46(c)(1)(i) and (c)(2)(i); SEC Rule 404(c)(1)(i) and (c)(2)(i). As discussed below, open trade equity resulting from the daily settlement of security futures can be used to satisfy the required margin.

[227] *See* discussion of extensions of credit in Section II.F.4. of this release.

[228] Regulation T generally delegates the authority to specify the amount or other position to satisfy the required margin for put or call options on a security, certificate of deposit, securities index or foreign currency, or a warrant on a securities index or currency carried in a securities account to the registered securities exchange or association authorized to trade the option (in the case of exchange-listed options) and to the creditor's examining authority (in the case of all other options), subject in each case to approval by the SEC. *See* 12 CFR 220.12(f).

[229] The rules of the national securities exchanges and the NASD recognize an exception for long listed or OTC options and warrants with a remaining period to expiration exceeding 9 months. Such contracts are valued at their current market value (as defined in Section 220.2 of Regulation T (12 CFR 220.2)), subject to a 75% margin requirement. *See, e.g.*, NYSE Rule 431(f)(2)(C).

[230] Meeting between SEC and CFTC staff and representatives of SIA/FIA (February 6, 2002).

[231] Telephone conversations between SEC staff and The OCC staff (February 20, 2002) and between SEC staff and CBOE staff (February 5, 2002).

[232] *See* CFTC Rule 41.46(c)(1)(ii); SEC Rule 404(c)(1)(ii).

[233] 15 U.S.C. 78q–1.

[234] 7 U.S.C. 7a–1.

[235] *See* CFTC Rule 41.43(a)(16); SEC Rule 401(a)(16).

[236] *See* Peregrine Letter; OneChicago Letter; NFA Letter; CME Letter; SIA/FIA Letter; Nasdaq Liffe Letter; SunGard Letter; and Morgan Stanley Letter.

[237] OneChicago Letter at 6.

[238] SunGard Letter at 2.

Exchange Act[239] or cleared and guaranteed by a derivatives clearing organization that is registered under Section 5b of the CEA,[240] and (ii) traded on or subject to the rules of a self-regulatory authority.[241] The Final Rules provide that variation settlement receivable (or payable) by an account at the close of trading on any day shall be treated as a credit (or debit) to the account on that day.[242]

d. *Margin Equity Securities*. The Final Rules generally limit the value of a margin equity security deposited as margin for security futures in a futures account to the security's "Regulation T collateral value," *i.e.*, the current market value of the security (based on its most recent closing price) less the percentage of required margin for a position in the security held in a margin account under Regulation T.[243] This amount, which is currently set at 50% of current market value, represents the amount of the value of a fully-paid margin equity security deposited into a securities margin account that would be available to satisfy the required margin for other positions in the account under Regulation T, *e.g.*, stock options. Margin equity securities deposited as collateral for security futures in a securities account remain subject to Regulation T margin requirements as well as the margin requirements of applicable self-regulatory authority rules.

By requiring FCMs to value margin equity securities as collateral for security futures at the levels established under Regulation T,[244] the Commissions intend to provide that margin equity securities used to satisfy margin requirements for security futures are valued in a consistent manner, regardless of the type of account in which a security future is carried. The Commissions recognize, however, that the Regulation T margin requirement applies only to new transactions that create or increase a margin deficiency in an account.[245] As a result, a uniform 50% haircut on margin equity securities in a futures account may result in the collection of more margin for security futures carried in a futures account than would be required for comparable positions carried in a securities account.

Accordingly, the Final Rules provide an alternative method for valuing margin equity securities used as collateral for security futures in a futures account based on the same initial and maintenance computations required under Regulation T and securities SRO rules with respect to transactions in the account.[246] Under this alternative method, the haircut for margin equity securities is equal to the lowest percentage of margin required for a margin equity security under the rules of a national securities exchange (currently, 25%). On any day when security futures transactions or related transactions[247] are effected in the account, however, a customer must satisfy a special margin requirement equal to the amount of any margin deficiency created or increased in the account if the margin equity securities were valued at their Regulation T collateral value (*i.e.*, 50% of current market value).

The Final Rules provide further that, if this alternative method for valuing margin equity securities is used in an account in which security futures or related positions are carried and such account is transferred from one security futures intermediary to another, the account may be treated as if it had been maintained by the transferee security futures intermediary from the date of its origin if the transferee accepts, in good faith, a signed statement of the transferor security futures intermediary (or, if that is not practicable, of the customer), that any margin call issued under the Final Rules has been satisfied.[248] This provision parallels Section 220.4(b)(7) of Regulation T, and is consistent with futures industry practices under Section 4d of the CEA.[249] It is intended to prevent one security futures intermediary from transferring an undermargined account to another security futures intermediary.

e. *Other Securities*. The Final Rules impose a haircut on exempt securities and nonequity securities deposited as margin for security futures carried in a futures account equal to the haircut established under the SEC's net capital rule.[250] This provision is intended to codify the haircut currently imposed on Treasury securities and other debt securities deposited as collateral for futures and options on futures under the rules of the designated contract markets. Exempt securities and nonequity securities deposited as collateral for security futures in a securities account will remain subject to the higher margin requirements applicable to such securities under Regulation T and self-regulatory authority rules.

f. *Foreign Currency*. The Final Rules provide that freely convertible foreign currency may be valued at an amount no greater than its daily marked-to-market U.S. dollar equivalent for purposes of determining whether the required margin for security futures carried in a securities or futures account is satisfied.[251] This provision reflects the maximum value assigned to foreign currencies under Regulation T.[252]

g. *Other Components of Equity*. The Final Rules provide that each other acceptable margin deposit or component of equity in a securities or futures account shall be valued at an amount no greater than its value in a Regulation T securities margin account.[253] This

[239] 15 U.S.C. 78q–1.

[240] 7 U.S.C. 7a–1.

[241] *See* CFTC Rule 41.43(a)(32); SEC Rule 401(a)(32).

[242] *See* CFTC Rule 41.46(c)(1)(vi) and (c)(2)(iii); SEC Rule 404(c)(1)(vi) and (c)(2)(iii).

[243] *See* CFTC Rule 41.43(a)(25); SEC Rule 401(a)(25). The Final Rules define the "current market value" of a security other than a security future to mean the most recent closing sale price of the security, as shown by any regularly published reporting or quotation service. CFTC Rule 41.43(a)(4); SEC Rule 401(a)(4). If there is no recent closing sale price, the security futures intermediary may use any reasonable estimate of the market value of the security as of the most recent close of business. *Id.*

[244] *See* CFTC Rule 41.46(c)(1)(iii); SEC Rule 404(c)(1)(iii).

[245] The initial margin required for the purchase of a margin equity security in a securities account under Regulation T is 50% of its current market value. However, the maintenance margin required for a position in a margin equity security under the rules of the securities self-regulatory organizations is 25% of current market value. *See, e.g.*, NYSE Rule 431(c)(1). Accordingly, a customer that seeks to use a fully paid equity security to satisfy the required margin for a new short option transaction may apply no more than 50% of the current market value of the security for that purpose. On subsequent days, the customer will not be required to deposit additional margin, regardless of changes in the price of the short option or equity security, unless the required margin for the short option exceeds 75% of the current market value of the equity security.

[246] *See* CFTC Rule 41.46(e); SEC Rule 404(e).

[247] A "related transaction" is defined to include any transaction in a related position that creates, eliminates, increases or reduces an offsetting position involving a security future, or any deposit or withdrawal of collateral (other than the deduction of variation settlement and other periodic deductions by a security futures intermediary from a customer account). CFTC Rule 41.43(a)(27); SEC Rule 401(a)(27). For example, if a customer unwinds an offsetting position in a futures account, such as by liquidating a long broad-based index future offsetting a basket of security futures, any margin equity securities used to satisfy the additional margin in the account required as a result of the transaction would have to be valued at their Regulation T value.

[248] *See* CFTC Rule 41.46(e)(3); SEC Rule 404(e)(3).

[249] 12 CFR 220.4(b)(7) and 7 U.S.C. 6d. *See* also NASD Rule 11870(d) and NFA Rule 2–27.

[250] *See* CFTC Rule 41.46(c)(1)(iv); SEC Rule 404(c)(1)(iv).

[251] *See* CFTC Rule 41.46(c)(1)(v) and (c)(2)(ii); SEC Rule 404(c)(1)(v) and (c)(2)(ii).

[252] Many foreign currencies already are subject to significant additional haircuts or margin requirements in securities and futures accounts under self-regulatory authority rules. As discussed above, security futures intermediaries and their customers would also have to observe limitations under applicable margin rules.

[253] *See* CFTC Rule 41.46(c)(1)(vii); SEC Rule 404(c)(1)(vii).

provision is intended to provide that any additional forms of collateral permitted under Regulation T in the future or other items in an account are valued under the Final Rules in accordance with Regulation T.

h. *Guarantees.* The Final Rules provide that no guarantee of a customer's account shall be given any effect for purposes of determining whether the required margin in an account is satisfied, except as permitted under the margin rules applicable to the account.[254] This provision is consistent with both the requirements currently applicable to securities accounts under Regulation T [255] and the requirements currently applicable to futures accounts under CFTC Rule 1.10.[256] Thus, the account-specific practices related to guarantees that are currently followed in securities accounts and futures accounts, respectively, would remain effective under this provision.

3. Satisfaction of the Required Margin for Positions Other than Security Futures

Because the scope of the Final Rules is limited to security futures and related positions, the rules require additional margin to be deposited in an account only when the required margin for security futures is not satisfied by the equity in the account. The required margin for all other positions carried in an account, and acceptable collateral for such positions, shall be determined in accordance with the margin rules applicable to the account.

The Final Rules do not prohibit security futures intermediaries from accepting different collateral or assigning greater collateral value to assets deposited as collateral with respect to other positions carried in an account, if permitted under applicable self-regulatory authority rules. For example, security futures intermediaries may use letters of credit to satisfy the required margin for commodity futures and commodity options (other than security futures) in a futures account, even if a security future is carried in the account, as long as the collateral or other equity allocated to the security future is sufficient to satisfy the requirement established under the Final Rules. Likewise, security futures intermediaries may value margin equity securities deposited to satisfy the required margin for commodity futures or commodity options (other than security futures) according to the rules of the applicable board of trade.

Moreover, security futures intermediaries may allocate collateral or other components of equity among security futures and such other positions as they consider appropriate. For example, a security futures intermediary may elect to allocate cash, open trade equity, option value, and nonequity securities to satisfy the required margin for security futures and related positions in a futures account, and allocate margin equity securities to satisfy the required margin for commodity futures and commodity options (other than security futures). This allocation would allow the security futures intermediary to value the margin equity securities as permitted by the applicable margin rules, rather than at the security's Regulation T collateral value, provided that the security futures in the account are adequately margined by the other collateral in the account.

To prevent assets used to satisfy the required margin for security futures from being counted twice for margin purposes, the Final Rules provide that transactions, positions or deposits used to satisfy the required margin for security futures or related positions shall be unavailable to satisfy the required margin for any other position or transaction or any other requirement.[257] In particular, a related position used to reduce the required margin for a security future may not be used in a strategy-based offset with another item in the account. This provision is consistent with the satisfaction restriction in Section 220.4(c)(4) of Regulation T.[258] For example:

- A deposit of $1000 in margin equity securities used to satisfy the required margin for a $500 margin call on a security future cannot also be used to satisfy a $350 margin call on a broad-based index future in a futures account, even if, under the margin rules applicable to the account, equity securities used as collateral for the broad-based index future may be valued at 85% of current market value (*i.e.* $850).
- A 100-share XYZ put option contract in a securities account may not be used to cover both a 100-share long XYZ security future contract as well as 100 shares of XYZ common stock.

The collateral used to satisfy the margin requirement with respect to a security future may of course be used to satisfy the margin requirement with respect to the same position under self-regulatory authority rules.

I. When Margin May Be Withdrawn

The Final Rules include provisions that specify when margin may be withdrawn from an account that contains security futures. Under the Proposed Rules, these provisions would have been incorporated into the Commissions' margin requirements through the application of Regulation T. Because the Final Rules do not expressly apply Regulation T, the Commissions have identified the circumstances in which a customer or a security futures intermediary may withdraw cash, securities or other collateral deposited as margin for security futures and related positions.[259]

1. Withdrawal of Margin by the Customer

The Final Rules provide that a customer may withdraw cash, securities, or other assets deposited as margin for security futures or related positions, provided that the equity in the account after such withdrawal is sufficient to satisfy the required margin for the security futures and related positions in the account under the Final Rules.[260]

Customers that use the alternative collateral valuation method for equity securities, pursuant to CFTC Rule 41.46(e) and SEC Rule 404(e), are subject to an additional restriction on withdrawals that parallels the withdrawal restrictions of Regulation T.[261] Specifically, cash, securities or other assets may not be withdrawn with respect to an account that uses the alternative method if:

(i) Additional cash, securities, or other assets are required to be deposited as margin for a transaction in the account on the same or a previous day pursuant to a special margin requirement; or

(ii) The withdrawal, together with other transactions, deposits, and withdrawals on the same day, would create or increase a margin deficiency if the margin equity securities were valued at their Regulation T collateral value.[262]

This restriction is intended to prevent a customer from withdrawing margin

[254] *See* CFTC Rule 41.46(f); SEC Rule 404(f).

[255] *See* 12 CFR 220.3(d). The Regulation T prohibition governs initial margin. The use of guarantees for purposes of maintenance margin is otherwise treated under applicable margin rules.

[256] 17 CFR 1.10. CFTC Rule 1.10(d) requires that an FCM's financial report be completed in accordance with the CFTC's Form 1–FR–FCM Instructions for reporting an FCM's net capital position. These instructions provide further that "an FCM may not consider a guarantee agreement as a substitute for margin" in customers' accounts. Thus, margin deficits are only satisfied with the actual transfer of free funds from the guaranteeing account.

[257] *See* CFTC Rule 41.46(d); SEC Rule 404(d).

[258] 12 CFR 220.4(c)(4).

[259] *See* CFTC Rule 41.47; SEC Rule 405.

[260] *See* CFTC Rule 41.47(a); SEC Rule 405(a).

[261] *See* 12 CFR 220.4(e).

[262] *See* CFTC Rule 41.46(e); SEC Rule 404(e).

deposited to satisfy a special margin requirement unless the customer's equity exceeds the required margin in the account or the customer substitutes securities of equivalent value.

2. Withdrawal of Margin by the Security Futures Intermediary

The Final Rules provide that a security futures intermediary may deduct certain payments and charges from a customer account to meet the customer's obligations to the security futures intermediary and third parties.[263] Specifically, without regard to the other provisions of the rule, the security futures intermediary may deduct the following items from an account:

(i) Variation settlement payable, directly or indirectly,[264] to a clearing agency or derivatives clearing organization to settle the customer's obligations under a security futures contract or other contracts cleared through the clearing agency or derivatives clearing organization;

(ii) Interest charged on credit maintained in the account;

(iii) Communication or shipping charges with respect to transactions in the account;

(iv) Payment of commissions, brokerage, taxes, storage and other charges lawfully accruing in connection with the positions and transactions in the account; and

(v) Any service charges that the security futures intermediary may impose. These items reflect the permissible withdrawals from a securities account and a futures account under Regulation T[265] and Section 4d of the CEA,[266] respectively. The Final Rules also permit a security futures intermediary to deduct any other items that may be deducted under Regulation T (*e.g.*, premiums on securities borrowed, dividends, interest, or other distributions due on borrowed securities), to the extent permitted under applicable margin rules.

J. Consequences of Failure To Collect Required Margin

The Commissions proposed that the amount of initial or maintenance margin required would be obtained as promptly as possible and in any event within three business days or within such shorter time period as may be imposed by applicable regulatory authority rules.[267] The Commissions also proposed that the time limits for collection of initial margin could be extended upon application by the creditor to its examining authority, as defined in Proposed CFTC Rule 41.44(a)(3) and Proposed SEC Rule 401(a)(3), to the extent permitted by applicable regulatory authority rules.[268] Failure to collect additional margin within the established period would have required the creditor to liquidate the account, as required by Regulation T.[269]

The Commissions received six comments on the issue of timing for collection of margin.[270] One commenter supported the proposed time limit for collection of margin, stating that a time limit of three business days or shorter, with the opportunity for extensions upon application, would be a reasonable time frame for initial and maintenance margin calls.[271]

One commenter disagreed with the proposed time limits and recommended that the Commissions adopt the time limits provided in Regulation T, which requires the collection of margin within five business days after the position is established (T+5), and the collection of maintenance margin as promptly as possible and in any event within fifteen business days.[272] Another commenter supported a T+1 margin settlement cycle and a T+5 collection period.[273] The same commenter observed that "[g]iven that the initial margin collection period for securities and listed securities options is T+5, and that, as a result of required capital charges, futures have an effective collection period of T+5, the Associations' members feel strongly that a T+5 collection period should also apply to security futures."[274]

Two other commenters urged the Commissions to recognize the existing time limits in both the securities and futures industries.[275] Specifically, these commenters believed that although the provisions governing the time of collection in Regulation T are different from those set forth by the CFTC and the futures exchange rules, the outcome is substantially similar.

Finally, another commenter recommended that the period for collecting initial and maintenance margin be extended to four days (T+4) in order to be consistent with existing requirements in the futures and securities industries.[276] That commenter also expressed concern regarding the procedures that must be followed if margin is not received in the time prescribed, noting that the Proposed Rules would require liquidation of positions in accordance with Regulation T. The commenter believed that requiring a firm to liquidate positions if a margin call is not met, or providing that the time period for collection could be extended by the firm's examining authority, could create significant burdens for both an FCM and its examining authority because these are not the current practices in the futures industry.

The Commissions have considered the commenters views and have decided not to adopt uniform time periods for collection of margin. The Commissions have determined that deference to account-specific rules in this instance will avoid operational costs that would be incurred in modifying existing practices, and will not provide an incentive for customers to select one type of account (securities or futures) over another.

In addition, the Commissions have decided not to require immediate liquidation of the positions in a customer account if the customer fails to deposit additional required margin within a prescribed number of days. The Commissions believe that, in general, a security futures intermediary should be adequately protected against potential adverse movements in customers' positions if it takes a capital charge for the amount by which the customer's account is undermargined. Accordingly, the Final Rules provide that if any margin call required by this Regulation (§§ 242.400 through 242.406) is not met in full, the security futures intermediary shall take the deduction required under CFTC or SEC rules,[277] as applicable, in computing its net capital.[278]

The Commissions have decided, however, to require that a security futures intermediary liquidate positions in an account if the account would liquidate to a deficit.[279] To provide

[263] *See* CFTC Rule 41.47(b); SEC Rule 405(b).

[264] The phrase "directly or indirectly" is intended to encompass payments either directly to a clearing agency or derivatives clearing organization, or payments made through a clearing broker.

[265] 12 CFR 220.4(f).

[266] 7 U.S.C. 6d.

[267] *See* Proposed CFTC Rule 41.46(a) and (b); Proposed SEC Rule 403(a) and (b).

[268] *See* Proposed CFTC Rule 41.46(c); Proposed SEC Rule 403(c).

[269] 12 CFR 220.4(d).

[270] *See* Peregrine Letter; SIA Credit Division Letter; SIA/FIA Letter; Morgan Stanley Letter; CME/CBOT Letter; and NFA Letter.

[271] Peregrine Letter at 2.

[272] SIA Credit Division Letter at 2.

[273] SIA/FIA Letter at 11.

[274] *Id.*

[275] *See* Morgan Stanley Letter at 10; CME/CBOT Letter at 5.

[276] NFA Letter at 5.

[277] 17 CFR 1.17(c)(5)(viii) or (ix); 17 CFR 240.15c3-1(c)(2)(xii).

[278] CFTC Rule 41.48(a); SEC Rule 406(a).

[279] CFTC Rule 41.48(b); SEC Rule 406(b). This is the same standard that applies to options specialists

firms with the flexibility to control liquidation of positions during adverse market conditions, the Final Rules provide that firms shall liquidate such positions promptly and in an orderly manner. This is consistent with futures industry practices in which FCMs, pursuant to customer agreements, exercise discretion in making liquidation decisions. In this regard, the Commissions believe that it is prudent business practice for security futures intermediaries to take steps to liquidate customer accounts well before they are in a deficit condition. The uniform liquidation requirement adopted under the Final Rules differs from the liquidation requirements imposed under Regulation T and securities SRO rules with respect to undermargined accounts.[280] The Final Rules clarify that this Regulation T liquidation requirement does not apply to security futures held in a securities account.[281]

K. CFTC Procedures for Notification of Proposed Rule Changes Related to Margin

In general, a designated contract market, including a "notice-designated" contract market,[282] or registered derivatives transaction execution facility ("DTF") that proposes to make a rule change regarding its security futures margin requirements (other than proposed rule changes that result in higher margin levels) must submit the proposed rule change to the SEC for approval in accordance with section 19(b) of the Exchange Act.[283] In addition, contract markets designated pursuant to Section 5 of the CEA and registered DTFs are also required under Section 5c(c) of the CEA to make certain filings with the CFTC regarding rule changes, including those for security futures products.[284] Because ATSs are not SROs under the Exchange Act, notice-designated contract markets that are ATSs are not required to submit proposed rule changes to the SEC for approval in accordance with section 19(b) of the Exchange Act.

Section 5c(c) of the CEA provides for two alternative procedures by which such a designated contract market or registered DTF may implement a proposed rule change.[285] First, in accordance with Section 5c(c)(1) of the CEA, a proposed rule change may be implemented by providing the CFTC with a written certification that the proposed rule change complies with the CEA.[286] Second, Section 5c(c)(2) of the CEA provides that, before the implementation of a proposed rule change, an entity may request that the CFTC grant prior approval of the rule change.[287]

Proposed CFTC Rule 41.48(a) required any notice-designated contract market that files a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with section 19(b)(2) of the Exchange Act[288] to concurrently provide to the CFTC a copy of such a proposed rule change and any accompanying documentation filed with the SEC.[289] Such notice-designated contract market was not required to provide any supplemental information, even if such information were subsequently provided to the SEC in the course of the SEC's review of the proposed rule change. The purpose of this Proposed Rule was to provide the CFTC, as a joint regulator of markets offering security futures products, with timely notification of a proposed rule change.

Proposed CFTC Rule 41.48(b) established the notification process for contract markets designated pursuant to Section 5 of the CEA[290] and registered DTFs. The process by which such an entity would notify the CFTC of having filed a proposed rule change with the SEC would depend on which procedure under Section 5c(c) of the CEA[291] the entity elected to follow.

Proposed CFTC Rule 41.48(b)(1) applied to any designated contract market registered under section 5 of the CEA or registered DTF that elects to seek the prior approval of the CFTC for a proposed rule change, in accordance with Section 5c(c)(2) of the CEA.[292] In such case, the contract market or DTF would file its requests with the SEC and CFTC concurrently.

Under Proposed CFTC Rule 41.48(b)(2), an entity that elects to implement a proposed rule change by filing a written certification with the CFTC in accordance with Section 5c(c)(1) of the CEA[293] would be required to provide a copy of the proposed rule change and any accompanying documentation that was filed with the SEC, concurrent with the SEC filing. Promptly after the SEC approves the proposed rule change, the designated contract market or registered DTF would file the written certification with the CFTC.

The CFTC requested comments on an alternative procedure under which an entity would file its written certification with the CFTC at the same time as it files the proposed rule change with the SEC, rather than after the SEC approves the proposed rule change.

The CFTC did not receive any comments relating to this issue, and it is therefore adopting the notification provisions as proposed, in all material respects.

III. Paperwork Reduction Act

A. CFTC

The Paperwork Reduction Act of 1995 ("PRA")[294] imposes certain requirements on federal agencies (including the CFTC and the SEC) in connection with their conducting or sponsoring any collection of information as defined by the PRA. The Final Rules that have been adopted do not require a new collection of information on the part of any entities subject to these rules. Accordingly, the requirements imposed by the PRA are not applicable to these rules.

B. SEC

The Paperwork Reduction Act does not apply because the rules do not impose recordkeeping or information collection requirements, or other collections of information that require

under the SEC's net capital rule. Exchange Act Rule 15c3–1(c)(2)(x)(D) (17 CFR 240.15c3–1(c)(2)(x)(D)).

[280] Under Regulation T, if any initial margin call is not met in full within one payment period after a margin deficiency is created or increased, a creditor must liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less (unless the margin deficiency created or increased is $1000 or less). 12 CFR 220.4(d). The Regulation T payment period is currently five business days, although it may be extended for one or more limited periods upon application by the creditor to its examining authority. *Id.* at 12 CFR 220.2, 220.4(c)(3). NYSE Rule 431 requires the amount of maintenance margin or mark to market required by any provision of the NYSE Rule 431 to be obtained within fifteen business days from the date such deficiency occurred, unless the Exchange has specifically granted the member organization additional time. NYSE Rule 431(f)(6).

[281] CFTC Rule 41.48(c); SEC Rule 406(c).

[282] A notice-designated contract market is a national securities exchange registered pursuant to section 6(a) of the Exchange Act (15 U.S.C. 78f(a)), a national securities association registered pursuant to section 15A(a) of the Exchange Act (15 U.S.C. 78*o*–3(a)), or an alternative trading system ("ATS") as defined in Section 1a(1) of the CEA (7 U.S.C. 1a(1)) that is designated as a contract market pursuant to Section 5f of the CEA (7 U.S.C. 7b–1).

[283] 15 U.S.C. 78s(b).

[284] 7 U.S.C. 7a–2(c). Notice-designated contract markets are exempt from the requirements of Section 5c of the CEA pursuant to Section 5f(b)(1)(D) of the CEA (7 U.S.C. 7a–2(b)(1)(D)).

[285] *See also* 66 FR 42256 (August 10, 2001) (CFTC rules implementing these procedures, codified in a new Part 40 of Title 17, CFTC Rules 40.5 and 40.6).

[286] 7 U.S.C. 7a–2(c)(1).

[287] 7 U.S.C. 7a–2(c)(2).

[288] 15 U.S.C. 78s(b)(2).

[289] The copy may be submitted to the CFTC electronically, by facsimile, or by delivery of a hard copy.

[290] 7 U.S.C. 7a–2.

[291] 7 U.S.C. 7a–2(c).

[292] 7 U.S.C. 7a–2(c)(2).

[293] 7 U.S.C. 7a–2(c)(1).

[294] 44 U.S.C. 3501 *et seq.*

the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et. seq.*

IV. Costs and Benefits of the Final Rules

A. CFTC

Section 15(a) of the CEA[295] requires that the CFTC, before promulgating a regulation under the CEA or issuing an order, consider the costs and benefits of its action. By its terms, Section 15(a) does not require the CFTC to quantify the costs and benefits of a new rule or determine whether the benefits of the rule outweigh its costs. Rather, Section 15(a) simply requires the CFTC to "consider the costs and benefits" of its action.

Section 15(a) further specifies that costs and benefits shall be evaluated in light of the following considerations: (1) Protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. Accordingly, the CFTC could, in its discretion, give greater weight to any one of the five considerations and could, in its discretion, determine that, notwithstanding its costs, a particular rule was necessary or appropriate to protect the public interest or to effectuate any of the provisions or to accomplish any of the purposes of the CEA.

This rulemaking constitutes a package of related rule provisions. The Final Rules establish the amount of initial and maintenance customer margin for transactions in security futures. The CFTC believes that the customer margin requirements for security futures are, in accordance with the CFMA, consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act.[296] The CFTC has evaluated the costs and benefits of these rules in light of the specific considerations identified in Section 15(a) of the CEA:

1. Protection of market participants and the public. In general, the Final Rules should further the protection of market participants and the public.

2. Efficiency and competition. As noted above, the margin requirements are consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act, as required under the CFMA. To the extent that the Final Rules permit FCMs and futures exchanges to maintain existing operational and business practices, the Final Rules enable market participants to minimize operational costs associated with the introduction of security futures, and preserve meaningful customer choice as to the type of account (securities or futures) in which the customer may elect to carry security futures. In certain respects, the Final Rules promote a level playing field between options exchanges and security futures exchanges, and between broker-dealers/securities accounts and FCMs/futures accounts. Accordingly, the Final Rules are not expected to have a negative impact on competition.

3. Financial integrity of futures markets and price discovery. The Final Rules should have a positive effect on the financial integrity of security futures markets by protecting against systemic risk.

4. Sound risk management practices. The Final Rules are consistent with sound risk management practices.

5. Other public considerations. The Final Rules are expected to preserve the financial integrity of markets trading security futures and prevent systemic risk, thereby benefiting the public. The CFTC believes that the Final Rules give rise to an acceptable level of cost in light of the expected benefits of the rules.

After evaluating these considerations, the CFTC has determined to adopt the Final Rules discussed above. The CFTC invited public comment on its cost-benefit analysis, but did not receive any comments in response to this invitation. Moreover, insofar as the comments received raise any matters that might be deemed to relate to the cost-benefit analysis, the CFTC has addressed such comments in the foregoing discussion and through modifications to the Proposed Rules.

B. SEC

Section 7 of the Exchange Act, which governs the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security), was amended by the CFMA to add provisions related to margin for security futures. On March 6, 2001, the Federal Reserve Board delegated its authority under section 7(c)(2) of the Exchange Act to establish margin requirements for security futures to the SEC and CFTC. The Final Rules establish such margin requirements.

Specifically, the CFMA amended section 7(c) of the Exchange Act to require that the rules preserve the financial integrity of markets trading security futures products, prevent systemic risk, and to require that: (1) The margin requirements for a security future be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act;[297] and (2) the initial and maintenance margin levels for a security future not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any exchange registered pursuant to section 6(a) of the Exchange Act, other than an option on a security future, and to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures, are and remain consistent with the requirements established by the Federal Reserve Board under Regulation T.

The SEC provided an estimate of the costs and benefits of the Proposed Rules, and requested comments on all aspects of its estimate, including identification of any additional costs or benefits of the proposed rules. The SEC encouraged commenters to identify and supply any relevant data, analysis and estimates concerning the costs and benefits of the proposed rules. Several commenters expressed the view that certain aspects of the Proposed Rules would impose costs. However, none of the commenters provided specific data regarding the overall costs and benefits of the Proposed Rules.

The SEC has considered the costs and benefits of the Final Rules. We are sensitive to the costs and benefits that might arise from compliance with our rules and amendments. In response to commenters' concerns about the potential costs related to the application of Regulation T to all transactions in security futures, the Commissions are adopting stand alone margin rules for security futures that apply only certain requirements of Regulation T that are necessary to satisfy the statutory requirement that the margin requirements for security futures be and remain consistent with Regulation T. The SEC understands that some aspects of the Final Rules may impose costs on some persons or entities. However, the Final Rules are being adopted pursuant to statutory directive and are necessary to permit trading in security futures. In addition, the SEC notes that the Final Rules will apply only to those broker-dealers and FCMs that choose to do a business in security futures.

[295] 7 U.S.C. 19(a).

[296] 15 U.S.C. 78f(a).

[297] 15 U.S.C. 78f(a).

1. Costs

The Final Rules will impose administrative costs on security futures intermediaries. Further, security futures intermediaries are responsible for complying with the Final Rules and thus will incur various costs. The SEC has identified below areas where the Final Rules may impose costs.

a. *Compliance with Regulation T.* The Proposed Rules would have applied Regulation T to financial relations between brokers, dealers, and members of national securities exchanges and their customers with respect to transactions in security futures and any related securities or futures contracts that are used to offset positions in such security futures. Accordingly, under the Proposed Rules, Regulation T would have applied to all transactions in security futures, whether they were effected in a securities account or a futures account. Several commenters expressed concern that applying Regulation T to security futures in futures accounts would result in substantial costs to FCMs resulting from the need to reprogram their margin systems to comply with Regulation T.

As noted above, the Final Rules do not apply Regulation T to all security futures transactions. Instead, as noted above, the Final Rules incorporate certain requirements of Regulation T as necessary to satisfy the requirement under section 7(c)(2) of the Exchange Act that the Final Rules be and remain consistent with Regulation T. The SEC believes that this aspect of the Final Rules should only impose minimal administrative costs on security futures intermediaries. For broker-dealers and members of national securities exchanges that trade security futures, there should be little or no cost imposed by this aspect of the Final Rules because they already are subject to Regulation T for other securities transactions. For FCMs, there will be some administrative costs associated with this aspect of the final rules to program their systems to comply with the specific provisions of Regulation T that are included in the Final Rules.

b. *Levels of Margin.* SEC Rule 403(b)(1) sets the level of margin at 20 percent of current market value, which is the same level that would have been set under the Proposed Rules. The 20 percent level is necessary to fulfill the requirement under Section 7(c)(2)(B)(iii) that the margin requirements for security futures be consistent with the margin requirements for comparable exchange-traded options.[298]

When the Proposed Rules were issued for comment, the SEC noted that the 20 percent margin level could appear to be high when compared to margining methodologies currently used for futures other than security futures. As a result, a potential cost of the margin levels is that they may lead to reduced interest in trading security futures and, therefore, foregone hedging opportunities.

However, while margin requirements on futures other than security futures generally range from 2–10 percent,[299] SEC staff estimated that applying traditional futures risk-based margining methods to security futures would require margin of greater than 10 percent.[300] In addition, however, SEC staff estimated that the proposed margin levels would reduce the chances that a margin account would not contain sufficient funds to cover a given day's price movement from approximately 5 percent using traditional risk-based futures margining to 0.3 percent. Further, economic research has thus far not been able to establish a strong relationship between futures margin levels and interest in the product.[301] Therefore, while the margin levels under the Final Rules may impose a cost, the SEC believes that the margin levels should lower chances of customer default and therefore lower systemic risk to the markets. For these reasons, and the statutory mandate that requires comparability between security futures margin and options margin, the SEC believes that the margin levels adopted in the Final Rules are appropriate.

c. *Computation of Margin.* The Final Rules require security futures intermediaries to compute and collect, on a daily basis, required margin for each customer's security future carried or held by such entity. This requirement is designed to assure contract performance and the integrity of the marketplace. In addition, all security futures intermediaries will pay or receive daily variation settlement (*i.e.*, the daily net gain or loss on a security future) as a result of all open futures positions being marked to current market value by the clearing organization.

The SEC believes that the daily required computation of the initial and maintenance margin requirements and the collection and disbursement of daily settlement variation for security futures by security futures intermediaries will require these entities to program or reprogram their computer systems to implement the margin computations and the settlement variation procedures for security futures. These entities may also incur additional data storage costs and resource costs associated with these calculations.

d. *Undermargined Accounts.* SEC Rule 406(a) requires a security futures intermediary to take a deduction in computing its net capital to the extent that any margin call required by the Final Rules is not met in full. In addition, SEC Rule 406(b) requires that a security futures intermediary liquidate positions in a prompt and orderly manner in any account in which security futures are held at any time there is a liquidating deficit in the account. The SEC believes that these aspects of the Final Rules may impose costs on security futures intermediaries by requiring them to evaluate information to determine for each customer's account involving security futures when margin calls required under the Final Rules have not been met. Security futures intermediaries may also incur costs in the form of capital charges with respect to customers that do not meet margin calls. In addition, security futures intermediaries that have customer accounts that fall into a liquidating deficit may incur costs in complying with the mandatory liquidation provisions of the Final Rules.

2. Benefits

The benefits of the Final Rules are related to the benefits that will accrue as a result of the enactment of the CFMA. By repealing the ban on futures

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[298] 15 U.S.C. 78g(c)(2)(B)(iii).

[299] Catrath, A., Adrangi, B and Alleder, M. (2001), *The Impact of Margins in Futures Markets: Evidence from the Gold and Silver Markets*, The Quarterly Review of Economics and Finance, 279.

[300] The SEC staff examined all securities with average daily trading volume greater than 50,000, using data from 2000 from the Center for Research in Security Prices ("CRSP"). Based on these data, the SEC staff calculated the daily price returns and the 30-day historical price volatility for each of the securities examined.

Based on the assumption that cash and futures prices typically move together, the SEC staff conducted a simulation, using actual security price movements as estimates for would be futures price movements. Based upon these security futures' price estimates, the staff determined the margin requirements for each of these security futures under both the 20 percent strategy-based approach and the traditional risk-based futures approach. The staff examined how often the funds attributable to margin requirements are insufficient to cover the daily price movements of these security futures. This is relevant to the examination of systemic risk because a necessary condition for customer default to occur is the depletion of the funds attributable to margin requirements (assuming no market risk to close out such position).

[301] For further details on these issues, *see* Fishe, R. P. H., Goldberg, L.G., (1986), *The Effects of Margins on Trading in Futures Markets*, Journal of Futures Markets, 261; Fishe, P.H., Goldberg, L.A., Gosnell, T.F. and Sinha, S. (1990), *Margin Requirement in Futures Markets: Their Relationship to Price Volatility*, The Journal of Futures Markets, 541.

on single securities and futures on narrow-based security indexes, the CFMA will enable a greater variety of financial products to be traded that potentially could facilitate price discovery and the ability to hedge. Investors will benefit by having a wider choice of financial products to buy and sell, and markets and market participants will benefit by having the ability to trade these products. These rules are a prerequisite to the commencement of trading in the new products, and therefore they are also a prerequisite to any benefits that may derive from the availability of these products.

a. *Benefits to Security Futures Intermediaries.* SEC Rule 403(b)(1) provides that the minimum initial and maintenance margin levels for each security future would be 20 percent of the current market value of such contract. Moreover, SEC Rule 404(b) provides that a security futures intermediary may accept as collateral cash, margin securities, exempted securities, or other collateral permitted under Regulation T, as well as shares in money market mutual funds, to satisfy a margin deficiency. The SEC believes that these aspects of the Final Rules will provide sound protection from customer default by reducing chances of depletion of margin accounts. Accordingly, the Final Rules should reduce systemic risk associated with the trading of these new products.

b. *Benefits to Customers.* SEC Rule 403(b)(2) provides that customers be permitted to offset positions involving security futures with certain related securities or futures. Such offsets would be proposed by regulatory authority rules that would be approved by the SEC pursuant to section 19(b)(2) of the Exchange Act and, as applicable, by the CFTC pursuant to Section 5c(c) of the CEA if such offsets were consistent with the requirements of section 7(c)(2)(B) of the Exchange Act, including the requirement that margin requirements for security futures be no less restrictive than those imposed on options. These offsets will provide benefits to customers because they will recognize the hedged nature of certain specified combined strategies and will permit lower margin requirements that better reflect the true risk of those strategies.

V. Consideration of Burden on Competition, Promotion of Efficiency and Capital Formation

Section 3(f) of the Exchange requires the SEC, when it is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[302] Section 23(a)(2) requires the SEC, in adopting rules under the Exchange Act, to consider the impact any rule would have on competition.[303] Section 23(a)(2) further provides that the SEC may not adopt a rule not necessary or appropriate in furtherance of the purposes of the Exchange Act. In the proposing release, the SEC requested comments on these statutory considerations. The SEC received no comments on the issue of competition, efficiency, or capital formation.

The SEC believes that the rules should promote efficiency by setting forth clear guidelines for security futures intermediaries when collecting customer margin related to security futures. Further, the SEC believes that the rules will provide sound protection from customer default by reducing the chances of depletion of margin accounts, thereby reducing systemic risk associated with the trading of these new products.

The SEC also believes that the rules would not impose any significant burden on competition. The Final Rules provide that security futures generally will be governed by the existing margin rules applicable to securities accounts and to futures accounts, which are not identical in all cases. However, the Final Rules also include uniform provisions, applicable to security futures regardless of the type of account in which they are held, which are designed to prevent competitive advantages from arising simply because security futures are held in one type of account rather than the other. The rules serve only to set forth margin requirements for security futures. In addition, the Final Rules satisfy section 7(c)(2)(B)(iii) of the Exchange Act, which, among other things, requires that the margin rules for security futures be consistent with those for comparable exchange-traded options. Accordingly, the Final Rules are designed to prevent competitive advantages from arising solely out of differences between the margin requirements for security futures and those for exchange-traded options. Lastly, the SEC believes that the rules will not have any impact on capital formation because the rules, as adopted, merely establish requirements governing the collection of customer margin. The SEC reiterates that the margin requirements would protect security futures intermediaries from customers' default, thus encouraging participation by these market participants in the trading of futures on both single securities and narrow-based security indexes. Therefore, the SEC believes that there could be an increased demand for the underlying securities, resulting in increased capital formation.

[302] 15 U.S.C. 78c(f).

[303] 15 U.S.C. 78w(a)(2).

VI. Regulatory Flexibility Act

A. CFTC

The Regulatory Flexibility Act ("RFA")[304] requires that federal agencies, in promulgating rules, consider the impact of those rules on small entities. The Final Rules will affect designated contract markets, registered DTFs, and FCMs. The CFTC has previously established certain definitions of "small entities" to be used by the CFTC in evaluating the impact of its rules on small entities in accordance with the RFA.[305]

In its previous determinations, the CFTC has concluded that contract markets are not small entities for purposes of the RFA, based on the vital role contract markets play in the national economy and the significant amount of resources required to operate as SROs.[306] Recently, the CFTC determined that notice-designated contract markets are not small entities for purposes of the RFA.[307] In addition, the CFTC has determined that other trading facilities subject to its jurisdiction, including registered DTFs, are not small entities for purposes of the RFA.[308]

In the Proposing Release, it was observed that the CFTC has previously determined that FCMs are not small entities for purposes of the RFA, based on the fiduciary nature of FCM-customer relationships as well as the requirements that FCMs meet certain minimum financial requirements.[309] The CFTC proposed to determine that notice-registered FCMs,[310] for the reasons applicable to FCMs registered in accordance with Section 4f(a)(1) of the CEA,[311] are not small entities for purposes of the RFA. Brokers or dealers that carry customer accounts and receive or hold funds for those customers, and are notice-registered as FCMs for the purpose of trading security futures, similarly have a fiduciary

[304] 5 U.S.C. 601 *et seq.*

[305] 47 FR 18618–21 (April 30, 1982).

[306] *Id.* at 18619.

[307] 66 FR 44960, 44964 (August 27, 2001).

[308] 66 FR 42256, 42268 (August 10, 2001).

[309] 47 FR at 18619.

[310] A broker or dealer that is registered with the SEC and that limits its futures activities to those involving security futures products, may notice register with the CFTC as an FCM in accordance with Section 4f(a)(2) of the CEA (7 U.S.C. 6f(a)(2)).

[311] 7 U.S.C. 6f(a)(1).

relationship with their customers and must meet analogous minimum financial requirements.[312]

The CFTC invited the public to comment on its proposed determination that notice-registered FCMs would not be small entities for purposes of the RFA. The CFTC also invited comments on its finding that there would not be a significant economic impact on a substantial number of small entities. The CFTC notes that no comments were received regarding either of these issues. Additionally, the CFTC notes that Congress mandated that customer margin for security futures be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 6(a) of the Exchange Act.[313] In adopting the Final Rules, the Commissions have striven to fulfill this requirement in the least burdensome way possible. The CFTC hereby determines that notice-registered FCMs are not small entities for purposes of the RFA. Further, the CFTC believes that the Final Rules will not have a significant economic impact on a substantial number of small entities.

B. SEC

Pursuant to section 605(b) of the Regulatory Flexibility Act ("RFA"),[314] the SEC certified that the adopted rule would not have a significant economic impact on a substantial number of small entities. This certification was attached to the Proposing Release No. 34–50720 (October 4, 2001) as Appendix A.[315] The SEC solicited comments concerning the impact on small entities and the RFA certification, but received no comments.

VII. Statutory Basis

The SEC is adopting Rules 400 through 406 pursuant to the Exchange Act, particularly Sections, 3(b), 6, 7(c), 15A, and 23(a). Further, these rules are adopted pursuant to the authority delegated jointly to the SEC, together with the CFTC, by the Federal Reserve Board in accordance with Exchange Act Section 7(c)(2)(A).

Text of Rules

List of Subjects

17 CFR Part 41

Brokers, Margin, Reporting and recordkeeping requirements, Security futures products.

17 CFR Part 242

Brokers, Securities.

Commodity Futures Trading Commission

17 CFR Chapter I

In accordance with the foregoing, Title 17, chapter I of the Code of Federal Regulations is amended as follows:

PART 41—SECURITY FUTURES PRODUCTS

1. The authority citation for Part 41 is revised to read as follows:

Authority: Sections 206, 251 and 252, Pub. L. 106–554, 114 Stat. 2763; 7 U.S.C. 1a, 2, 6f, 6j, 7a–2, 12a; 15 U.S.C. 78g(c)(2).

2. The part heading for Part 41 is revised to read as set forth above.

§ 41.41 [Redesignated]

3. In Part 41, § 41.41 is redesignated as § 41.3.

4. Part 41 is amended by adding Subpart E (§§ 41.42 through 41.49) to read as follows:

Subpart E—Customer Accounts and Margin Requirements

Sec.

41.42 Customer margin requirements for security futures—authority, purpose, interpretation, and scope.
41.43 Definitions.
41.44 General provisions.
41.45 Required margin.
41.46 Type, form and use of margin.
41.47 Withdrawal of margin.
41.48 Undermargined accounts.
41.49 Filing proposed margin rule changes with the Commission.

Subpart E—Customer Accounts and Margin Requirements

§ 41.42 Customer margin requirements for security futures—authority, purpose, interpretation, and scope.

(a) *Authority and purpose.* Subpart E, §§ 41.42 through 41.49, and 17 CFR 242.400 through 242.406 ("this Regulation") are issued by the Commodity Futures Trading Commission ("Commission") jointly with the Securities and Exchange Commission ("SEC"), pursuant to authority delegated by the Board of Governors of the Federal Reserve System under section 7(c)(2)(A) of the Securities Exchange Act of 1934 ("Exchange Act"). The principal purpose of this Regulation (Subpart E, §§ 41.42 through 41.49) is to regulate customer margin collected by brokers, dealers, and members of national securities exchanges, including futures commission merchants required to register as brokers or dealers under section 15(b)(11) of the Exchange Act, relating to security futures.

(b) *Interpretation.* This Regulation (Subpart E, §§ 41.42 through 41.49) shall be jointly interpreted by the SEC and the Commission, consistent with the criteria set forth in clauses (i) through (iv) of section 7(c)(2)(B) of the Exchange Act and the provisions of Regulation T (12 CFR part 220).

(c) *Scope.*

(1) This Regulation (Subpart E, §§ 41.42 through 41.49) does not preclude a self-regulatory authority, under rules that are effective in accordance with section 19(b)(2) of the Exchange Act or section 19(b)(7) of the Exchange Act and, as applicable, section 5c(c) of the Commodity Exchange Act ("Act"), or a security futures intermediary from imposing additional margin requirements on security futures, including higher initial or maintenance margin levels, consistent with this Regulation (Subpart E, §§ 41.42 through 41.49), or from taking appropriate action to preserve its financial integrity.

(2) This Regulation (Subpart E, §§ 41.42 through 41.49) does not apply to:

(i) Financial relations between a customer and a security futures intermediary to the extent that they comply with a portfolio margining system under rules that meet the criteria set forth in section 7(c)(2)(B) of the Exchange Act and that are effective in accordance with section 19(b)(2) of the Exchange Act and, as applicable, section 5c(c) of the Act;

(ii) Financial relations between a security futures intermediary and a foreign person involving security futures traded on or subject to the rules of a foreign board of trade;

(iii) Margin requirements that clearing agencies registered under section 17A of the Exchange Act or derivatives clearing organizations registered under section 5b of the Act impose on their members;

(iv) Financial relations between a security futures intermediary and a person based on a good faith determination by the security futures intermediary that such person is an exempted person; and

(v) Financial relations between a security futures intermediary and, or arranged by a security futures intermediary for, a person relating to trading in security futures by such person for its own account, if such person:

(A) Is a member of a national securities exchange or national securities association registered pursuant to section 15A(a) of the Exchange Act; and

[312] *See* Exchange Act Rule 15c3–1(a)(2), 17 CFR 240.15c3–1(a)(2).

[313] 15 U.S.C. 78f(a).

[314] 5 U.S.C. 601 *et seq.*

[315] *See* Proposing Release, *supra* note 6.

(B) Is registered with such exchange or such association as a security futures dealer pursuant to rules that are effective in accordance with section 19(b)(2) of the Exchange Act and, as applicable, section 5c(c) of the Act, that:

(*1*) Require such member to be registered as a floor trader or a floor broker with the Commission under section 4f(a)(1) of the Act, or as a dealer with the SEC under section 15(b) of the Exchange Act;

(*2*) Require such member to maintain records sufficient to prove compliance with this paragraph (c)(2)(v) and the rules of the exchange or association of which it is a member;

(*3*) Require such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis; and

(*4*) Provide for disciplinary action, including revocation of such member's registration as a security futures dealer, for such member's failure to comply with this Regulation (Subpart E, §§ 41.42 through 41.49) or the rules of the exchange or association.

(d) *Exemption.* The Commission may exempt, either unconditionally or on specified terms and conditions, financial relations involving any security futures intermediary, customer, position, or transaction, or any class of security futures intermediaries, customers, positions, or transactions, from one or more requirements of this Regulation (Subpart E, §§ 41.42 through 41.49), if the Commission determines that such exemption is necessary or appropriate in the public interest and consistent with the protection of customers. An exemption granted pursuant to this paragraph shall not operate as an exemption from any SEC rules. Any exemption that may be required from such rules must be obtained separately from the SEC.

§ 41.43 Definitions.

(a) For purposes of this Regulation (Subpart E, §§ 41.42 through 41.49) only, the following terms shall have the meanings set forth in this section.

(1) *Applicable margin rules* and *margin rules applicable to an account* mean the rules and regulations applicable to financial relations between a security futures intermediary and a customer with respect to security futures and related positions carried in a securities account or futures account as provided in § 41.44(a) of this subpart.

(2) *Broker* shall have the meaning provided in section 3(a)(4) of the Exchange Act.

(3) *Contract multiplier* means the number of units of a narrow-based security index expressed as a dollar amount, in accordance with the terms of the security future contract.

(4) *Current market value* means, on any day:

(i) With respect to a security future:

(A) If the instrument underlying such security future is a stock, the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable number of shares per contract; or

(B) If the instrument underlying such security future is a narrow-based security index, as defined in section 1a(25)(A) of the Act, the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.

(ii) With respect to a security other than a security future, the most recent closing sale price of the security, as shown by any regularly published reporting or quotation service. If there is no recent closing sale price, the security futures intermediary may use any reasonable estimate of the market value of the security as of the most recent close of business.

(5) *Customer* excludes an exempted person and includes:

(i) Any person or persons acting jointly:

(A) On whose behalf a security futures intermediary effects a security futures transaction or carries a security futures position; or

(B) Who would be considered a customer of the security futures intermediary according to the ordinary usage of the trade;

(ii) Any partner in a security futures intermediary that is organized as a partnership who would be considered a customer of the security futures intermediary absent the partnership relationship; and

(iii) Any joint venture in which a security futures intermediary participates and which would be considered a customer of the security futures intermediary if the security futures intermediary were not a participant.

(6) *Daily settlement price* means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, under the rules of the applicable exchange, clearing agency, or derivatives clearing organization.

(7) *Dealer* shall have the meaning provided in section 3(a)(5) of the Exchange Act.

(8) *Equity* means the equity or margin equity in a securities or futures account, as computed in accordance with the margin rules applicable to the account and subject to adjustment under § 41.46(c), (d) and (e) of this subpart.

(9) *Exempted person* means:

(i) A member of a national securities exchange, a registered broker or dealer, or a registered futures commission merchant, a substantial portion of whose business consists of transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, futures commission merchants, floor brokers, or floor traders, and includes a person who:

(A) Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader that are effecting transactions in securities, commodity futures, or commodity options;

(B) Earns at least $10 million in gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader; or

(C) Earns at least 10 percent of its gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader.

(ii) For purposes of paragraph (a)(9)(i) of this section only, *persons affiliated with* a futures commission merchant, floor broker, or floor trader means any partner, officer, director, or branch manager of such futures commission merchant, floor broker, or floor trader (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such futures commission merchant, floor broker, or floor trader, or any employee of such a futures commission merchant, floor broker, or floor trader.

(iii) A member of a national securities exchange, a registered broker or dealer, or a registered futures commission merchant that has been in existence for less than one year may meet the definition of exempted person based on a six-month period.

(10) *Exempted security* shall have the meaning provided in section 3(a)(12) of the Exchange Act.

(11) *Floor broker* shall have the meaning provided in section 1a(16) of the Act.

(12) *Floor trader* shall have the meaning provided in section 1a(17) of the Act.

(13) *Futures account* shall have the meaning provided in § 1.3(vv) of this chapter.

(14) *Futures commission merchant* shall have the meaning provided in section 1a(20) of the Act.

(15) *Good faith*, with respect to making a determination or accepting a statement concerning financial relations with a person, means that the security futures intermediary is alert to the circumstances surrounding such financial relations, and if in possession of information that would cause a prudent person not to make the determination or accept the notice or certification without inquiry, investigates and is satisfied that it is correct.

(16) *Listed option* means a put or call option that is:

(i) Issued by a clearing agency that is registered under section 17A of the Exchange Act or cleared and guaranteed by a derivatives clearing organization that is registered under section 5b of the Act; and

(ii) Traded on or subject to the rules of a self-regulatory authority.

(17) *Margin call* means a demand by a security futures intermediary to a customer for a deposit of cash, securities or other assets to satisfy the required margin for security futures or related positions or a special margin requirement.

(18) *Margin deficiency* means the amount by which the required margin in an account is not satisfied by the equity in the account, as computed in accordance with § 41.46 of this subpart.

(19) *Margin equity security* shall have the meaning provided in Regulation T.

(20) *Margin security* shall have the meaning provided in Regulation T.

(21) *Member* shall have the meaning provided in section 3(a)(3) of the Exchange Act, and shall include persons registered under section 15(b)(11) of the Exchange Act that are permitted to effect transactions on a national securities exchange without the services of another person acting as executing broker.

(22) *Money market mutual fund* means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 that is considered a money market fund under § 270.2a-7 of this title.

(23) *Persons associated with a broker or dealer* shall have the meaning provided in section 3(a)(18) of the Exchange Act.

(24) *Regulation T* means Regulation T promulgated by the Board of Governors of the Federal Reserve System, 12 CFR part 220, as amended from time to time.

(25) *Regulation T collateral value*, with respect to a security, means the current market value of the security reduced by the percentage of required margin for a position in the security held in a margin account under Regulation T.

(26) *Related position*, with respect to a security future, means any position in an account that is combined with the security future to create an offsetting position as provided in § 41.45(b)(2) of this subpart.

(27) *Related transaction*, with respect to a position or transaction in a security future, means:

(i) Any transaction that creates, eliminates, increases or reduces an offsetting position involving a security future and a related position, as provided in § 41.45(b)(2) of this subpart; or

(ii) Any deposit or withdrawal of margin for the security future or a related position, except as provided in § 41.47(b) of this subpart.

(28) *Securities account* shall have the meaning provided in § 1.3(ww) of this chapter.

(29) *Security futures intermediary* means any creditor as defined in Regulation T with respect to its financial relations with any person involving security futures, including:

(i) Any futures commission merchant;

(ii) Any partner, officer, director, or branch manager (or person occupying a similar status or performing similar functions) of a futures commission merchant;

(iii) Any person directly or indirectly controlling, controlled by, or under common control with (except for business entities controlling or under common control with) a futures commission merchant; and

(iv) Any employee of a futures commission merchant (except an employee whose functions are solely clerical or ministerial).

(30) *Self-regulatory authority* means a national securities exchange registered under section 6 of the Exchange Act, a national securities association registered under section 15A of the Exchange Act, a contract market registered under section 5 of the Act or section 5f of the Act, or a derivatives transaction execution facility registered under section 5a of the Act.

(31) *Special margin requirement* shall have the meaning provided in § 41.46(e)(1)(ii) of this subpart.

(32) *Variation settlement* means any credit or debit to a customer account, made on a daily or intraday basis, for the purpose of marking to market a security future or any other contract that is:

(i) Issued by a clearing agency that is registered under section 17A of the Exchange Act or cleared and guaranteed by a derivatives clearing organization that is registered under section 5b of the Act; and

(ii) Traded on or subject to the rules of a self-regulatory authority.

(b) Terms used in this Regulation (Subpart E, §§ 41.42 through 41.49) and not otherwise defined in this section shall have the meaning set forth in the margin rules applicable to the account.

(c) Terms used in this Regulation (Subpart E, §§ 41.42 through 41.49) and not otherwise defined in this section or in the margin rules applicable to the account shall have the meaning set forth in the Exchange Act and the Act; if the definitions of a term in the Exchange Act and the Act are inconsistent as applied in particular circumstances, such term shall have the meaning set forth in rules, regulations, or interpretations jointly promulgated by the SEC and the Commission.

§ 41.44 General provisions.

(a) *Applicable margin rules.* Except to the extent inconsistent with this Regulation (Subpart E, §§ 41.42 through 41.49):

(1) A security futures intermediary that carries a security future on behalf of a customer in a securities account shall record and conduct all financial relations with respect to such security future and related positions in accordance with Regulation T and the margin rules of the self-regulatory authorities of which the security futures intermediary is a member.

(2) A security futures intermediary that carries a security future on behalf of a customer in a futures account shall record and conduct all financial relations with respect to such security future and related positions in accordance with the margin rules of the self-regulatory authorities of which the security futures intermediary is a member.

(b) *Separation and consolidation of accounts.*

(1) The requirements for security futures and related positions in one account may not be met by considering items in any other account, except as

permitted or required under paragraph (b)(2) of this section or applicable margin rules. If withdrawals of cash, securities or other assets deposited as margin are permitted under this Regulation (Subpart E, §§ 41.42 through 41.49), bookkeeping entries shall be made when such cash, securities, or assets are used for purposes of meeting requirements in another account.

(2) Notwithstanding paragraph (b)(1) of this section, the security futures intermediary shall consider all futures accounts in which security futures and related positions are held that are within the same regulatory classification or account type and are owned by the same customer to be a single account for purposes of this Regulation (Subpart E, §§ 41.42 through 41.49). The security futures intermediary may combine such accounts with other futures accounts that are within the same regulatory classification or account type and are owned by the same customer for purposes of computing a customer's overall margin requirement, as permitted or required by applicable margin rules.

(c) *Accounts of partners.* If a partner of the security futures intermediary has an account with the security futures intermediary in which security futures or related positions are held, the security futures intermediary shall disregard the partner's financial relations with the firm (as shown in the partner's capital and ordinary drawing accounts) in calculating the margin or equity of any such account.

(d) *Contribution to joint venture.* If an account in which security futures or related positions are held is the account of a joint venture in which the security futures intermediary participates, any interest of the security futures intermediary in the joint account in excess of the interest which the security futures intermediary would have on the basis of its right to share in the profits shall be margined in accordance with this Regulation (Subpart E, §§ 41.42 through 41.49).

(e) *Extensions of credit.* (1) No security futures intermediary may extend or maintain credit to or for any customer for the purpose of evading or circumventing any requirement under this Regulation (Subpart E, §§ 41.42 through 41.49).

(2) A security futures intermediary may arrange for the extension or maintenance of credit to or for any customer by any person, provided that the security futures intermediary does not willfully arrange credit that would constitute a violation of Regulation T, U or X of the Board of Governors of the Federal Reserve System (12 CFR parts 220, 221, and 224) by such person.

(f) *Change in exempted person status.* Once a person ceases to qualify as an exempted person, it shall notify the security futures intermediary of this fact before entering into any new security futures transaction or related transaction that would require additional margin to be deposited under this Regulation (Subpart E, §§ 41.42 through 41.49). Financial relations with respect to any such transactions shall be subject to the provisions of this Regulation (Subpart E, §§ 41.42 through 41.49).

§ 41.45 Required margin.

(a) *Applicability.* Each security futures intermediary shall determine the required margin for the security futures and related positions held on behalf of a customer in a securities account or futures account as set forth in this section.

(b) *Required margin.*—(1) *General rule.* The required margin for each long or short position in a security future shall be twenty (20) percent of the current market value of such security future.

(2) *Offsetting positions.* Notwithstanding the margin levels specified in paragraph (b)(1) of this section, a self-regulatory authority may set the required initial or maintenance margin level for an offsetting position involving security futures and related positions at a level lower than the level that would be required under paragraph (b)(1) of this section if such positions were margined separately, pursuant to rules that meet the criteria set forth in section 7(c)(2)(B) of the Exchange Act and are effective in accordance with section 19(b)(2) of the Exchange Act and, as applicable, section 5c(c) of the Act.

(c) *Procedures for certain margin level adjustments.* An exchange registered under section 6(g) of the Exchange Act, or a national securities association registered under section 15A(k) of the Exchange Act, may raise or lower the required margin level for a security future to a level not lower than that specified in this section, in accordance with section 19(b)(7) of the Exchange Act.

§ 41.46 Type, form and use of margin.

(a) *When margin is required.* Margin is required to be deposited whenever the required margin for security futures and related positions in an account is not satisfied by the equity in the account, subject to adjustment under paragraph (c) of this section.

(b) *Acceptable margin deposits.* (1) The required margin may be satisfied by a deposit of cash, margin securities (subject to paragraph (b)(2) of this section), exempted securities, any other asset permitted under Regulation T to satisfy a margin deficiency in a securities margin account, or any combination thereof, each as valued in accordance with paragraph (c) of this section.

(2) Shares of a money market mutual fund may be accepted as a margin deposit for purposes of this Regulation (Subpart E, §§ 41.42 through 41.49), *Provided that:*

(i) The customer waives any right to redeem the shares without the consent of the security futures intermediary and instructs the fund or its transfer agent accordingly;

(ii) The security futures intermediary (or clearing agency or derivatives clearing organization with which the shares are deposited as margin) obtains the right to redeem the shares in cash, promptly upon request; and

(iii) The fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.

(c) *Adjustments.*—(1) *Futures accounts.* For purposes of this section, the equity in a futures account shall be computed in accordance with the margin rules applicable to the account, subject to the following:

(i) A security future shall have no value;

(ii) Each net long or short position in a listed option on a contract for future delivery shall be valued in accordance with the margin rules applicable to the account;

(iii) Except as permitted in paragraph (e) of this section, each margin equity security shall be valued at an amount no greater than its Regulation T collateral value;

(iv) Each other security shall be valued at an amount no greater than its current market value reduced by the percentage specified for such security in § 240.15c3–1(c)(2)(vi) of this title;

(v) Freely convertible foreign currency may be valued at an amount no greater than its daily marked-to-market U.S. dollar equivalent;

(vi) Variation settlement receivable (or payable) by an account at the close of trading on any day shall be treated as a credit (or debit) to the account on that day; and

(vii) Each other acceptable margin deposit or component of equity shall be valued at an amount no greater than its value under Regulation T.

(2) *Securities accounts.* For purposes of this section, the equity in a securities account shall be computed in accordance with the margin rules

applicable to the account, subject to the following:

(i) A security future shall have no value;

(ii) Freely convertible foreign currency may be valued at an amount no greater than its daily mark-to-market U.S. dollar equivalent; and

(iii) Variation settlement receivable (or payable) by an account at the close of trading on any day shall be treated as a credit (or debit) to the account on that day.

(d) *Satisfaction restriction.* Any transaction, position or deposit that is used to satisfy the required margin for security futures or related positions under this Regulation (Subpart E, §§ 41.42 through 41.49), including a related position, shall be unavailable to satisfy the required margin for any other position or transaction or any other requirement.

(e) *Alternative collateral valuation for margin equity securities in a futures account.*

(1) Notwithstanding paragraph (c)(1)(iii) of this section, a security futures intermediary need not value a margin equity security at its Regulation T collateral value when determining whether the required margin for the security futures and related positions in a futures account is satisfied, *provided that:*

(i) The margin equity security is valued at an amount no greater than the current market value of the security reduced by the lowest percentage level of margin required for a long position in the security held in a margin account under the rules of a national securities exchange registered pursuant to section 6(a) of the Exchange Act;

(ii) Additional margin is required to be deposited on any day when the day's security futures transactions and related transactions would create or increase a margin deficiency in the account if the margin equity securities were valued at their Regulation T collateral value, and shall be for the amount of the margin deficiency so created or increased (a "special margin requirement"); and

(iii) Cash, securities, or other assets deposited as margin for the positions in an account are not permitted to be withdrawn from the account at any time that:

(A) Additional cash, securities, or other assets are required to be deposited as margin under this section for a transaction in the account on the same or a previous day; or

(B) The withdrawal, together with other transactions, deposits, and withdrawals on the same day, would create or increase a margin deficiency if the margin equity securities were valued at their Regulation T collateral value.

(2) All security futures transactions and related transactions on any day shall be combined to determine the amount of a special margin requirement. Additional margin deposited to satisfy a special margin requirement shall be valued at an amount no greater than its Regulation T collateral value.

(3) If the alternative collateral valuation method set forth in paragraph (e) of this section is used with respect to an account in which security futures or related positions are carried:

(i) An account that is transferred from one security futures intermediary to another may be treated as if it had been maintained by the transferee from the date of its origin, if the transferee accepts, in good faith, a signed statement of the transferor (or, if that is not practicable, of the customer), that any margin call issued under this Regulation (Subpart E, §§ 41.42 through 41.49) has been satisfied; and

(ii) An account that is transferred from one customer to another as part of a transaction, not undertaken to avoid the requirements of this Regulation (Subpart E, §§ 41.42 through 41.49), may be treated as if it had been maintained for the transferee from the date of its origin, if the security futures intermediary accepts in good faith and keeps with the transferee account a signed statement of the transferor describing the circumstances for the transfer.

(f) *Guarantee of accounts.* No guarantee of a customer's account shall be given any effect for purposes of determining whether the required margin in an account is satisfied, except as permitted under applicable margin rules.

§ 41.47 Withdrawal of margin.

(a) *By the customer.* Except as otherwise provided in § 41.46(e)(1)(ii) of this subpart, cash, securities, or other assets deposited as margin for positions in an account may be withdrawn, provided that the equity in the account after such withdrawal is sufficient to satisfy the required margin for the security futures and related positions in the account under this Regulation (Subpart E, §§ 41.42 through 41.49).

(b) *By the security futures intermediary.* Notwithstanding paragraph (a) of this section, the security futures intermediary, in its usual practice, may deduct the following items from an account in which security futures or related positions are held if they are considered in computing the balance of such account:

(1) Variation settlement payable, directly or indirectly, to a clearing agency that is registered under section 17A of the Exchange Act or a derivatives clearing organization that is registered under section 5b of the Act;

(2) Interest charged on credit maintained in the account;

(3) Communication or shipping charges with respect to transactions in the account;

(4) Payment of commissions, brokerage, taxes, storage and other charges lawfully accruing in connection with the positions and transactions in the account;

(5) Any service charges that the security futures intermediary may impose; or

(6) Any other withdrawals that are permitted from a securities margin account under Regulation T, to the extent permitted under applicable margin rules.

§ 41.48 Undermargined accounts.

(a) *Failure to satisfy margin call.* If any margin call required by this Regulation (Subpart E, §§ 41.42 through 41.49) is not met in full, the security futures intermediary shall take the deduction required with respect to an undermargined account in computing its net capital under SEC or Commission rules.

(b) *Accounts that liquidate to a deficit.* If at any time there is a liquidating deficit in an account in which security futures are held, the security futures intermediary shall take steps to liquidate positions in the account promptly and in an orderly manner.

(c) *Liquidation of undermargined accounts not required.* Notwithstanding § 41.44(a)(1) of this subpart, § 220.4(d) of Regulation T (12 CFR 220.4(d)) respecting liquidation of positions in lieu of deposit shall not apply with respect to security futures carried in a securities account.

§ 41.49 Filing proposed margin rule changes with the Commission.

(a) *Notification requirement for notice-designated contract markets.* Any self-regulatory authority that is registered with the Commission as a designated contract market under section 5f of the Act shall, when filing a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with section 19(b)(2) of the Exchange Act, concurrently provide to the Commission a copy of such proposed rule change and any accompanying documentation filed with the SEC.

(b) *Filing requirements under the Act.* Any self-regulatory authority that is registered with the Commission as a designated contract market under section 5 of the Act or a derivatives transaction execution facility under section 5a of the Act shall, when filing a proposed rule change regarding customer margin for security futures with the SEC for approval in accordance with section 19(b)(2) of the Exchange Act, submit such proposed rule change to the Commission as follows:

(1) If the self-regulatory authority elects to request the Commission's prior approval for the proposed rule change pursuant to section 5c(c)(2) of the Act, it shall concurrently file the proposed rule change with the Commission in accordance with § 40.5 of this chapter.

(2) If the self-regulatory authority elects to implement a proposed rule change by written certification pursuant to section 5c(c)(1) of the Act, it shall concurrently provide to the Commission a copy of the proposed rule change and any accompanying documentation filed with the SEC. Promptly after obtaining SEC approval for the proposed rule change, such self-regulatory authority shall file its written certification with the Commission in accordance with § 40.6 of this chapter.

Dated: July 31, 2002.

By the Commodity Futures Trading Commission.

Catherine D. Dixon,

Assistant Secretary.

Securities and Exchange Commission

17 CFR Chapter II

In accordance with the foregoing Title 17, chapter II, part 242 of the Code of Federal Regulations is amended as follows:

PART 242—REGULATIONS M AND ATS

1. The authority citation for part 242 is revised to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 80a–23, 80a–29, and 80a–37.

2. Part 242 is amended by adding the undesignated center heading "Regulation M" before § 242.100.

3. An undesignated center heading and §§ 242.400 through 242.406 are added to read as follows:

Customer Margin Requirements for Security Futures

Sec.

242.400 Customer margin requirements for security futures—authority, purpose, interpretation, and scope.
242.401 Definitions.
242.402 General provisions.
242.403 Required margin.
242.404 Type, form and use of margin.
242.405 Withdrawal of margin.
242.406 Undermargined accounts.

Customer Margin Requirements for Security Futures

§ 242.400 Customer margin requirements for security futures—authority, purpose, interpretation, and scope.

(a) *Authority and purpose.* Sections 242.400 through 242.406 and 17 CFR 41.42 through 41.49 ("this Regulation, §§ 242.400 through 242.406") are issued by the Securities and Exchange Commission ("Commission") jointly with the Commodity Futures Trading Commission ("CFTC"), pursuant to authority delegated by the Board of Governors of the Federal Reserve System under section 7(c)(2)(A) of the Securities Exchange Act of 1934 ("Act") (15 U.S.C. 78g(c)(2)(A)). The principal purpose of this Regulation (§§ 242.400 through 242.406) is to regulate customer margin collected by brokers, dealers, and members of national securities exchanges, including futures commission merchants required to register as brokers or dealers under section 15(b)(11) of the Act (15 U.S.C. 78*o*(b)(11)), relating to security futures.

(b) *Interpretation.* This Regulation (§§ 242.400 through 242.406) shall be jointly interpreted by the Commission and the CFTC, consistent with the criteria set forth in clauses (i) through (iv) of section 7(c)(2)(B) of the Act (15 U.S.C. 78g(c)(2)(B)) and the provisions of Regulation T (12 CFR part 220).

(c) *Scope.* (1) This Regulation (§§ 242.400 through 242.406) does not preclude a self-regulatory authority, under rules that are effective in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) or section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)) and, as applicable, section 5c(c) of the Commodity Exchange Act ("CEA") (7 U.S.C. 7a–2(c)), or a security futures intermediary from imposing additional margin requirements on security futures, including higher initial or maintenance margin levels, consistent with this Regulation (§§ 242.400 through 242.406), or from taking appropriate action to preserve its financial integrity.

(2) This Regulation (§§ 242.400 through 242.406) does not apply to:

(i) Financial relations between a customer and a security futures intermediary to the extent that they comply with a portfolio margining system under rules that meet the criteria set forth in section 7(c)(2)(B) of the Act (15 U.S.C. 78g(c)(2)(B)) and that are effective in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and, as applicable, section 5c(c) of the CEA (7 U.S.C. 7a–2(c));

(ii) Financial relations between a security futures intermediary and a foreign person involving security futures traded on or subject to the rules of a foreign board of trade;

(iii) Margin requirements that clearing agencies registered under section 17A of the Exchange Act (15 U.S.C. 78q–1) or derivatives clearing organizations registered under section 5b of the CEA (7 U.S.C. 7a–1) impose on their members;

(iv) Financial relations between a security futures intermediary and a person based on a good faith determination by the security futures intermediary that such person is an exempted person; and

(v) Financial relations between a security futures intermediary and, or arranged by a security futures intermediary for, a person relating to trading in security futures by such person for its own account, if such person:

(A) Is a member of a national securities exchange or national securities association registered pursuant to section 15A(a) of the Act (15 U.S.C. 78o–3(a)); and

(B) Is registered with such exchange or such association as a security futures dealer pursuant to rules that are effective in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and, as applicable, section 5c(c) of the CEA (7 U.S.C. 7a–2(c)), that:

(*1*) Require such member to be registered as a floor trader or a floor broker with the CFTC under Section 4f(a)(1) of the CEA (7 U.S.C. 6f(a)(1)), or as a dealer with the Commission under section 15(b) of the Act (15 U.S.C. 78o(b));

(*2*) Require such member to maintain records sufficient to prove compliance with this paragraph (c)(2)(v) and the rules of the exchange or association of which it is a member;

(*3*) Require such member to hold itself out as being willing to buy and sell security futures for its own account on a regular or continuous basis; and

(*4*) Provide for disciplinary action, including revocation of such member's registration as a security futures dealer, for such member's failure to comply with this Regulation (§§ 242.400 through 242.406) or the rules of the exchange or association.

(d) *Exemption.* The Commission may exempt, either unconditionally or on specified terms and conditions, financial relations involving any security futures intermediary, customer, position, or transaction, or any class of security futures intermediaries, customers, positions, or transactions, from one or more requirements of this Regulation (§§ 242.400 through 242.406), if the Commission determines that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors. An exemption granted pursuant to this paragraph shall not operate as an exemption from any CFTC rules. Any exemption that may be required from such rules must be obtained separately from the CFTC.

§ 242.401 Definitions.

(a) For purposes of this Regulation (§§ 242.400 through 242.406) only, the following terms shall have the meanings set forth in this section.

(1) *Applicable margin rules* and *margin rules applicable to an account* mean the rules and regulations applicable to financial relations between a security futures intermediary and a customer with respect to security futures and related positions carried in a securities account or futures account as provided in § 242.402(a) of this Regulation (§§ 242.400 through 242.406).

(2) *Broker* shall have the meaning provided in section 3(a)(4) of the Act (15 U.S.C. 78c(a)(4)).

(3) *Contract multiplier* means the number of units of a narrow-based security index expressed as a dollar amount, in accordance with the terms of the security future contract.

(4) *Current market value* means, on any day:

(i) With respect to a security future:

(A) If the instrument underlying such security future is a stock, theproduct of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable number of shares per contract; or

(B) If the instrument underlying such security future is a narrow-based security index, as defined in section 3(a)(55)(B) of the Act (15 U.S.C. 78c(a)(55)(B)), the product of the daily settlement price of such security future as shown by any regularly published reporting or quotation service, and the applicable contract multiplier.

(ii) With respect to a security other than a security future, the most recent closing sale price of the security, as shown by any regularly published reporting or quotation service. If there is no recent closing sale price, the security futures intermediary may use any reasonable estimate of the market value of the security as of the most recent close of business.

(5) *Customer* excludes an exempted person and includes:

(i) Any person or persons acting jointly:

(A) On whose behalf a security futures intermediary effects a security futures transaction or carries a security futures position; or

(B) Who would be considered a customer of the security futures intermediary according to the ordinary usage of the trade;

(ii) Any partner in a security futures intermediary that is organized as a partnership who would be considered a customer of the security futures intermediary absent the partnership relationship; and

(iii) Any joint venture in which a security futures intermediary participates and which would be considered a customer of the security futures intermediary if the security futures intermediary were not a participant.

(6) *Daily settlement price* means, with respect to a security future, the settlement price of such security future determined at the close of trading each day, under the rules of the applicable exchange, clearing agency, or derivatives clearing organization.

(7) *Dealer* shall have the meaning provided in section 3(a)(5) of the Act (15 U.S.C. 78c(a)(5)).

(8) *Equity* means the equity or margin equity in a securities or futures account, as computed in accordance with the margin rules applicable to the account and subject to adjustment under § 242.404(c), (d) and (e) of this Regulation (§§ 242.400 through 242.406).

(9) *Exempted person* means:

(i) A member of a national securities exchange, a registered broker or dealer, or a registered futures commission merchant, a substantial portion of whose business consists of transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, futures commission merchants, floor brokers, or floor traders, and includes a person who:

(A) Maintains at least 1000 active accounts on an annual basis for persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader that are effecting transactions in securities, commodity futures, or commodity options;

(B) Earns at least $10 million in gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader; or

(C) Earns at least 10 percent of its gross revenues on an annual basis from transactions in securities, commodity futures, or commodity options with persons other than brokers, dealers, persons associated with a broker or dealer, futures commission merchants, floor brokers, floor traders, and persons affiliated with a futures commission merchant, floor broker, or floor trader.

(ii) For purposes of paragraph (a)(9)(i) of this section only, persons affiliated with a futures commission merchant, floor broker, or floor trader means any partner, officer, director, or branch manager of such futures commission merchant, floor broker, or floor trader (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such futures commission merchant, floor broker, or floor trader, or any employee of such a futures commission merchant, floor broker, or floor trader.

(iii) A member of a national securities exchange, a registered broker or dealer, or a registered futures commission merchant that has been in existence for less than one year may meet the definition of exempted person based on a six-month period.

(10) *Exempted security* shall have the meaning provided in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12)).

(11) *Floor broker* shall have the meaning provided in Section 1a(16) of the CEA (7 U.S.C. 1a(16)).

(12) *Floor trader* shall have the meaning provided in Section 1a(17) of the CEA (7 U.S.C. 1a(17)).

(13) *Futures account* shall have the meaning provided in § 240.15c3–3(a) of this chapter.

(14) *Futures commission merchant* shall have the meaning provided in Section 1a of the CEA (7 U.S.C. 1a).

(15) *Good faith*, with respect to making a determination or accepting a statement concerning financial relations with a person, means that the security futures intermediary is alert to the circumstances surrounding such financial relations, and if in possession of information that would cause a prudent person not to make the determination or accept the notice or certification without inquiry, investigates and is satisfied that it is correct.

(16) *Listed option* means a put or call option that is:

(i) Issued by a clearing agency that is registered under section 17A of the Act (15 U.S.C. 17q–1) or cleared and guaranteed by a derivatives clearing organization that is registered under Section 5b of the CEA (7 U.S.C. 7a–1); and

(ii) Traded on or subject to the rules of a self-regulatory authority.

(17) *Margin call* means a demand by a security futures intermediary to a customer for a deposit of cash, securities or other assets to satisfy the required margin for security futures or related positions or a special margin requirement.

(18) *Margin deficiency* means the amount by which the required margin in an account is not satisfied by the equity in the account, as computed in accordance with § 242.404 of this Regulation (§§ 242.400 through 242.406).

(19) *Margin equity security* shall have the meaning provided in Regulation T.

(20) *Margin security* shall have the meaning provided in Regulation T.

(21) *Member* shall have the meaning provided in section 3(a)(3) of the Act (15 U.S.C. 78c(a)(3)), and shall include persons registered under section 15(b)(11) of the Act (15 U.S.C. 78*o*(b)(11)) that are permitted to effect transactions on a national securities exchange without the services of another person acting as executing broker.

(22) *Money market mutual fund* means any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8) that is considered a money market fund under § 270.2a–7 of this chapter.

(23) *Persons associated with a broker or dealer* shall have the meaning provided in section 3(a)(18) of the Act (15 U.S.C. 78c(a)(18)).

(24) *Regulation T* means Regulation T promulgated by the Board of Governors of the Federal Reserve System, 12 CFR part 220, as amended from time to time.

(25) *Regulation T collateral value*, with respect to a security, means the current market value of the security reduced by the percentage of required margin for a position in the security held in a margin account under Regulation T.

(26) *Related position*, with respect to a security future, means any position in an account that is combined with the security future to create an offsetting position as provided in § 242.403(b)(2) of this Regulation (§§ 242.400 through 242.406).

(27) *Related transaction*, with respect to a position or transaction in a security future, means:

(i) Any transaction that creates, eliminates, increases or reduces an offsetting position involving a security future and a related position, as provided in § 242.403(b)(2) of this Regulation (§§ 242.400 through 242.406); or

(ii) Any deposit or withdrawal of margin for the security future or a related position, except as provided in § 242.405(b) of this Regulation (§§ 242.400 through 242.406).

(28) *Securities account* shall have the meaning provided in § 240.15c3–3(a) of this chapter.

(29) *Security futures intermediary* means any creditor as defined in Regulation T with respect to its financial relations with any person involving security futures.

(30) *Self-regulatory authority* means a national securities exchange registered under section 6 of the Act (15 U.S.C. 78f), a national securities association registered under section 15A of the Act (15 U.S.C. 78o–3), a contract market registered under Section 5 of the CEA (7 U.S.C. 7) or Section 5f of the CEA (7 U.S.C. 7b–1), or a derivatives transaction execution facility registered under Section 5a of the CEA (7 U.S.C. 7a).

(31) *Special margin requirement* shall have the meaning provided in § 242.404(e)(1)(ii) of this Regulation (§§ 242.400 through 242.406).

(32) *Variation settlement* means any credit or debit to a customer account, made on a daily or intraday basis, for the purpose of marking to market a security future or any other contract that is:

(i) Issued by a clearing agency that is registered under section 17A of the Act (15 U.S.C. 78q–1) or cleared and guaranteed by a derivatives clearing organization that is registered under Section 5b of the CEA (7 U.S.C. 7a–1); and

(ii) Traded on or subject to the rules of a self-regulatory authority.

(b) Terms used in this Regulation (§§ 242.400 through 242.406) and not otherwise defined in this section shall have the meaning set forth in the margin rules applicable to the account.

(c) Terms used in this Regulation (§§ 242.400 through 242.406) and not otherwise defined in this section or in the margin rules applicable to the account shall have the meaning set forth in the Act and the CEA; if the definitions of a term in the Act and the CEA are inconsistent as applied in particular circumstances, such term shall have the meaning set forth in rules, regulations, or interpretations jointly promulgated by the Commission and the CFTC.

§ 242.402 General provisions.

(a) *Applicable margin rules.* Except to the extent inconsistent with this Regulation (§§ 242.400 through 242.406):

(1) A security futures intermediary that carries a security future on behalf of a customer in a securities account shall record and conduct all financial relations with respect to such security future and related positions in accordance with Regulation T and the margin rules of the self-regulatory authorities of which the security futures intermediary is a member.

(2) A security futures intermediary that carries a security future on behalf of a customer in a futures account shall record and conduct all financial relations with respect to such security future and related positions in accordance with the margin rules of the self-regulatory authorities of which the security futures intermediary is a member.

(b) *Separation and consolidation of accounts.*

(1) The requirements for security futures and related positions in one account may not be met by considering items in any other account, except as permitted or required under paragraph (b)(2) of this section or applicable margin rules. If withdrawals of cash, securities or other assets deposited as margin are permitted under this Regulation (§§ 242.400 through 242.406), bookkeeping entries shall be made when such cash, securities, or assets are used for purposes of meeting requirements in another account.

(2) Notwithstanding paragraph (b)(1) of this section, the security futures intermediary shall consider all futures accounts in which security futures and related positions are held that are within the same regulatory classification or account type and are owned by the same customer to be a single account for purposes of this Regulation (§§ 242.400 through 242.406). The security futures intermediary may combine such accounts with other futures accounts that are within the same regulatory classification or account type and are owned by the same customer for purposes of computing a customer's overall margin requirement, as permitted or required by applicable margin rules.

(c) *Accounts of partners.* If a partner of the security futures intermediary has an account with the security futures intermediary in which security futures or related positions are held, the security futures intermediary shall disregard the partner's financial relations with the firm (as shown in the partner's capital and ordinary drawing accounts) in calculating the margin or equity of any such account.

(d) *Contribution to joint venture.* If an account in which security futures or related positions are held is the account of a joint venture in which the security futures intermediary participates, any interest of the security futures intermediary in the joint account in excess of the interest which the security futures intermediary would have on the basis of its right to share in the profits shall be margined in accordance with this Regulation (§§ 242.400 through 242.406).

(e) *Extensions of credit.* (1) No security futures intermediary may extend or maintain credit to or for any customer for the purpose of evading or circumventing any requirement under this Regulation (§§ 242.400 through 242.406).

(2) A security futures intermediary may arrange for the extension or maintenance of credit to or for any customer by any person, provided that the security futures intermediary does not willfully arrange credit that would constitute a violation of Regulation T, U or X of the Board of Governors of the Federal Reserve System (12 CFR parts 220, 221, and 224) by such person.

(f) *Change in exempted person status.* Once a person ceases to qualify as an exempted person, it shall notify the security futures intermediary of this fact before entering into any new security futures transaction or related transaction that would require additional margin to be deposited under this Regulation (§§ 242.400 through 242.406). Financial relations with respect to any such transactions shall be subject to the provisions of this Regulation (§§ 242.400 through 242.406).

§ 242.403 Required margin.

(a) *Applicability.* Each security futures intermediary shall determine the required margin for the security futures and related positions held on behalf of a customer in a securities account or futures account as set forth in this section.

(b) *Required margin.*—(1) *General rule.* The required margin for each long or short position n a security future shall be twenty (20) percent of the current market value of such security future.

(2) *Offsetting positions.* Notwithstanding the margin levels specified in paragraph (b)(1) of this section, a self-regulatory authority may set the required initial or maintenance margin level for an offsetting position involving security futures and related positions at a level lower than the level that would be required under paragraph (b)(1) of this section if such positions were margined separately, pursuant to rules that meet the criteria set forth in section 7(c)(2)(B) of the Act (15 U.S.C. 78g(c)(2)(B)) and are effective in accordance with section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)) and, as applicable, Section 5c(c) of the CEA (7 U.S.C. 7a–2(c)).

(c) *Procedures for certain margin level adjustments.* An exchange registered under section 6(g) of the Act (15 U.S.C. 78f(g)), or a national securities association registered under section 15A(k) of the Act (15 U.S.C. 78*o*–3(k)), may raise or lower the required margin level for a security future to a level not lower than that specified in this section, in accordance with section 19(b)(7) of the Act (15 U.S.C. 78s(b)(7)).

§ 242.404 Type, form and use of margin.

(a) *When margin is required.* Margin is required to be deposited whenever the required margin for security futures and related positions in an account is not satisfied by the equity in the account, subject to adjustment under paragraph (c) of this section.

(b) *Acceptable margin deposits.* (1) The required margin may be satisfied by a deposit of cash, margin securities (subject to paragraph (b)(2) of this section), exempted securities, any other asset permitted under Regulation T to satisfy a margin deficiency in a securities margin account, or any combination thereof, each as valued in accordance with paragraph (c) of this section.

(2) Shares of a money market mutual fund may be accepted as a margin deposit for purposes of this Regulation (§§ 242.400 through 242.406), *provided that:*

(i) The customer waives any right to redeem the shares without the consent of the security futures intermediary and instructs the fund or its transfer agent accordingly;

(ii) The security futures intermediary (or clearing agency or derivatives clearing organization with which the shares are deposited as margin) obtains the right to redeem the shares in cash, promptly upon request; and

(iii) The fund agrees to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.

(c) *Adjustments.*

(1) *Futures accounts.* For purposes of this section, the equity in a futures account shall be computed in accordance with the margin rules applicable to the account, subject to the following:

(i) A security future shall have no value;

(ii) Each net long or short position in a listed option on a contract for future delivery shall be valued in accordance with the margin rules applicable to the account;

(iii) Except as permitted in paragraph (e) of this section, each margin equity security shall be valued at an amount no greater than its Regulation T collateral value;

(iv) Each other security shall be valued at an amount no greater than its current market value reduced by the percentage specified for such security in § 240.15c3–1(c)(2)(vi) of this chapter;

(v) Freely convertible foreign currency may be valued at an amount no greater than its daily marked-to-market U.S. dollar equivalent;

(vi) Variation settlement receivable (or payable) by an account at the close of trading on any day shall be treated as a credit (or debit) to the account on that day; and

(vii) Each other acceptable margin deposit or component of equity shall be valued at an amount no greater than its value under Regulation T.

(2) *Securities accounts.* For purposes of this section, the equity in a securities account shall be computed in accordance with the margin rules applicable to the account, subject to the following:

(i) A security future shall have no value;

(ii) Freely convertible foreign currency may be valued at an amount no greater than its daily mark-to-market U.S. dollar equivalent; and

(iii) Variation settlement receivable (or payable) to an account at the close of trading on any day shall be treated as a credit (or debit) by the account on that day.

(d) *Satisfaction restriction.* Any transaction, position or deposit that is used to satisfy the required margin for security futures or related positions under this Regulation (§§ 242.400 through 242.406), including a related position, shall be unavailable to satisfy the required margin for any other position or transaction or any other requirement.

(e) *Alternative collateral valuation for margin equity securities in a futures account.*

(1) Notwithstanding paragraph (c)(1)(iii) of this section, a security futures intermediary need not value a margin equity security at its Regulation T collateral value when determining whether the required margin for the security futures and related positions in

a futures account is satisfied, *provided that:*

(i) The margin equity security is valued at an amount no greater than the current market value of the security reduced by the lowest percentage level of margin required for a long position in the security held in a margin account under the rules of a national securities exchange registered pursuant to section 6(a) of the Act (15 U.S.C. 78f(a));

(ii) Additional margin is required to be deposited on any day when the day's security futures transactions and related transactions would create or increase a margin deficiency in the account if the margin equity securities were valued at their Regulation T collateral value, and shall be for the amount of the margin deficiency so created or increased (a "special margin requirement"); and

(iii) Cash, securities, or other assets deposited as margin for the positions in an account are not permitted to be withdrawn from the account at any time that:

(A) Additional cash, securities, or other assets are required to be deposited as margin under this section for a transaction in the account on the same or a previous day; or

(B) The withdrawal, together with other transactions, deposits, and withdrawals on the same day, would create or increase a margin deficiency if the margin equity securities were valued at their Regulation T collateral value.

(2) All security futures transactions and related transactions on any day shall be combined to determine the amount of a special margin requirement. Additional margin deposited to satisfy a special margin requirement shall be valued at an amount no greater than its Regulation T collateral value.

(3) If the alternative collateral valuation method set forth in paragraph (e) of this section is used with respect to an account in which security futures or related positions are carried:

(i) An account that is transferred from one security futures intermediary to another may be treated as if it had been maintained by the transferee from the date of its origin, if the transferee accepts, in good faith, a signed statement of the transferor (or, if that is not practicable, of the customer), that any margin call issued under this Regulation (§§ 242.400 through 242.406) has been satisfied; and

(ii) An account that is transferred from one customer to another as part of a transaction, not undertaken to avoid the requirements of this Regulation (§§ 242.400 through 242.406), may be treated as if it had been maintained for the transferee from the date of its origin, if the security futures intermediary accepts in good faith and keeps with the transferee account a signed statement of the transferor describing the circumstances for the transfer.

(f) *Guarantee of accounts.* No guarantee of a customer's account shall be given any effect for purposes of determining whether the required margin in an account is satisfied, except as permitted under applicable margin rules.

§ 242.405 Withdrawal of margin.

(a) *By the customer.* Except as otherwise provided in § 242.404(e)(1)(ii) of this Regulation (§§ 242.400 through 242.406), cash, securities, or other assets deposited as margin for positions in an account may be withdrawn, provided that the equity in the account after such withdrawal is sufficient to satisfy the required margin for the security futures and related positions in the account under this Regulation (§§ 242.400 through 242.406).

(b) *By the security futures intermediary.* Notwithstanding paragraph (a) of this section, the security futures intermediary, in its usual practice, may deduct the following items from an account in which security futures or related positions are held if they are considered in computing the balance of such account:

(1) Variation settlement payable, directly or indirectly, to a clearing agency that is registered under section 17A of the Act (15 U.S.C. 78q–1) or a derivatives clearing organization that is registered under section 5b of the CEA (7 U.S.C. 7a–1);

(2) Interest charged on credit maintained in the account;

(3) Communication or shipping charges with respect to transactions in the account;

(4) Payment of commissions, brokerage, taxes, storage and other charges lawfully accruing in connection with the positions and transactions in the account;

(5) Any service charges that the security futures intermediary may impose; or

(6) Any other withdrawals that are permitted from a securities margin account under Regulation T, to the extent permitted under applicable margin rules.

§ 242.406 Undermargined accounts.

(a) *Failure to satisfy margin call.* If any margin call required by this Regulation (§§ 242.400 through 242.406) is not met in full, the security futures intermediary shall take the deduction required with respect to an undermargined account in computing its net capital under Commission or CFTC rules.

(b) *Accounts that liquidate to a deficit.* If at any time there is a liquidating deficit in an account in which security futures are held, the security futures intermediary shall take steps to liquidate positions in the account promptly and in an orderly manner.

(c) *Liquidation of undermargined accounts not required.* Notwithstanding Section 402(a) of this Regulation (§§ 242.400 through 242.406), section 220.4(d) of Regulation T (12 CFR 220.4(d)) respecting liquidation of positions in lieu of deposit shall not apply with respect to security futures carried in a securities account.

Dated: August 1, 2002.

By the Securities and Exchange Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02–19892 Filed 8–13–02; 8:45 am]

BILLING CODE 6351–01–P; 8010–01–P

The Clearing Corporation

Acceptable Securities and Haircut Rates

- Updated April, 2004 -

Listed below are the acceptable securities and their corresponding haircut rates for original margin collateral. Haircuts are applied to all non-cash collateral (except letters of credit) and are set to various percentages, depending on the security type and maturity. In addition, certain securities will be accorded additional margin value based on the accrued interest component. All original margin collateral must have accurate, reliable, and timely price information that are available to The Clearing Corporation in order to be accepted.

The Clearing Corporation may adjust the margin value and/or the haircut rate of a particular security at any time if it determines, in its sole discretion, market conditions warrant such action. In addition, The Clearing Corporation reserves the right to accept or reject any original margin collateral based on, but not limited to: portfolio concentration limits, security price, market volatility, or limited secondary markets.

Security Type	Years Remaining To Maturity			
U.S. Government Securities	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
Treasury Bills, Notes, and Bonds	0.20%	1.00%	2.00%	3.00%
Treasury Strips	0.30%	1.25%	3.00%	6.00%
Government Sponsored Enterprise (GSE)	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
Fannie Mae (FNMA), Freddie Mac (FHLMC), Federal Home Loan Bank (FHLB), and Federal Farm Credit Banks (FFCB)	0.50%	2.00%	4.00%	6.00%
Foreign Sovereign Debt	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
Canada				
Bonds and Bills	3.00%	3.50%	4.50%	6.00%
France				
Bonds (OAT), Bills, and Notes (BTAN, BTF)	3.00%	3.50%	4.50%	6.00%
Germany				
Bonds (Bunds, Kassenobligation), Bills (Bubils), and Notes (Schatzs)	3.00%	3.50%	4.50%	6.00%
United Kingdom				
Gilts and Bills	3.00%	3.50%	4.50%	6.00%

Currently, The Clearing Corporation will only accept sovereign debt through Bank One (London) if such debt is registered as eligible to be transferred via the Euroclear or Clearstream systems. Bank One (London) has advised us that the above listed security types meet this criteria. Please note that clearing participants will be responsible for all taxes and fees that are assessed in connection with the deposit, holding and withdrawal of these securities.

The Clearing Corporation

- Debt Instruments: Part 2 of 2 -

Security Type	Years Remaining To Maturity			
Municipal Securities	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
'AAA' / Insured	1.50%	3.00%	5.00%	7.00%
'AA'	2.00%	4.00%	6.00%	8.00%
'A'	3.00%	5.00%	7.00%	9.00%
Corporate Debt	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
'AAA'	2.00%	3.00%	4.00%	6.00%
'AA'	3.00%	4.00%	5.00%	7.00%
'A'	4.00%	5.00%	7.00%	10.00%
'BBB'	5.00%	6.00%	10.00%	15.00%
Commercial Paper	**- 1 Year**			
'A1' / 'P1'	4.00%			

The Clearing Corporation will accept U.S. dollar-denominated domestic issues of the aformentioned securities, including: variable interest rate securities (floaters), zero coupons, and those containing embedded options.

The Clearing Corporation allows no more than 25% of any clearing participant's margin requirement (or no more than $1,000,000 if 25% of the margin requirement is less than $1,000,000) to be satisfied with municipal or corporate debt securities.

The Clearing Corporation will not accept debt instruments from clearing participants issued by their parent or affiliated companies.

- Mortgage Securities -

Security Type	Years Remaining To Maturity			
Government Sponsored Enterprise (GSE)	**- 1 Year**	**1 - 5 Yrs**	**5 - 10 Yrs**	**10 Years +**
Fannie Mae (FNMA) MBSs	------ 6% Haircut Across All Maturity Classes ------			
Freddie Mac (FHLMC) Gold PCs	------ 6% Haircut Across All Maturity Classes ------			

The Clearing Corporation will accept single class Fannie Mae MBSs as well as Freddie Mac Gold PCs. Securities included in, but not limited to, the following list are not acceptable to satisfy margin requirements: CMOs, multiple class securities such as REMICs, MACRs, and SMBs; Fannie Megas; Freddie Mac Giant PCs, Structured Passthroughs, nor ARM PCs.

The Clearing Corporation allows no more than 25% of any clearing participant's margin requirement (or no more than $5,000,000 if 25% of the margin requirement is less than $5,000,000) to be satisfied with acceptable mortgage securities.

The Clearing Corporation

Money Market Mutual Funds

Platform Availability: Brown Brothers	Platform Availability: Harris Bank	Platform Availability: Fund Directly	Acceptable Funds (Subject To 2% Haircut): Fund Name and Share Class	Identifier: CUSIP
X	X		AIM - STIC Liquid Assets Portfolio (Cash Management)	825251788
	X	X	BlackRock Provident Institutional - TempCash	09248U643
	X	X	BlackRock Provident Institutional - TempFund	09248U619
X			Brown Brothers Harriman Common Settlement Fund	05528A109
X			Dreyfus Cash Management Fund (Institutional Shares)	26188J206
X	X		Federated Prime Obligations Fund (Institutional Shares)	60934N203
X	X		Fidelity Investments Institutional MMF - Domestic Portfolio	316175405
X	X		Goldman Sachs Financial Square Money Market Fund	38141W232
X	X		Goldman Sachs Financial Square Prime Obligations Fund	38141W364
	X		Harris Insight Fund (Exchange Class)	414548412
X	X		J.P. Morgan Prime Money Market Fund (Institutional Shares)	62826N770
X			Merrill Lynch Institutional Fund	590901104
X	X		Merrill Lynch Premier Institutional Fund	589978105
X			Merrimac Cash Series (Premium Class)	590266102
X	X		NationsBanc Cash Reserves (Capital Shares)	63859B105
X			NationsBanc Money Market Reserves (Capital Shares)	63859B790
X	X		One Group Institutional Prime Money Market Fund	68231N206
X			Rydex US Government Money Market Fund (Institutional Shares)	78355E817
X			UBS Select Money Market Fund (Institutional Shares)	90262Y505

The Clearing Corporation's acceptance of a Fund's shares for margin purposes does not constitute a representation that such Fund complies with CFTC Rule 1.25 or a recommendation or advice with respect to an investment in such Fund.

No more than 5% of the total number of outstanding shares of a fund will be accepted from any clearing participant as original margin collateral.

Money Market Funds may be deposited with the Clearing Corporation only in increments of 1000 shares. Depending on the practices of a given Fund, such shares will either be transferred to a Clearing Corporation account established at the Fund, or deposited in the existing Clearing Corporation custody account at a settlement bank.

Clearing participants investing in Funds using the latter method will be required to maintain at least one demand deposit account at that settlement bank (and supply the account number(s) to The Clearing Corporation). Such clearing participants should also contact the settlement bank directly to determine what, if any, additional documents accounts may be required.

The Clearing Corporation

Guidelines

Only common stock listed on a major exchange that has last sale reporting pursuant to a consolidated transaction reporting plan or that trade over the counter and are designated a National Market System security in addition to being eligible for processing within the DTC system.

All stock posted as original margin must have a minimum price of $10 per share and be rated at least 'BBB' by Standard and Poor's or Moody's. There will be no margin credit granted if the share price or rating should fall below the prescribed levels.

The Clearing Corporation will not accept common stock from clearing participants issued by their parent or affiliated companies.

The Clearing Corporation will accept no more than 25% of any clearing participant's margin requirement (or no more than $1,000,000 if 25% of the margin requirement is less than $1,000,000) in the form of common stock.

Equity securities that are delivered for original margin must be free and clear of any liens and must be received directly from the clearing participant's DTC account.

Clearing participants needs to have an account with the DTC and must notify the Risk Management Department and the Treasury Operations Department of its request to participate in the program. The following accounts have been set up by The Clearing Corporation with DTC to facilitate this process:

The Clearing Corporation's DTC House Acct. #838
The Clearing Corporation's DTC Customer Account #839

Haircut

30%

- Common Stock -

When a delivery is received through the DTC's system the entire title and ownership interest in the equity position will be transferred over to The Clearing Corporation. Cash dividends, voting rights, and other cash payments on equities credited to The Clearing Corporation's DTC account are assigned by The Clearing Corporation to the delivering clearing participant. Stock splits and other distributions that relate to the same equity for which the distribution date comes after the payable date will be credited to The Clearing Corporation's DTC account.

To initiate a transaction in the Equity for Original Margin Program, clearing participants are asked to notify The Clearing Corporation's Treasury Operations Department by 9:00 a.m. (CT) and to use the DTC system to deliver a free pledge of securities to the appropriate Clearing Corporation DTC account by 11:00 a.m. Clearing Corporation staff will review all requests to post equity securities as original margin via the DTC terminal system and if the equity securities comply with The Clearing Corporation's criteria, the clearing participant's original margin position will be updated for the same day credit. The common stock will be priced daily.

The Clearing Corporation may decrease the margin value of a particular stock at any time if the market conditions warrant such action.

The Clearing Corporation

- Letters of Credit -

Issuing Bank

Banco Santander Central Hispano, S.A. (NY Branch)
Bank of America
Bank of Montreal
Bank One, NA
BNP Paribas
Caixa Geral de Depositos (NY Branch)
CoBank, ACB
Commerzbank AG (NY Branch)
Danske Bank
Harris Trust and Savings Bank
IntesaBci (NY Branch)
Northern Trust Company
SANPAOLO IMI SpA
Svenska Handelsbanken
UBS

Guidelines

LC's are not subject to a haircut.

Each LC posted as original margin must be valid for a period no more than 1 year.

No bank may issue letters of credit for the benefit of an affiliated clearing participant.

Each bank may issue total LC's up to an amount determined by the Board of Governors. This limit may affect a clearing participant's ability to post a LC from a particular bank.

Specific Collateral Examples and General Hints

Security Type

U.S. Treasury Bills

CUSIP	Maturity
912795QE4	6/24/2004
912795QV6	7/29/2004
912795QZ7	8/26/2004
912795RE3	9/30/2004
912795RG8	10/14/2004

U.S. Treasury Strips

CUSIP	Maturity
912833KU3	2/15/2019
912833KV1	5/15/2019
912833LJ7	8/15/2022
912803BD4	11/15/2024
912803BM4	11/15/2027

U.S. Notes and Bonds

CUSIP	Maturity
912810FE3	8/15/2028
912810FF0	11/15/2028
912810FG8	2/15/2029
912810FM5	5/15/2030
912810FP8	2/15/2031

Government Sponsored Enterprise Debt

CUSIP	Maturity
3134A4NW0	3/15/2007
31359MFS7	6/15/2010

Government Sponsored Enterpr. Mortgage

31335GL60	10/1/2025
31335GNQ4	5/1/2026

Many questions tend to surface regarding Government Sponsored Enterprise (GSE) or "agency" debt. As a general guideline, The Clearing Corporation will glady accept both bullet and callable fixed and floating rating obligations of Fannie Mae, Freddie Mac, Federal Home Loan Banks, and Federal Farm Credit Banks of the following types: Discounts, Capital Debentures, Medium-Term Notes, Zero Coupons, Consolidated Bonds, and Strips. Mortgage instruments of Fannie Mae and Freddie Mac are permissible subject to the provisions specified in the "Mortgage Securities" section of this document.

For any questions regarding specific collateral pledges, please contact the Risk Management Department:

Bernie Mattes (312) 986-3444
Chip Chong (312) 986-3497

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VOLUME 21 - BULLETIN #160

TO: ALL CLEARING MEMBERS
FROM: BUSINESS SYSTEMS GROUP
DATE: July 27, 2001
SUBJECT: **Money Market Funds as Collateral**

The CFTC has amended Rule 1.25 to permit the investment of customer funds by futures commission merchants into money market mutual funds ("Fund" or "Funds"). In connection with that amendment, the Clearing Corporation will permit shares of Funds, subject to certain conditions, to be deposited as original margin for both house and customer origin.

The Clearing Corporation must approve each Fund before its shares can be deposited as original margin. Under the policies of the Clearing Corporation, no more than 5% of the total number of outstanding shares of a fund will be accepted from any clearing member as margin collateral. All such shares will be subject to a 5% haircut and may be deposited with the Clearing Corporation only in increments of 1000 shares. Depending on the practices of a given Fund, such shares will either be transferred to a Clearing Corporation account established at the Fund, or deposited in the existing Clearing Corporation custody account at a settlement bank. If the Fund requests that shares be held in a Clearing Corporation account established at the Fund, the clearing member will need to establish an account or accounts with the Fund to purchase shares and transfer them to the account of the Clearing Corporation. If the Fund requests that shares be held in existing custody accounts at the settlement bank, the clearing member will need to purchase shares through that settlement bank for deposit in the Clearing Corporation custody account. Clearing members investing in Funds using the latter method will be required to maintain at least one demand deposit account at that settlement bank (and supply the account number(s) to the Clearing Corporation). Such clearing members should also contact the settlement bank directly to determine what, if any, additional documents or accounts may be required.

Currently, the Clearing Corporation has approved shares of the following Funds for deposit as original margin:

FUND	ACCOUNT STRUCURE	SETTLEMENT BANK/FUND
BBH Common Settlement Fund	Existing Custody Accounts	Brown Brothers Harriman & Co
Goldman Sachs - Financial Square Prime Obligations Fund	Existing Custody Accounts	Brown Brothers Harriman & Co.
Goldman Sachs - Financial Square Money Market Fund	Existing Custody Accounts	Brown Brothers Harriman & Co.
BlackRock Provident Institutional Funds, TempFund	Fund Accounts	BlackRock Provident Institutional Funds, TempFund
Federated - Prime Obligations Fund	Fund Accounts	Federated - Prime

		Obligations Fund
Federated - Prime Cash Obligations Fund	Fund Accounts	Federated - Prime Cash Obligations Fund

The Clearing Corporation continues to review applications from other Funds and will advise members when and as shares of such Funds are approved for deposit as original margin.

Should you have any questions, please call or e-mail one of the following Business Systems Analysts:

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Marc MacQuarrie	786-5732	marc.macquarrie@botcc.com
Molly McMahon	786-3804	molly.mcmahon@botcc.com
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Jill Turner	786-5718	jill.turner@botcc.com
Matt Walsh		matt.walsh@botcc.com
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9.05 Margins

It shall be incumbent upon each Clearing Member that his trades and trades of his customers be margined up to the time of the such trades by the Clearing House.

(A) Original Margin

Original Margin shall be paid on Exchange commodity transactions in such form as determined by the Board of Directors. Origi changed at the discretion of the Board.

(B) Variation Margins

The President of the Exchange, at any time during the day, may call for variation margins to meet the variations in the market. be paid to the Exchange within the time limits prescribed by the President.

(C) Additional and Advance Margin

In the President's discretion if the protection of the Exchange so requires, the President may call for additional original margin f more clearing members in such forms, and at such times as the President may specify. The President may lower the margins t when the Exchange no longer requires the protection of increased margins.

(D) Straddle Margins

(1) Futures Straddles

A Clearing Member carrying an account which has both a long and a short futures position with the Clearing House in a particu the same or different contracts but in no event for the same delivery month of the same contract, may treat such long and short extent they are equal in quantity as a futures straddle. Each trade comprising a straddle shall be subject to separate brokerage charges. Initial margins deposited shall be the higher required for either trade or trades and when so deposited shall be sufficie but each trade shall be brought to the settling price, daily. When one trade of a straddle transaction is closed out all the remaini that comprise the straddle must have the required original margin deposited with the Clearing House.

(2) Options Straddles

A Clearing Member carrying an account which has both (1) a short call option and a long call option; (2) a short put option and (3) a long put option and a long call option; or (4) a short put option and a short call option, in a particular commodity, but in no series, may treat such positions to the extent they are equal in quantity as an options straddle. Each trade comprising a straddl separate brokerage and clearing charges. Initial margins deposited shall be the higher required for either trade or trades and w shall be sufficient for both trades but each trade shall be brought to the settling price, daily. When one trade of a straddle trans all the remaining trade or trades that comprise the straddle must have the required original margin deposited with the Clearing I

(E) Clearing Members may meet original margin calls by depositing:

(1) Cash (U.S. Currency);

(2) Original Margin Certificates issued by an original margin depository, in form acceptable to the Clearing House, for delivery t Clearing House, representing securities issued by the Department of Treasury of the United States of America maturing within the date of the deposit and guaranteed as to principal and interest by the United States Government; such securities shall be v percent (95%) of the par value; or

(3) Subject to a maximum limit of 50% of the Clearing Member's total original margin obligations, Irrevocable Letters of Credit p of the Clearing House including such Letters of Credit that are deposited with the Clearing Member in accordance with Exchan customer, in form acceptable to the Clearing House, issued by or confirmed by an original margin depository and having an ex less than three (3) or more than eighteen (18) months from the date of issuance; provided, however, that such Letter of Credit meet original margin obligations during the fifteen calendar days prior to the expiration date thereof (if the fifteenth day prior to t Letter of Credit is not a business day, the period during which such Letter of Credit may not be used to meet original margin obl on the business day immediately preceding that day); and, provided further, that on the business day preceding the fifteenth ca the expiration of the Letter of Credit, the Clearing House shall issue a call for original margin to be deposited in a form and man the Clearing House for positions held open as of the close of business on that day and margined by the Letter of Credit. The Cl have the unqualified right to call on any Letter of Credit at any time prior to expiration.

(4) Shares in a money market mutual fund that complies with CFTC Regulation §1.25 and that has been approved by the Boar following conditions:

(i) for purposes of original margin, such shares will be valued at 95% of market value; (ii) a Clearing Member's participation in a shall be limited to no more than 5% of that fund; and (iii) no more than 25% of the total assets of an approved money market m used to meet original margin obligations at the Exchange.

(F) The Clearing House shall have the right, at all times, to prohibit or otherwise limit the use as original margin by any Clearing of credit or of securities under this Rule.

(G) The Clearing House shall retain the original margin deposited with respect to any futures contract against which a delivery r issued until the business day after the delivery date or such date as designated by the Clearing House.

(H) Customer Accounts with the Exchange

(1) Except as provided in subsection (2) below, all customer funds deposited with the Exchange shall be held in accordance wit Exchange Act and Commission Regulation 1.20 in an account identified as Customer Segregated. Customer funds shall be seg Exchange and treated as belonging to the customers of the clearing member. Pursuant to this Rule, clearing members register Commission Merchants shall not be required to obtain a segregated acknowledgment letter from the Exchange.

(2) Customer funds deposited with the Exchange for cleared transactions in over-the-counter pari-mutuel auctions may be depo member account or a customer non-regulated account. Neither account shall be treated as a customer segregated account.

Notice to Members

Notice No. 20
01/14/2002

Amendments to NYMEX Rule 9.05 (Margins)

Please be advised that the Exchange has amended Rule 9.05, which governs Clearing Members' use of money market mutual funds to meet original margin requirements on the NYMEX Division. The amendments are shown below and become effective today.

Previously, a Clearing Member's participation in any approved fund or any group of approved funds offered by the same issuer was limited to the greater of $250,000 or 25% of the Clearing Member's total original margin obligations.

By comparison, the new rule amendments delete this restriction, in effect allowing a Clearing Member to meet 100% of its margin requirements with shares in one money market fund.

However, the Clearing Member's participation in any such fund will be limited to 5% of that money market fund.

With regard to Rule 9.05, the Exchange continues to require that a money market fund must be approved by the NYMEX Board and also must comply with CFTC Regulation ?? 1.25.

AMENDMENTS TO NYMEX Rule 9.05 (Margins)

(asterisk indicates additions; bracketing indicates deletion)

Rule 9.05 Margins

(E) Clearing Members may meet original margin calls by depositing:

(4) Shares in a money market mutual fund that complies with CFTC Regulation 1.25 and that has been approved by the Board, subject to the following conditions:

(i) for purposes of original margin, such shares will be valued at 95% of market value:

(ii) a Clearing Member's participation in any approved fund [or any group of approved funds offered by the same issuer] shall be limited to [the greater of $250,000 or 25% of the Clearing Member's total original margin obligations] * no more than 5% of that fund; *

(iii) no more than 25% of the total assets of an approved money market mutual fund may be used to meet original margin obligations at the Exchange.

Should you have any questions or require any further information, please contact exchangeinfo@nymex.com

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NYMEX

Notice # **01-184**
May 31, 2001

TO: All NYMEX Division Members and Member Firms

FROM: Neal L. Wolkoff, Executive Vice President

RE: **Reminder on Use of Money Market Funds as Original Margin Deposits on the NYMEX Division**

DATE: May 31, 2001

This Notice is a reminder regarding certain rule changes and related policy guidelines that will go into effect on June 1, 2001 for the NYMEX Division. The rule changes going into effect on June 1, 2001 on the NYMEX Division allow shares of certain money market mutual funds to be acceptable for purposes of original margin deposits.

Corresponding rule changes for the COMEX Division have also been approved by the NYMEX Board of Directors and filed with the CFTC; the changes for the COMEX Division will be implemented at a later date.

Rule Amendments
The amendments generally require that in order to be used for such purpose, a money market fund must be approved by the NYMEX Board and also must comply with CFTC Regulation § 1.25. For purposes of original margin, the Exchange's Clearing House will value such money market fund shares at 95% of their market value. In addition, a Clearing Member's participation in any approved fund or any group of approved funds offered by the same issuer shall be limited to the greater of $250,000 or 25% of the Clearing Member's total original margin obligations. Finally, no more than 25% of the total assets of an approved money market mutual fund may be used to meet original margin obligations at the Exchange.

Exchange Policy on Money Market Funds
The NYMEX Board of Directors also recently adopted three additional guidelines that will be applicable to such funds. First, until further notice from the Exchange, the Board has determined to limit the number of money market funds available for this purpose to ten. Second, the Board will require that henceforth each fund applying for such status must have a minimum value of $5 billion. Finally, each fund further must provide for same day payment if notification is made by 3:00 p.m. on that day..

AMENDMENTS TO NYMEX RULE 9.05 ("MARGINS")

(Asterisks indicate additions; brackets indicate deletions.)

Rule 9.05. MARGINS

* * * *

(E) Clearing Members may meet original margin calls by depositing:

*(4) Shares in a money market mutual fund that complies with CFTC Regulation §1.25 and that has been approved by the Board, subject to the following conditions:

(i) for purposes of original margin, such shares will be valued at 95% of market value;

(ii) a Clearing Member's participation in any approved fund or any group of approved funds offered by the same issuer shall be limited to the greater of $250,000 or 25% of the Clearing Member's total original margin obligations;

(iii) no more than 25% of the total assets of an approved money market mutual fund may be used to meet original margin obligations at the Exchange.*

[Shares of Brown Brothers Harriman & Co. Common Settlement Fund, valued at 95% of market value.]

930.C. Acceptable Performance Bond Deposits[33]

Clearing members may accept from their account holders as performance bond cash currencies of any denomination, readily marketable securities (as defined by SEC Rule 15c3-1(c)(11) and applicable SEC interpretations), **money market** mutual funds allowable under CFTC Regulation 1.25, and bank–issued letters of credit.

Clearing members shall not accept as performance bond from an account holder securities that have been issued by the account holder or an affiliate of the account holder unless the clearing member files a petition with and receives permission from Exchange staff.

Bank-issued letters of credit must be in a form acceptable to the Exchange. Such letters of credit must be drawable in the United States . Clearing members shall not accept as performance bond from an account holder letters of credit issued by the account holder, an affiliate of the account holder, the clearing member, or an affiliate of the clearing member.

All assets deposited by account holders to meet performance bond requirements must be and remain unencumbered by third party claims against the depositing account holder.

Except to the extent that Exchange staff shall prescribe otherwise, cash currency performance bond deposits shall be valued at market value. All other performance bond deposits other than letters of credit shall be valued at an amount not to exceed market value less applicable haircuts as set forth in SEC Rule 240.15c3-1.[34]

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47599; File No. SR–OCC–2002–04]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Granting Approval of a Proposed Rule Change Relating to Money Market Funds as Margin Collateral

March 31, 2003.

I. Introduction

On January 29, 2002, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") proposed rule change SR–OCC–2002–04 pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").[1] Notice of the proposal was published in the **Federal Register** on January 16, 2003.[2] No comment letters were received. For the reasons discussed below, the Commission is granting approval of the proposed rule change.

II. Description

The change to OCC's rule 604 expands the permissible forms of margin collateral to include shares in money market funds. The rule change also reorganizes the rule and makes certain nonsubstantive format changes.

Rule 604 specifies the forms of collateral that may be deposited as margin. Permitted forms of margin collateral include cash, government securities, letters of credit, and certain equity and debt securities.[3] OCC regularly reviews these forms of collateral for suitability with the intent of addressing clearing members' desire to use a diverse combination of readily available and cost-effective forms of collateral while ensuring that collateral is limited to instruments that are relatively stable in value and are easily converted to cash. OCC believes that shares in certain money market funds meet these criteria and that it is appropriate for OCC to expand its categories of acceptable collateral to include such instruments.

OCC believes that the professional asset management, liquidity, and stable principal value typically associated with money market funds make shares in such funds an attractive collateral alternative for all OCC clearing accounts. As a result of recent amendments to the regulations of the Commodity Futures Trading Commission ("CFTC"), clearing members that are registered as futures commission merchants are now permitted to invest customer funds of their futures customers in money market fund shares.[4] Accordingly, clearing members want to be able to pledge shares in such funds as margin for their "non-proprietary" cross-margining accounts. OCC believes that such deposits are appropriate collateral not only for cross-margining accounts but for all accounts.

Requirements for Eligibility of Funds

OCC will define acceptable money market funds as those meeting the criteria of SEC rule 2a–7,[5] "Money Market Funds," under the Investment Company Act of 1940 ("ICA"),[6] subject to certain additional criteria. The ICA sets the standards by which mutual funds and other investment vehicles operate, and rule 2a–7 thereunder requires a qualifying money market fund to meet certain portfolio maturity, quality, and diversification criteria. Instruments that may qualify as permitted investments for money market funds typically include U.S. Treasury securities, repurchase agreements, Federal agency securities, commercial paper, certificates of deposit, time deposits, corporate notes, asset-backed securities, and municipal securities. To minimize credit risk, OCC will accept only money market funds that limit their investments to "first tier securities" as defined in rule 2a–7 under the ICA.[7] Although certain types of instruments that qualify as first tier securities would not qualify to be pledged directly as margin collateral under rule 604,[8] OCC believes that the rating requirements and maturity prerequisites combined with inherent diversification of the funds provides sufficient protection to warrant acceptance of shares of money market funds containing such instruments.

To ensure a diverse group of fund investors so that the actions of any one shareholder (*e.g.*, redeeming a large interest in a fund) do not materially disrupt the ability of the fund to redeem shares in an orderly manner, rule 604(b)(3) will prohibit a clearing member from depositing as margin collateral any money market fund where a registered holder of the money market fund has an interest of 10% or more in the money market fund.

In order for a fund's shares to be acceptable as margin collateral, the fund (and/or its sponsor, transfer agent, or other agent as appropriate) will be required to represent to OCC that it meets the foregoing requirements and to agree that it will continue to do so. In addition, OCC will require the fund to make certain other agreements intended to further ensure OCC's ability to convert fund shares promptly to cash if necessary.

Redemption

While the ICA generally prohibits mutual funds from suspending the right of redemption, the ICA does allow funds to postpone the payment of redemption proceeds for up to seven days after the tender of fund shares to the fund or its agent. The ICA also allows for the suspension or postponement of redemption in certain emergency situations. In addition, while the intent of a money market fund is to redeem shares in cash, most issuers retain the right to redeem their shares in kind where the redeeming shareholder would receive portfolio securities rather than cash. Any such action would introduce liquidation risk as well as additional costs associated with the sale of such securities.

Rule 604(b)(3)(i)(H) will require any fund accepted as margin collateral to waive its rights under the ICA to delay redemption or to redeem in kind. The fund will instead have to agree to redeem fund shares in cash no later than the business day following a redemption request by OCC with limited exceptions for unscheduled closings of Federal Reserve Banks or the New York Stock Exchange. These waivers of redemption restrictions along with the next day

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[1] 15 U.S.C. 78s(b)(1).

[2] Securities Exchange Act Release No. 47146 (January 9, 2003), 68 FR 2385.

[3] Pursuant to a rule filing approved by the Commission last year, OCC clearing members are allowed to deposit as margin debt securities issued by Congressionally chartered corporations that OCC's membership/margin committee has approved. Securities Exchange Act Release No. 45745 (April 12, 2002), 67 FR 19467 (April 19, 2002) (File No. SR–OCC–2001–04).

[4] In December 2000, the CFTC amended its Regulation 1.25 to expand the range of instruments in which FCMs and clearing organizations may invest customer segregated funds to include highly liquid instruments such as money market mutual funds. Rules Relating to Intermediaries of Commodity Interest Transactions, 65 FR 77993 (December 13, 2000).

[5] 17 CFR 270.2a–7.

[6] 15 U.S.C. 80a *et seq.*

[7] In general, a first tier security is a security with a remaining maturity of 397 calendar days or less that: (i) Has received a short-term rating from at least two nationally recognized statistical rating organizations in the highest short-term rating category for debt obligations; (ii) is unrated but is deemed to be of comparable quality to securities identified in (i) as determined by the fund's board of directors; (iii) is issued by a registered investment company that is itself a money market fund; or (iv) is a government security. 17 CFR 270.2a–7(a)(12).

[8] For example, OCC does not currently accept commercial paper, certificates of deposit, time deposits, corporate notes, asset-backed securities, or municipal securities.

payment requirement have been established to maintain adequate liquidity of margin collateral and are also intended to be consistent with the redemption conditions contained in CFTC rule 1.25.[9]

Valuation

OCC will require funds to perform a net asset value computation at least once per day with the dissemination of such computation to be made available to OCC no later than 9 a.m. central time the following day. Given the diversified nature of eligible fund investments as well as the investment duration limitations, a daily computation of net asset value appears reasonable. Nevertheless, OCC will apply a 2% haircut on the current market value of fund shares. The 2% haircut was selected for consistency with the treatment of similar assets under the net capital rule.[10]

OCC's Security Interest

As in the case of other securities held as collateral, OCC will require that clearing members give OCC a first priority perfected security interest in deposited fund shares. Because shares in money market funds are typically not issued in certificated form, ownership is established by registration of the securities on the books of the fund or its transfer agent. OCC can ordinarily obtain a perfected security interest in fund shares registered in the name of a clearing member by execution of the fund's standard three-party agreement among OCC, the clearing member, and the fund or its transfer agent.

In addition, to preclude a situation whereby a clearing member secures its obligations to OCC with collateral managed and within the control of that clearing member or a related party, an association restriction is included in rule 604(b)(3)(iii). This restriction is consistent with OCC rules regarding the deposit of government securities, debt or equity issues, or letters of credit as margin collateral.[11] This standard may be waived if the issuing institution can demonstrate that an acceptable arrangement has been made for the control of underlying portfolio investments and for the processing of OCC redemption requests by a third party.

OCC is also moving the provisions which require compliance with the Commission's rule 15c3–3 when applicable, formerly set forth in rule 604(d)(2), have been moved so that these provisions apply not only to equity and debt securities but to all securities deposited as margin under rule 604(b). A sentence has been added to these provisions to require compliance with the CFTC's customer protection regime when securities are deposited with respect to futures accounts.

OCC believes that the proposed rule change is consistent with the requirements of section 17A of the Securities Exchange Act of 1934, as amended, because it enhances the efficiency of the clearing system while still allowing OCC to safeguard securities and funds by permitting clearing members to collateralize their obligations to OCC with an additional form of highly liquid, stable value assets.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder and particularly with the requirements of section 17A(b)(3)(F).[12] Section 17A(b)(3)(F) requires that the rules of a clearing agency be designed to assure the safeguarding of securities and funds which are in the custody or control of the clearing agency or for which it is responsible. The Commission believes that OCC's rule change meets this requirement because while OCC clearing members will be able to deposit money market funds as margin collateral, OCC has established procedures with respect to the deposits of money market funds as margin collateral that should ensure that OCC will be able to safeguard the securities and funds that are within its custody or control or for which it is responsible.

IV. Conclusion

On the basis of the foregoing, the Commission finds that the proposed rule change is consistent with the requirements of the Act and in particular section 17A of the Act and the rules and regulations thereunder.

It is therefore ordered, pursuant to section 19(b)(2) of the Act, that the proposed rule change (File No. SR–OCC–2002–04) be and hereby is approved.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[13]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 03–8387 Filed 4–4–03; 8:45 am]

BILLING CODE 8010–01–P

[9] CFTC Regulation 1.25(c)(5), 65 FR 77993, 78010, 78011 (Dec. 13, 2000); *see also*, 65 FR 82270 (Dec. 28, 2000). CFTC Interpretive Letter No. 01–31 (April 2, 2001) (Funds will be deemed in compliance with Regulation 1.25(c)(5) even though they provide for delayed redemption in specified emergency situations).

[10] 17 CFR 240.15c3–1(c)(2)(vi)(D)(*1*).

[11] OCC rule 604, Interpretation and Policies .07 and .10.

[12] 15 U.S.C. 78q–1(b)(3)(F).

[13] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–47605; File No. SR–Phlx–2003–17]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto by the Philadelphia Stock Exchange, Inc. To Adopt a License Fee for Transactions in Standard & Poor's Depository Receipts®

April 1, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on March 17, 2003, the Philadelphia Stock Exchange, Inc. ("Phlx" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Exchange amended the proposal on March 28, 2003.[3] The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend its Summary of Equity Charges to adopt a license fee of $0.00025 per share per trade side for sides greater than 500 shares, with no maximum fee per trade side charged to Non-PACE Customers[4] and Electronic Communications Networks ("ECNs"),[5] and a license fee

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] On March 28, 2003, the Exchange filed a Form 19b–4, which completely replaced and superceded the original filing in its entirety ("Amendment No. 1"). For purposes of calculating the 60-day abrogation period, the Commission considers the period to have commenced on March 28, 2003, the date the Exchange filed Amendment No. 1. 15 U.S.C. 78(s)(b)(3)(C).

[4] PACE is the acronym for the Exchange's Automated Communication and Execution System, which is the Exchange's order routing, delivery, execution and reporting system for its equity trading floor. *See* Exchange Rules 229 and 229A.

[5] ECNs shall mean any electronic system that widely disseminates to third parties orders entered therein by an Exchange market maker or over-the-

publication of the notice of the filing. The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the publication of notice because such approval will allow DTC to establish a set up fee for open-ended mutual funds deposited at DTC at the same time it makes open-ended mutual funds depository eligible.[6]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*) or
- Send an E-mail to *rule-comments@sec.gov*. Please include File Number SR–DTC–2005–02 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–DTC–2005–02. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of DTC and on DTC's Web site at *http://www.dtc.org*. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–DTC–2005–02 and should be submitted on or before March 29, 2005.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[7] that the proposed rule change (File No. SR–DTC–2005–02) be and hereby is approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[8]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. E5–971 Filed 3–7–05; 8:45 am]

BILLING CODE 8010–01–P

[6] Securities Exchange Act Release No. 51289 (March 2, 2005) [File No. SR–DTC–2005–01].

[7] 15 U.S.C. 78s(b)(2).

[8] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51289; File No. SR–DTC–2005–01]

Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Make Open-Ended Funds Depository Eligible

March 2, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] notice is hereby given that on February 16, 2005, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by DTC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The purpose of the proposed rule change is to make open-ended funds depository eligible.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, DTC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DTC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.[2]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

Due to processing problems that DTC has experienced with open-ended funds in the past, open-ended funds are not eligible for deposit at DTC. The proposed rule change allows DTC to accept open-ended funds for deposit but will not make the full range of DTC services available for these funds. Participants will be able to hold open-ended funds in their accounts at DTC and will be able to pledge open-ended funds to other DTC participants using DTC's system. Other than holding and pledging, no other services (*i.e.*, redemption services, reorganization services, dividend payments, or valued transactions) will be available to participants for open-ended funds. Dividends paid on open-ended funds will not be paid to DTC but will be paid to participants outside of DTC's system pursuant to instructions the open-ended fund's issuer or its agent receives from participants. Participants will deposit shares in open-ended funds into their DTC accounts and will withdraw shares in open-ended funds from their DTC accounts through the Deposit or Withdrawal at Custodian ("DWAC") service.

The proposed rule change is consistent with the requirements of Section 17A of the Act[3] and the rules and regulations thereunder applicable to DTC because it assures the safeguarding of securities and funds which are in the custody or control of DTC because DTC will safeguard open-ended funds in a manner consistent with the manner it safeguards other securities. It will also promote efficiencies related to pledges of open-ended funds.

(B) Self-Regulatory Organization's Statement on Burden on Competition

DTC does not believe that the proposed rule change will have any impact on or impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments relating to the proposed rule change have been

[1] 15 U.S.C. 78s(b)(1).

[2] The Commission has modified the text of the summaries prepared by DTC.

[3] 15 U.S.C. 78q–1.

prospectus and will note this prospectus delivery requirement in the Notice to Participants.

This approval order is conditioned on the Exchange's adherence to these representations.

Finally, the Commission believes that the Exchange's rules imposing trading restrictions and information barriers on Specialist Participants in GLD are reasonable and consistent with the Act. These rules generally require a Specialist Participant to report to the Exchange a list of all accounts for trading gold or gold derivatives over which the Specialist Participant exercises investment discretion or has an interest. Furthermore, Specialist Participants and their affiliated persons will be required to make available to the Exchange, upon request, their books and records pertaining to transactions in gold and gold derivatives.

The Commission finds good cause for approving the proposal prior to the 30th day after the date of publication of the notice of filing thereof in the **Federal Register**. As noted previously, the Commission previously found that the listing and trading of GLD on NYSE is consistent with the Act.[35] The Commission presently is not aware of any regulatory issue that should cause the Commission to revisit that earlier finding or preclude the trading of GLD on the Exchange pursuant to UTP. Therefore, accelerating approval of the proposal should benefit investors by creating, without undue delay, additional competition in the market for GLD.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[36] that the proposed rule change (SR–CHX–2004–41) as amended, is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[37]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. E5–936 Filed 3–7–05; 8:45 am]

BILLING CODE 8010–01–P

[35] *See supra* note 3.

[36] 15 U.S.C. 78s(b)(2).

[37] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51290; File No. SR–DTC–2005–02]

Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Establish a Set Up Fee for Open-Ended Mutual Funds

March 2, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] notice is hereby given that on February 16, 2005, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I and II below, which items have been prepared primarily by DTC. The Commission is publishing this notice and order to solicit comments from interested persons and to grant accelerated approval of the proposal.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The purpose of the proposed rule change is to establish a set up fee for open-ended mutual funds.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, DTC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DTC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of such statements.[2]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to establish a set up fee for open-ended mutual funds deposited at DTC. The $10,000 fee, payable by the family of funds,[3] will be for the first CUSIP in the family of funds to become eligible for deposit at DTC.[4] The fee must be paid before the first CUSIP becomes eligible for deposit at DTC. DTC will not charge the set up fee for additional CUSIPs issued by the same family of funds. Limiting the DTC services available to an open-ended mutual fund involves manual processing at the time of making it eligible, which leads to significant processing costs for DTC.

The proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to DTC because the proposed rule change allows for Open-Ended Funds to be deposited at DTC assuring the safeguarding of securities and funds which are in the custody or control of DTC because DTC will safeguard Open-Ended Funds in a manner consistent with the manner it safeguards other securities.

(B) Self-Regulatory Organization's Statement on Burden on Competition

DTC does not believe that the proposed rule change will have an impact on or impose a burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments relating to the proposed rule change have been solicited or received. DTC will notify the Commission of any written comments received by DTC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder and particularly with the requirements of Section 17A(b)(3)(F).[5] Section 17A(b)(3)(F) requires that the rules of a clearing agency be designed to remove impediments to and to perfect the mechanism of a national system for the prompt and accurate clearance and settlement of securities transactions. The Commission believes that the approval of DTC's rule change is consistent with this section because it will allow DTC to provide this service whereby those pledging and those taking pledges of open-ended mutual funds will be able to benefit from an automated service with uniform procedures.

DTC has requested that the Commission approve the proposed rule change prior to the thirtieth day after

[1] 15 U.S.C. 78s(b)(1).

[2] The Commission has modified the text of the summaries prepared by DTC.

[3] A family of funds is a group of mutual funds that is managed by the same fund company.

[4] Open-Ended Funds will have limited use of DTC's services.

[5] 15 U.S.C. 78q–1(b)(3)(F).

publication of the notice of the filing. The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the publication of notice because such approval will allow DTC to establish a set up fee for open-ended mutual funds deposited at DTC at the same time it makes open-ended mutual funds depository eligible.[6]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*) or
- Send an E-mail to *rule-comments@sec.gov*. Please include File Number SR–DTC–2005–02 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–DTC–2005–02. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of DTC and on DTC's Web site at *http://www.dtc.org*. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–DTC–2005–02 and should be submitted on or before March 29, 2005.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[7] that the proposed rule change (File No. SR–DTC–2005–02) be and hereby is approved on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[8]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. E5–971 Filed 3–7–05; 8:45 am]

BILLING CODE 8010–01–P

[6] Securities Exchange Act Release No. 51289 (March 2, 2005) [File No. SR–DTC–2005–01].

[7] 15 U.S.C. 78s(b)(2).

[8] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51289; File No. SR–DTC–2005–01]

Self-Regulatory Organizations; The Depository Trust Company; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Make Open-Ended Funds Depository Eligible

March 2, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),[1] notice is hereby given that on February 16, 2005, The Depository Trust Company ("DTC") filed with the Securities and Exchange Commission ("Commission") the proposed rule change described in Items I, II, and III below, which items have been prepared primarily by DTC. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The purpose of the proposed rule change is to make open-ended funds depository eligible.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, DTC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. DTC has prepared summaries, set forth in sections (A), (B), and (C) below, of the most significant aspects of these statements.[2]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

Due to processing problems that DTC has experienced with open-ended funds in the past, open-ended funds are not eligible for deposit at DTC. The proposed rule change allows DTC to accept open-ended funds for deposit but will not make the full range of DTC services available for these funds. Participants will be able to hold open-ended funds in their accounts at DTC and will be able to pledge open-ended funds to other DTC participants using DTC's system. Other than holding and pledging, no other services (*i.e.*, redemption services, reorganization services, dividend payments, or valued transactions) will be available to participants for open-ended funds. Dividends paid on open-ended funds will not be paid to DTC but will be paid to participants outside of DTC's system pursuant to instructions the open-ended fund's issuer or its agent receives from participants. Participants will deposit shares in open-ended funds into their DTC accounts and will withdraw shares in open-ended funds from their DTC accounts through the Deposit or Withdrawal at Custodian ("DWAC") service.

The proposed rule change is consistent with the requirements of Section 17A of the Act[3] and the rules and regulations thereunder applicable to DTC because it assures the safeguarding of securities and funds which are in the custody or control of DTC because DTC will safeguard open-ended funds in a manner consistent with the manner it safeguards other securities. It will also promote efficiencies related to pledges of open-ended funds.

(B) Self-Regulatory Organization's Statement on Burden on Competition

DTC does not believe that the proposed rule change will have any impact on or impose any burden on competition.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments relating to the proposed rule change have been

[1] 15 U.S.C. 78s(b)(1).

[2] The Commission has modified the text of the summaries prepared by DTC.

[3] 15 U.S.C. 78q–1.

solicited or received. DTC will notify the Commission of any written comments received by DTC.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A)(iii) of the Act[4] and Rule 19b–4(f)(4)[5] thereunder because the proposed rule does not significantly affect the respective rights or obligations of the clearing agency or persons using the service and does not adversely affect the safeguarding of securities or funds in the custody or control of the clearing agency or for which it is responsible. At any time within sixty days of the filing of such rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*) or
- Send an E-mail to *rule-comments@sec.gov*. Please include File Number SR–DTC–2005–01 on the subject line.

Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609.

All submissions should refer to File Number SR–DTC–2005–01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of DTC and on DTC's Web site at *http://www.dtc.org*. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–DTC–2005–01 and should be submitted on or before March 29, 2005.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[6]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. E5–972 Filed 3–7–05; 8:45 am]

BILLING CODE 8010–01–P

[4] 15 U.S.C. 78s(b)(3)(A)(iii).

[5] 17 CFR 240.19b–4(f)(4).

[6] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–51295; File No. SR–ISE–2005–14]

Self-Regulatory Organizations; International Securities Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 Thereto Relating to Position Limits and Exercise Limits

March 2, 2005.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on February 25, 2005, the International Securities Exchange, Inc. ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by ISE. On March 1, 2005 the ISE filed Amendment No. 1 to the proposed rule change.[3] The Exchange has filed the proposal as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act[4] and Rule 19b–4(f)(6) thereunder,[5] which renders it effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The ISE proposes to amend ISE Rules 412, 413, and 414 to increase the standard position and exercise limits for equity options contracts and options on the Nasdaq-100 Index Tracking Stock ("QQQQ"). The text of the proposed rule change is available on the ISE's Web site (*http://www.iseoptions.com*), at the ISE's Office of the Secretary, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the ISE included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing several change to ISE Rule 412 (Position Limits), ISE Rule 413 (Exemptions from Position Limits), and ISE Rule 414 (Exercise Limits). ISE Rule 412 subjects equity options to one of five different position limits depending on the trading volume and outstanding shares of the underlying security. ISE Rule 413 establishes certain qualified hedging transactions and positions that are exempt from established options position limits as prescribed under ISE Rule 412. ISE Rule 414 establishes exercise limits for the corresponding options at the same levels as the corresponding security's position limits. On February 23, 2005, the Commission granted accelerated approval of a rule change proposed by the Chicago Board

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Amendment No. 1 made certain technical changes to Exhibit 5 to the filing.

[4] 15 U.S.C. 78s(b)(3)(A).

[5] 17 CFR 240.19b–4(f)(6).

WILLIAM J. GUSTE, JR.
ATTORNEY GENERAL

State of Louisiana
DEPARTMENT OF JUSTICE
Baton Rouge
70804

MAY 16 1989

OPINION NUMBER 88-546-A

OPINION NUMBER 88-546-A

8 - A Bond Issues
90-A-2 Public Funds

Art. VII, §14 of 1974 La. Constitution
Art. IV, §12 of 1974 La. Constitution
Art. I, §23 of 1974 La. Constitution

R.S. 9:2127(B); R.S. 24:175; R.S. 33:2295
R.S. 39:1271

Modification of opinion finding mutual fund unconstitutional. Massachusetts business trust mutual fund investment is permissible.

Ms. Mary E. Arceneaux
General Counsel
Louisiana Bankers Association
P. O. Box 2871
Baton Rouge, LA 70821

Dear Ms. Arceneaux:

You requested reconsideration of Opinion Number 88-546 pertaining to mutual funds. Opinion Number 88-546 found that an investment in a mutual fund is actually the purchase of an undivided ownership in a mutual fund company, and not a purchase of the underlying securities. The opinion held that R.S. 9:2127, as it applies to public funds, is violative of Article VII, Section 14(A) of the Louisiana Constitution. For the same reasons as R.S. 9:2127 was found to be in violation of the Louisiana Constitution, R.S. 33:2955 and R.S. 39:1271, as amended by Act 317 of the 1987 Regular Session and Act No. 895 of the 1988 Regular Session, were also found to be unconstitutional insofar as those statutes purport to allow the investment of public funds in mutual funds.

Your request for reconsideration of the opinion is limited to investments in a mutual fund organized as a Massachusetts business trust. The characteristics of this type of mutual fund are as follows:

1. The fund is a trust doing business as a no-load (no sales commission), open-end diversified investment company registered under the Investment Company Act of 1940, 15 U.S.C. §80a-1, *et seq.*

2. The trust is established as a Massachusetts business trust in which the trust instrument establishing the fund authorizes the issuance of

an unlimited number of units of beneficial interest of a single class, each of which units represents an equal proportionate beneficial interest in the assets of the trust.

3. The units are offered to the public and the proceeds of sale of such units are invested exclusively in short-term U.S. Government securities payable directly by the United States Government or directly guaranteed thereby.

4. An investment in the fund is highly liquid, with significant ease and speed of purchase and redemption of shares any day on which the New York Stock Exchange is open. No charge is made for handling a redemption.

5. The fund has a custodial arrangement for securities and cash of the trust with an independent custodian bank for deposit of any securities or cash not in book entry form.

6. A fidelity bond is maintained on employees of the manager of the fund based on the asset value of the fund.

A unitholder in an Massachusetts business trust mutual fund owns an undivided beneficial interest in the underlying assets of the trust established. Chapter 182, Section 1 of the General Laws of the Commonwealth of Massachusetts defines a Massachusetts business trust as "a trust operating under a written instrument or declaration of trust, the beneficial interest under which is divided into transferable certificates of participation or shares . . . ." In State Tax Commission v. Colbert, 344 Mass. 494, 183 N.E.2d 277 (1962), involving a real estate trust, the Massachusetts Supreme Judicial Court noted that a trust unitholder

> "held an equitable interest in the real property held by the trust. Kinney v. Treasurer & Recr. Gen., 207 Mass. 368, 371, 93 N.E. 586, 35 L.R.A., N.S., 894. Peabody v. Treasurer & Recr. Gen., 215 Mass. 129, 131, 102 N.E. 435. Baker v. Commissioner of Corps. & Taxn., 253 Mass. 130, 138, 148 N.E.

> 593. <u>It was a beneficial interest in the real estate itself and not, as in the case of a corporation, an interest distinct from the corporate assets.</u> <u>See Kenney v. Hodges</u>, 215 Mass. 112, 115, 102 N.E. 432. Despite similarities between a business trust and a corporation, a trust is treated as a distinct type of business entity ..."

<u>Id</u>. at 278 (emphasis added). See also, <u>Peterson v. Hopson</u>, 306 Mass. 597, 29 N.E.2d 140, 150 (1940); <u>Goodhue v. State Street Trust Co.</u>, 267 Mass. 28, 165 N.E. 701, 704 (1929).

Other states have concluded that a Massachusetts business trust investment is the same thing as an investment in the trust corpus. <u>Narragansett Mut. Fire Ins. Co. v. Burnham</u>, 154 A. 909, 911 (R.I. 1931). Also, the Comptroller of the Currency in <u>Banking Circular 220</u> dated November 21, 1988 concluded that national banks, which are also prohibited by the National Bank Act from purchasing equity investments such as shares or stocks of private companies for their own account, may nevertheless purchase units of the type of mutual fund described above.

In <u>Borg v. Department of Revenue</u>, 1988 Westlaw 83815 (Or. Tax), 11 Or.T.R. 67 (1988) (slip opinion), the Court discussed whether the tax exempt character of income from United States obligations in the hands of a Massachusetts business trust flows through and remains exempt in the hands of the beneficiaries. The Court found that it did, citing also, <u>Andras v. Illinois Dept of Rev.</u>, 154 Ill.App.3rd 37, 506 N.E.2d 439 (1987), cert den. ____ U.S. ____, 108 S.Ct. 1223, 99 L.Ed.2d 424 (1988); <u>Matz v. Dept. of Treas.</u>, 155 Mich.App. 778, 401 N.W.2d 62 (1986); <u>Comm. of Rev. v. Plymouth Home National Bank</u>, 394 Mass. 66, 473 N.E.2d 1139 (1985).

Based upon the foregoing, Opinion 88-546 is incorrect to the extent that it finds that mutual funds known as Massachusetts business trusts having the characteristics hereinabove described violate the provisions of Article VII, Section 14(A) of the Louisiana Constitution. It is the opinion of this office that investing in Massachusetts business trust mutual funds is tantamount to investing in direct United States government securities. Opinion No. 88-546 is hereby modified to provide that the above described investment does not violate Article VII, Section 14(A) of the Constitution.

However, Opinion No. 88-546 is maintained and affirmed insofar as it applies to any other mutual fund not having the characteristics of the Massachusetts business trust as outlined herein.

Trusting this adequately responds to your request, I remain

Sincerely,

WILLIAM J. GUSTE, JR.
Attorney General

WJG,Jr./MSH/jav

STATE OF INDIANA

OFFICE OF THE ATTORNEY GENERAL

PAMELA CARTER
ATTORNEY GENERAL

STATE HOUSE
INDIANAPOLIS 46204

September 5, 1996

Mr. Steven A. Miller, Treasurer
Bryan Hall 205C
Indiana University
Bloomington, Indiana 47405-1207

Re: Official Opinion 96-3: University Mutual Fund Investments

Dear Mr. Miller:

This letter addresses your request for an official opinion concerning the "shareholder" clause of Article 11, Section 12 of the Indiana Constitution. Specifically, you asked whether Indiana University may invest in money market mutual funds without running afoul of that clause. For the reasons stated below, I conclude that the provision would permit Indiana University to invest in such funds, as long as they are established as business trusts and the underlying portfolio consists of permissible investments.

I. BACKGROUND AND FACTS

Indiana University wishes to invest in money market mutual funds so that it can deposit funds in an interest bearing account overnight, instead of waiting until the following morning to invest daily deposits. Currently, the University loses income, because some accounts received cannot be transferred to the University's main depository until the next morning. As an arm of the State and recipient of state funding, Indiana University is subject to the constitutional provision, although the constitutional prohibition does not apply to investments of private funds held in trust by the University.[1] For purposes of this opinion, it is assumed that the University wants to invest both types of assets in money market funds, if constitutionally permitted.

A mutual fund is a type of open-end investment company that holds a pool of underlying securities. Such funds sell shares to investors, either with or without a premium or "load" to

[1] *See Sendak v. Trustees of Indiana University*, 260 N.E.2d 601 (Ind. 1970); *State Board of Accounts v. Indiana University Foundation*, 647 N.E.2d 342 (Ind. Ct. App. 1995), 8 Ind. Op. Att'y Gen. 24, 25 (1978); *accord* Ind. Code § 4-12-1-2(d) (for budget purposes, the term "state agency" includes state supported universities and colleges).

cover fund expenses. The funds later redeem shares at their net asset value when the investor decides to sell. The net asset value depends upon the value of the fund's portfolio at the time of the redemption. That value is determined by subtracting liabilities attributable to the shares from the value of the fund's assets.

Many mutual funds are organized as business trusts, sometimes called "Massachusetts business trusts." Under such a trust, investors hold "transferable certificates, issued pursuant to the provisions of the trust instrument ... evidencing beneficial interests in the trust estate"[2] In other words, beneficiaries of a business trust own an equitable interest in the underlying trust property.

Money market mutual funds are mutual funds that are designed to return a market rate of interest, while maintaining a stable value, normally of $1 per share. Such funds invest in short-term debt instruments such as government securities, commercial paper, and large denomination bank certificates of deposits.[3] The Investment Company Act of 1940[4] and the rules promulgated under it closely regulate money market mutual funds. Thus, Rule 2a-7 permits money market funds to invest only in securities that present minimal credit risks and that comply with the rule's definition of eligible securities.[5] In general, eligible securities are securities that mature within 397 days or less and that fall within the two highest rating categories for short-term debt obligations as rated by nationally recognized statistical rating organizations.[6] The rule also provides for unrated securities that are comparable. Tight governmental regulation and careful analysis by rating organizations provide substantial security in obtaining interest and repayment of principal. Of course, the funds cannot *guarantee* that the net asset value will remain stable at $1.00, but deviations from this norm are rare.

Just as stability of the fund's net asset value cannot be absolutely guaranteed, all fixed-income securities are subject to price fluctuations based on interest rate movements, maturity, liquidity, and the supply and demand for each type of security. This is true of underlying obligations issued or backed by the federal government, as well as privately issued securities. As an Advisory Letter from the Office of the Comptroller of the Currency to national banks stated, "Concentrations of bank assets in long-term fixed-rate assets, in any form, leave a bank vulnerable to interest-rate movements."[7] State funds will be vulnerable to interest-rate fluctuations both if the State invests in securities directly or if the State invests in mutual funds. Because of the diversification and active management designed to achieve stability of a money

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[2] Ind. Code § 23-5-1-2.

[3] *See generally*, STANDARD AND POOR'S, MONEY MARKET FUND'S REVIEW (Nov. 1995).

[4] 15 U.S.C.A. § 80a *et. seq.*

[5] 17 CFR § 270.2a-7 (c)(3).

[6] 17 CFR § 270.2a-7 (5)(i-iii).

[7] AL 87-3 Off. Comptroller of the Currency (Oct. 15, 1987).

market fund, the interim risks are probably less than those of investing in individual, underlying securities.

II. ANALYSIS

After careful research and analysis, I conclude that the University may invest in money market mutual funds that are organized as Massachusetts business trusts, so long as the underlying trust portfolio consists of permissible investments. An investor in a Massachusetts business trust owns a beneficial interest in the trust estate itself, so the trust entity is transparent for constitutional purposes. In addition, such investments comport with the spirit of the constitutional provision because they carry little risk of financial loss. To the extent an opinion by a prior Attorney General suggests that the mere business trust form alone results in a constitutionally impermissible investment, it is hereby disapproved.

Article 11, section 12 of the Indiana Constitution provides that "The State shall not be a stockholder in any bank; nor shall the credit of the State ever be given, or loaned, in aid of any person, association or corporation; nor shall the State become a stockholder in any corporation or association."[8] The amendment was incorporated into the Indiana Constitution in 1852 after the State became nearly bankrupt from investments in public improvement projects that included canal, turnpike and railroad construction. Both the State and the State Bank invested heavily in the improvements. The State Bank not only extended credit to private corporations involved in the construction, it also purchased their stock, making the State a partner in the construction projects.[9] As the Indiana Supreme Court has noted, the purpose of the amendment "was to bar the State of Indiana from placing state money at risk in corporate stock."[10]

In *Northern Indiana Bank v. State Board of Finance*,[11] a 1983 decision, our Supreme Court looked to the purpose of amendment in ruling that the State could invest in deposit-type savings associations. The court did not consider the technical denomination of such an institution as an "association" to be dispositive. Rather the Court focused on the investment's risk. Thus, the Court held that the State could use savings associations because the State, "is not engaging in hazardous transactions, and it does not, by virtue of a deposit, become a speculative partner."[12]

Likewise, State investments in money market mutual funds, do not violate the purpose of the stockholder clause. Money market mutual funds do not make the state a "partner in speculation," because these investments involve minimal risk. The Investment Company Act[13]

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[8] Ind. Const. art. 11, § 12.

[9] *Northern Indiana Bank v. State Board of Finance*, 457 N.E.2d 527 (Ind. 1983).

[10] *Public Employees' Retirement Fund v. Pearson*, 459 N.E.2d 715 (Ind. 1984).

[11] *Northern Indiana Bank v. State Board of Finance*, 457 N.E.2d at 529-530 (Ind. 1983)

[12] *Id.* at 530.

[13] 15 U.S.C.A 80a *et. seq.*

requires that such funds only invest in stable securities that have received high stability ratings by nationally recognized statistical ranking organizations. Therefore, while not risk-free, these investments are exceptionally secure. Indeed, it is not uncommon for banks and savings and loan associations to offer "money market" accounts to their customers. Mutual funds with more aggressive investment strategies (and therefore greater risk) may, of course, require a different conclusion.

A 1962 opinion by a prior Attorney General[14] should be limited to situations that invoke the policy of Article 11, section 12. Though that opinion purported to conclude that the provision would prohibit the Public Employees' Retirement Fund from investing in mutual funds or open-ended investment trusts, it did so without any consideration of either the constitutional purpose or the underlying nature of the investments. The opinion reached its conclusion by mechanically classifying mutual funds as associations without any regard for their widely varying characteristics. Employing extremely broad language, the opinion stated: "it is my opinion that opened-end investment trusts and mutual funds would be 'corporations or associations' within the meaning of those terms as used in the Indiana Constitution, Art 11, Sec. 12."[15] The analysis used by the 1962 opinion falters for two reasons. First, more recent court opinions have more closely examined the nature of the investment. Second, the opinion did not examine the State's underlying interest in the assets of the mutual fund. It thus did not separately address mutual funds which merely served as vehicles for the State to hold otherwise permissible investments.

The opinion found that mutual funds may take the form of corporations or business trusts, and that if the mutual fund was organized as a business trust it would come within the term association. Quoting Webster's Third New Dictionary the opinion defined an association as "an organization of persons having a common interest ... having no charter from the state, but having the general form and mode of procedure of a corporation." Using such an general definition, the opinion found that mutual funds were associations, and therefore, prohibited State investments in the funds.

However, this wooden and formalistic approach is inconsistent with more recent caselaw. Our Supreme Court has indicated that its evaluation of the constitutionality of an investment does not depend upon such superficial labels. Thus, in *Northern Indiana Bank and Trust Co., v. State Board of Finance*, the Court's analysis did not begin and end with whether the state had formally become a member of an "association" when it made deposits into a savings and loan association. Rather, the court examined the characteristics of a depositor in a savings and loan association and contrasted them with the characteristics of a stockholder in a corporation. The Court found that there were important differences between the two types of investments. First, although a depositor has the right to vote, the right is limited and not as important as in the case of a stockholder. Second, a depositor is guaranteed a fixed return in the form of interest on the

[14] 37 Ind. Att'y Gen. 185, 189 (1962).

[15] *Id.* at 189.

deposit, whereas a shareholder's return is based upon the profitability of the corporation. Third, and what the court found as the most important distinction, depositors may withdraw their money at any time, unlike stockholders who must sell their stock to another party.[16] The court's analysis makes clear that the 1962 opinion, relying as it did on a formalistic view of what constitutes an "association" was erroneous, and therefore should be rejected.[17]

Just as the Indiana Supreme Court examined the differences between the rights and obligations of corporate shareholders and those of depositors in a savings and loan in *Northern Indiana Bank and Trust Co.*, the rights of money market fund investors must be considered. Here, like savings and loan depositors, money market fund shareholders have limited voting rights. Second, although a money market mutual fund does not *guarantee* its shareholders a return on their investment, the funds come as close as possible to guaranteeing such a result with their conservative management and stringent regulation. Third, like depositors, mutual fund shareholders may withdraw their money from the fund at any time. Therefore, fund shareholders do not resemble typical stockholders in many important respects, and ownership of money market fund shares will not make the state a stockholder in a corporation or association.

The 1962 opinion's broad conclusion also should be rejected because it failed to analyze the underlying ownership interest involved. An investor's ownership interest in a mutual fund depends upon the organization of the fund and the type of investments it buys. Many such funds are organized as common law trusts, often called Massachusetts business trusts. As defined by the Indiana Business Trust Act, holders of business trust certificates own a beneficial interest in the trust estate.[18] By investing in funds organized as business trusts, Indiana University becomes an equitable owner of an undivided interest in the underlying securities, not a stockholder in some separate "association." Of course, this means that the underlying portfolio of the mutual fund must consist of permissible investments. While a detailed discussion of such investments is beyond the scope of this opinion, some, such as corporate equities, would so clearly run afoul of the shareholder clause as to be impermissible.[19]

Recent Attorney General opinions from other States also approve of appropriate mutual fund investments. For example, the Louisiana Attorney General has modified an earlier opinion that had announced a general prohibition on state investment in mutual funds.[20] After distinguishing the types of ownership interests that could be gained from purchasing different

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[16] *Id.* at 530-531.

[17] *Cf.* 1994 Op. Atty. Gen. 4 at page 8, available via the internet at http://www.ai.org/atty_gen/html/public/opinion/oo944.html (disapproving 1989 Op. Atty. Gen. 9).

[18] Ind. Code § 23-5-1-2; *State Tax Commission v. Colbert*, 183 N.E.2d 277 (Mass. 1962).

[19] *See Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985) (applying plain language of Securities Act to cover common stock, despite claim that the economic reality of the transaction was a "sale of business").

[20] 88-546 A La. Op. Att'y Gen. (1989).

mutual funds, the opinion concluded that the State could invest in mutual funds organized as Massachusetts business trusts, because investment in this type of mutual fund was identical to investing in the trust estate.[21] Similarly, a Nebraska Attorney General opinion concluded that "[b]y investing in mutual funds comprised solely of U.S. Government securities, a subdivision of the state would not normally be entering into a private business venture or enterprise."[22] Thus, the opinion concluded that the State could invest in these mutual funds as long as it did not acquire "any ownership interest in the investment trust company."[23]

These types of investments are also consistent with Indiana statutory provisions which allow the Indiana University Trustees to invest University funds in the same manner as other trustees, who may engage in "every kind of investment," as long as the trustee exercises "the judgment and care under the circumstances then prevailing."[24] Like other statutes, these provisions are presumed constitutional, and the burden to rebut this presumption is upon any challenger. All reasonable doubts must be resolved in favor of an act's constitutionality.[25]

The benefits that Indiana University will gain from investing in money market mutual funds also support the conclusion that such investments are permissible. The University will gain increased liquidity, the expertise of experienced fund managers to invest their deposits, and the interest that it currently loses from its inability to invest deposits made during the day until the following morning. Given the statutory grant of authority to the Trustees to make prudent investments, any finding of the Trustees' choice of investments as unconstitutional would have to overcome a presumption that the Trustee's investments were constitutional, because it is assumed that the Trustees acted according to their statutory authority and duty.

III. CONCLUSION

For the reasons stated above, I conclude that the University may invest in money market mutual funds, so long as those funds are organized as business trusts and their underlying portfolios consist of permissible investments.

Sincerely,

Pamela Carter

Pamela Carter
Attorney General of Indiana

---

[21] *Id.*

[22] 95041 Neb. Op. Att'y Gen. (1995).

[23] *Id.*

[24] Ind. Code § 20-12-1-2 (10). Ind. Code 30-4-3-3(c)

[25] *Bunker v. National Gypsum Co.*, 441 N.E.2d 8, 11 (Ind. 1982).

Exhibit C

S&P MMF Ratings Criteria.

STANDARD
& POOR'S
Setting the Standard

Money Market Fund Ratings Criteria

2003

STANDARD & POOR'S INVESTMENT SERVICES
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Money Market Fund Ratings Criteria

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COMMENTARY

Money Market Fund Ratings Criteria

BACKGROUND AND OVERVIEW

Standard & Poor's has been rating money market funds since 1984. A money market fund rating is a safety rating, expressing Standard & Poor's opinion of the ability of a fund to maintain principal value and to limit exposure to loss. Ratings can range from 'AAAm' to 'Dm', with the 'm' denoting a money market fund. The 'm' distinguishes the money market fund rating from a Standard & Poor's traditional debt rating. A traditional debt rating usually is not subscripted and indicates a borrower's ability to repay principal and interest on a timely basis. A money market fund rating is not directly comparable to a debt rating because of differences in investment characteristics, rating criteria, and the creditworthiness of portfolio investments.

Standard & Poor's money market fund ratings encompass the following:

- Analysis of a fund's investment credit quality
- Liquidity
- Management
- Investment guidelines
- Strategies
- Operational policies
- Internal controls

A money market fund rating serves as a current assessment of the fund's overall safety as Standard & Poor's conducts ongoing monitoring of a fund's portfolio and management. Standard & Poor's has updated its rating criteria for money market funds as financial markets and financial products change and expand. Distinct criteria have been established for each rating category *(see Money Market Fund Ratings Definitions and Criteria Summary below)*.

RATING APPROACH AND PROCESS

Standard & Poor's rates money market funds solely upon the request of fund management (or sponsor), which agrees to provide all necessary portfolio information on a timely basis. The rating process begins when Standard & Poor's receives a written request to have a particular fund rated. At this point, the analyst assigned to the fund will request the fund sponsor to submit fund information *(see Information Needed for a Money Market Fund Rating, on page 4)*. Upon

Money Market Fund Ratings Definitions and Criteria Summary

A money market fund rating is not directly comparable with a bond rating due to differences in investment characteristics, rating criteria, and creditworthiness of portfolio investments. For example, a money market fund portfolio provides greater liquidity, price stability, and diversification than a long-term bond, but not necessarily the credit quality that would be indicated by the corresponding bond rating. Ratings are not commentaries on yield levels. A money market fund rating is not a recommendation to buy, sell or hold units or shares of the fund. Further, the rating may be changed, suspended, or withdrawn as a result of changes in, or unavailability of, information related to the fund.

Rating	Definition	Minimum*** A-1+	Maximum A-1	Maximum A-2	Maximum Weighted Avg. Maturity (WAM) (Days)	Floating Rate Notes (FRN) Maximum Final Maturity
AAAm	Safety is excellent. Fund provides superior capacity to maintain principal value and limit exposure to loss.	50%	50%	0%	60	Two years
AAm	Safety is very good. Fund provides strong capacity to maintain principal value and limit exposure to loss.	20%	80%	5% overnight	75	Three years
Am	Safety is good. Fund provides sound capacity to maintain principal value and limit exposure to loss.	0%	100%	10% overnight	90	Four years
BBBm	Safety is fair. Fund provides adequate capacity to maintain principal value and limit exposure to loss.	0%	100%	25% overnight	90	Five years
Dm	Fund has failed to maintain principal value; realized or unrealized losses exceed 0.5% of net asset value.					

G — The letter 'G' follows the rating symbol when a fund's portfolio consists entirely of direct U.S. government securities.
+ or – — Ratings may be modified (except AAAm) to show relative standing within the rating categories.

*** Investments rated A-1 maturing in 7 days or less can be counted toward the A-1+ percentage minimums.

review of the information, the analyst schedules a meeting with fund investment officials at their offices *(see Suggested Agenda for Money Market Fund Rating Management Meeting, on page 5)*.

After this meeting, the analyst and back-up analysts present their findings to a rating committee composed of senior Standard & Poor's fund analysts. The committee examines all relevant information uncovered in the rating process and votes on an initial rating. Once a rating is assigned to a money market fund, the fund is monitored on a weekly basis to ensure the accuracy of the rating.

Standard & Poor's actively monitors a fund's

- credit quality,
- average maturity,
- level of liquidity,
- introduction of new investments, and
- management.
  See Information Needed to Monitor a Money Market Fund Rating, on page 6.

Additionally, Standard & Poor's conducts annual management review meetings for each rated fund to discuss changes that may have occurred in a fund's

- investment policy,
- philosophy,
- personnel,
- ownership,
- operations,
- daily operating procedures, and
- controls.

Standard & Poor's receives an annual fee for assigning and maintaining ratings for money market funds.

This publication is intended to describe the ratings criteria Standard & Poor's applies in the ratings process for money market funds. It is essential that managers and sponsors of rated funds clearly understand the parameters that make up the particular rating category, as these tend to be more stringent than regulatory requirements. By electing to meet the rating standards, fund management has demonstrated a commitment to its shareholders to limit a fund's market price exposure knowing that this may result in a lower yield for higher rated funds under certain market conditions. It should be stressed that lower ratings within the investment grade rating categories (down to 'BBBm') do not indicate that there is something "wrong" with a fund, but simply that the fund is managed with a slightly higher level of market risk. Investors should expect higher returns as compensation for these risks. A rating below 'BBBm' indicates that the fund does not provide adequate safety.

As outlined above, a money market fund rating reflects Standard & Poor's opinion of the safety of invested principal based on an analysis of portfolio credit quality, market price exposure, liquidity and management. Credit quality incorporates the credit risk of securities and the counterparty risk of transaction-based investments, such as repurchase agreements (repos). Market price exposure relates to the potential for a decline in the market value of a money market fund's assets. Within this area, Standard & Poor's looks at a fund's

- weighted average maturity (WAM),
- liquidity,
- diversification,
- investments in variable and floating-rate securities,
- policies regarding securities lending and reverse repos,
- shareholder composition,
- pricing of securities, and
- net asset value (NAV) deviation procedures.

The quality of management is based on a meeting with senior fund officials, and is based on public and nonpublic information.

Information Needed for a Money Market Fund Rating

1. Letter requesting a Standard & Poor's rating
2. The most recent prospectus and statement of additional information
3. A copy of the annual reports for the past three years
4. Approved list of issuers for the fund and sample credit file
5. Policies regarding repurchase agreements (repos) including a copy of the master repo(s) and legal representation
6. Policies regarding use of securities lending and reverse repos
7. Historical variation between marked-to-market and amortized cost pricing in terms of share price monthly for the past three years (or since the fund's inception if less than three years old)
8. Explanation of any unusual deviation in the share price from $1.00 during the past three years (greater than 0.0015)
9. High and low weighted average portfolio maturities for each month during the past three years
10. Subscription and redemption history on a monthly basis for the past three years, reflecting gross purchases and gross redemptions
11. Detailed shareholder information, total number, mix (retail/institutional), and percentage held by each of the ten largest shareholders
12. Current list of portfolio holdings
13. Level of insurance coverage (Fidelity Bond, Error & Omission, Director & Officer)
14. A copy of the most recent SEC post-examination letter and fund adviser's response letter
15. Biographies and organization chart for key fund employees

CREDIT QUALITY

In evaluating a fund's credit quality, Standard & Poor's examines the risks associated with the quality, type, and diversification of the securities in each fund's portfolio. The credit quality assessment for each instrument is based on the credit rating Standard & Poor's has assigned to the security. The minimum credit quality standards for each fund' is based on the fund's rating and maturity structure of its portfolio *(see Money Market Fund Ratings Definitions and Criteria Summary, page 3)*.

For funds rated 'AAAm', all securities should carry a Standard & Poor's rating of 'A-1+' or 'A-1' or deemed to be of equivalent credit quality by Standard &

Suggested Agenda for Money Market Fund Rating Management Meetings

OVERVIEW

1. Brief history of the fund
   - ☐ Primary constituency
   - ☐ Growth patterns
   - ☐ Fund performance for the past three years (if applicable)
2. Basic philosophy
   - ☐ Investment and marketing strategy
   - ☐ Operating controls
3. Organization
   - ☐ Staff size and function
   - ☐ Role of board of directors and sponsors
   - ☐ Primary functions of key officers

CREDIT RISK

1. Credit quality of eligible investments
   - ☐ How approved list of eligible investments is determined
   - ☐ What the approved list includes
   - ☐ When and by whom approved list can be modified
   - ☐ Comparison of eligible and actual investments
   - ☐ Criteria for creditworthiness
   - ☐ Credit evaluation system
   - ☐ Degree of reliance on Standard & Poor's credit ratings
2. The effect that public rating changes have on eligibility for investment
3. Policies on repurchase agreements
   - ☐ Eligible sellers and repurchasers
   - ☐ Underlying securities
   - ☐ Degree of overcollateralization
   - ☐ Perfection of first priority security interest
4. Diversification/concentration
   - ☐ Investment mix allowances by type
   - ☐ Investment mix allowances by credit quality
   - ☐ Maximum individual holdings by issuer and affiliates

MARKET PRICE RISK

1. Maturity
   - ☐ General posture on weighted average portfolio maturity and maturity distribution
   - ☐ Basis for extending or shortening weighted average portfolio maturity
   - ☐ Historical maximums and averages of portfolio maturity
2. Liquidity
   - ☐ Portfolio mix and its change with market conditions
   - ☐ Types of instruments purchased or not purchased, and [illegible]
   - ☐ Term repurchase agreements (repos)
   - ☐ Esoteric securities
   - ☐ Other secondary market considerations
3. Redemption
   - ☐ Recent experience and assumptions relating to maturity structure
   - ☐ Largest weekly redemptions
   - ☐ Shareholder base and account characteristics

PRICING POLICY

1. Accounting method
   - ☐ Pricing system and sources
2. Frequency and method of marking portfolio(s) to market
3. Triggers for management action and actual example

OPERATING SCENARIOS

1. Use of securities lending and reverse repos and accompanying risk management policies
2. Circumstances under which a fund(s) would extend weighted average maturity beyond normal guidelines or alter credit quality
3. Trends in interest rate changes and tolerance to fund assets

CONTROLS

1. Daily modus operandi with respect to investments
   - ☐ Procedures for assuring timely purchases and redemptions of shares and timely liquidation of investments
   - ☐ Computer applications, adequacy of computer facilities, and computer back-up provisions
   - ☐ Disaster recovery plans
   - ☐ Fidelity bond coverage, errors and omissions insurance, and other liability protection
2. History of any previous back office problems
3. Time needed to meet shareholder redemption requests
4. Methods of monitoring investments and approved list
5. Role of compliance officer

Information Needed to Monitor a Money Market Fund Rating

1. Portfolio data, weekly:
   - Total assets, net assets, total portfolio valuation (original cost, amortized cost, and market/mark-to-market) for each security
   - Mark-to-market net asset value (NAV) per share
   - Total number of fund shares outstanding
   - Breakdown by issue, issuer, amount, maturity, and rating
   - Percent of portfolio covered by each credit support provider
   - Weighted average portfolio maturity for each day of the week
   - Net subscriptions and redemptions on day of portfolio valuation and on day of greatest amount of redemption during the week
   - Revisions to prior week's portfolio holdings
   - CUSIP numbers for all securities (where applicable)
   - Terms of floating-rate notes (reset formula, frequencies)
   - Net yield (current seven day, and 30 day)
   - Interfund loan position, including details on the money loaned at any time during the prior week, the name of the borrowing fund(s), the net asset size of the borrowing fund(s), and the maturities and interest rates of each loan
   - Identification of nonstandard repurchase agreements (repos), Credit-Linked Notes (CLNs), and other esoteric securities
2. Revisions to current eligible security schedule
3. Changes in investment policies or operating procedures
4. Current prospectus and statement of additional information
5. Notification of changes to prospectus or statement of additional information
6. Notification of fund name change or merger
7. Notification of changes in board of directors, senior management, investment advisor, or custodian
8. Annual and semiannual reports
9. All press releases relevant to the fund

Poor's. A minimum of 50% of its portfolio should be comprised of 'A-1+' rated instruments. 'AAm', 'Am' and 'BBBm' ratings criteria allows for holdings in 'A-2' quality securities with overnight maturities, and provides for increased levels of 'A-1' exposure. The levels reflect acceptable amounts of credit risk for the different fund rating categories and are based on historical default and ratings transition rates for short-term debt securities. Additionally, securities rated A-1 or the equivalent by Standard & Poor's that are on CreditWatch with negative implications should be limited to maturities of 30 days or less.

Credit quality criteria are based on results of Standard & Poor's internal study on the stability of short-term ratings. By combining an analysis of the yield spread movements, resulting from changes in the underlying credit quality of money market instruments, together with the study of Standard & Poor's historical ratings performance data, we have developed the credit quality investment guidelines for rated money market funds to maintain a consistent level of credit risk within each rating category. Investments rated 'A-1' maturing in 7 days or less can be counted toward the 'A-1+' percentage minimums.

Diversification guidelines are in most instances similar to those mandated by regulation (for U.S. money market funds, Rule 2a-7). The first- and second-tier diversification limits apply to both taxable and tax-exempt money market funds. Standard & Poor's has established credit quality standards and diversification criteria for repurchase agreement (repo) providers and government agency issues.

MARKET PRICE EXPOSURE

By far, the most complex part of money market fund analysis is judging a fund's sensitivity to changing market conditions. Absolute stability of net asset value (NAV) is a myth perpetuated by the amortized cost method of pricing securities. All fixed-income securities are subject to price fluctuations based on

- interest rate movements,
- maturity,
- liquidity,
- credit risk or perceived credit risk, and
- the supply and demand for each type of security.

These factors are just as true for money market funds as for longer-term fixed-income mutual funds. The amortized cost method of pricing permits money market fund investments to be priced by amortizing any discount or premium in purchase price straight to its maturity. For example, the amortized cost price of a 90-day security with a par value of 100 that was purchased for 99.10 will increase in value by 0.01 each day until it matures, notwithstanding any changing market conditions. The amortized cost method masks market risk by permitting funds to value securities as if no outside factors exist.

The theory behind allowing amortized cost pricing is that the most instruments eligible for purchase by money market funds have minimal market volatility due to their short maturities and high credit quality. It is also cheaper for funds to use this method than to get actual market prices on a daily basis. Money market funds are required to periodically calculate the market value of their assets to determine if the fund's actual NAV per share deviates materially from $1.00 and to take action if significant deviation exists. Deviations of greater than plus or minus 0.5% can create a situation in which a fund sells and redeems shares at a price other than $1.00, or "breaks the dollar". Clearly, there is a very small margin for error. Recognizing this small margin for error, Standard & Poor's has focused heavily on the potential deviation in market value (referred to as market price exposure) in establishing money market fund rating criteria. Variables analyzed for each fund rating include

- weighted average maturity (WAM),
- liquidity,
- index and spread risk,
- diversification,
- potential dilution of a fund's asset base, and
- security and portfolio valuation methods.

Combined, these factors determine each fund's market price exposure.

Weighted Average Maturity (WAM)
Determination of market price exposure starts with an examination of a fund's susceptibility to rising interest rates. The portfolio's weighted average maturity (WAM) is a key determinant of the tolerance of a fund's investments to rising interest rates. In general, the longer the WAM, the more susceptible the fund is to rising interest rates. A fund comprised entirely of Treasury securities with a WAM of 45 days could withstand approximately twice the interest rate increase than could a fund with a 90-day WAM, leaving all other factors aside *(see sidebar Protecting Money Market Funds from Interest Rate Swings)*.

Standard & Poor's assesses the sensitivity of the market value of the portfolio's assets to interest rate changes, with lower sensitivity having a more favorable influence on the fund's rating. For the 'AAAm' rating category, Standard & Poor's criteria calls for a maximum WAM of 60 days. However, some funds have distinct liquidity needs based on asset size, asset volatility, and shareholder profile and cannot safely manage with a 60 day WAM. Funds with less than $100 million in assets and/or funds with a highly concentrated or highly volatile shareholder base may be limited to a shorter WAM, unless fund management can make a compelling case otherwise.

Standard & Poor's is often asked to rate small funds with limited operating history (start-up funds) that have a concentrated shareholder base, or a new shareholder base with uncertain liquidity needs. Standard & Poor's considers the potential impact of a large redemption by one or more of the major shareholders to be a significant risk to a fund's ability to maintain a stable net asset value (NAV). Consequently, until a fund has grown to at least $100 million with a diverse and seasoned shareholder base, Standard & Poor's will seek assurances that the fund manages to a shorter WAM with higher levels of liquidity. Higher WAMs are usually considered appropriate for funds in lower rating categories with the maxi-

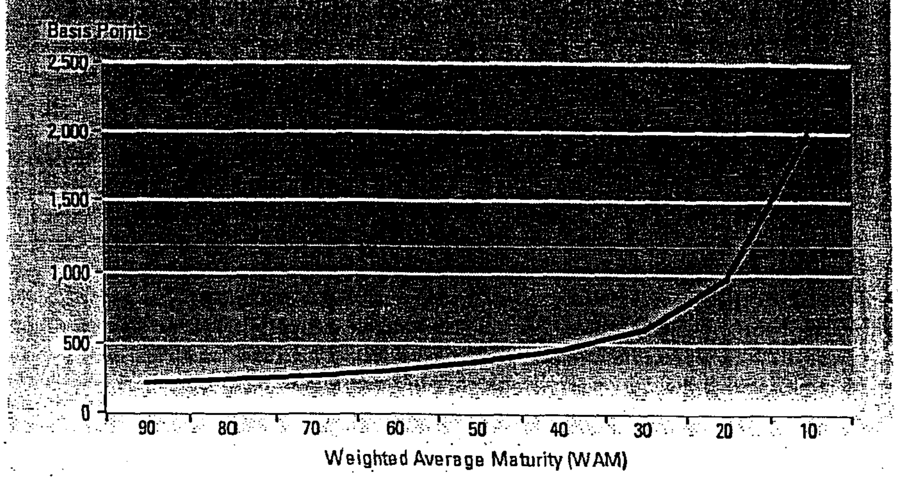
Protecting Money Market Funds from Interest Rate Swings

In accordance with established Standard & Poor's criteria for rated money market funds, maximum weighted-average portfolio maturity (WAM) guidelines are implemented to assure minimal net asset value (NAV) fluctuation under most market conditions.

WAM (days)	0.9990	0.9980	0.9970	0.9960	0.9950	0.9940
90	41	82	124	165	205	249
80	46	92	138	18[illegible]	231	2[illegible]
70	52	105	158	210	263	315
60	61	122	183	245	306	367
50	74	147	221	295	369	443
40	92	184	276	368	461	553
30	123	245	367	490	613	735
20	182	368	576	768	957	1,151
10	405	810	1,215	1,655	2,028	2,436

The relationship between interest rate shifts and NAV volatility has led Standard & Poor's to restrict 'AAAm' rated money market funds to a maximum WAM of 60 days. The chart below illustrates the inverse relationship between fund WAM and the minimum positive interest rate shift necessary to cause NAV to fall to a given level. Consider, for example, an elementary model fund that holds one Treasury bill and has a WAM of 90 days. In today's interest rate environment, an instantaneous upward shift of 205bp would need to occur before the NAV of the model fund would fall to 0.9950. If the same model fund had a WAM of 60 days, it could sustain a 306bp interest rate shift before its NAV falls to 0.9950.

Minimum Interest Rate Shift Necessary To Drop NAV from $1.00 to $0.9950



mum WAM limits for 'AAm' and 'Am' rated funds set at 75 days and 90 days, respectively *(see Money Market Fund Ratings Definitions and Criteria Summary, page 3).*

Liquidity
Interest rate sensitivity is not the only factor that can affect the principal value of a money market fund's portfolio. Liquidity of a money market fund's portfolio is critical to maintaining a stable net asset value (NAV). The liquidity of a security refers to the speed at which that security can be sold for approximately the price at which the fund has it valued or priced. Securities that are less liquid are subject to greater price variability. Certain securities may be liquid one day, and illiquid the next. In determining a fund's rating, Standard & Poor's considers each fund's liquidity needs and its ability to quickly sell portfolio holdings if the need arises to meet cash outflows or large redemptions.

The liquidity of portfolio investments is also of critical importance in determining a fund's market price exposure, because the degree of liquidity can greatly impact the market value of investments and result in an erosion of a fund's NAV. In reviewing a fund's liquidity, Standard & Poor's takes into consideration the

- types of investments and their secondary market liquidity,
- presence of securities with limited liquidity (e.g., those whose liquidity is dependent on the Issuing entity or broker/dealer),
- the fund's level of cash or overnight securities including overnight repurchase agreements (repos), and
- the portfolio's concentrations by Issuers and affiliates.

A fund with a higher proportion of relatively illiquid investments is more susceptible to experience a sizable decline in its portfolio market value than one holding highly liquid investments.

The size and breadth of the primary and secondary market, and hence demand for different types of securities factors into the liquidity equation. Clearly, the greater the demand for an instrument, the more liquid it is. However, some securities can be quite liquid when the Issuer or that particular market is performing well. When markets turn (e.g., due to event risk), or when the market experiences a flight to quality due to actual or perceived higher market or credit risk, certain instruments can experience significant price movements and liquidity can dry up rapidly. This was the case with the structured notes market in 1993 and 1994, and for Funding Agreements in 1999. Structured notes were designed to perform well and predictably during periods of stable or falling interest rates. The interest rate environment of 1993 made them popular and fairly liquid. The fact that these securities were issued by government agencies also enhanced marketability and liquidity. When short rates began rising in 1994, the demand, and consequently, the liquidity of these instruments dried up. The illiquid nature of these securities was exacerbated when regulators declared that such securities were clearly inappropriate investments for money market funds.

The liquidity of Funding Agreements has been directly tied to the Issuing entity because these securities are not actively traded on the secondary market. Funding Agreements are usually issued with a "put feature" that provides the investor with the ability to convert the investment back to cash upon notice to the Issuing entity. Therefore, the investor is very dependent upon the Issuing entity to provide liquidity for Funding Agreements. In 1999, an Insurance company that had issued a sizeable amount of Funding Agreements experienced a sudden and unexpected series of credit downgrades, resulting in a rush of holders to exercise their puts. When this Issuer failed to meet it's put obligations, holders of Funding Agreements were left with "lower credit and illiquid securities" presenting these funds with significant market value risk.

Liquidity is not always easy to measure. As noted, some securities may be very liquid in certain markets and very illiquid in others. Securities tend to be less liquid if they are

- not often traded,
- in short supply,
- relatively new and innovative, or
- highly structured.

Other factors influencing liquidity are the number of dealers making a market in the security, the complexity of the security, and the seasonal nature of supply and demand, particularly in the tax-exempt market.

Government Agency Concentration
Liquidity analysis is performed on all issues and Issuers, no matter what their level of credit quality. Securities with minimal credit risk, such as U.S. government agency obligations, may deviate in price for reasons other than interest rate movements. While the credit quality of these agencies is not typically a major concern, adverse publicity, or market rumors about an agency can impact the price and liquidity for even U.S. agency securities. For this reason, Standard & Poor's considers diversification to be an important feature for all securities, including U.S. agency securities.

Short-term liquidity can dry up for all types of securities and this could pose liquidity problems for funds holding large amounts of a U.S. agency's paper. The spreads in yields between short-term agency securities, whether fixed- or variable-rate, and traditional benchmarks such as the Treasury bill are subject to widening due to a number of factors. For fixed-rate securities with maturities of less than one year, the impact of spread widening on the price of the security is minimal. However, given the small margin for error that money market funds are permitted, high concentrations in the securities of any one agency might potentially expose the fund to material spread-widening risks.

For these reasons, Standard & Poor's has government agency diversification criteria for rated money market funds. Generally, Standard & Poor's expects no more than a 33 1/3% (one-third) exposure to any single government agency. Funds that have agency concentrations exceeding one-third of assets are expected to maintain lower weighted average maturities (WAMs) and or higher levels of highly liquid securities to reduce this exposure. The impact of spread widening can be viewed as synonymous with market interest rates rising only for those securities. Therefore, if a fund had a 50% concentration in any one agency and spreads for that agency's securities widened by 20bp, the impact on the market value of the fund's overall portfolio could be comparable to the effect of market rates rising 10bp without that spread-widening.

Funds with a WAM of 60 days should be able to withstand up to a one-day 300bp rise in interest rates without breaking the dollar (holding all other factors constant). Standard & Poor's has calculated various break the dollar levels for different U.S. agency given various spread-widening assumptions. The spread-widening and instantaneous interest rate increase assumptions differ for each rating category *[see Weighted Average Maturity (WAM) Adjustments for Agency Concentrations, below]*. These criteria are meant as a general guideline. Circumstances can differ from fund to fund based on the overall profile of the agency securities including maturities of the agency securities, type of securities (fixed- versus variable-rate), other sources of liquidity in the fund, and the issuing agency.

Variable and Floating Rate Securities
Standard & Poor's expects investment policies to include clear and explicit guidelines regarding variable-rate notes (VRNs), floating-rate notes (FRNs) and other synthetic instruments. Fund investment policies should incorporate procedures regarding approval, risk measurement, control, and limits related to investment in structured notes and other floating/variable-rate instruments. Fund managers holding such securities should

Weighted Average Maturity (WAM) Adjustments for Agency Concentrations

[illegible]

METHODOLOGY
Step 1 — Standard & Poor's assumes the following worst-case spread-widening and instantaneous interest rate rises:

Rating category	Spread widening (bp)	Interest rate increase (bp)
AAAm	100	300
AAm	75	250
Am	50	225
BBBm	25	200

Step 2 — The spread-widening number is then multiplied by the fund concentration in the securities of any one agency.
Step 3 — The product is then added to the applicable interest rate increase to determine the equivalent interest rate sensitivity that the fund may exhibit.
Step 4 — The interest rate sensitivity equivalent calculated in Step 3 is applied to Standard & Poor's interest rate sensitivity matrix to determine the maximum WAM that allows the fund to maintain a net asset value above 0.9950.

APPLICATION
Because there is a range of maximum WAMs for each rating category, with the actual maximum determined on a case-by-case basis, Standard & Poor's uses adjustment factors to determine the proper maximum WAM for each fund. The adjustment factors are simply the maximum WAM for the rating category minus the WAM determined in Step 4 above.

Example:
1. Assume an 'AAAm' rated fund has a 50% agency concentration in FHLB.
2. (0.5)(100bp spread widening) + (300bp interest rate rise) = 350bp.
3. At an instantaneous interest rate rise of 350bp, a fund with an WAM of 52 days or less will remain above 0.995.

[illegible]

'AAAm' level (100bp spread, 300bp movement)

Agency concentration (%)	Adjustment factor (from 60 days)
[illegible]	[illegible]
[illegible]	[illegible]
[illegible]	10
[illegible]	[illegible]

'AAm' level (75bp spread, 2[illegible]0bp movement)

Agency concentration (%)	Adjustment factor (from 75 days)
40-44	13
45-54	[illegible]
55-64	16
65-70	17

'Am' level (50bp spread, 225bp movement)

Agency concentration (%)	Adjustment factor (from 90 days)
40-44	16
45-54	17
55-64	19
65-70	20

'BBBm' level (25bp spread, 200bp movement)

Agency concentration (%)	Adjustment factor (from 90 days)
40-44	4
45-54	5
55-64	6
65-70	7

be able to present an analytical basis for determining that such notes have a reasonable likelihood of maintaining, or repricing to, amortized cost value at each reset until maturity. This analytical basis should include a review of historical index behavior and sensitivity analysis.

Standard & Poor's criteria for FRNs and VRNs in rated money market funds calls for written guidelines and procedures that ensure:

- No purchase of range notes, dual index notes, "deleveraged" notes (notes linked to a multiple of the index where the multiple is less than one), or notes linked to lagging indices [e.g., Cost of Funds Index (COFI)] or to long-term indices (e.g., five-year or 10-year Treasuries).
- No purchase of VRNs with coupons tied to indices, index formulas, or index spreads with less than 95% correlation with the U.S. Federal Funds Rate. Indices with historically high correlations are: Three-Month Treasury Bill, Three-Month LIBOR, Six-Month LIBOR, Prime Rate, and Commercial Paper Composite.
- At the 'AAAm' level, the final maturity for all FRNs/VRNs will not exceed two years.
- At the 'AAm' level, the final maturity for all FRNs/VRNs will not exceed three years.
- At the 'Am' level, the final maturity for all FRNs/VRNs will not exceed four years.
- At the 'BBBm' level the final maturity for all FRNs/VRNs will not exceed five years.
- Where valuation is not based on actual dealer bids, there must be clear notification and disclosure of any other valuation methodology (e.g., matrix pricing). Pricing policies should include techniques to verify and validate FRN/VRN pricing on a recurring basis.
- Weekly reporting of FRN/VRN holdings to Standard & Poor's should include current market price, CUSIP, coupon or interest rate terms, frequency of reset, market value, put features, and any other significant terms and conditions.

Index and Spread Risk

Variable rate notes (VRN) and floating rate notes (FRNs) present unique market price risks. VRNs and FRNs used in money market funds are typically linked to conventional money market indices, providing funds with yields that track short-term interest rate movements. These investments are designed to exhibit less interest rate risk when compared with fixed-rate investments. However, this is not always the case for all VRNs and FRNs. Factors affecting the value of these instruments include index risk and spread risk.

Index risk is the possibility that the coupon of a VRN or FRN will not adjust in tandem with money market rates. Index risk can be introduced by calculating the variable-rate coupon based on a non-money market index, a money market index in which the coupon adjusts based on a multiple (or fraction) of the index, or an index based on the difference (or spread) between two or more indices.

When analyzing VRNs and FRNs in money market funds, Standard & Poor's compares the index used in the variable-rate adjustment formula to a standard money market index, such as the Federal Funds Rate. Standard & Poor's believes that for all money funds rated 'BBBm' and above, the index should have a correlation of at least 95% of the effective Federal Funds Rate. By this measure, non-traditional money market fund indices such as the 11th District Cost of Funds Index (COFI) and the 2-Year Constant Maturity Treasury Index are clearly unsuitable, with historical correlations of well below 90% *(see sidebar Correlations of Various Indices)*.

Some VRNs and FRNs may use indices that are highly correlated to traditional money market indices. Yet, because of their rate adjustment formulas, they can still introduce significant price risk. One example is an adjustment formula tied to a multiple or fraction of a money market index. For this reason, stress testing is important. Although there are a variety of valid techniques to model potential performance of these securities under adverse market environments, one straightforward approach is to look at VRN/FRN performance under significant interest rate movements. If a VRN/FRN can withstand a 3% (300bp) move in rates without causing its value to deviate significantly, the VRN/FRN should behave adequately under most interest rate environments. In order to "pass" the 3% stress test, the yield on the VRN/FRN would need to increase by a comparable amount.

The ultimate maturities of VRNs/FRNs are also risk factors. The concern here is not index risk, but the spread risk associated with longer-dated securities. For example, a government agency may issue five-year adjustable-rate notes that reset weekly at the Three-Month Treasury Bill

Correlation of Various Indices
(Monthly data from 10/1/92 to 9/30/02)

Index	Correlation to Fed Funds
Fed Funds	[illegible]
[illegible]	[illegible]
[illegible]	[illegible]
PRIME	[illegible]
30 day Commercial Paper	[illegible]
6 month LIBOR	[illegible]
60 day Commercial Paper	97.12%
90 day Commercial Paper	96.55%
3 month T-Bill	96.28%
6 month T-Bill	92.01%
COFI	90.97%
1 year CMT	90.46%
1 year T-Bill	88.18%
2 year CMT	82.47%

Source: Federal Reserve Bank
LIBOR—London Interbank Offered Rate
CMT—Constant Maturity Treasury
COFI—Cost of Funds Index

Rate plus 25bps. Over a period of time, these securities may be perceived by the market as warranting a higher spread to the Three-Month Treasury because of liquidity, credit, supply and demand, political events, or volatility in market interest rates. Investors may demand that subsequent comparably dated securities of that agency be sold at 50bp above the Three-Month Treasury Bill Rate. This creates a negative drag of 25bp, potentially for the remaining life of the original security, and could materially affect its market value. This may occur even though the maturities of these VRNs can be calculated at seven days (time to next reset) for regulatory purposes, and their coupons are tied to a highly correlated index.

Because of the potential impacts of spread risk on the market prices of VRNs and FRNs, Standard & Poor's expects rated funds to limit the remaining maturity of U.S. government VRNs/FRNs to two years for 'AAAm', three years for 'AAm', four years for 'Am', and five years for 'BBBm'. Corporate and structured (e.g., asset backed securities or ABS) VRNs/FRNs have the added risk of credit deterioration and should be limited to final maturities of 13 months or less for money market funds registered under rule 2a-7 of the Investment Company Act of 1940. The percentage of VRNs/FRNs in a fund also enters into the rating analysis to determine a fund's overall risk profile. For example, a fund that was 50% invested in VRNs/FRNs with four-year remaining maturities would not receive an 'Am' rating due to spread risk concerns. Percentages of VRNs/FRNs in each fund are analyzed on a case-by-case basis in conjunction with the fund's other holdings.

Standard & Poor's final maturity guidelines for non U.S. registered funds and non-U.S. domiciled funds limits the remaining maturity of VRNs/FRNs of sovereign Issuers rated 'AAA' by Standard & Poor's to two years for 'AAAm', three years for 'AAm', four years for 'Am', and five years for 'BBBm'. On a case-by-case basis, consideration will be given to requests from rated funds to approve holdings of FRNs/VRNs for Issuers other than 'AAA'-rated sovereigns (i.e., corporates and ABS) with time to final maturity greater than 397 days but no more than two years. Before granting approval to extend the maturity range of VRN/FRN holdings, Standard & Poor's will seek assurance that ample liquidity can be maintained by virtue of the fund's size, diversified shareholder base and range of other assets and that adequate resources are available to analyze and manage credit risk. If such practice is approved, all such FRNs/VRNs must be rated 'A-1+' or equivalent and the total holdings of all such FRNs/VRNs will be limited to no more than 10% of net assets of the fund *(see page 28 for more information on this topic).*

Shareholder Characteristics

A money market fund's market price exposure is also affected by the flow of money into and out of the fund. Unexpected redemptions can have a direct influence on a fund's net asset value (NAV). Therefore, Standard & Poor's carefully reviews the characteristics of each fund's shareholder base to determine the potential impact that significant redemptions might pose on a fund's market price exposure. Money market funds are permitted to issue and redeem shares at $1.00, provided that their market value is between $0.995 and $1.005. As funds can pay out $1.00 on shares that may actually be worth as little as $0.995, the remaining shareholders in the fund absorb the difference. This is referred to as dilution, as redeeming shares at a price above their actual market value is diluting the value of the fund's holdings.

Dilution can accelerate fund losses in a rising interest rate environment, causing a fund to break the dollar. In the below example Impact of Dilution, a 150bp rise in interest rates causes a 90-day weighted average maturity (WAM) portfolio's market value to drop to $0.9963 per share. A subsequent 25% redemption (paid out at $1.00 per share) dilutes the portfolio's value to $0.9947, thus breaking the dollar. This occurs because although the

Impact of Dilution

ASSUMPTIONS	
Portfolio asset value:	$100 million
Weighted average maturity (WAM):	90 days
Number of shares:	100 million
Share value:	$1.00
Share price:	$1.00
EVENT 1	
Interest rates rise 150bp (1.50%)	
Result	
Number of shares:	100,000,000
Portfolio value drops to:	$99,630,000
Unrealized loss:	$370,000 ($100,000,000 - $99,630,000)
Share value:	$0.9963 ($99,630,000/100,000,000 shares)
Share price:	$1.00 per share
EVENT 2	
In conjunction with Event 1, fund experiences 25% redemption	
Result	
Number of shares:	75,000,000
Portfolio value drops to:	$74,630,000 ($99,630,000 - $25,000,000)
Unrealized loss:	$370,000
Share value:	$0.9947 ($74,630,000/75,000,000 shares)
Share price:	$0.99 per share

unrealized loss in the fund remains the same, the loss is spread over a smaller number of shares. While sudden 150bp rises in interest rates are rare, several large redemptions during a period of steadily rising interest rates can produce similar results.

Dilution concerns are heightened for funds with sophisticated institutional shareholders. These investors realize that a fixed $1.00 NAV is an illusion based on convenient valuation methods and can easily take advantage of this phenomenon. For example, if an investor held $1 million in 90-day U.S. Treasury bills yielding 5%, and if interest rates increased 150 basis points, the value of the investment would drop by approximately $3,700 and the investor's yield would remain at 5%. Instead, assume that the investor held one million shares of a money market fund holding exclusively Treasury bills with a WAM of 90 days and yielding 5% (setting aside fund expenses for this example). If interest rates rose 150bp, the investor could sell the fund investment for $1.00 per share and not experience any loss. The investor could then purchase 90-day Treasury bills yielding 6.5%, instantaneously increasing its return by 1.5%. If this type of market-sophisticated shareholder represents a material percentage of a fund's assets, substantial dilution in share price is likely due to large and sudden redemptions.

In analyzing money market funds, Standard & Poor's review of shareholder constituency encompasses the number, average holding size, type, the size of the largest accounts, historical asset volatility, and the relationship fund management has with it largest investors. The proportion of retail versus institutional investors and the past history of redemptions are also examined. Funds with histories of volatile subscription and redemption patterns are expected to maintain shorter weighted average portfolio maturities.

Standard & Poor's expects that a fund's investments should be tailored to its potential cash flow needs. For funds with a volatile or potentially volatile shareholder base, a more conservative approach must be taken with regard to WAM and liquidity. Funds with more stable or predictable cash flows, such as retail funds or institutional funds with large, diverse shareholder compositions, can be somewhat more aggressive. Standard & Poor's uses a matrix that stress tests portfolios based on the effect of interest rate movements and redemptions at a variety of WAM levels *[see Multifactor Net Asset Value (NAV) Sensitivity Analysis, below and Standard & Poor's Sensitivity Matrix, page 13]*.

Portfolio structure is also a factor in determining the risk dilution presents to a fund. Funds with a barbelled maturity structure (heavily weighted in short-term maturities with the remainder in longer-term securities) are more susceptible to the negative effects of shareholder redemptions than laddered portfolios (relatively evenly spaced maturities). If a barbelled fund experiences redemptions in a rising interest rate environment, the short end of the fund will likely be liquidated in order to avoid taking significant realized losses.

Multifactor Net Asset Value (NAV) Sensitivity Analysis

Standard & Poor's criteria for rating money market funds incorporate analysis of both interest rate sensitivity and redemption/subscription volatility. Standard & Poor's has established maximum weighted average maturity (WAM) guidelines, which, under most market conditions, protect against significant market price fluctuation. When WAM values are analyzed in lockstep with redemption/subscription assumptions, net asset value (NAV) volatility is exacerbated. NAV is sensitive to interest rate shifts, net redemptions, and the combined effects of sudden interest rate shifts and instantaneous net redemptions (see Standard & Poor's Sensitivity Matrix). The end column of Standard & Poor's Sensitivity Matrix shows NAV change due to interest rate increases with no redemptions. The critical assumption needed to compute the values for this column is that WAM represents, to some extent, duration of the portfolio. This assumption having been made, an example using a hypothetical money market fund will be used to illustrate the methodology behind the sensitivity analysis.

Assume the hypothetical money market fund has an NAV of $1.00 and a WAM of 60 days when the market experiences a 250bp interest rate increase.

Formula 1

$$\text{New NAV} = \text{NAV} - (\text{WAM}/365) \times (\text{bp shift}/10{,}000)$$
$$0.99589 = 1.00000 - (60/365) \times (250/10{,}000)$$

The next consideration in the model is dilution. Dilution occurs when shareholders are paid out $1.00 per share while the fund's NAV is less than $1.00. To complete the example, assume the hypothetical money market fund now suffers the effect of dilution due to a 20% redemption when the NAV is 0.99589. The following formula would be used:

Formula 2

$$\text{New NAV} = [(\text{NAV} - \%\ \text{Change})/(1 - \%\ \text{Change})]$$
$$0.99486 = [(0.99589 - 0.20)/(1 - 0.20)]$$

Thus, the NAV of a model fund that experiences a 250bp interest rate shift and a subsequent redemption of 20% would fall to 0.99486. The results of several different scenarios assuming different interest rate increases and redemptions are detailed in Standard & Poor's Sensitivity Matrix.

This will cause the WAM of the fund to extend, creating greater interest rate sensitivity and exacerbating the negative effects of future redemptions. Laddered portfolios are less exposed in these circumstances, although they are by no means insulated from rising interest rates and redemptions. As part of the rating process, Standard & Poor's considers whether each fund's portfolio structure is best suited to its shareholder base and potential asset outflows.

Pricing
Standard & Poor's expects that all money market fund investment advisers have the ability to price (mark to market) portfolio securities and calculate net asset value (NAV) in-house. Additionally, Standard & Poor's asks rated funds to price securities at least weekly. In many cases, investment advisers rely exclusively on fund administrators to perform such functions. While fund administrators have proven apable providers of such services and provide independent prices, Standard & Poor's believes that all investment advisers should have some built-in redundancies to check the administrators' work, questioning any discrepancies that may oĉcur. For securities that are difficult to price, such as structured notes or other less liquid instruments, two or more dealer bids are suggested.

A Standard & Poor's money market fund rating directly addresses the ability of a fund to maintain a NAV that does not deviate by more than one-half of 1%. For a fund to effectively stay within this narrow range, accurate pricing of its securities is essential. Most money market fund instruments are highly liquid and easy to price. However, some complex, structured, and derivative securities present pricing difficulties.

Standard & Poor's Sensitivity Matrix

Assumptions: WAM = [illegible] days					
Starting Market Value = [illegible] per share					
BP increase					
300	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
250	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
200	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
150	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
100	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
50	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Redemption	30%	20%	10%	5%	0%
Assumptions: WAM = [illegible] days					
Starting Market Value = $1.00 per share					
BP increase					
300	0.9930	0.9938	0.9945	[illegible]	[illegible]
250	0.9941	0.9949	0.9954	0.9957	0.9959
200	0.9953	0.9959	0.9963	0.9965	0.9967
150	0.9965	0.9969	0.9973	[illegible]	0.9975
100	0.9977	0.9979	0.9982	0.9983	0.9984
50	0.9988	0.9990	0.9991	0.9991	0.9992
Redemption	30%	20%	10%	5%	0%
Assumptions: WAM = 90 days					
Starting Market Value = $1.00 per share					
BP increase					
300	0.9894	0.9908	0.9918	0.9922	0.9926
250	0.9911	0.9923	0.9932	0.9935	0.9938
200	0.9929	0.9938	0.9945	0.9948	0.9951
150	0.9944	0.9954	0.9959	0.9961	0.9963
100	0.9964	0.9969	0.9973	0.9974	0.9975
50	0.9982	0.9985	0.9986	0.9987	0.9988
Redemption	30%	20%	10%	5%	0%

Complex and derivative securities often lack efficient, liquid markets. Trading in these securities can be infrequent, creating varying price quotes among dealers and wide bid/ask spreads. The prices of these types of securities may be determined in a variety of ways, including dealer quotes, matrix pricing formulas, spreads to benchmark securities, pricing services, or even by the fund advisers themselves. All of these methods have drawbacks. Dealer quotes on thinly (infrequently) traded securities often represent indicative pricing levels and rarely constitutes an actual bid to purchase the security. Matrix prices, pricing service quotes, and spread calculations are not based on actual trades, and do not represent a price at which anyone actually offered to purchase the security. These methods calculate a hypothetical price that is not verifiable. Pricing by fund managers often occurs when the manager either disagrees with the other pricing methods or holds securities so unique that other pricing methods are inadequate. Clearly, even if the fund manager can determine fair value prices based on in-depth analytics, it is far from certain that any buyers are willing to purchase the securities at or near those prices.

Before purchasing complex, derivative, or less-liquid securities, portfolio managers should carefully examine the pricing issue. It is necessary to evaluate the number of available pricing sources, with an eye toward identifying material discrepancies. Portfolio managers should also be aware of pricing methodology, and compare the results to recent trading activity. It is inadvisable for a fund's manager to solely accept the calculations of a security's Issuer or dealer in determining the value of an investment. This information may be either highly biased or based on inaccurate assumptions, or both. Portfolio managers should not only be able to determine their own fair value for securities that are difficult to price, but also need to consider the marketplace for each security and the potential volatility that can be caused by inefficient market pricing. If a fund adviser lacks the ability to assess the potential market behavior of a security with a high degree of comfort, the security should not be purchased for that money market fund.

Should a fund experience a situation where stability of its $1.00 NAV is in jeopardy, there are several actions the fund may take. These include

- withholding dividends,
- selling securities to realize gains or losses,
- valuing the shares at the market rather than at amortized cost, or
- waiting out the situation to determine if the problem is only temporary.

In the rating process, Standard & Poor's reviews the formal and informal policies and procedures the fund has in place to monitor and correct such situations.

MANAGEMENT

Essential to any analysis of managed portfolios is an understanding of the strengths and weaknesses of management. The process by which money market funds are rated includes meetings with fund officials to discuss fund investment objectives, portfolio management techniques, and risk aversion strategies. Standard & Poor's evaluates the effectiveness of fund management in implementing a dynamic investment process consistent with the fund's stated goals and objectives.

Standard & Poor's believes that these meetings are central to a meaningful fund rating service. Management assessment considers the following:

- Experience and track record in portfolio management
- Operating policies and risk preferences
- Credibility and commitment to policies
- Extent and thoroughness of internal controls and commitment to oversight

Standard & Poor's judges each fund management team on its own merits. Focus is placed on the way the fund is managed in relation to its shareholder base and stated investment objectives. Standard & Poor's closely examines how daily operations of the fund are conducted. This examination includes organizational structures, depth of staff, and adequacy and level of investment controls.

Experience

All too often, investment advisers will assign their least-experienced portfolio managers to run their money market funds. The theory is that securities with short maturities are less risky and require minimal investment expertise. This is a mistake. The subtleties of managing a fund that has a 0.5% margin for error require skilled professionals.

An experienced fund manager with a proven track record in money market funds greatly enhances a fund's safety. This manager does not necessarily have to make every investment decision, but should be closely involved with the fund. It is acceptable for less senior personnel to execute trades and make certain investment decisions within strict parameters. However, an experienced money market fund manager should be monitoring these activities daily.

It is also necessary to distinguish between an experienced money market fund manager and someone who has experience managing long-term investments. Managing a stable net asset value (NAV) fund is very different from managing a bond fund with a variable share price. Investment policies and strategies that may be very prudent for bond funds can be disastrous for money market funds. The precision necessary in running a money market fund successfully takes a different mindset than is required in managing other fixed-income vehicles. An experienced fixed-income manager does not necessarily equate to an effective money market fund manager. Therefore, Standard & Poor's emphasizes the level of experience in managing money market funds in its review of fund management. Lack of experience can result in a lower rating, more stringent rating criteria [such as shorter weighted average maturity (WAM)], or both.

Operating Procedures and Risk Preferences

The processes involved in managing a money market fund directly affect its safety. Standard & Poor's evaluates the fund manager's operating procedures in conjunction with each rating. A key component of this review is the investment decision-making process. Numerous investment decisions are made daily for all money market funds. Standard & Poor's examines how these decisions are made and who is charged with executing them.

Fund advisers that conduct frequent investment committee meetings to arrive at both short-term and intermediate-term investment strategies are viewed more favorably than those who leave investment strategy decisions strictly up to the fund manager. This helps prevent any one individual from having an inordinate amount of influence on the strategy of a fund. The role of an investment committee should be to set investment guidelines and strategies. The portfolio managers then have the job of executing these strategies using their expertise in managing money market funds.

Standard & Poor's also focuses on the amount, type, and quality of information used in making policy and investment decisions. This includes the size and capabilities of the credit and risk research staff, the access to current economic data and analysis, and the types of on-line business information services used.

All fund prospectuses contain investment policies that fund advisers must follow. These policies tend to be quite general, typically mimicking regulation and thereby giving fund managers considerable investment leeway. It is prudent for fund advisers to establish written internal procedures to better define both the fund's investment guidelines and the manager's operating policies.

Credit quality is one area that should be documented with formal written procedures. A fund adviser should establish an approved investment list as well as policies for adding or removing names from that list. Additionally, a process and methodology for periodically evaluating the credit quality of all approved investments should be established. The use of an internal credit rating scale is beneficial. Such a scale sets a standard of comparison that can be widely recognized, especially when evaluating securities for which Nationally Recognized Statistical Rating Organizations (NRSROs) have differing views. They also provide evidence that independent analysis has been done, particularly if a credit committee must approve the internal ratings.

The investment management arm of a bank or broker/dealer often obtains its credit research from somewhere else in the organization, such as a central credit research department. In these situations, it is essential that the investment adviser have immediate access to all changes in credit standing. Standard & Poor's has seen organizations in which credit information was distributed firm wide on a quarterly or semiannual basis. This is inadequate. Ideally, a representative from the investment adviser should attend credit committee meetings to ensure a good flow of market information.

Funds also benefit from having clear and explicit investment policies regarding the use of variable-rate notes, structured notes, and derivative instruments. Fund investment policies should incorporate procedures on the approval, risk measurement, control, and limits related to these investments. Fund managers should be able to present an analytical basis for determining that such securities are eligible fund investments and have a reasonable likelihood of remaining at or repricing to their amortized cost value at each reset until maturity. This analytical basis should include a review of historical index behavior and sensitivity analysis.

The ultimate policy responsibility for any mutual fund lies with its board of directors or trustees. The board is elected by fund shareholders to oversee their investments and management. Boards entrust investment advisers to handle the funds' day-to-day affairs, but should not rely on the advisers to always act in the best interest of the shareholders. Investment advisory contracts are based on a percentage of fund assets. Therefore, it is beneficial for advisers to attract money into their funds. Historically, high returns have been a way to attract these assets. Higher returns are also associated with greater risks. Boards must establish investment policies that are strict enough to prevent fund advisers from taking risks that are not in the best interest of the shareholders. They must also establish stringent procedures for reviewing and enforcing these policies.

Board members are not necessarily investment professionals and may lack expertise in money market fund management. Still, a board should act as an independent body and demand that advisers be able to clearly explain all investments and investment strategies. Standard & Poor's feels that boards should receive detailed reports regarding fund investments and activities at least monthly. Boards should be active, questioning fund advisers at any time during the year, not just at quarterly meetings. Too often, boards are passive or lack the necessary independence, which could lead to rubber-stamp approval of investment adviser activities. Such boards are not fulfilling their responsibility to fund shareholders.

Investing, by definition, is risk taking. Investment advisers are paid to take risks commensurate with the desires of fund shareholders. There is no way to eliminate risk in money market funds and still provide adequate returns on investment. Even the most conservatively managed fund can be in jeopardy of breaking the dollar if there are sufficiently adverse market conditions. Fund managers differ in their risk preferences, as they should. Managers who say they are "market-neutral", or who have no opinion on future interest rate movements, are either not telling the whole truth or deceiving themselves and their investors. Conservative and aggressive investment strategies can be effective, provided that the proper operating procedures are in place to ensure that these strategies are consistent with prudently established guidelines.

Internal Controls

Money market funds universally have the investment objective of maintaining a constant net asset value (NAV) per share. Because of the small margin for error allowable to achieve this goal, Standard & Poor's closely considers the internal controls of fund advisers. Included here are pricing policies, NAV deviation procedures, depth of staff, stress testing capabilities, asset flow monitoring, trade ticket verification, systems backups, level of oversight, and disaster recovery.

Accurate pricing is a key factor in maintaining a stable NAV. Standard & Poor's expects all investment advisers to be capable to accurately price portfolio securities and calculate a fund's actual NAV in-house, and to do so periodically. Advisers are expected to compare the market value of the fund to its amortized cost value on a weekly basis. In many cases, investment advisers rely exclusively on fund administrators or outside pricing services to perform this function. While these outside providers are typically reliable sources, mistakes do occur, especially for securities that are difficult to price. Outside providers did a poor job in pricing structured notes in early 1994. All investment advisers should have some built-in redundancies to check the work of the outside providers and question any discrepancies that may occur.

Not only do investment advisers need to be able to calculate NAV, but they also need to have explicit written plans for dealing with any material deviation. NAV deviation procedures are the responsibility of the investment adviser and the fund's board. Regulation dictates that action must be contemplated if a fund's NAV deviates by more than 0.5% from $1.00. Standard & Poor's money market fund ratings specifically address the likelihood of this deviation occurring. Therefore, Standard & Poor's expects rated funds to have written policies that initiate action long before that point. At minimum, these policies should dictate action at a 0.25% deviation. Required actions should include a meeting among senior fund officials, notification of board members, and establishment of a formal action plan. All portfolio managers should be completely familiar with these NAV deviation procedures, and not rely on a third-party administrator for implementation. Since it is in the best interest of the advisor to be proactive in dealing with NAV deviations, Standard & Poor's requests daily portfolio pricing (marked-to-market) and NAV calculations when deviations reach the following for each specific rating category:

- 'AAAm' 0.15%(.9985/1.0015)
- 'AAm' 0.20%(.9980/1.0020)
- 'Am' 0.25%(.9975/1.0025)
- 'BBBm' 0.30%(.9970/1.0030)

It is also important that the controls of a fund do not suffer when the primary portfolio manager is not managing the fund, as substitute managers may not have the investment experience of the primary manager. However, it is inexcusable to lack the necessary controls to prevent mistakes from occurring when the primary manager is not available. Each member of the investment adviser's staff with the authority to manage the fund on a temporary basis should be adequately trained in the investment policies and guidelines for those funds. Additionally, a set of procedures should be in place to automatically review the work of a substitute portfolio manager each day that the substitute manager is overseeing the fund(s).

Fund managers should also be reasonably prepared for the unexpected. This entails the ability to perform "what if" and stress test analyses. A fund manager should be able to calculate the impact of any security purchase on the fund's weighted average maturity (WAM). This calculation should factor in the influence of sudden or unexpected redemptions in conjunction with the security purchase.

Additionally, fund managers should have the ability to stress test both individual securities and entire portfolios. Individual security tests should estimate price sensitivity under severe interest rate movements. Portfolio testing should stress the fund's assets in aggregate under the same interest rate scenarios, but should also measure the impact of dilution on NAV assuming sizable redemption activity. The magnitude of the potential redemption activity should take into account historical redemptions and the nature of the shareholder base. Funds with interest rate-sensitive institutional investors need to stress test redemptions at much higher levels than funds with typically more stable retail investors.

Redemption volatility adds to the difficulty of managing a money market fund. The feature of immediate liquidity is a key element in the growth and popularity of money market funds. Investors like the idea of having quick access to their money. Yet, the uncertainty created by instant liquidity can make it difficult to employ a consistent investment strategy. Funds with very volatile shareholder accounts are subject to the greatest risk. It is nearly impossible to accurately predict cash inflows and outflows, but fund managers can take steps to prepare for them.

Frequent communication with a fund's largest shareholders is an important way to get indications of redemptions. It is also a way to stay informed of how long large deposits are expected to stay in the fund so managers can invest appropriately. Some funds have policies that encourage prior notification of large withdrawals. Other funds will refuse "hot money", which is money from investors who are very interest rate sensitive. Hot money tends to leave a fund quickly in rising interest rate environments, causing dilution to NAV and potentially harming the remaining shareholders. Fund managers should be very familiar with the redemption patterns of their largest investors. This facilitates the management of cash flow volatility, thus enhancing fund safety.

Proper controls also entail trade ticket verification. All trade tickets should require two signatures, one belonging to the individual executing the trade and the other to a portfolio manager or senior level member of the investment advisory staff. Additionally, it is beneficial to have a computer system that is tailored to the investment parameters of each fund. In such a portfolio management system, unauthorized investments would be kicked out, immediately alerting portfolio managers to the mistake. These systems can also do the same for purchases that cause a fund's WAM to exceed established limits.

Computer systems are vital to managing mutual funds. Standard & Poor's review of a fund's controls examines backup computer capabilities. System failure cannot shut down a mutual fund, even for a short amount of time, as shareholders expect access to their money. All computer processes for a fund should be replicated on another system, usually with a custodian or administrator. Fund advisers should back up data nightly to an offsite location. It is also important to have detailed contingency management and disaster recovery plans that are tested periodically. Earthquakes in Los Angeles and San Francisco, floods in Houston and tropical storms hitting New Jersey are just a few past examples of situations in which emergency action plans had to be executed.

SEC POST-EXAMINATION LETTERS

All rated funds that are registered under Rule 2a-7 of the Investment Company Act of 1940 must submit a copy of the latest SEC post-examination letter and the investment adviser's response to Standard & Poor's. If no letter has been received, fund counsel must represent that no letter was in fact received from the SEC. As part of its monitoring of money fund ratings, Standard & Poor's requests such information annually. SEC letters are requested even if the letter addresses other money funds managed by the same adviser and not the rated fund specifically. Standard & Poor's rates money market fund based on representations from fund advisers and does not perform an audit. Where an audit is performed, as in the case of the SEC examination, Standard & Poor's believes that the outcome of the audit can provide important insights into the daily operations of the adviser, which may ultimately affect fund safety.

TAX-EXEMPT MONEY MARKET FUNDS

Standard & Poor's also analyzes tax-exempt money market funds that invest primarily in short-term municipal securities. In assigning ratings to tax-exempt money market funds, Standard & Poor's analytical scope factors in all Nationally Recognized Statistical Rating Organization (NRSRO) ratings assigned to individual securities. This policy allows Standard & Poor's to take a broad-based portfolio approach in analyzing all tax-exempt funds.

In order to rate tax-exempt money market funds that hold securities that Standard & Poor's has not rated, Standard & Poor's must be able to assess the funds' credit evaluation methods. Therefore, in conjunction with all ratings assigned to tax-exempt funds, Standard & Poor's conducts a detailed review of each fund's credit analysis approach. This entails a meeting with each fund's credit research staff to examine their analytical practices, procedures, and methodologies.

The examination covers

- security evaluation,
- market analysis,
- security selection,
- asset dispersion,
- diversification,
- pricing,
- ongoing monitoring of credits,
- sources of secondary market information,
- response to distressed credit situations,
- resource dedication, and
- staff qualifications.

Discussions focus on the use of NRSRO ratings, any internal rating systems, and the process in which each fund's approved list of securities is presented to and reviewed by the fund's board of directors.

Standard & Poor's has specific criteria for assessing securities rated by other NRSROs. Standard & Poor's may discount ratings by other NRSROs based on where each security would likely be classified under Standard & Poor's rating scale. In most cases, such a discount would involve a drop by no more than one rating category. However, in some sectors where Standard & Poor's believes other NRSROs diverge significantly from Standard & Poor's rating approach, discounts may be more than one category. Additionally, unrated securities are assessed on a case-by-case basis.

Generally, Standard & Poor's will classify securities as lesser quality if:

- The security is within a sector or category of municipal securities where there tends to be material differences in the ratings assigned to like securities by the various NRSROs.

Or

- The security is within a sector or category of municipal securities in which the NRSRO(s) rating the security has limited market presence.

Standard & Poor's ratings guidelines state that for a tax-exempt fund to be rated by in the highest categories by Standard & Poor's, all securities held by the fund should be rated either 'SP-1+' or 'A-1+' or 'SP-1' or 'A-1'. The proportions for each rating depend on the fund's rating category (see Money Market Fund Rating Definitions and Criteria Summary, page 3). In considering other rating scales, Standard & Poor's makes the following distinctions:

- Securities not rated by Standard & Poor's that have been assigned the highest short-term rating by another NRSRO and have a long-term rating comparable to Standard & Poor's 'AAA' are considered Standard & Poor's 'A-1+' equivalent for money market fund rating purposes only.
- Securities not rated by Standard & Poor's that have been assigned the highest short-term rating by another NRSRO and have a long-term rating comparable to Standard & Poor's 'AA' are considered Standard & Poor's 'A-1' equivalent for money market fund rating purposes only.
- Securities not rated by Standard & Poor's that have been assigned the highest short-term rating by another NRSRO and possess credit support from an entity rated 'A-1+' by Standard & Poor's are considered Standard & Poor's 'A-1+' equivalent for money market fund rating purposes only.
- Securities not rated by Standard & Poor's that have been assigned the highest short-term rating by another NRSRO and possess credit support from an entity rated 'A-1' by Standard & Poor's are considered Standard & Poor's 'A-1' equivalent for money market fund rating purposes only.
- General obligation debt not rated by Standard & Poor's issued by a municipality that has an 'SP-1+' or 'A-1+' short-term unsecured debt rating from Standard & Poor's is considered Standard & Poor's 'A-1+' equivalent for money market fund rating purposes only.
- General obligation debt not rated by Standard & Poor's issued by a municipality that has an 'SP-1' or 'A-1' short-term unsecured debt rating from Standard & Poor's is considered Standard & Poor's 'A-1' equivalent for money market fund rating purposes only.

These criteria serve as recommended guidelines for rating tax-exempt funds. In assigning actual ratings, Standard & Poor's bases its final analytical determination on its review of each fund's portfolio management and credit research areas.

INVESTING IN OTHER MONEY MARKET FUNDS

Standard & Poor's criteria calls for rated money market funds that invest in other money market funds (also called Registered Investment Companies or RICs) to carry an identical rating. For example, a Standard & Poor's 'AAAm' money market fund may only invest in Standard & Poor's 'AAAm' money market funds. Funds registered under Rule 2a-7 are limited to a 10% investment in other money market funds. Standard & Poor's money market fund criteria for funds that are not registered under Rule 2a-7 (e.g., off-shore funds, government investment pools) generally calls for a maximum 25% exposure to any one fund with no stated maximum exposure. However, while no maximum is stated, Standard & Poor's will inquire as to the feasibility of one rated fund investing a majority of its assets other rated funds. This includes an analysis of the rated funds position on fee rebates since investing in another money market fund will ultimately cause the shareholder to be paying fees on two funds. In addition, there are also percentage limits that the investing fund may comprise of the fund it is investing in, as it would not be prudent for the fund to invest in another rated fund if it were going to comprise a significant portion of its assets.

REPURCHASE AGREEMENTS (REPOS)

While Standard & Poor's recognizes the importance of the collateral securing these repurchase agreements (repos), our main focus with regards to the risk in these securities has always been on the creditworthiness of the counterparty.

Generally speaking, the underlying securities in traditional repos are typically ineligible investments for money market funds, either because of their maturity (longer than 397 days) or type (certain mortgage-backed securities). A fund that takes possession of such collateral will have to sell it as soon as possible. Any delay in a fund's ability to sell the securities could create both liquidity and market risks inappropriate for money funds.

This is especially true for non-traditional collateral, as these security types (e.g., non-investment grade corporates, equities) possess higher potential price volatility than traditional collateral *[see "Non-Traditional" Repurchase Agreement (Repo) Collateral section on page 19].*

The following bullets and table outline specific repo criteria for 'AAAm' rated money market funds:

- The aggregate amount of all repos (regardless of the rating) with maturities of more than seven calendar days may not exceed 10% of a fund's total assets.
- Overnight repos with any single 'A-1' Issuer are limited to no more than 25% of a fund's total assets.
- Repos with maturities beyond overnight and less than or equal to seven days with any single Issuer ('A-1+') are limited to no more than 25% of a fund's total assets.
- Repos with maturities beyond overnight and less than or equal to seven days with any single Issuer ('A-1') are limited to no more than 10% of a fund's total assets.

For these criteria, the maturity of a repo is defined as the absolute maturity of the agreement. If, however, the agreement contains a put that would result in a lower effective maturity for the agreement, Standard & Poor's will review the repo documentation to be certain of the unconditional nature of the put feature. Standard & Poor's has the same criteria for both tri-party and deliverable repos. However, where a tri-party repo is used, Standard & Poor's will examine the fund adviser's procedures ensuring that the proper type and amount of collateral is received.

Credit Quality	Overnight (1 day)	2 to 7 Days	>7 Days
A-1+	*	25%	10%**
A-1	25%	10%	10%**
A-2	0%	0%	0%

*While Standard & Poor's does not formally propose any diversification guidelines for overnight repo with any single 'A-1+' counterparty, we believe it is prudent for a rated money market fund to maintain a minimal amount of diversification and thus we would be concerned with a fund that was comfortable holding > 40% in an overnight repo with any single 'A-1+' Issuer/counterparty.

**Aggregate exposure to term repo greater than 7 days is limited to 10%.

Standard & Poor's repo diversification criteria for funds rated 'AAm', 'Am' and 'BBBm' is identical to the above table except for the permitted exposure to 'A-2' Issuers on an overnight or one day basis of 5% for 'AAm', 10% for 'Am' and 25% for 'BBBm'.

To ensure that repos are properly secured, Standard & Poor's looks for certain written representations from all funds investing in repos. Regarding perfection of the fund's security interest in repo collateral, Standard & Poor's seeks written representations that the fund takes delivery of the collateral in either of the following manners:

- The fund, or a third party acting solely as agent for the fund, has possession of the securities.

Or

- The securities have been legally transferred to the fund under other applicable laws, except that the fund may not enter into any hold-in-custody arrangements.

In addition, Standard & Poor's also looks for written representations that confirm the following:

- A written master repo (e.g., the Bond Market Association standard repo form) governs all repo transactions.
- The fund takes all necessary steps to acquire and maintain a first perfected security interest in any repo securities, any substituted securities, and all pro-

ceeds derived from the repo securities.

- For purposes of perfecting the fund's security interest, the counterparty owns all repo securities free of any other claims.
- The fund intends to pay the purchase price for the securities, as stated in the applicable governing agreement.
- The counterparty will not incur, or allow others to incur, any equal or prior liens on the securities.
- The fund has no knowledge of any fraud involved in any of the repo transactions it undertakes.

If the fund enters into repos with Securities Investor Protection Corp. (SIPC) and non-SIPC counterparties eligible to be debtors under the U.S. Bankruptcy Code, the fund should also provide assurance that the repos meet the Bankruptcy Code definition of a repo.

If the fund enters into repos with financial institutions subject to FIRREA, the fund must provide the following items:

- Assurance stating that the repos satisfy the definition of a repurchase agreement and "qualified financial contract" under FIRREA.
- Written representations to the effect that:
  1. All other requirements under FIRREA have been met as outlined in policy statements by the FDIC and RTC dated Dec. 12, 1989; and
  2. The fund, in accepting securities from a counterparty that is subject to FIRREA, is not in any way acting to defraud the counterparty, nor does the fund have any prior knowledge to the effect that the counterparty is insolvent, or may become insolvent, as a result of the completion of any such repo transaction.

Non-Traditional Repurchase Agreement (Repo) Collateral

U.S. government or U.S. government agency securities including Treasuries, Agency Discount Notes and Agency Mortgage Backed Securities have customarily been used to collateralize repurchase agreements (repos). Most recently, broker/dealers have pledged "non-traditional" collateral, including investment and non-investment grade corporate debt, money market securities and even shares of U.S. equities to back their repo obligations. A key reason behind this recent interest is that repos backed by "non-traditional collateral" provide a boost to money fund yields. While the growth in non-traditional collateral has been in part spurred by brokers seeking to leverage other asset types; the demand is more likely fueled by the added basis points that comes with the non-traditional collateral.

Standard & Poor's Money Market Fund Rating Criteria for repos collateralized by "non-traditional" assets addresses the credit quality and diversification guidelines that are consistent with its money market fund ratings. The guidelines for non-traditional collateral are more restrictive than traditional collateral because the non-traditional collateral may not qualify for preferential treatment under the Federal Deposit Insurance Act or the Federal Bankruptcy Code and therefore, must be treated as unsecured obligations of the Issuer (counterparty).

Standard & Poor's credit quality criteria for repo collateralized by "non-traditional" assets calls for the counterparties (e.g. broker/dealers) to either have an explicit Issuer or counterparty rating from Standard & Poor's of A-1 or A-1+, or have a letter of guaranty from an 'A-1' or 'A-1+' (Standard & Poor's rated) parent company. This differs from repo collateralized by traditional collateral, as traditional repo may be transacted with unrated broker/dealers that are 50% or more owned by a parent company that is rated 'A-1' or better by Standard & Poor's qualify for the highest three rating categories ('AAAm', 'AAm','Am').

Standard & Poor's 'diversification criteria for repos collateralized by "non-traditional" assets calls for the maximum exposure to any single counterparty (or broker/dealer) is limited to 5% of total fund assets. This differs from repo collateralized by traditional collateral, as they may comprise up to 25% per dealer depending on the credit quality of the broker/dealer.

Additionally, Standard & Poor's considers term repo agreements beyond seven days (for both traditional and non-traditional collateral) to be illiquid, and as such, should be limited to no more than 10% of total fund assets. Standard & Poor's also expects that the underlying collateral in term repo agreements to be priced daily and maintained at the required collateralization levels.

Evaluating Repurchase Agreement (Repo) Counterparties

The following criteria relates only to counterparty assessments for repurchase agreements (repos) collateralized by traditional collateral in rated money market funds and is not a comment on the unrated entity's ability to repay its unsecured debt or satisfy other contractual obligations.

Standard & Poor's recognizes that many money market funds transact repos with unrated subsidiaries of highly rated financial institutions. Standard & Poor's looks directly to the parent's short-term rating to determine the level of creditworthiness of unrated repo counterparties that are subsidiaries of rated entities. In establishing this criterion, Standard & Poor's recognizes that repos, as secured transactions, differ from unsecured obligations. Standard & Poor's reviews the legal structure of each fund's repos before assigning a rating to the fund.

Unrated entities that are at least 50% owned by rated parents are considered at the same investment level as the parent's rating. Therefore, a repo transaction with an unrated broker/dealer whose parent has an 'A-1+" rating is assessed at 'A-1+' equivalent for money market fund rating purposes only. Likewise, a repo with an entity whose parent is rated "A-'1' is viewed as an 'A-1' equivalent for money market fund rating purposes only.

For the case of rated repo counterparties that have parents with higher short-term ratings, Standard & Poor's looks to the parent's rating in assessing the proper level, provided that the subsidiary is at least 50% owned. For all other rated repo participants, the actual Standard & Poor's short-term rating applies.

FUNDING AGREEMENTS

Funding Agreements are floating-rate investment contracts issued by insurance companies for the institutional marketplace. These investment contracts are popular with some money funds due to their attractive yields and put provisions. The put provision allows the owner of a floating-rate Funding Agreement contract to receive back its investment in a specified number of days. Most money funds prefer seven-day puts although 30-, 90-, 180-day, and one-year puts are also available. Most floating-rate Funding Agreement indexes are pegged to one- or three-month LIBOR. Prime, commercial paper composite index, and one-year constant maturity treasury have also been used.

When evaluating Funding Agreements as eligible investments for rated money market funds, Standard & Poor's considers the credit quality of the Issuer (insurance company), the terms of the agreement including contract maturity, reset index rate, and frequency of rate adjustments (e.g., weekly, quarterly), and any put or demand features. In order for the Funding Agreement to be an eligible investment for Standard & Poor's rated money market funds, the insurance company issuing the investment contract must possess an 'A-1' or 'A-1+' short-term rating from Standard & Poor's. In addition, contracts issued by a non-rated subsidiary of a rated insurance company are not eligible for rated money market funds. As for the variable-rate features of the Funding Agreements, the reset rates should be tied to indices considered to be money market rates, such as LIBOR, Fed Funds, T-bill, and CP composite rates.

Standard & Poor's also considers the potential for credit and liquidity risks presented by these contracts. Given the illiquid nature of short-term Funding Agreements (i.e., no secondary market trading), contracts that include short puts and demand features (generally seven to 30 days) offer a greater level of protection against credit deterioration of the issuing company. To provide for liquidity in the event of credit action, some Funding Agreements include credit event put provisions, which provide the buyer (the fund) the ability to put back the contract to the issuing entity upon a downgrade of its rating. Standard & Poor's views this feature favorably since it enhances the fund's liquidity options.

Since Funding Agreements pay a variable rate of interest on periodic reset dates, money market funds can take advantage of the maturity shortening provision under Rule 2a-7 of the Investment Company Act of 1940 regulating money market funds. Hence, a Funding Agreement with a one-year maturity and 30-day reset dates, are treated as 30-day instruments by money market funds for purposes of calculating their average portfolio maturity. However, these securities are considered to be part of the 10% illiquid basket as per Rule 2a-7. Funding agreements that provide for seven-day or daily puts are not subject to the illiquid basket treatment.

EXTENDIBLE NOTES

Extendible notes come in many forms but can generally be classified under two broad categories based on who possesses the option to extend – the holder of the security or the Issuer of the security. When comparing the two types, Standard & Poor's looks more favorably towards those instruments where the holder of the security possesses the option because this option allows the holder to more actively manage the maturity risk associated with the Issuer. However, for extendible securities where the holder possesses the option, Standard & Poor's does not believes it is prudent for a fund to extend the maturity if the Issuer experiences any credit deterioration, including being put on CreditWatch Negative or upon a downgrade. For those securities where it is the Issuer's option to extend the maturity, the following guidelines apply.

Extendible commercial notes (ECNs) have received increasing interest from money market funds. On the surface, ECNs look very much like traditional commercial paper, but provide a twist. Highly rated corporations issue ECNs for a finite period of time, say 90 days. They differ from commercial paper in that the Issuer, at its discretion, can extend the maturity of the note to a maximum of 390 days. The Issuer has the option to call the notes at any time during the extension period. Like commercial paper, ECNs are offered at a discount rate based on the initial maturity date. If extended, the rate becomes variable based on a spread above LIBOR. The size of this spread is dictated by the short-term credit rating of the Issuer and the spread's magnitude is designed to discourage the Issuer from extending the maturity date. The benefit to the Issuer is they can issue ECNs without a back-up liquidity facility. At the initial redemption date, if the Issuer lacks the necessary funding to pay off the notes, it can simply extend the maturity until alternative funding is obtained. These differ from previously issued short-term notes in which the option to extend was controlled by the note holders.

Extension would occur when the Issuer has no other viable refinancing options, making the ECN holder the lender of last resort. This would be a precarious position for a money market fund to be in, even though it receives a premium for accepting this risk. While the premium rate may seem attractive (e.g., 110% of LIBOR for 'A-1+' credits, 115% for 'A-1' credits), money market funds could face liquidity and pricing problems. The fact that the Issuer cannot place new commercial paper into the market implies that the fund will have equal trouble finding buyers for its ECN position, rendering its holding illiquid. At this point, accurate pricing of the securities becomes complex, particularly given the Issuer's option to call the ECNs at any time. Standard & Poor's believes that prior to purchasing these securities, money market fund advisers should adopt a detailed investment policy for ECNs and be prepared to hold the securities to the extended maturity date.

Standard & Poor's money market fund criteria calls for rated money market funds to book the maturity of ECNs to the initial redemption date and count them toward their 10% less liquid basket of securities. Short-term credit ratings on ECNs are treated the same as the Issuer's commercial paper ratings (for Standard & Poor's rated money market funds, commercial paper Issuers must be rated 'A-1' or better by Standard & Poor's). While it is considered unlikely that the Issuer will extend the notes, upon extension, the rates change from fixed to variable, and money market funds should calculate maturity based on final maturity date. Although interest rates for ECNs reset periodically (typically monthly) after extension occurs, calculating days to maturity by referencing the reset date is imprudent. Money fund regulation permits funds to calculate maturity for variable-rate securities based on the reset date. This applies only when the market value of securities can be reasonably expected to approximate amortized cost at each reset until final maturity. Extension of an ECN would only occur when an Issuer experiences an adverse credit event, or if the market encountered a liquidity crunch. In either case, the ability to project the market value of the ECN is likely to be materially impaired.

INTERFUND LENDING

Standard & Poor's has formulated guidelines for interfund lending in rated money market funds. For those management companies who have received exemptive orders from the SEC to lend cash between funds (managed by the same investment adviser), Standard & Poor's believes that adherence to the following guidelines is consistent with investment practices of highly rated money market funds. Standard & Poor's looks for:

Opinion written by either in-house or external counsel for the fund evidencing that the Fund lending cash has a lien on the borrowing funds' assets that is senior to that of fund shareholders and service providers (i.e. custodians, distributors, investment advisers).

Established guidelines that specify percentages that each rated fund may lend (to each fund and in aggregate) as well as the percentages that each borrowing fund may borrow.

Additionally, rated funds should:

- Refrain from lending to funds with more than 35% emerging markets exposure
- Refrain from lending to funds that have lost greater than 25% of their assets within the past five business days (through any combination of redemptions and market depreciation)
- Rated money market funds should refrain from borrowing from other funds except to meet emergency liquidity needs (i.e., not to lever the fund or otherwise enhance yield)

As part of the weekly monitoring report, rated funds should provide details on the amount of money loaned at any time during the prior week, the name of the borrowing fund(s), the net asset size of the borrowing fund(s), and the maturity and interest rate terms of the loan(s). Additionally, Standard & Poor's requests that rated funds provide written notification of these policies prior to commencement of any such transactions.

CALLABLE AND CONVERTIBLE NOTES

Callable and convertible notes are designed to perform well in stable interest rate environments. Both callable and convertible notes can present money market funds with unique market risks including call risk, reinvestment risk, interest rate risk, and liquidity risk. Given these multiple risks factors, managers should closely evaluate the pricing and market risks presented by these securities.

Corporations and government agencies issue short-term callable debt generally with one-year final maturities and with monthly or quarterly call dates. Due to the call feature, the interest rates (yield) for these securities are generally higher than those for equivalent non-callable instruments. The added risk is 'uncertain' principal maturity. There are several ways that this risk can manifest, for example, during periods of rising interest rates, the value of these callable notes will decrease, as would a similar non-callable fixed-income security. During a period of falling rates, however, the price of callable notes will not appreciate in proportion with non-callable notes given the increased likelihood that the callable notes will be called at the next call date. Investors will be unwilling to pay any material premium in the purchase price given the call risk.

Callable note investors also face the risk of having their notes called away when rates fall. Reinvestment occurs when Issuers call the securities. Issuers are more likely to call (or retire their outstanding debt) when interest rates have dropped as this provides an opportunity to obtain cheaper financing. Investors of callable notes that are called will have to reinvest at lower rates.

Convertible notes are a variation on short-term callable notes as convertible notes while not callable can be converted from a fixed rate to a floating rate at the option of the Issuer. The holder is short the convertible feature, and thus is paid a yield premium to offset this uncertainty or risk. Like callables, convertible notes are typically issued with one-year final maturities at attractive fixed rates or with predetermined floating-rate formulas. The value of convertible notes will also fall during rising rate periods, behaving much like standard fixed rate instruments. However, when rates fall, the price appreciation of convertible notes will be limited due to the increased likelihood of conversion. The conversion risk is similar to call risk and thus has similar inherent price or market risks. The key difference is that upon conversion, the interest earned on the convertible notes is based on a predetermined formula, while the note holders control the reinvestment options for the callable notes.

Standard & Poor's believes it is prudent for fund managers to perform stress tests on these securities under various interest rate scenarios to determine the relative value of holding these securities during periods of both rising and falling rates.

Assumptions should include the magnitude of the interest rate decline required for the securities to be called or converted and the frequency of the options that may be exercised (e.g., monthly, quarterly). Managers should closely evaluate the risk and reward trade-offs presented by these securities before investing in these notes.

In holding convertible notes, a fund is taking all the risks of a fixed-rate instrument, while potentially receiving the lower returns that floating-rate instruments provide in a declining interest rate environment. To make these notes more attractive, Issuers typically set the floating rate reset formulas at spreads above an index (such as Fed Funds or LIBOR) that are higher than the market rate for variable rate securities. While such formulas may look enticing in the near term, spreads may widen over time, potentially creating a below market yield as such times as the notes are converted. In fact, the Issuers of convertible notes have an incentive to exercise the conversion option should spreads widen sufficiently, even if short-term interest rates remain stable. In essence, this gives them the opportunity to finance at below market rates. This risk does not apply to callable notes because once the security has been called, the holder is free to reinvest at current market rates, either fixed or variable.

Since callable and convertible notes are more complex than standard fixed rated securities, determining reliable prices for these is a more difficult task. Managers should price these securities to market on a regular basis with multiple broker-dealers or reliable sources to ensure accurate market values as dealer quotations are subject to a wide degree of subjectivity. Since these securities often lack an efficient and liquid secondary market, portfolio managers should be able to value these securities internally based on their own in depth analysis. Given the less liquid nature of these instruments, the securities can experience higher price volatility.

If properly analyzed and accounted for, callable and convertible notes can be appropriate investments for money market funds. For instance, when calculating the weighted average maturity (WAM), callables and convertibles must be booked to their final maturity dates. If the Issuer exercises the option on the convertible note, then the maturity can be calculated to the next reset date, assuming the price on the note can still reasonably be expected to remain at or near par on subsequent reset dates. If spreads for comparable floating rate notes have changed materially, the convertible notes should continue to be booked to their final maturity dates.

Further, Standard & Poor's believes that because of the inherent risks present in these securities, money market funds should impose limitations to their exposure to callable and convertible notes, thereby mitigating the risk of unanticipated price volatility. These limits should be based on the fund's cash flow volatility, liquidity needs, and overall market price exposure.

MASTER NOTES AND PROMISSORY NOTES

Effective March 1, 2003 Standard & Poor's money market fund rating credit quality criteria for promissory notes and master notes will call for these notes to be issued by an Issuer that has an explicit Issuer rating or a counterparty rating of 'A-1+' or 'A-1' from Standard & Poor's. Eligible master notes or promissory notes that are not issued by a rated entity may be secured by a letter of guaranty from a parent company rated 'A-1' or 'A-1+' by Standard & Poor's. Promissory notes and master notes currently held by Standard & Poor's rated money market funds that do not meet the revised criteria will be allowed to mature.

While a majority of promissory and master notes are issued by rated Issuers, some master and promissory notes are issued by unrated subsidiaries of Standard & Poor's rated entities. Prior to the revised criteria, Standard & Poor's based the creditworthiness of promissory and master notes issued by un-rated subsidiaries on the Standard & Poor's ratings of the Issuer's parent company. However, a comprehensive review of the ratings correlation between parent companies and their subsidiaries indicates that there is often a disparity in the credit ratings, or the creditworthiness, between a parent company and its subsidiaries. The disparity in the ratings between a parent company and its subsidiaries can be attributed to the subsidiaries domicile, regulatory environment, or the importance of the subsidiary to the parent company. Given

SECURITIES LENDING AND REVERSE REPURCHASE (REPO) AGREEMENTS

Reverse repurchase agreements (repos)

SECURITIES LENDING AND REVERSE REPURCHASE (REPO) AGREEMENTS

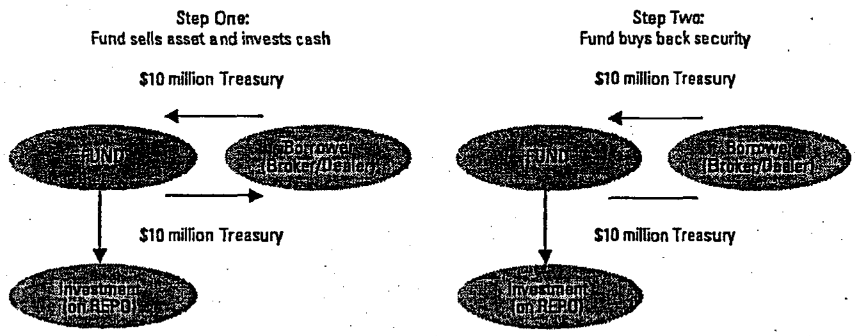
Reverse repurchase agreements (repos) and securities lending are investment strategies used by some taxable money market funds, primarily to enhance investment income. Standard & Poor's has specific criteria concerning the lending of portfolio securities by a fund to banks and broker/dealers. The criteria apply not only to direct loans of securities, but also to reverse repos. These transactions can create risks for money funds in the areas of credit and market price exposure in the form of leverage.

Reverse repos entered the spotlight in 1994 when several bond funds and Orange County California's investment pool recognized significant losses due to this leveraging technique. While reverse repo transactions are typically associated with longer-term fixed-income portfolios, money market fund advisers are increasingly making them part of their strategies.

A reverse repo is a leveraging technique in which a fund simultaneously agrees to sell and repurchase a security it owns. A reverse repo is often viewed as collateralized borrowing since a fund incurs a liability and uses the security as collateral. As an example, assume a money fund owns a $10 million Treasury note and wants to borrow funds overnight. The fund will sell the $10 million Treasury note to the counterparty for settlement today. At the same time, the fund agrees to buy back the $10 million Treasury note for settlement tomorrow, plus interest. The result is that the fund has borrowed overnight funds for one day (rate times $10 million times one day/360). During the term of the reverse repo, the fund's total assets and liabilities are increased by the amount of the reverse repo, while net assets remain the same *[see sidebar Reverse Repurchase Repo Agreement Transaction]*.

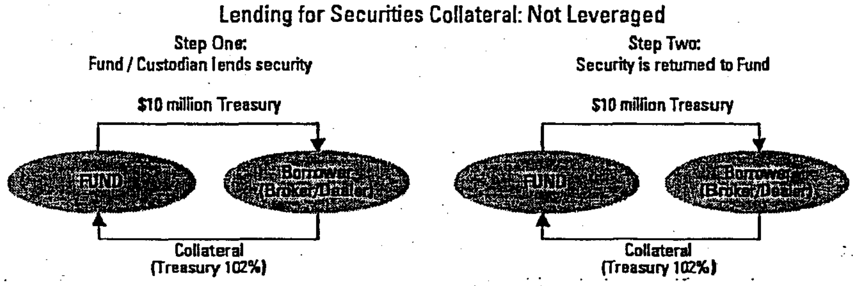
The main reason for using reverse repos is to enhance income by investing borrowed cash at a higher rate than the cost to borrow (reverse repo rate). Portfolio managers also use reverse repos to provide liquidity to funds. For example, a

Reverse Repurchase Agreement (Repo) Transaction



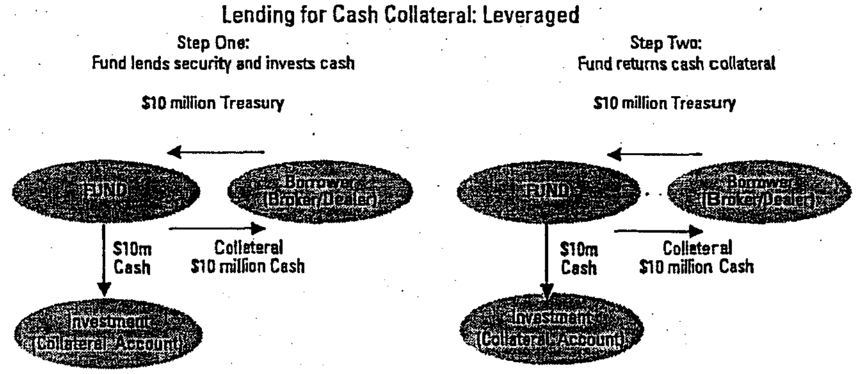
Return: Difference between income on investment and borrowing costs
Risks: COUNTERPARTY: borrower declares bankruptcy and collateral less than value of securities sold
LIQUIDITY: reversed asset tied up for term of reverse repo
OPERATIONAL: report transaction, monitor collateral, adjust WAM
SHAREHOLDER DISCLOSURE: increase in assets and liabilities

Lending for Securities Collateral: Not Leveraged



Return: Fee paid to find to borrow securities; split with custodian if custodian involved
Risks: COUNTERPARTY: borrower declares bankruptcy and collateral less than value of securities sold
LEGAL: fund not allowed to touch collateral or delays
LIQUIDITY: assets tied up for term of loan
OPERATIONAL: cost to monitor collateral
DISCLOSURE: footnote on shareholder reports

Lending for Cash Collateral: Leveraged



Return: Difference between investment income and loan expense; split with custodian if custodian involved
Risks: COUNTERPARTY: borrower declares bankruptcy and collateral less than value of securities
LEVERAGE: need to adjust WAM for leverage
LEGAL: fund not allowed to touch collateral or delays
LIQUIDITY: assets tied up for term of loan
OPERATIONAL: cost to monitor collateral, is WAM reflected correctly
DISCLOSURE: should increase assets & liabilities

portfolio manager may choose to raise cash via reverse repos to provide liquidity, rather than having to sell securities at an inopportune time.

Securities lending, an investment strategy used by money fund managers to enhance income (or to lower custody expenses), can also increase the risk level of a money fund portfolio via leverage. Some fund advisers are now using securities lending, which was once a strategy of large institutional investors. Fund custodians typically orchestrate the securities lending process, but some larger fund companies have in-house lending operations.

Traditionally, securities lending was viewed as a low-risk strategy with which a fund manager (via the custodian) could simply focus on the credit quality of the counterparty and the loan collateral. If a fund accepts securities as collateral, it encounters a different set of risks than if the fund accepts cash collateral *(see Lending for Securities Collateral: Not Leveraged, page 23)*. In the former case, the fund (usually via the custodian) lends securities for a fee to a broker/dealer (borrower) and requires securities as collateral. The dealer provides collateral, typically in the form of Treasuries, at 102% of the loaned securities' value, which is marked-to-market on a daily basis. When the loan terminates (often the next day), the broker returns the securities and the fund returns the collateral. If a custodian handles the operation, the fees are split between the fund and the custodian. The major risks are that the borrower defaults or files for bankruptcy and, at the same time, the price of the collateral drops to less than the value of the loaned securities.

Securities lending is viewed as a more aggressive strategy from an investment standpoint if cash collateral is accepted. The fund (via the custodian) lends out securities but accepts cash collateral instead of securities *(see Lending for Cash Collateral: Leveraged, page 23)*. The custodian invests the cash in securities with the aim of beating the cost of the loan and splitting the income with the fund. While the income is split between the fund and custodian, the fund bears all risks of the assets. Regardless of whether the fund or custodian invests the cash collateral, the result is that the assets of the fund are increased (a leverage impact). This type of securities lending has a similar risk profile to reverse repos.

Many banks have entered the securities lending business since the late 1980s. This has led to lower fees and, in turn, more aggressive investment policies. In November 1994, investors and custodians learned about the true risks in securities lending when The Boston Co., a unit of Mellon Bank Corp., announced a $130 million net write-off ($223 million pretax) related to securities lending losses. In The Boston Co. case, instead of accepting securities as collateral, the custodian accepted cash as collateral and was willing to take on significant investment risks. Although The Boston Co. was acting as an agent, not as a principal, it absorbed its clients' losses for business reasons.

Standard & Poor's reverse repo and securities lending criteria take into account incremental risks associated with these strategies. The criteria focus primarily on the counterparty credit quality, the term of the transaction, and the effect that leverage has on a portfolio's weighted average maturity (WAM).

As with repos, Standard & Poor's views reverse repos and securities lending transactions as posing counterparty risk, and therefore limits counterparty ratings to 'A-1+' and 'A-1' at the 'AAAm' and 'AAm' rating levels. As a general guideline, Standard & Poor's views all investments made by the fund (related to reverse repos and securities lending) as assets of the fund. In each of these cases, a modified WAM is calculated. Standard & Poor's then applies its sensitivity matrix, as is done with all rated money market funds.

Standard & Poor's also takes a conservative view when analyzing the structure and term of the overall transaction. All transactions should be "matched" on both sides. For example, cash from a reverse repo with a seven-day term should be invested in a security with a seven-day maturity. Additionally, at the 'AAAm' rating level, the transactions should not exceed 25% of net assets on maturities less than or equal to 7 days or 10% on maturities greater than 7 days, with the term of the transaction limited to 30 days or less. Since the securities that are reversed or loaned out are tied up for the term of the transaction, Standard & Poor's views these securities as illiquid for transactions beyond seven days.

Standard & Poor's is also concerned with incremental risks associated with purchasing agency variable-rate notes (VRNs) with borrowed monies (via reverse repos or securities lending). To limit the potential for mismatching maturities, Standard & Poor's feels it is inappropriate for highly rated funds to invest greater than 10% of borrowings in VRNs. For example, a $100 million portfolio that levers 25%, or $25 million of net assets, should limit VRNs to 10%, or $2.5 million, of the borrowed funds in VRNs. All VRN purchases should meet Standard & Poor's VRN guidelines for rated money market funds.

The reverse repo and securities lending criteria recognize the incremental risks associated with these strategies. The following example will assist in understanding the effects that leverage can have on a fund's WAM. Assume an unlevered fund is comprised of a 60-day Treasury security, or a bullet portfolio with a WAM of 60 days. This $100 million portfolio enters into a reverse repo, or lends 25% of its assets and invests the proceeds in an overnight deposit. While this transaction is matched, Standard & Poor's also analyzes the reported effective WAM. If the overnight repo investment is included in the portfolio, the WAM (gross) could be reported as 48 days ([80% * 60 days] + [20% * one day] = 48 days). However, because the increase in assets to $125 million has a leverage effect, the WAM has to be calculated on a net basis, which is 60 days. To properly adjust the WAM, take the unlevered portfolio WAM of 60 days and add the WAM of the borrowed assets (60 + [25% * one day]). If the fund invested in a 30-day security, the fund's effective WAM would be 68 days (60 +

Impact of Redemptions on Weighted Average Maturity (WAM) of a Levered Portfolio

Redemption (%) Gross	Effective LEV Factor	Effect on WAM Invest in Overnight REPO
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]
[illegible]	[illegible]	[illegible]

Redemption (%) Gross	Effective LEV Factor	Effect on WAM Invest in 30 day
0	1.25	68
[illegible]	1.27	70
10	1.29	73
15	1.31	76
20	1.33	80
25	1.36	82
30	1.40	84
35	1.44	87
40	1.50	90
45	1.57	94
50	1.67	100

Assumptions: (1) Unlevered weighted average maturity (WAM) portfolio is 60 days. (2) Initial portfolio was levered 25% of net assets. (3) Initial unlevered barbell portfolio is 50% 120-day Treasuries and 50% overnight repurchase agreement (repo). (4) Overnight repo is used to meet redemptions. (5) Effective leverage calculated immediately after redemption.

[25% * 30]). Further, Standard & Poor's analyzed the impact of redemptions on the levered portfolios and found the WAM differences to become even more significant. For example, the 60-day portfolio with 25% net leverage experiences a sharp rise in its effective WAM to 80 days following an immediate 20% redemption in assets *[see Impact of Redemptions on Weighted Average Maturity (WAM) of a Levered Portfolio page 25]*.

Standard & Poor's expects rated funds to provide the following information with regards to securities lending and reverse repo transactions on a weekly basis:

- Gross assets (market value basis) and net assets (market)
- Percentage of fund in reverse repo and/or securities lending transactions
- All terms of transaction (i.e., counterparty, collateral type)
- Investments from transactions included in portfolio holdings reports as fund assets
- Weighted average portfolio maturity calculation adjusted for effects of leverage

REGULATION VS. RATINGS

Rule 2a-7 of the Investment Company Act of 1940 is the primary section of regulation that governs U.S. domestic money market funds. The rule has been formally amended several times since its adoption in 1983 and there have been numerous interpretive releases and exemptive orders with regard to 2a-7 rules issued by the SEC over the past few decades. Rule 2a-7 was established to limit risks in money market funds could take to provide investors safety of principal and liquidity from money market fund investing. The rule, and prudent management, has been very effective to attaining these goals.

Standard & Poor's money market fund ratings address a money market fund's ability to provide principal safety and liquidity, but there are significant differences between the minimum standards required by Rule 2a-7 and Standard & Poor's rating criteria for the highest rating categories. In fact, a fund that met the bare minimum regulatory requirements would at best qualify for a 'BBBm' rating from Standard & Poor's. This rating could be lower depending on the fund's cash flow patterns, management experience and controls, investment parameters, and current marked-to-market net asset value (NAV).

The main areas in which Standard & Poor's approach differs from Rule 2a-7 guidelines are in the treatment of a portfolio's:

- Weighted average maturity (WAM)
- Credit quality
- Floating rate securities
- Less-liquid securities
- Repurchase agreements (repos)

In dealing with weighted average portfolio maturity, Rule 2a-7 allows for a maximum of 90 days. There is a common misconception that this is a blanket endorsement for a 90-day WAM but this is not the case. The rule states that a fund's WAM should be at an appropriate level to maintain a stable NAV, but in no case exceed 90 days. It implies that funds with volatile or less liquid assets or interest rate-sensitive shareholders should seek lower WAM levels.

The highest rating that a money market fund that allows for a 90-day WAM can get from Standard & Poor's is 'Am'. Analysis shows that a fund with a 90-day WAM will likely break the dollar as a result of an interest rate rise of 205 basis points, without taking into account subscription or redemption activity. Higher rating categories require lower WAMs, with 'AAAm' fund guidelines set at a maximum of 60 days; however, this can be set lower depending on the types of assets held and shareholder characteristics.

Rule 2a-7 delineates minimum credit

quality standards for money market funds. A taxable money market fund must have at least 95% of its assets invested in first-tier securities. A first-tier security is defined as being in the highest rating category of at least two nationally recognized statistical rating organizations (NRSROs) or deemed equivalent by the fund's adviser. The remaining 5% may be in second-tier securities (rated in the second-highest rating category by two NRSROs or deemed equivalent by the fund's adviser). First-tier securities have a 5% Issuer diversification limit (excluding government securities). Issuer concentrations are limited to 1% for second-tier securities. Certain exceptions are made for tax-exempt money market funds.

Standard & Poor's criteria for 'BBBm' ratings closely mirror Rule 2a-7 minimum standards. Higher rating categories require higher credit quality standards but there are no second-tier securities allowed in 'unds in Standard & Poor's investment grade fund ratings ('BBBm' or better). The SEC recognizes Standard & Poor's 'A-1' short-term rating category as first-tier. Standard & Poor's, however, uses a plus (+) symbol with some ratings to indicate relative strength within the category. Criteria for all ratings of outline a minimum acceptable percentage of Standard & Poor's rated securities. Rule 2a-7 does not distinguish between 'A-1' and 'A-1+' ratings.

Rule 2a-7 views the credit quality of a repo as that of the securities underlying the agreement provided that the collateral qualifies for preferential treatment under the Federal Deposit Insurance Act or the Federal Bankruptcy Code. Since repos typically involve government securities, no diversification requirements apply. Standard & Poor's rating criteria look to the creditworthiness of the repo counterparty. The criteria are somewhat less stringent in terms of diversification and credit quality for 'A-1+' and 'A-1' quality counterparties than the criteria for unsecured obligations because of the short-term nature of the transactions and the fact that they are secured. However, Standard & Poor's is not comfortable with solely looking at the underlying instruments, as discussed in the repo section of the criteria.

NEGATIVE YIELDS VS. "BREAKING THE DOLLAR"

Money market funds have remained popular even though the yield on the average U.S. money-market fund recently hovered near an all-time low of 1% (at the end of 2002). The low yields are vexing enough for fixed-income investors although they still look relatively good compared to the losses posted by the average equity fund over the past few years. But they may also be the cause of another unpleasant surprise. Since fund expense ratios – (the percentage amount a fund charges to cover operating costs) may in some cases exceed the actual yield, investors who redeem their fund shares may find that their balance is actually lower than the amount they originally put in. In essence, the fund has posted a negative return, even though it has maintained its principal value and had a positive yield. Many money market funds are partially waiving or cutting fees to avoid this situation and to remain competitive.

Some fund professionals have warned that if rates go even lower, it might cause money-market funds to "break the dollar", a situation where the fund's principal value dips below $1.00 per share. It is important to realize the difference between high management fees eating up a fund's principal and the erosion in a fund's assets because of portfolio investment losses.

Standard & Poor's money market fund rating addresses the "safety" of the money fund's investments, and therefore, focuses on a fund's ability to limit loss. In the U.S., money market funds seek to maintain a "stable" net asset value (NAV) (or $1.00 NAV per share). The more conservative money market funds seek to avoid "breaking the one dollar per share or buck" by investing in highly creditworthy, short-term and very liquid investments while avoiding securities with higher degrees of credit, market or liquidity risk.

While investors should be cognizant of the fee structure of a money market fund, particularly its total expense ratio, fees are not part of the ratings assessment. Since the rating is focused on a money market fund's ability to avoid losing ½ of 1% or more (because if it loses more than ½ penny it would be "'forced" to pay out 99 cents a share), Standard & Poor's analysis is mainly focused on the fund's portfolio level risk (e.g., credit ,market risk, liquidity, and management). Therefore, as long as the market value of the fund does not deviate by ½% and has sufficient liquidity to meet redemptions, the fund should maintain a "stable" share price. Yields have and will continue to rise and fall over time, and as of the end of 2002, yields were at their lowest level since the 1960's.

If you were to invest $10,000 in a rated money fund and receives back $9,950 at the end of one year because your fees were higher than your return, doesn't this mean that the fund "broke the dollar"? While the investor may not be happy with the return of the investment, the fund has maintained principal value and did have a positive yield. Let's say, for instance, that the fund had a 1.00% yield over the past year, but its total expense ratio was 1.50%. In this situation, the investor would receive back their original $10,000 investment plus the 1.00% yield MINUS the 1.50% - thereby netting the investor "less" than the original $10,000 (approximately $9,950). If the fund had a total expense ratio of 0.50%, it would have generated a positive return of nearly $50.00, and the investor would have received back $10,050 at year-end.

An example of a fund "breaking the dollar" is as follows. Let's say that money market funds are yielding 4%, with a total expense ratio of 1.50%. If you invested $10,000 in a money market fund and during the time you held this investment, the fund experienced a problem with a security in its portfolio and had to sell it for a 2% market value loss to the overall portfolio. That loss is reflected in the amount of assets available to pay investors when they decide to redeem their shares in the fund. If you decide to redeem you shares at this point, your shares would be worth $0.98. While you may receive a check for

$10,050 your principal (now $9,800), plus the $400 dividend payout, minus the $150 in fund expenses (1.50%) netting $10,050, this fund actually experienced a principal loss since its market value deviated by more than ½ of 1% or 2%, in this case. This is when a fund "breaks the dollar". So even though the fund had a higher return for the one-year holding period, it did lose principal value. It should be emphasized, though, that this is an exceptionally rare occurrence.

LIMITED LIQUIDITY BASKET

Money market fund's that abide by Rule 2a-7, both U.S. based and certain offshore funds, can elect to classify and hold up to 10% of their assets in an illiquid basket. This illiquid basket was intended to provide money market funds with a safe holding place to prevent these "illiquid" securities from causing a deterioration of a money market fund's net asset value (NAV) during periods of illiquidity for these securities. Standard & Poor's recognizes that a number of rated money funds are taking on increased price risk by holding certain securities, that while they may not consider these securities to be part of the fund's illiquid basket, Standard & Poor's deems these securities to be less liquid than other money market securities. For this reason, Standard & Poor's is implementing up to a 10% "limited liquidity basket" for rated money market funds.

These "limited liquidity" securities tend to be less liquid for a variety of reasons. Liquidity may be limited due to their relative newness to money markets, limited trading activity or inactive secondary markets, dependency on a single Issuer or broker, the small number of dealers making a market in the security, customization of the security or the complex nature of the security. Since liquidity is defined as the speed at which the security can be sold for the price at which the fund has it valued, accurate pricing and a deep secondary market are considered key in determination and stability of the fund's overall marked-to-market calculation. There have been instances where a certain security or security type has performed as expected and was liquid one day, but when markets turn (e.g., due to a market event such as default or put) these less liquid instruments could perform quite poorly as measured by price depreciation and liquidity, causing further stress on the market value of the money market fund.

Standard & Poor's assigns ratings to money market funds based on the fund's credit quality and liquidity, and its ability to manage both the market risks and liquidity risks associated with these holdings given its shareholder base. Each money market fund's liquidity needs and its ability to hold and manage less liquid securities is considered on a case-by-case basis. A fund with a limited operating history, or with a volatile shareholder base may not be able to effectively manage and maintain a high degree of share price stability with any exposure to securities with limited liquidity. In addition, a fund manager must be able to:

- Clearly and effectively demonstrate a thorough understanding of the risks presented by the security
- Internally price or value the security
- Offset the liquidity risks presented to the fund by these limited liquidity securities

Securities considered to possess "limited liquidity" by Standard & Poor's are limited up to an aggregate of 10% of fund assets. Currently, the following securities should be considered to be part of the "limited liquidity" basket:

Note: Securities not listed below may be considered by Standard & Poor's to possess limited liquidity.

- Funding Agreements having unconditional puts beyond 7 days
- Extendible notes where the Issuer of the security has the option to extend
- Term repurchase agreements (repos) beyond 7 days
- Securities denominated in currencies other than a fund's base currency and swapped back into the base currency of the fund
- Time deposits exceeding 7-days to maturity, unless the deposit agreement has a specific option enabling the holder to break the deposit without a penalty or additional cost
- Master notes, promissory notes and loan participation notes
- Credit linked notes (CLNs)

CLNs and other credit default swaps present funds with "limited liquidity" due to their inherent credit leverage and dependency on a specific broker for liquidity. Given these two risks, credit linked notes held by rated money market funds should mature in 13 months or less and be limited to a maximum of 5% of a fund's total assets diversified by 1% per issue and 2% per sponsor/broker. Securities sponsored by a broker/dealer that are not CLNs will not count toward this 2% limit. It is also recommended that funds take the most conservative route when applying its diversification guidelines by also counting the exposure to the underlying credit of a CLN (i.e., reference entity) toward their Issuer diversification guidelines.

Standard & Poor's must rate all securities held in the limited liquidity basket 'A-1' or 'A-1+'. In addition, Standard & Poor's rated funds should contact Standard & Poor's prior to purchasing any newly created securities or questionable security types not on this list to determine their liquidity and eligibility status. Standard & Poor's will re-evaluate the status of these securities and will update the limited liquidity list on an ongoing basis.

EUROPEAN/OFFSHORE MONEY MARKET FUND RATINGS

The following criteria apply to European and Offshore registered or (non U.S. 2a-7 registered) Money Market Fund Safety Ratings.

Credit Quality

If a fund invests in a security that possesses a guarantee from a rated third party, the rated guarantors should comply with Standard & Poor's credit criteria for the respective fund-rating category. Standard & Poor's will also conduct a review of any guarantees to ensure they meet Standard & Poor's minimum requirements for rated funds.

Maturity

The remaining term to maturity or, in the case of floating rate variable rate securities, the interest reset date of any security at the date of purchase, should not exceed 397 days. Maturity limits for floating rate or variable rate securities are detailed in the section below: Floating/Variable Rate Securities (FRN/VRN).

Liquidity

Generally no more than 10% of any fund should be invested in securities considered illiquid or less liquid than typical money market eligible securities. Such securities include: securities denominated in currencies other than a fund's base currency and swapped back into the base currency of the fund; time deposits exceeding 7-days to maturity, unless the deposit agreement has a specific option enabling the holder to break the deposit without a penalty or additional cost; and repurchase transactions (repos) with terms greater than 7 days, *(see Limited Liquidity Basket, page 27).*

Diversification

No single Issuer should represent more than 5% of fund assets, however an exception can be made for exposure up to 10% per issue if 5% of such exposure matures within 90 days. 'AAA' rated OECD government issues are excluded from this condition, although in the case of single OECD Issuers, diversification of issues should be included).

Floating/Variable Rate Securities (FRN/VRN)

Standard & Poor's has reviewed its guidelines for floating rate note (FRN) and variable rate note (VRN) holdings in non-U.S. domiciled money market funds and made the following additions to its criteria. Current guidelines limit the maximum final maturity of all floating and variable rates securities held by a 'AAAm' rated money market fund. This limit is set at 397 days unless the security is issued by sovereign Issuer rated 'AA' or better by Standard & Poor's in which case the maximum final maturity is two years.

Under new guidelines on a case-by-case basis, consideration will be given to requests from 'AAAm'-rated funds to approve holdings of FRNs/VRNs for Issuers other than 'AAA'-rated sovereigns with time to final maturity greater than 397 days but no more than two years. All such FRNs/VRNs must have a Standard & Poor's short-term rating of 'A-1+'. If the Issuer does not possess a short-term rating, a Standard & Poor's long-term rating of 'AA' or better is required.

The total holdings of all such FRN/VRNs will be limited to no more than 5% per Issuer and in aggregrate to no more than 10% of net assets of the fund. Additionally, these investments should be public (not privately placed) liquid issues (i.e., established secondary market) and each fund should not be comfortable owning a large portion of issue outstanding.

Before granting approval to extend the maturity range of FRN/VRN holdings, Standard & Poor's will seek assurance that ample liquidity can be maintained by virtue of the fund's size, diversified shareholder base and range of other assets and that adequate resources are available to analyze and manage credit risk.

With respect to asset backed (ABS) floating rate securities, internal research by Standard & Poor's has indicated that the most prudent practice for Standard & Poor's rated money market funds is to limit investments in ABS floating rate instruments to a legal final maturity of two years or less. Standard & Poor's does not believe it is appropriate for highly rated money market funds to use the expected maturity date of such instruments as this date is calculated at the time of issuance and periodically thereafter based on the expected cash flows. The legal final, also known as the rated final, is the date by which the principal will ultimately be made under a worst-case scenario.

Accumulating Net Asset Value (NAV) Funds

Like $1.00 per share Net Asset Value (NAV) or stable money market fund ratings, Standard & Poor's accumulating NAV money market fund ratings address the safety of invested principal and the funds ability to maintain principal value and limit exposure to loss.

In monitoring an accumulating fund's NAV, Standard & Poor's reviews the daily published share price of each rated fund to make sure that there is a constantly increasing NAV and that if there is a decrease, it does not deviate more then the following percentages from its highest point: 'AAAm' 0.15%, 'AAm' 0.20%, 'Am' 0.25% and 'BBBm' 0.30%. If a fund's share price deviates beyond the amounts listed above, Standard & Poor's will ask the fund for a daily pricing/marked-to-market NAV calculation. It is important to note the Standard & Poor's money market fund rating on an accumulating NAV fund, does not address decreases in NAV due to periodic distribution of accrued income.

In addition to receiving the daily-published share price, Standard & Poor's requests a weekly calculation of the value of assets in the fund, calculated on a marked-to-market value basis rather than an amortized cost basis. This is an important element of the surveillance as this allows us to monitor the ability of the fund to repay investor's original capital, while continuing to offer yield independently. Many money-market funds in Europe accumulate rather than distribute interest and we have previously monitored the funds ability to maintain a continually increasing unit price. As such, we ask all rated accumulating NAV funds to calculate an equivalent stable share value (i.e., 1.00) by dividing net assets calculated on a marked-to-market value basis by net assets calculated on an amortized cost basis and express this figure to 5 decimal places.

Custodian

Generally a rated fund's custodian should be rated at least 'A-2' by Standard & Poor's or be deemed equivalent to 'A-2' in consultation with Standard & Poor's mutual fund analysts. ■

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Exhibit D

Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004

Federated®

Prime Obligations Fund

Institutional Shares

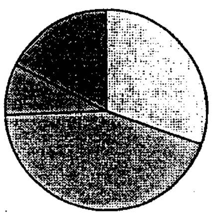
4th Quarter 2004 *All information is as of 12/31/04 unless otherwise noted.*

Credit Ratings

AAAm *Standard & Poor's*
Aaa *Moody's*
AAA *Fitch*
NAIC Approved

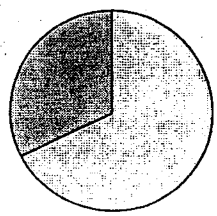
Portfolio Assets: $17.5 billion

Portfolio Composition



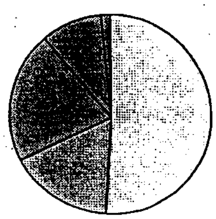
- *Commercial Paper & Notes **29.5%***
- *Variable Rate Instruments **44.9%***
- *Overnight Securities **7.1%***
- *Bank Instruments **18.5%***

Credit Quality Composition



- *A-1+ **68.7%***
- *A-1 **31.3%***

Effective Maturity Schedule



- *1-7 Days **50.8%***
- *8-30 Days **17.9%***
- *31-90 Days **20.9%***
- *91-180 Days **9.2%***
- *181 + Days **1.2%***

Effective Average Maturity: 30 Days

Investor Goal

The fund seeks to provide investors with a high level of current income, a high quality portfolio and liquidity. The fund pursues its objective through corporate money market securities including commercial paper, repurchase agreements, variable rate instruments and bank instruments. All securities are domestic sourced only.

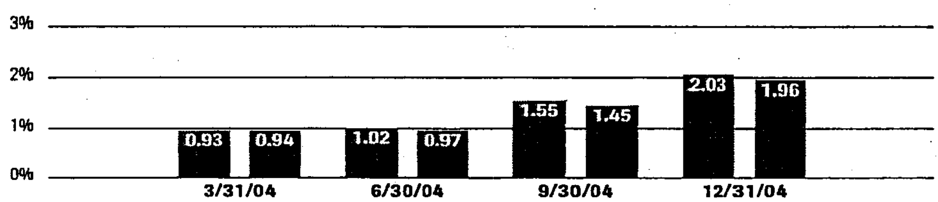
Fund Features

- This fund is currently rated with Triple A ratings from three credit rating agencies: Standard & Poor's, Moody's and Fitch.
- Approved by the National Association of Insurance Commissioners (NAIC).
- Invests exclusively in First Tier – the highest credit quality securities.
- A portfolio consisting of domestic income sourced issuers may lead to tax benefits for some corporate investors.
- The 5 p.m. EST cut-off time for purchases and redemptions gives institutional investors more time to complete daily cash processing and initiate late day deposit transactions.

Fund Performance

Yield History (%)

7-Day
30-Day



Net yields are based on the average daily income dividend and average net asset value for the 7 days, 30 days and 12 months ended 12/31/04.

Net Yields	7-Day	30-Day	12-Month
Prime Obligations Fund	**2.03**	**1.96**	**1.24**

Annualized Yields	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
7-Day	**0.94**	**0.95**	**0.93**	**0.93**	**0.95**	**1.02**	**1.17**	**1.35**	**1.55**	**1.62**	**1.82**	**2.03**
30-Day	**0.94**	**0.94**	**0.94**	**0.93**	**0.94**	**0.97**	**1.14**	**1.28**	**1.45**	**1.61**	**1.75**	**1.96**

1 Year Total Return: 1.25%

Performance data quoted represents past performance which is no guarantee of future results. Investment return will vary. An investor's shares, when redeemed, may be worth more or less than the original cost.

Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To view performance current to the most recent month-end, visit our Web site at www.federatedinvestors.com, "Products" section or call 1-800-341-7400.

See reverse for important definitions and disclosures.

Not FDIC Insured ▪ May Lose Value ▪ No Bank Guarantee

Prime Obligations Fund
Institutional Shares

Top Ten Holdings

Total % of Portfolio: 39.3%

Merrill Lynch & Co., Inc.
Morgan Stanley
Sigma Finance Corp.
HBOS PLC
WestLB AG (Guaranteed)
Caisse des Depots et Consignations
Citigroup, Inc.
Federal Home Loan Bank System
K2 Corp.
Goldman Sachs Group, Inc.

Fund Statistics

Fund Manager
Deborah Cunningham

Inception Date
3/26/90

Cusip Number
60934N-203

Nasdaq Symbol
POIXX

Newspaper Listing
PrimeOb IS

Cut Off Times
5:00 p.m. EST - Purchases
5:00 p.m. EST - Redemptions

For more complete information about any Federated fund, please call your investment professional or Federated at 1-800-341-7400 for prospectuses. You should consider the fund's investment objectives, risks, charges and expenses carefully before you invest. Information about these and other important subjects is in the fund's prospectus, which you should read carefully before investing.

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World-Class Investment Manager®

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G01104-88 (1/05)

All information is as of 12/31/04 unless otherwise noted.

The average maturity target range for Federated's prime money market funds was decreased during the fourth quarter by 5 days to 35 – 45 days. During the quarter, the Federal Reserve raised the Fed Funds target rate two more times--by 25 basis points each—on November 10 and on December 14, bringing the period end target rate to 2.25%. Federated continued to target a barbelled structure, with 6 month paper being the long end, and overnight and floating rate securities representing the short-end.

Deborah Cunningham
CIO of Money Markets & Senior Vice President

Fund Manager Biography

Portfolio Manager:	Deborah Cunningham
Years of Investment Experience:	18
Area of Responsibility:	Additional responsibility for the Tax-Exempt Municipal Investment Group.
Previous Experience:	Head of Taxable Money Market Group, Federated Investors; Performance Analysis Supervisor, Federated Investors; Performance Analyst, Federated Investors
Professional Associations:	Director and Former President, Pittsburgh Society of Financial Analysts
Education:	B. A., Duquesne University; M. B. A., Robert Morris College

Ratings from Leading Agencies

Money market ratings are an assessment of the safety of invested principal and the ability to maintain a stable market value of the fund's shares. Ratings are based on an evaluation of several factors, including credit quality, diversification and maturity of assets in the portfolio, as well as management strength and operational capabilities. Ratings are subject to change and do not remove market risk.

About Federated

Founded in 1955, Federated Investors, Inc., one of the largest U. S. mutual fund companies, continues its tradition of excellence as a world-class investment manager. Federated's money management style - built on proprietary research - is disciplined, striving for consistent, competitive performance year after year. Assets under management are approximately $180 billion, consisting of a family of mutual funds and separately managed equity, fixed income, money market and international accounts for corporations, institutions and individuals. Federated is ranked among the top 6% of managers for equity, the top 6% for fixed income and the top 2% for money market mutual fund managers, based on assets under management in open-end funds. *(Strategic Insight, 11/30/04)*

An investment in the fund is neither insured nor guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.

- *Performance shown is for the Institutional Shares. The fund offers additional share classes whose performance will vary due to differences in charges and expenses. Please consult your financial institution regarding your eligibility to purchase these classes.*
- *Net yields are based on the average daily income dividend and average net asset value for the 7 days, 30 days and 12 months ended 12/31/04. The 7-day net annualized yield is based on the average net income per share for the 7 days ended on the date of calculation and the offering price on that date. The 30-day net yield is the annualized average net investment income per share calculated for each of the previous 30 days. The 12 month net yields are based on the average daily income dividend and average net asset value for the 12 months ended 12/31/04.*
- *For an indefinite period of time, the investment adviser is waiving all or part of its fee and in addition, may reimburse the fund for all or part of its expenses. This increases income to the fund and results in a higher return to investors. Otherwise, the 7-day yield would have been 1.70% and total return would have been lower. Total return represents the change in value of an investment after reinvesting all income and capital gains. Yield quotations more closely reflect the current earnings of the fund than the total return quotation.*
- *An AAAm rating by Standard & Poor's is obtained after S&P evaluates a number of factors, including credit quality, market price, exposure and management. Money market funds rated Aaa by Moody's are judged to be of an investment quality similar to Aaa-rated fixed income obligations, that is, they are judged to be of the best quality. Fitch's money market fund ratings are an assessment of the safety of invested principal and the ability to maintain a stable value of the fund's shares. Ratings are based on an evaluation of several factors including credit quality, diversification and maturity of assets in the portfolio as well as management strength and operational capabilities. This fund is on the National Association of Insurance Commissioners approved list of Exempt money market mutual funds.*
- *The fund is a managed portfolio and its holdings are subject to change.*
- *The holdings percentages are based on net assets at the close of business on 12/31/04 and may not necessarily reflect adjustments that are routinely made when presenting net assets for formal financial statement purposes.*

This must be preceded or accompanied by a current prospectus.

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Prime Cash Obligations Fund

Institutional Shares

4th Quarter 2004

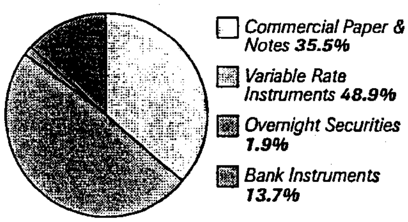
All information is as of 12/31/04 unless otherwise noted.

Credit Ratings

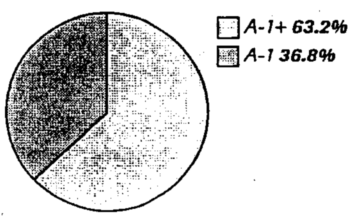
AAAm *Standard & Poor's*
Aaa *Moody's*
NAIC Approved
AAA *Fitch*

Portfolio Assets: $8.0 billion

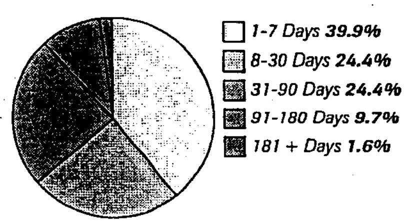
Portfolio Composition



Credit Quality Composition



Effective Maturity Schedule



Effective Average Maturity: 34 Days

Investor Goal

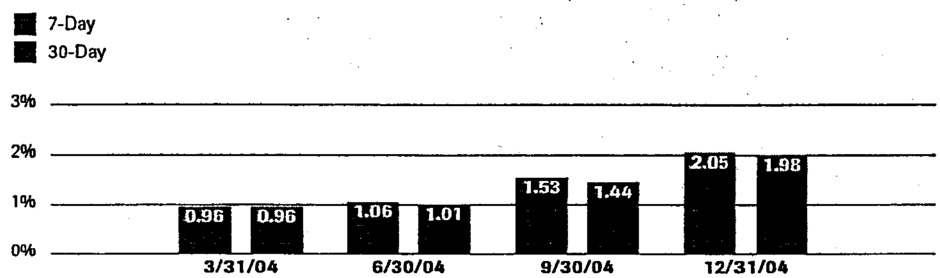
The fund seeks to provide investors with a high level of current income, a high quality portfolio and liquidity. The fund pursues its objective through corporate money market securities including commercial paper, repurchase agreements, variable rate demand notes and bank instruments.

Fund Features

- Through investment in corporate securities, the fund offers investors a potentially higher yield than a portfolio of government securities.
- Highest possible ratings from Standard & Poor's and Moody's underscores the portfolio's high credit quality and relative safety.
- Approved by the National Association of Insurance Commissioners (NAIC).
- Invests exclusively in First Tier - the highest credit quality securities.

Fund Performance

Yield History (%)



Net yields are based on the average daily income dividend and average net asset value for the 7 days, 30 days and 12 months ended 12/31/04.

Net Yields	7-Day	30-Day	12-Month
Prime Cash Obligations Fund	2.05	1.98	1.26

Annualized Yields	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
7-Day	0.96	0.96	0.96	0.95	0.98	1.06	1.21	1.34	1.53	1.67	1.85	2.05
30-Day	0.97	0.97	0.96	0.95	0.97	1.01	1.17	1.29	1.44	1.61	1.77	1.98

1 Year Total Return: 1.27%

Performance data quoted represents past performance which is no guarantee of future results. Investment return will vary. An investor's shares, when redeemed, may be worth more or less than the original cost.

Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To view performance current to the most recent month-end, visit our Web site at www.federatedinvestors.com, "Products" section or call 1-800-341-7400.

See reverse for important definitions and disclosures.

Not FDIC Insured ▪ May Lose Value ▪ No Bank Guarantee

Prime Cash Obligations Fund
Institutional Shares

Top Ten Holdings

Total % of Portfolio: 40.2%

Merrill Lynch & Co., Inc.
Societe Generale
Citigroup, Inc.
General Electric Capital Services
Sigma Finance Corp.
National City Corp.
HBOS PLC
Morgan Stanley
Goldman Sachs Group, Inc.
Caisse des Depots et Consignations

Fund Statistics

Fund Manager
Deborah Cunningham

Inception Date
2/8/93

Cusip Number
60934N-625

Nasdaq Symbol
PCOXX

Newspaper Listing
PrmCshObl

Cut Off Times
3:00 p.m. EST - Purchases
3:00 p.m. EST - Redemptions

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G01417-63 (1/05)

All information is as of 12/31/04 unless otherwise noted.

The average maturity target range for Federated's prime money market funds was decreased during the fourth quarter by 5 days to 35 – 45 days. During the quarter, the Federal Reserve raised the Fed Funds target rate two more times—by 25 basis points each—on November 10 and on December 14, bringing the period end target rate to 2.25%. Federated continued to target a barbelled structure, with 6 month paper being the long end, and overnight and floating rate securities representing the short-end.

Deborah Cunningham
CIO of Money Markets & Senior Vice President

Fund Manager Biography

Portfolio Manager:	Deborah Cunningham
Years of Investment Experience:	18
Area of Responsibility:	Additional responsibility for the Tax-Exempt Municipal Investment Group.
Previous Experience:	Head of Taxable Money Market Group, Federated Investors; Performance Analysis Supervisor, Federated Investors; Performance Analyst, Federated Investors
Professional Associations:	Director and Former President, Pittsburgh Society of Financial Analysts
Education:	B. A., Duquesne University; M. B. A., Robert Morris College

Ratings from Leading Agencies

Money market ratings are an assessment of the safety of invested principal and the ability to maintain a stable market value of the fund's shares. Ratings are based on an evaluation of several factors, including credit quality, diversification and maturity of assets in the portfolio, as well as management strength and operational capabilities. Ratings are subject to change and do not remove market risk.

About Federated

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- *For an indefinite period of time, the investment adviser is waiving all or part of its fee and in addition, may reimburse the fund for all or part of its expenses. This increases income to the fund and results in a higher return to investors. Otherwise, the 7-day yield would have been 1.94% and total return would have been lower. Total return represents the change in value of an investment after reinvesting all income and capital gains. Yield quotations more closely reflect the current earnings of the fund than the total return quotation.*
- *An AAAm rating by Standard & Poor's is obtained after S&P evaluates a number of factors, including credit quality, market price, exposure and management. Money market funds rated Aaa by Moody's are judged to be of an investment quality similar to Aaa-rated fixed income obligations, that is, they are judged to be of the best quality. Fitch's money market fund ratings are an assessment of the safety of invested principal and the ability to maintain a stable value of the fund's shares. Ratings are based on an evaluation of several factors including credit quality, diversification and maturity of assets in the portfolio as well as management strength and operational capabilities. This fund is on the National Association of Insurance Commissioners approved list of Exempt money market mutual funds.*
- *The fund is a managed portfolio and its holdings are subject to change.*
- *The holdings percentages are based on net assets at the close of business on 12/31/04 and may not necessarily reflect adjustments that are routinely made when presenting net assets for formal financial statement purposes.*

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Attachment II:

Treasury Strategies Memorandum
to the Division of Market Regulation,
SEC
October 2006

Treasury Strategies

The Power of Experience℠

Assessing the Risks of 15c3-3 Investment Options

Prepared by Treasury Strategies, Inc.
January, 2007

Background

During the course of Treasury Strategies' consulting work with commercial banks, security dealers and mutual fund companies, we have explored the practices of broker dealers ("brokers") for managing their 15c3-3 Special Reserve Bank Account and their collateral for borrowing fully-paid or excess margin securities ("15c3-3 funds").

For the Special Reserve Bank Account, brokers currently maintain commercial bank accounts, trust ledger accounts or custodial accounts which can be invested in a number of securities/deposits including:

- Money market deposit accounts (MMDAs)
- CDs
- U.S. Treasury securities
- Treasury-backed repurchase agreements.

In terms of collateral for borrowing fully-paid or excess margin securities, brokers can utilize a number of instruments including irrevocable letters of credit, bankers acceptances and negotiable CDs.

The primary purpose of this assessment is to compare and contrast the risks inherent in relying upon bank instruments versus money market mutual funds ("MMMFs") for 15c3-3 funds.

For purposes of this discussion, money market mutual funds are those that meet 2a-7 SEC criteria and are rated AAAm by Standard and Poor's.

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Executive Summary

Deposits into MMDAs directly and via trust ledger accounts are permitted investments for 15c3-3 Special Reserve funds. Such uncollateralized bank deposits expose the depositor to the risk profile of the bank itself. In each of the areas below, AAAm rated MMMFs offer equivalent or enhanced safety and liquidity, over and above that of an uncollateralized deposit at a U.S. commercial bank.

Bank irrevocable letters of credit, bankers acceptances and negotiable CDs are acceptable instruments as collateral for borrowing customers' fully-paid or excess margin securities. These instruments are only as strong as the credit quality of the issuing bank itself. Again, in each of the areas below, AAAm rated MMMFs are equivalent or superior.

- Financial Strength - MMMFs with a AAAm rating have the highest credit rating awarded. No large commercial bank has been able to maintain a AAA rating and very few even achieve AA status.

- Risk of failure - Over the past fifteen years, there have been no failures among AAAm rated MMMFs. Among all MMMFs, there has been only one failure of a very small fund and a small number of assisted transactions. During that same period, there have been 350 commercial bank failures and an undisclosed number of assisted transactions.

- Quality of underlying investments - The minimum credit quality of an underlying investment by a AAAm rated fund is A1. 100% of assets meet or exceed that level of credit quality. In contrast, only about 30% of commercial bank assets are in securities of that quality.

- Off-balance sheet exposure - Under Rule 2a-7, MMMFs are not permitted to enter into derivative transactions or to have any other off-balance sheet exposures. Commercial banks, especially larger banks, have considerable off-balance sheet activity.

- Interest rate risk - The maximum permitted average maturity of a AAAm rated fund is 60 days. This limits exposure to changing interest rates. A sampling of major banks shows that between 40% and 60% of their portfolios are considerably longer with maturities of more than one year.

- Concentration risk - Per Rule 2a-7, MMMF portfolios are required to be highly diversified – no more than 5% of their assets can be invested in the securities of any one issuer. Under current practices, brokers expose up to 50% of their 15c3-3 funds to the credit risk of a single issuer - an MMDA account at a commercial bank.

- Ownership interest – Trust ledger accounts are pooled interests which raises questions about the specific ownership of pooled funds in a single account. An investment in money market funds provides a specific ownership interest to each investor.

As described above and in more detail on the following pages, AAAm MMMFs offer a number of risk minimization benefits, when compared to bank instruments such as MMDA accounts. These benefits include reduced credit risk, duration risk, concentration risk, and ownership risk. For the same reasons, they offer a number of benefits over bank letters of credit as15c3-3 collateral.

Current Investment Practices for Broker 15c3-3 Funds

In practice, brokers invest approximately 50 - 70% of their 15c3-3 funds in U.S. Treasury securities and U.S. Treasury backed repurchase agreements. The remaining 30 – 50% of 15c3-3 funds are most commonly placed in bank MMDA accounts, through direct deposit or indirect deposit via a trust ledger product.

Direct deposit to a bank MMDA account is a straightforward transaction:

- MMDA account established in the broker's name
- 15c3-3 funds deposit amount is limited to 10% of the financial institution's capital
- 15c3-3 funds deposit amount is limited to 50% of the broker's net excess capital
- Interest is earned on 15c3-3 funds balances

Indirect deposit to a bank MMDA through a trust ledger account is a more complicated transaction:

- Trust ledger account established in broker's name
- Trust department establishes an MMDA at the bank under the trust's name
- 15c3-3 funds from all brokers are pooled into one aggregate deposit
- Pooled funds deposited into MMDA Account
- Interest earned on pooled funds is allocated to individual broker trust ledger accounts by Trust department

- 15c3-3 funds deposit amount into the trust ledger account is not subject to any limitation based on the bank's capital such as the 10% limitation for a direct investment into an MMDA

While both MMDA and trust ledger accounts are heavily used for broker 15c3-3 funds investments, trust ledger accounts are preferred, as they typically pay higher interest than MMDA accounts. This is because bank treasury departments ascribe lower volatility to pooled trust funds (vs. individual MMDA accounts) and assign them higher internal value, allowing higher interest to be paid. The unfortunate upshot is that it exacerbates the incentive for broker dealers to chase rates and actually increases the potential deposit volatility on a bank's balance sheet.

Financial Strength

A financial firm's credit rating is an assessment of the firm's ability to maintain principal and limit exposure to loss. As shown below, AAAm rated money market mutual funds have a higher S&P rating than any of the top U.S. commercial banks. Twelve large banks doing business in the U.S have all received credit ratings of AA or less for their banking activities. Not one of these banks achieves the AAA rating of the top rated money market mutual funds.

Financial Institution	Credit Rating
AAAm Money Market Mutual Fund	AAAm
Citibank	AA
Bank of America	AA
State Street Bank	AA
WFC Holdings (Wells Fargo)	AA
ABN Amro NV	AA-
Bank of New York	AA-
Deutsche Bank AG	AA-
JPMorgan Chase Bank	AA-
Mellon Bank	AA-
SunTrust Bank	AA-
Wachovia Bank	AA-
PNC Bank	A+

Source: Standard and Poor's

S&P ratings incorporate a thorough analysis of corporate structure, markets and strategy, credit risk, diversification risk, funding and liquidity, capital and earnings.

Risk of Failure

350 U.S. banking institutions have failed during the last fifteen years.

As illustrated in the following chart, only one money market mutual fund has failed during this time period. Aside from this one exception, no investor in a MMMF has ever lost money.

FAILURES OF FINANCIAL INSTITUTIONS		
Year	Money Market Mutual Funds	Commercial Banks
2005	0	0
2004	0	3
2003	0	3
2002	0	10
2001	0	3
2000	0	6
1999	0	7
1998	0	3
1997	0	1
1996	0	5
1995	0	6
1994	1	13
1993	0	41
1992	0	122
1991	0	127
15 yr. Total	**1**	**350**

Sources: U.S. Federal Reserve Bulletin; Treasury Strategies, Inc.

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Quality of Underlying Investments

By SEC regulation, money market mutual funds are required to invest in low risk securities. In contrast, U.S. commercial banks issue consumer and commercial loans with varying degrees of credit quality. FDIC insurance adds additional security for deposits in federally insured banks, and covers the first $100,000 in a money market deposit account. This offers minimal protection for brokers, as their typical 15c3-3 fund bank deposits are millions, and even billions, of dollars.

The charts below compare asset categories held by one AAAm rated money market mutual fund with those held by U.S. commercial banks. As shown, the Federated Prime Obligations Fund has 100% of its assets in low risk, high credit quality securities. Conversely, U.S. commercial banks hold only 13% of their assets in Treasury and Agency securities. They hold their remaining assets in other securities, real estate, commercial and consumer loans.

Assets Federated Prime Obligations Fund	
Highly Rated Assets:	
Treasury/Agency/Repo	9%
A-1+ Securities	72%
A-1 Securities	19%
Subtotal Highly Rated Assets:	**100%**
Non-Prime Assets:	**0%**
Total	**100%**

Source: Federated Prime Obligations Fund

Assets U.S. Commercial Banks	
Highly Rated Assets:	
Treasury and Agency securities	13%
Other Securities	11%
Interbank Loans	3%
Cash	3%
Subtotal Highly Rated Assets:	**30%**
Real Estate Loans	33%
Commercial/Industrial Loans	12%
Other Loans and Leases	9%
Consumer Loans	8%
Other Assets	8%
Non-Prime Assets:	**70%**
Total	**100%**

Sources: U.S. Federal Reserve Bulletin;

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Interest Rate Risk

Bank liabilities (deposits) are typically short-term and bank assets (loans) can be fairly long-term (maturities range from overnight to 30 years). This significant mismatch of asset-liability durations leads to interest rate sensitivity in a bank's balance sheet. While bank treasury departments are charged with managing such risk, in a volatile interest rate environment, the market value of the bank's equity (capital) is at risk.

A sampling of large U.S. banks indicates that between 40% and 60% of assets are invested with maturities of longer than one year. Some extend longer than ten years.

Money market mutual funds are required to have a weighted average portfolio maturity not to exceed 90 days, and may not hold any instrument with an outstanding maturity greater than 397 days. AAAm money market mutual funds have an even stricter weighted average maturity maximum of 60 days, and a fund such as Federated Prime Obligations Fund has a weighted average maturity of 36 days. The short duration of a money market mutual fund portfolio allows the fund managers to closely align portfolio holdings with interest rate movements, reducing the opportunity for economic loss to investors.

Concentration Risk

As the charts on page 9 show, U.S. commercial banks, on average, hold more than 50% of their assets in loans, with 33% in real estate loans. This lack of diversification increases the risk of bankruptcy in the event of an economic downturn in specialized industry sectors.

SEC regulations specifically address the risks to brokers of concentrating their 15c3-3 funds deposits with a small number of banks. These regulations limit a broker's deposits with one bank to 10% of the bank's capital and 50% of the broker dealer's excess net capital. However, even these restrictions permit a broker to deposit several billion dollars in 15c3-3 funds with a single bank. This level of deposits in an institution whose investment portfolio can have heavy asset concentration in a few industry sectors creates significant concentration risk for the broker.

Brokers using trust ledger accounts are not limited to the 10% capital restriction and are able to concentrate more of their deposits with fewer institutions. This further increases concentration risk.

Conversely, according to SEC regulations, a money market fund may not invest more than five percent of its total assets in the securities of any one issuer. In practice, money market mutual funds typically hold in excess of 100 different issues in their investment portfolios. This practice of diversification among issuers and industries limits a fund's concentration risk.

Pooled versus Specific Interest

When brokers deposit 15c3-3 funds into Trust ledger accounts, those funds are pooled into a single MMDA account (an omnibus account) at the bank. This raises questions about the specific ownership of funds in the pooled account. The pooling of funds does not give the broker a specific interest in this omnibus MMDA account, which could be risky and economically detrimental to the broker in the event of a bank's bankruptcy.

Conversely, an investment in money market mutual funds gives a specific interest in the fund to each investor; each investor has a specified number of ownership shares in the fund. In the event of a fund failure, each investor is entitled to their ownership in the fund.

Conclusions

Treasury Strategies has assessed the risks inherent in both bank instruments and AAAm rated money market mutual funds with respect to the customer protection objectives of rule 15c3-3. We have analyzed the ability of both banks and AAAm money market mutual funds to safeguard customer assets from the perspectives of:

- Financial strength
- Risk of failure
- Quality of underlying investments
- Off- balance sheet exposure
- Interest rate risk
- Concentration risk
- Pooled vs. Specific Interest

We conclude that for the purposes of both the Special Reserve Bank Account and the collateral for fully-paid or excess margin securities under15c3-3, AAAm money market mutual funds as at least as safe as the currently permissible bank instruments and in many respects, superior.

For further information, contact:

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Attachment III:

Letter to Michael Macchiaroli,
Associate Director,
Division of Market Regulation, SEC,
from Stuart J. Kaswell, Dechert LLP,
July 5, 2006
and
Memorandum to
Eugene F. Maloney, Federated Investors,
re: Money Market Fund Shares
as Eligible Customer Fund Investments
Under the Commodity Exchange Act,
July 5, 2006.

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July 5, 2006

Michael A. Macchiaroli
Associate Director
Office of Risk Management
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Mr. Macchiaroli:

As you know, on behalf of our client, Federated Investors, Inc. ("Federated"), we have petitioned the Securities and Exchange Commission (the "SEC" or the "Commission") regarding amendments to Rule 15c3-1 and Rule 15c3-3 under the Securities Exchange Act of 1934 (the "Exchange Act").[1] We also understand that the Commission may issue a proposal for rulemaking that raises some of issues addressed in our Amended Petition.

We wish to provide some information comparing the SEC's treatment of money market funds under Rule 15c3-3 to the Commodity Futures Trading Commission's ("CFTC") analogous treatment of money market funds. Attached is a memorandum prepared by my partner, Susan Ervin, outlining the CFTC's segregation requirements for futures commissions merchants ("FCMs"). The memorandum discusses how FCMs may use money market funds to hold segregated customer funds. The memorandum makes the following points:

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1 *See* petition from Federated Investors, Inc., to the Securities and Exchange Commission, April 3, 2003, amended April 4, 2005, available at http://www.sec.gov/rules/petitions/shtml (the "Amended Petition").

- It has been a hallmark of regulation under the Commodity Exchange Act ("CEA") to maintain strict segregation of customer funds and property.

- After decades of drastically limiting the permissible investments of customer funds, in 2000 the CFTC allowed FCMs to invest such fund in money market funds. The rule initially limited FCMs to using money market funds that received the highest rating from a nationally recognized statistical rating agency, if rated at all.

- After several years of favorable experience, the CFTC amended its rule and allowed FCMs to use any money market fund. To our knowledge, the CFTC has not publicly identified any problems that have resulted as a consequence of this further change.

We compare the CFTC's regime to the regulation of broker-dealers:

- Unlike the regulation of broker-dealers, there is no analog to the Securities Investor Protection Corporation and the Securities Investor Protection Act of 1970. As a consequence, the CFTC's segregation requirements are essential to protecting the customers of FCMs.

- Under Section 4d(d) of the CEA, an FCM may not borrow customers' funds or property. By comparison, Rule 15c3-3(b)(3) allows broker-dealers to borrow customers' fully paid or excess margin securities, provided that they are fully secured.

- At the close of each day, an FCM must have segregated sufficient funds to meet 100% of its obligations to customers. It must make up any deficiency with its own funds that day. By comparison, under Rule 15c3-3(e)(3) a broker-dealer must calculate the amount to be deposited in the special reserve bank account on a weekly, and in some instances, on a monthly, basis.

Despite (or, indeed because of,) the critical importance of the segregation requirements under the CEA and CFTC's rules, and the need to calculate that amount every single day, the CFTC allows FCMs to use money market funds for deposits of segregated funds. We respectfully submit that the SEC should allow broker-dealers analogous authority to use money market funds in a regulatory regime that also has protections augmenting the segregation requirements. We do not believe that there can be any customer protection justification that allows FCMs to use money market funds for segregation purposes, but denies broker-dealers the authority to use money market funds in an analogous function, especially when the SEC itself regulates money market funds.

We appreciate your consideration of our views and would be pleased to discuss these issues with you at your convenience.

Sincerely yours,

Stuart J. Kaswell
Partner

Attachment: Money Market Funds as Eligible Customer Fund Investments Under the Commodity Exchange Act, June 30, 2006.

Cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Annette L. Nazareth

Jon Kroeper, Counsel to Chairman Cox
Daniel M. Gallagher, Counsel to Commissioner Atkins

Eugene F. Maloney, Executive Vice President and Corporate Counsel, Federated Investors, Inc.

Dechert LLP

MEMORANDUM

DATE July 5, 2006

TO Eugene F. Maloney
Executive Vice President and Corporate Counsel
Federated Investors, Inc.

FROM Susan C. Ervin
Partner
Dechert LLP

COPY Stuart J. Kaswell
Partner
Dechert LLP

RE Money Market Fund Shares as Eligible Customer Fund Investments Under the Commodity Exchange Act

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Question Presented

You have asked us to review the history of the rules permitting a futures commission merchant ("FCM") to hold segregated customer funds in a money market mutual fund. This memorandum reviews that history.

Summary

For 70 years, a futures broker's duty to segregate customer funds sufficient at all times to meet one hundred percent of its obligations to each customer has been a cornerstone of the futures regulatory structure. The Commodity Exchange Act ("CEA") and Commodity Futures Trading Commission ("CFTC") rules govern the segregated status, permissible investments, authorized locations, accounting requirements, replenishment of shortfalls and other matters relevant to the safeguarding of segregated funds held for customers. The effect of the CEA and CFTC requirements is that futures customer funds are held in a statutory trust, assuring satisfaction of customer ownership claims despite the absence of any government-sponsored account insurance for futures

accounts. Since 1936, when Congress enacted the CEA segregation requirements, the CEA and subsequent CFTC rules have closely limited investments of such funds to maximize the safety and stability of the segregated account. Since 1968, only government securities and government-guaranteed securities have been permissible investments. In 2000, however, the CFTC adopted rule amendments that "acknowledge the development of new financial instruments over the last 60 years and should both enable [FCMs] to remain competitive globally and domestically and maintain safeguards against systemic risk."[1] These amendments authorized FCMs to invest segregated customer funds in money market fund shares, among other specified instruments. Following this initial authorization, the CFTC has amended its rules to further enhance the ability of FCMs to invest in money market shares, reaffirming the appropriateness of money market fund investments for customer segregated funds.

Discussion

The CEA Section 4d(2) Segregation Requirement. Since its enactment in 1936, Section 4d(2) of the CEA has established the fundamental principle of segregation of customer funds and the trust-like nature of the broker's duties in respect of such funds. An essential premise of the futures customer-broker relationship is that the broker holds customer funds at all times on behalf of and as the property of the customer: under Section 4d(2), the FCM must "treat and deal" with each customer deposit "as belonging to such customer," refrain from using such funds or property on behalf of any other customer for its own purposes and use its own capital to replenish any deficit in the funds held for customers. Customer funds must be "segregated" fully from the broker's own funds or those of any other person, a safeguard designed to assure that customer funds are readily identifiable in the event of an FCM's insolvency. At the close of each business day, an FCM must have in its segregated fund accounts sufficient funds to meet 100% of its obligations to its customers. The CEA and CFTC rules create multiple ancillary safeguards applicable to FCMs -- minimum capital requirements, early warning reporting requirements, periodic financial reports, audited financials, and recordkeeping duties, among others -- which serve the principal goal of preserving the integrity of the segregated customer funds account by ensuring the ability of the FCM to replenish any shortfall in

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[1] 65 FR 77993, 78007 (December 13, 2000).

segregation funds. Protection of customer funds thus "is one of the most important purposes of the [CEA] and [CFTC] regulations."[2]

Investment of Customer Funds. Since its enactment in 1936, Section 4d(2) has permitted FCMs to invest customer funds, subject to significant constraints on the nature of the permissible investments. As originally enacted, Section 4d(2) authorized FCMs to invest customer funds only in governmental obligations and in certain investment securities. Subsequently, the investments specified in Section 4d(2) were narrowed to government obligations of the U.S., general obligations of any state or political subdivision thereof, or obligations fully guaranteed as to principal and interest by the U.S., all such investments "to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe." CFTC Rule 1.25 gives effect to the statutory restraints upon investments of customer funds.

In addition to restricting investments of customer funds, Section 4d(2) also regulates deposits of customer funds with banks and clearinghouses, providing that customer funds and property "may, for convenience, be commingled and deposited in the same amount or accounts with any bank or trust company or with the clearinghouse organization" of the futures exchange on which the customers' futures transaction is entered. From 1937 until 2000, the CFTC construed Section 4d(2) of the CEA to require that when customer funds were deposited in banks or other depositories, they must be placed in demand deposit accounts in which they were available for immediate withdrawal and thus earned no interest.[3] Given these constraints, FCMs were limited to investing customer funds in U.S. or other governmental obligations or placing such funds in non-interest bearing accounts. The effect of these limitations was that only a meager return on customer funds could be obtained, despite the fact that investments outside the statutory categories were likely to be as or more secure than the permitted investments and would also generate additional income.

Investment of Segregated Funds in Money Market Shares. While Section 4d(2) of the CEA continues to specify government obligations as the only permissible investments

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[2] 67 FR 52641, 52644 (August 13, 2002).

[3] *See* Financial and Segregation Interpretation No. 9 – Money Market Deposit Accounts and NOW Accounts, 1 Comm. Fut. L. Rep. (CCH) ¶ 7119 (Nov. 23, 1983) (Opinion of the CFTC's Division of Trading and Markets).

of customer funds, in 2000 the CFTC undertook a major review of its regulation of FCMs and other futures intermediaries and proposed extensive rule amendments designed to modernize its regulatory framework. In considering the subject of investment of customer funds, the CFTC has observed that its primary interest is "in preserving the integrity of the customer segregated account."[4] To fulfill the objectives of the segregated funds requirement, "[n]ot only must there be sufficient value in the account at all times, but the quality of investments must reflect an acceptable level of credit, market and liquidity risk."[5] The CFTC proposed to permit investments of customer segregated funds in money market shares (among other specified investments), based upon its conclusion that "an expanded list of permitted investments could enhance the yield available to FCMs, clearing organizations and their customers without compromising the safety of customer funds."[6]

By amendments to Rule 1.25 adopted in December 2000, investments of customer funds were permitted in: (1) obligations issued by any agency sponsored by the U.S.; (2) certificates of deposit issued by a bank, as defined in Section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank issued by the FDIC; (3) commercial paper; (4) corporate notes; and (5) interests in money market mutual funds.[7] With respect to money market funds, the CFTC required that the money market fund be an investment company that is registered under the Investment Company Act of 1940 and holds itself out to investors as a money market fund, be sponsored by a federally regulated financial institution or other specified entities, have its net asset value computed by 9:00 a.m. each business day and be able to redeem interests by the next business day following a redemption request. Funds rated by a nationally-recognized statistical rating organization were required to be rated at the highest rating issued by that organization.

Subsequent Rulemaking Reaffirming Eligibility of Money Market Fund Shares. Since its 2000 amendments to Rule 1.25, the CFTC has revisited and further amended the

[4] 70 FR 5577, 5581 (February 3, 2005).

[5] *Id.*

[6] 65 FR 39008, 39014 (June 22, 2000).

[7] 65 FR 77993 (December 13, 2000).

relevant rule provisions, including those relating to money market funds. In 2003, the CFTC published for comment a proposed rule change to eliminate of one of the previously adopted restrictions upon eligible money market shares, together with several clarifying changes.[8] The CFTC did not identify any adverse effects of the previously adopted Rule 1.25 amendments, and it received only favorable comments on the proposed amendments. In its final rule amendments, the CFTC clarified the requirement of next-day redemption and eliminated the requirement that money market funds rated by a nationally recognized statistical rating organization be rated at the highest rating of that organization.[9] In taking this action, the CFTC noted both that the rating requirement was anomalous in that unrated money markets were permissible, and that SEC Rule 2a-7 establishes important risk-limiting standards governing the portfolio quality, diversification, and maturity of money market mutual funds.[10] The CFTC's expansion of its initial rule amendments authorizing segregated customer funds to be invested in money market fund shares reflects its continuing view that these investments are fully consistent with the framework of strict safeguards for segregated customer funds and the absence of any adverse experience with this category of investments.

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[8] 68 FR 38654 (June 30, 2003).

[9] 70 FR 28190, 28194-28195 (May 17, 2005).

[10] *Id.*

Attachment IV:

No-Action/Interpretive
Request 15c2-4 – Draft Request to
James A. Brigagliano,
Division of Market Regulation
SEC
March 5, 2005

March , 2005

Via Hand Delivery

James A. Brigagliano, Esq.
Assistant Director – Trading Practices
Office of Risk Management and Control
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-1001

Re: Federated Investors, Inc. – Request for Interpretive or No-Action Relief

Dear Mr. Brigagliano:

On behalf of our client Federated Investors, Inc. ("Federated"), we respectfully request that the staff of the Division of Market Regulation (the "Staff") provide interpretive guidance, or alternatively no-action relief, under paragraph (b) of Rule 15c2-4 (the "Rule") under the Securities Exchange Act of 1934, as amended ("Exchange Act"), to permit funds received by a broker, dealer or municipal securities dealer participating in the type of offering described in paragraph (b) of the Rule ("Contingency Offering") to be invested in a money market fund that meets the conditions described herein (a "Designated Fund").

1. Federated

Federated is one of the largest investment management organizations in the United States, with total assets under management of approximately $179.3 billion as of December 31, 2004. Federated's money market assets in both funds and separate accounts totaled $124.3 billion at December 31, 2004. Average money market assets were $125.3 billion for the quarter ended December 31, 2004. Federated's money market funds are used for cash management and short-term investment by a wide array of institutions, including banks, corporate fiduciaries, broker-dealers, business organizations, and public entities.

2. Rule 15c2-4(b)

Rule 15c2-4 under the Exchange Act imposes certain requirements on the transmission or maintenance of payments received by a broker, dealer or municipal securities dealer in connection with distributions of securities other than firm commitment underwritings. Specifically, paragraph (b) of Rule 15c2-4 provides that all funds received by a broker, dealer or municipal securities dealer in connection with a distribution made on an "all or none" basis, or any other basis which contemplates that payment is not made to the person on whose behalf the distribution is being made until some further event or contingency occurs, must be: (1) promptly deposited in a separate bank account for which the broker, dealer or municipal securities dealer serves as agent or trustee for the persons who have the beneficial interests therein, until the event or contingency has occurred ("Eligible Bank Account"), at which point the funds are to be promptly provided to those who are entitled thereto;[1] or (2) promptly transmitted to a bank that has agreed in writing to hold such funds in escrow for the persons who have beneficial interests therein and to transmit or return such funds to the persons entitled thereto when the event or contingency has occurred ("Escrow Bank").[2]

The Securities and Exchange Commission ("Commission") has stated on several occasions that the Rule seeks to protect subscribers' funds from unlawful activities by, or financial reverses of, a broker-dealer participating in a Contingency Offering that would prevent either the issuer from receiving the proceeds of the offering or the customer being reimbursed if the distribution is not completed.[3]

3. *<u>Proposal to Permit Funds Received From a Contingency Offering to be Invested in Designated Funds</u>*

Federated seeks interpretive or no-action advice under the Rule to permit monies received by a broker, dealer or municipal securities dealer in connection with a Contingency Offering to be invested in shares of a Designated Fund. For purposes of this request, a Designated Fund is defined as a money market fund that is registered under the Investment Company Act of 1940, as amended ("1940 Act"),[4] and that, in addition to meeting all of the requirements of Rule 2a-7 under the 1940 Act, has received a the highest money market fund rating ("AAA-rated") from a nationally recognized statistical rating organization ("NRSRO").

As noted above, the Rule requires that all funds received by a broker, dealer or municipal securities dealer in connection with a Contingency Offering be promptly deposited in an Eligible Bank Account or promptly transmitted to an Escrow Bank. The requested interpretive or no-action advice does not seek to modify this requirement. Rather, the requested interpretive or no-action advice would make it clear that the bank could invest such funds in shares of a Designated

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1 *See* Rule 15c2-4(b)(1).

2 *See* Rule 15c2-4(b)(2).

3 *See, e.g., In the Matter of the Application of Robert Tretiak*, Exchange Act Rel. No. 47534 (Mar. 19, 2003) ("*Tretiak*"); *Lowell H. Listrom & Co., Inc.*, 48 S.E.C. 360, 362-63 (1985) (president of broker-dealer found to have engaged in conduct inconsistent with just and equitable principles of trade when he caused firm to subject customer funds to risks Rule 15c2-4 was designed to prevent) ("*Listrom*"); Exchange Act Rel. No. 11532 (June 11, 1975) (release addressing the requirements of Rules 10b-9 and Rule 15c2-4 under the Exchange Act as they relate to issuers, underwriters, and broker-dealers engaged in "all or nothing" offerings); Exchange Act Rel. No. 6737 (Feb. 21, 1962) (adopting Rule 15c2-4).

4 Money market funds generally are open-end management investment companies registered under the 1940 Act that have as their investment objective generation of income, preservation of liquidity through investment in short-term, high quality securities. *Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 21837 (Mar. 21, 1996), 61 FR 13955, 13957 (Mar. 28, 1996) ("*Money Market Rule Revisions*").

Fund pending the occurrence of the contingency. Federated respectfully submits that this proposal is within both the plain language and intent of the Rule.

4. Prior Staff Interpretations of the Rule Relating to Permissible Investments

The Rule by its terms does not prohibit investor funds deposited in an Eligible Bank Account or transmitted to an Escrow Bank from being invested in money market fund shares. In 1984, however, in response to a request for interpretive guidance from the National Association of Securities Dealers, Inc. ("NASD"), the Staff took the position that the Rule permits only the following investments: bank accounts (including savings accounts), bank money market accounts, short term certificates of deposit issued by a bank, and short term securities issued or guaranteed by the U.S. Government (collectively, "Current Permissible Investments").[5] The Staff also specifically stated that the Rule does *not* permit the following investments:

(a) money market funds;
(b) corporate equity and debt securities;
(c) repurchase agreements;
(d) bankers' acceptances;
(e) commercial paper; and
(f) municipal securities.[6]

The Staff's position was intended to limit the risk of loss of funds pending the occurrence or non-occurrence of the contingency. The Staff noted that any instrument in which offering proceeds are invested must be capable of being readily sold or otherwise disposed of for cash by the time the contingency occurs without any dissipation of the offering proceeds invested. As discussed further below, Federated submits that the scope of Current Permissible Investments should be expanded to include shares of a Designated Fund. Like Current Permissible Investments, Designated Fund shares are capable of being readily sold or otherwise disposed of for cash by the time the contingency occurs without any dissipation of the offering proceeds invested. Designated Fund shares would provide to investors a level of safety and liquidity fully consistent with the intent of the Rule and similar to that provided by Current Permissible Investments, while potentially offering a higher return and lower transaction costs than Current Permissible Investments.[7]

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5 NASD Notice to Members 84-7 (Jan. 30, 1984) ("NTM 84-7").

6 *Id; see also* Letter to Investment Company Registrants (pub. avail. December 2, 1992).

7 *See Willkie Farr & Gallagher* (pub. avail. October 23, 2000) ("*Willkie Farr*").

5. *Overview of Money Market Funds*

a. *Background*

Money market funds were first introduced in 1972[8] and, therefore, were not in existence when the Rule was adopted. More than thirty years later, for the week ended Wednesday, March 23, 2005, total money market fund assets stood at $1.906 trillion.[9] The rate of increase in money market fund assets over this period has been striking – at the end 2003, money market fund assets totaled approximately $2.052 trillion, compared to $179.3 billion at the end of 1983, the year that Rule 2a-7 under the 1940 Act was adopted.[10]

Money market funds generally seek to maintain a stable share price, typically $1.00 per share, in reliance upon Rule 2a-7 under the 1940 Act.[11] This stable share price of $1.00 has encouraged investors to view investments in money market funds as an alternative to bank deposits or checking accounts, even though money market funds lack federal deposit insurance, and there is no guarantee that money market funds will maintain a stable share price.[12] Indeed, the Commission has observed that "investors generally treat money market funds as cash investments."[13]

Money market funds have been widely accepted by both retail and institutional investors. Institutional investors have been attracted to money market funds in recent years for various reasons. The Investment Company Institute has noted that "[t]he growth in business holdings of money funds is partly due to corporations' preference to outsource cash management to mutual funds rather than holding liquid securities directly."[14] Corporations that purchase money market shares are able to obtain daily liquidity at par, together with true daily choice, flexibility and economies of scale that are unavailable through internal management of their liquid assets.[15]

b. *Regulation of Money Market Funds*

To maintain a stable share price, the vast majority of money market funds use the amortized cost method of valuation or the penny-rounding method of pricing permitted by Rule 2a-7 under the 1940 Act. The 1940 Act and applicable rules generally require investment

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8 Source: ICI Mutual Fund Fact Book at inside front cover (42nd ed. 2002).

9 Source: ICI at www.ici.org/home/mm_03_24_05.html# TopOfPage.

10 Source: ICI 2004 Mutual Fund Fact Book at 108.

11 *Money Market Rule Revisions*, *supra* note 4, 61 FR at 13957.

12 *Id.*

13 *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Investment Company Act Rel. No. 25870 (Dec. 18, 2002), 68 FR 160, 165 (Jan. 2, 2003); *see also Willkie Farr*, *supra* note 7.

14 ICI Mutual Fund Fact Book, *supra* note 8.

15 *See id; see also Willkie Farr*, *supra* note 7.

companies to calculate current net asset value per share by valuing portfolio instruments at market value or, if market quotations are not readily available, at fair value as determined in good faith by, or under the direction of, the board of directors. Rule 2a-7 exempts money market funds from these provisions, but contains a number of conditions designed to minimize the deviation between a fund's stabilized share price and the market value of its portfolio. In particular, Rule 2a-7's conditions relating to portfolio diversification (paragraph (c)(4)), credit quality (paragraph (c)(3)), and maturity (paragraph (c)(2)) are intended to reduce the likelihood of significant deviations between a fund's share price and its market based per share net asset value by requiring funds to invest in a diversified pool of high quality instruments whose short remaining maturity helps assure that they are not significantly affected by changes in interest rates.[16]

1) Portfolio Diversification

Rule 2a-7 subjects a money market fund to diversification requirements designed to limit the fund's exposure to the credit risk of any single issuer. The applicability of the diversification requirements will depend on whether the fund is taxable, such as a Designated Fund, or tax-exempt.[17] Taxable funds must limit their investments in the securities of any one issuer other than Government securities to five percent of fund assets.

2) Portfolio Quality

Money market funds may purchase only securities that are denominated in U.S. dollars,[18] pose minimal credit risk to the fund, and are "Eligible Securities" as defined in Rule 2a-7(c)(3)(i). "Eligible Securities" are defined generally as: (i) securities that are rated in one of the highest two short-term rating categories by the "Requisite NRSROs"[19]; or (ii) comparable

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16 *Proposed Revisions to Rules Regulating Money Market Funds*, Investment Company Act Rel. No. 17589 (July 17, 1990), 55 FR 30239 (July 25, 1990). *See generally* Jack W. Murphy & Douglas P. Dick, *Money Market Funds, in* FINANCIAL PRODUCT FUNDAMENTALS: A GUIDE FOR LAWYERS, Ch. 9 (Clifford E. Kirsch ed., 2001).

17 The issuer diversification requirements do not apply with respect to a money market fund's holdings of Government securities, because the Commission does not consider holdings of Government securities to present significant credit risk. Rule 2a-7(c)(4)(i). Rule 2a-7's treatment of Government securities is derived from Section 5(b)(1) of the 1940 Act, which excludes investments in Government securities from the limitations imposed upon diversified investment companies with respect to investments in a single issuer.

18 The staff of the Division of Investment Management has issued two no-action letters permitting funds to hold themselves out as money market funds if they invested solely in debt securities denominated in a specified foreign currency, provided that the funds otherwise complied with the terms of Rule 2a-7. *SSgA International Liquidity Fund* (pub. avail. Dec. 2, 1998); *Five Arrows Short-Term Investment Trust* (pub. avail. Sept. 26, 1997). These funds seek to maintain a constant net asset value in their designated currency and accept purchases and effect redemptions only in that currency.

19 The term "Requisite NRSROs" is defined in Rule 5b-3(c)(6) under the 1940 Act as any two nationally recognized statistical rating organizations ("NRSROs"), or, if only one NRSRO has issued a rating at the time the fund acquires the security, that NRSRO. "NRSRO" is defined in Rule 5b-3(c)(5) as any nationally

unrated securities. Taxable funds must limit aggregate fund investments in so-called second tier securities[20] to no more than five percent of fund assets, with investment in the second tier securities of any one issuer being limited to the greater of one percent of fund assets or one million dollars.

Rule 2a-7(c)(3) further requires a money market fund to limit its portfolio investments to Eligible Securities determined by the fund's board of directors to present minimal credit risks. This determination must be based on factors affecting the credit quality of the issuer in addition to any ratings assigned to the securities by an NRSRO. Rule 2a-7 permits the responsibility for the minimal credit risk determination to be delegated by the fund's board of directors,[21] and as a matter of practice money market funds take advantage of this flexibility. Nonetheless, the fund's board of directors remains ultimately responsible for the minimal credit risk determination and has responsibility for overseeing the determination.

A money market fund's board of directors must reassess promptly whether a security presents minimal credit risks when the fund's investment adviser becomes aware that an unrated security or a second tier security has been given a rating by any NRSRO below the NRSRO's second highest rating category. A money market fund must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.[22]

3) Portfolio Maturity

A money market fund is required to maintain a dollar-weighted average portfolio maturity appropriate to the objective of maintaining a stable net asset value per share. In addition, Rule 2a-7 provides that a money market fund may not acquire[23] any instrument having a remaining maturity of greater than 397 calendar days, and may not maintain a dollar-weighted average portfolio maturity of more than 90 days. The Commission has stated that the purpose of Rule 2a-7's maturity provisions is to limit a money market fund's exposure to interest rate risk.[24]

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recognized statistical rating organization, as that term is used in paragraphs (c)(vi)(E), (F) and (H) of Rule 15c3-1 under the Exchange Act, that is not an "affiliated person," as defined in section 2(a)(3)(C) of the 1940 Act, of the issuer of, or any insurer or provider of credit support for, the security.

20 Rule 2a-7(a)(20) defines a "second tier security" as an Eligible Security that is not a "first tier security." Rule 2a-7(a)(11) generally defines a first tier security as a security that is rated by the Requisite NRSROs in the highest rating category for short-term debt obligations, and comparable unrated securities.

21 *Money Market Rule Revisions, supra* note 4, 61 FR at 13973.

22 *Id.*, 61 FR at 13961 n.44.

23 Rule 2a-7(a)(1) defines "acquire" to mean any purchase or subsequent rollover, but does not include the failure to exercise a demand feature.

24 *Money Market Rule Revisions, supra* note 4, 61 FR at 13971.

Rule 2a-7 provides that the maturity of a portfolio security generally will be equal to the period remaining (calculated from the trade date or such other date on which the fund's interest in the security is subject to market action) until the date, in accordance with the terms of the security, the principal amount of the security must unconditionally be paid, or in the case of a security called for redemption, the date on which the redemption payment must be made (the "final maturity").[25] A money market fund, however, may measure the maturity of a "variable rate security" or a "floating rate security" (collectively, "adjustable rate securities") by reference to a date that is earlier than the final maturity date.

Rule 2a-7 defines a "variable rate security" as an instrument, the terms of which provide for the adjustment of the interest rate on specified dates and that, upon adjustment, can reasonably be expected to have a market value that approximates par value. A "floating rate" security is defined as an instrument, the terms of which provide for the adjustment of its interest rate whenever a specified benchmark changes and that, at any time, can reasonably be expected to have a market value that approximates par value. Under Rule 2a-7, the maturity of an adjustable rate Government security is determined with reference to the interest readjustment date if, upon readjustment, the security can reasonably be expected to have a market value that approximates its par value.[26]

4) Portfolio Liquidity

Money market funds are also subject to stringent portfolio liquidity standards. A money market fund is limited to investing no more than ten percent of its assets in illiquid securities.[27] The Commission considers a security to be illiquid if it cannot be disposed of within seven days in the ordinary course of business at approximately the price at which the fund has valued it.[28] The Commission, however, has reiterated the observation of the staff of the Division of Investment Management ("IM Staff") that, because a broker-dealer normally is required to settle securities transactions not later than three business days after the trade date ("T+3"), many money market funds must meet redemption requests within three days because a broker or dealer will be involved in the redemption process.[29] The Commission cautioned money market funds to

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25 A security that is subject to a "mandatory tender feature" - *i.e.*, a feature providing that the principal amount of the security will be paid off on a specified date unless the holder elects to remain invested – can be treated as having its maturity measured by reference to the payment date of the tender feature. *Money Market Rule Revisions, supra* note 4, 61 FR at 13970 n.151.

26 *Id.* at 13971.

27 Investment Company Act Rel. No. 13380 (July 11, 1983), 48 FR 32555 (July 18, 1983) (adopting Rule 2a-7), at n. 37-38.

28 *Money Market Rule Revisions, supra* note 4, 61 FR at 13966.

29 *See id., citing* Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, ICI (pub. avail. May 26, 1995).

assess the mix of their portfolio holdings to determine whether, under normal circumstances, they will be able to facilitate compliance with T+3 by brokers or dealers.[30]

6. *AAA-Rated Money Market Funds*

We proposed that the Commission define Designated Funds as money market funds that both meet the requirements of Rule 2a-7 *and* are AAA-rated).[31] Under this standard, both Federated's Prime Obligation Fund and Prime Cash Obligations Fund would qualify as Designated Funds.[32] We summarize below the basic S&P criteria[33] for a AAAm rating[34]

S&P engages in an extremely sophisticated analysis of a money market fund before granting its AAAm rating. S&P examines credit risk, market price risk, pricing policies, operating scenarios, and controls for the money market fund. S&P will not designate a money market fund as AAAm rated unless the fund meets and maintains those very high standards.

- S&P's AAAm rating is defined to mean that:
  - Safety is excellent. Fund provides superior capacity to maintain principal value and limit exposure to loss.[35]

The criteria that must be met to qualify for such a rating are as follows:

- at least 50% of the money market fund's investments must have a short-term rating of A-1+ (which is the highest gradation of the highest S&P short-term rating);
- no more than 50% of the money market fund's investments may have a short-term rating of A-1;
- none of the fund's investments may have a short-term rating of A-2 (which is S&P's second highest short-term rating category);

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30 *See id.*

31 We note that the Commission already relies on ratings from NRSROs in determining the appropriate net capital treatment of different securities. *See, e.g.*, 15c3-1(c)(2)(vi)(E).

32 Quarterly "fact sheets" for the Federated Prime Obligations Fund and the Federated Prime Cash Obligations Fund for the fiscal quarter ended December 31, 2004 are attached for your reference.

33 Although the other NRSROs follow similar approaches, this discussion will focus on S&P's ratings criteria, as drawn from *S&P MMF Ratings Criteria.*

34 These are discussed in great detail in S&P's 2003 publication *Money Market Funds Ratings Criteria*, a copy of which is attached for your reference ("*S&P MMF Ratings Criteria*"). Other NRSROs follow generally similar approaches to rating money market funds, but have not published as detailed a discussion of their criteria.

35 *See S&P MMF Ratings Criteria* at p. 3.

- the money market fund's weighted average maturity must not exceed 60 days; and
- the maximum final maturity for floating rate notes in which the money market fund invests must not exceed two years.[36]

AAA-rated MMFs also compare favorably to the bank deposits into which Rule 15c2-4 permits a broker-dealer to invest monies received and held in escrow in connection with distributions of securities (other than firm commitment underwritings) pending final disposition of those funds..[37]

7. *Safety Record of Money Market Funds*

General-purpose money market funds[38] have amassed an impressive record of safety over a period of 31 years. The vast majority of those funds have never invested in any money market instrument that did not pay off at maturity. There have been relatively isolated circumstances in which a money market fund has experienced the potential for deviations between its stabilized share price and its market based per share net asset value by virtue of its investments in: (a) second-tier commercial paper; or (b) adjustable rate securities in which the interest rate readjustment formulas resulted in the market values of the securities not returning to par at the time of an interest rate readjustment. In all but one such instance, however, to maintain their funds' stable net asset values, the funds' investment advisers purchased the distressed or defaulted securities from their money market funds at their amortized cost value (plus accrued interest), or contributed capital to the funds, to preserve the fund's $1.00 share price.[39]

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36 *See id.*

37 In this respect, the rule and the Staff's interpretation in NTM 84-7 specify only very broad safety and soundness requirements for the bank deposit, which is likely to be uninsured.

38 The term "general purpose money market funds" refers to money market funds that may invest in the full panoply of instruments permitted by Rule 2a-7.

39 *Id.*, 61 FR at 13972 n. 162. One institutional money market fund holding adjustable rates notes, a series of Community Bankers Mutual Fund, Inc., liquidated in September 1994 at 96 cents per share. Press reports generally treated this liquidation as the first instance in which a money market fund had "broken a dollar." *Id.*

In a subsequent enforcement action, the Commission found that the fund's two portfolio managers had not assessed adequately the risks of investing a large portion of the fund's portfolio in such derivatives, in an environment of rising short-term interest rates. *In the Matter of Craig S. Vanucci and Brian K. Andrew*, Securities Act Rel. No. 7625 (Jan. 11, 1999). In a related enforcement action, the Commission also found that the fund's board authorized the fund to sell its shares while omitting to disclose, or while making false and misleading disclosure of, material facts concerning the percentage of illiquid securities in the Fund's portfolio. *In the Matter of John E. Backlund, John H. Hankins, Howard L. Peterson, and John G. Guffey*, Securities Act Rel. No. 7626 (Jan. 11, 1999).

Commission amendments to Rule 2a-7 subsequent to its adoption in 1983 have greatly limited the ability of a money market fund to invest in second-tier commercial paper, and have prohibited a money market fund from investing in an adjustable rate security if its interest rate readjustment formula does not ensure that the market value of the security will return to par once a readjustment occurs.

Federated recognizes that, in 1984, when the Staff took the position that money market funds shares did not constitute permissible investments, money market funds were still in their infancy. Rule 2a-7 had been adopted only six months before the NASD issued NTM 84-7. A sufficient track record arguably did not exist to enable the Staff to conclude that investments in money market fund shares do not subject customer funds to the risks that Rule 15c2-4 was designed to prevent. More than twenty years later, the track record of money market funds amply demonstrates that Rule 2a-7 has operated and does operate successfully to minimize any credit, interest rate or liquidity risk created by an investment even in a general-purpose money market fund. A Designated Fund for purposes of the requested interpretive or no-action advice would be subject to limitations on its portfolio securities well beyond those imposed in Rule 2a-7, to provide still greater assurance that an investment in shares of a Designated Fund will not put the proceeds of a Contingency Offering at risk of possible dissipation or risk of loss as a result of possible unlawful activities by, or financial reversals of, the broker, dealer or municipal securities dealer participating in the Contingency Offering.

8. *Regulatory Acceptance of the Use of Money Market Funds as a Cash Equivalent*

Federated submits that shares of Designated Funds do not present any increased market risk, credit risk or other risks relative to those of the Current Permissible Investments. In the years since the NASD issued NTM 84-7, numerous federal and state financial regulators (including the Commission and its staff), self-regulatory organizations, state legislatures, and federal courts have addressed this very issue in a variety of analogous circumstances. In each case, they have permitted regulated entities to invest in money market funds.

For example, in *Willkie Farr*, the IM Staff permitted a group of industrial operating companies to treat investments in shares of money market funds as a cash item for the purposes of Section 3(a)(1)(C) of, or Rule 3a-1 under, the 1940 Act. The Commission previously had taken the position that demand deposits with banks constitute cash items, but had not considered whether money market fund shares could similarly constitute cash items. The IM Staff stated that the references to cash items in those provisions were intended to encompass assets that have a high degree of liquidity and relative safety of principal. The Staff reiterated the Commission's observation that "the stable NAV and other characteristics offered by money market funds -- a diversified and professionally managed portfolio of securities, *relative safety of principal, high degree of liquidity*, and a wide range of shareholder services -- have made money market funds a popular cash management tool for institutions and businesses . . . ."[40] In agreeing to treat money

40 *Willkie Farr*, *supra* note 7 (emphasis added) , citing *Money Market Rule Revisions*, *supra* note 4, 61 FR at 13957. Federated notes that federal deposit insurance is currently limited to $100,000 per account.

market fund shares as cash items, the IM Staff stated that "*[a]s with bank deposits and checking accounts*, investments in money market funds permit an issuer to maintain ready cash reserves for use in meeting its business expenses."[41]

Additional examples where money market funds are permitted investments include investment of the assets of national banks (Office of the Comptroller of the Currency),[42] state-chartered banks (Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation),[43] and federal credit unions (National Credit Union Administration);[44] customer funds held in custody by futures commission merchants and futures clearing organizations (Commodity Futures Trading Commission);[45] margin collateral (Board of Trade Clearing Corporation,[46] New York Mercantile Exchange,[47] Chicago Mercantile Exchange,[48] and the Options Clearing Corporation[49]); assets of state and municipal entities,[50] assets subject to trust indentures, and trust and other fiduciary assets (numerous state laws).[51] The Commission staff has authorized the pre-funded portion of an asset-backed issuance to be invested in money market mutual funds as an alternative to eligible financial assets that convert to cash.[52]

Most recently, the Commission and the Commodity Futures Trading Commission issued joint final rules to establish margin requirements for security futures ("Final Rules").[53] The Final

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Consequently, the vast majority of assets in Eligible Bank Accounts or with Escrow Banks are not covered by deposit insurance.

41 *Willkie Farr, supra* note 7 (emphasis added), *citing Role of Independent Directors of Investment Companies*, Investment Company Act Rel No. 24082 (October 14, 1999), 64 FR 59825, 59827 (Nov. 3, 1999).

42 *See* Banking Circular BC-220 (Nov. 21, 1986).

43 *See, e.g.*, 12 CFR § 208.123.

44 12 CFR § 702.105(a)(2).

45 17 CFR § 1.25(a)(viii).

46 *See* Board of Trade Clearing Corporation Bulletin, vol. 21, no. 160 (July 27, 2001).

47 *See* NYMEX Rule 9.05.

48 *See* CME Rule 930.C, *available at* http://www.cme.com/risk_management/financialunit/riskmanagement_financialunit_acceptablecollateral.cfm.

49 *Order Granting Approval of a Proposed Rule Change Relating to Money Market Funds as Margin Collateral*, Exchange Act Rel. No. 47599 (Mar. 31, 2003), 68 FR 16849 (Apr. 7, 2003). *See also* SR-DTC-2005-01 and SR-DTC-2005-02.

50 *See, e.g.*, IOWA CODE § 12B.10(4); Alaska Permanent Fund Corporation, Resolution 98-5, § 1(o); 2002 San Diego County Treasurer's Pooled Money Fund Investment Policy.

51 *Federated Investors, Inc.* (pub. avail. July 8, 1997).

52 *See, e.g.*, 88-546-A La. Op. Atty. Gen. (May 16, 1989); 96-3 Ind. Op. Atty. Gen. (Sept. 5, 1996).

53 *Customer Margin Rules Relating to Security Futures*, Exchange Act Rel. No. 46292 (Aug. 1, 2002), 67 FR 53145 (Aug. 14, 2002).

Rules seek to preserve the financial integrity of markets trading security futures, prevent systemic risk, and assure that the margin requirements for security futures are consistent with the margin requirements for comparable exchange-traded option contracts.[54] The Final Rules permit the use of money market fund shares to satisfy the required margin for security futures and related positions carried in a securities account or futures account, subject to certain conditions.[55] These conditions are intended to facilitate a security futures intermediary's hypothecation or liquidation of money market fund shares deposited as margin for security futures, as necessary to meet a customer's clearing obligations.[56] Under the Final Rules, a security futures intermediary may accept money market fund shares as margin if the following conditions are met:

- the customer must waive any right to redeem the fund shares without the consent of the security futures intermediary and must instruct the fund or its transfer agent accordingly;

- the security futures intermediary (or clearing agency or derivatives clearing organization with which the security is deposited as margin) must obtain the right to redeem the shares in cash, promptly upon request; and

- the fund must agree to satisfy any conditions necessary or appropriate to ensure that the shares may be redeemed in cash, promptly upon request.[57]

The ability under the Final Rules to use money market fund shares as collateral reflects a recognition by the Commission that the use of money market fund shares as collateral is consistent with the preservation of the financial integrity of markets trading security futures, and that it will not create or exacerbate systemic risk. In addition, the Final Rules recognize that money market fund shares may be liquidated promptly for cash without any significant risk that the value of the money market fund shares will have declined.

The regulatory treatment accorded holdings of shares of money market funds in the above-described circumstances demonstrates that such funds offer institutions a highly efficient and convenient mechanism for managing cash, with safety of principal and daily liquidity comparable to the Current Permissible Investments. Permitting investments in Designated Funds will be entirely consistent with the safety and liquidity objectives contemplated by the Rule.

In sum, numerous financial regulators, self-regulatory organizations, and state legislatures have approved the use of money market funds for use by institutional investors as a safe and efficient alternative to direct investments in Government securities and other short-term investments. Federated respectfully requests interpretive or no-action relief by the Staff in recognition of the fact that the temporary investments in Designated Funds pursuant to the Rule

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54 *Id.*, 67 FR at 53146.

55 *Id.*, 67 FR at 53162.

56 *Id.*

57 *Id.*

provide investors with the at least the same level of protection as do investments in Current Permissible Investments.

9. *Prior No-Action Positions and Enforcement Actions Under the Rule*

Finally, we note that the Staff has granted no-action relief under the Rule to permit new and innovative arrangements in instances when the arrangements would not subject customer funds to the types of risks Rule 15c2-4 seeks to prevent. For example, the Staff has permitted a non-bank escrow agent to handle funds for a contingency offering pursuant to a tripartite agreement with a bank.[58] The Staff has also permitted a proposed sweep arrangement under which funds for an initial public offering of a federally regulated savings and loan association converting from mutual ownership to stock ownership were permitted to be held in investor accounts by participating broker-dealers until just before the settlement.[59] These arrangements were disclosed in the applicable registration statement and were designed to provide investors with more efficient means of cash management while effectuating the intent of the Rule. As with *Trident*, Federated requests interpretive or no-action guidance to permit greater flexibility and efficiency in the investment of funds held temporarily by broker-dealers in connection with a Contingency Offering.[60]

Conclusion

Rule 15c2-4 seeks to protect investors' funds from the unlawful activities by, or financial reverses of, a broker-dealer participating in a Contingency Offering that would prevent either the issuer from receiving the proceeds of the offering or the customer from receiving return of his investment if the distribution is not completed. To this end, the Staff has limited Current Permissible Investments to bank accounts and instruments that are capable of being readily sold or otherwise disposed of for cash by the time the contingency occurs without any dissipation of the offering proceeds invested. Federated respectfully submits that shares of Designated Funds likewise may be readily sold or otherwise disposed of for cash by the time the contingency occurs without any dissipation of the offering proceeds invested. Consequently, we request that the Staff provide Federated with interpretive guidance or no-action relief under Rule 15c2-4(b) to permit monies received by a broker, dealer or municipal securities dealer in connection with a Contingency Offering to be invested in shares of a Designated Fund.

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58 *Capitol City Escrow* (pub. avail. Oct. 17, 1990).

59 *Trident Securities, Inc.* (pub. avail. Apr. 17, 1987).

60 In contrast to these previous no-action positions and the proposal described herein, the Commission has brought enforcement actions where a broker-dealer fails to follow the requirements of the Rule and places investors' monies at risk or otherwise fails to properly handle offering proceeds. *See, e.g., Tretiak, supra* note 3; *In the Matter of Richard Harriton*, Securities Act Rel. No. 7853 (Aug. 5, 1999); *In the Matter of Bear, Stearns Securities Corp.*, Securities Act Rel. No. 7718 (Apr. 20, 2000); *Listrom, supra* note 3. These types of issues are not presented in the proposal by Federated, which would not subject customer funds to the types of risks that Rule 15c2-4 seeks to prevent.

Pursuant to Securities Act Rel. No. 6269, we enclose seven copies of this no-action request. Please contact either of the undersigned with any comments or questions concerning this request. Thank you for your attention to this matter.

Very truly yours,

Stuart J. Kaswell
Partner

David J. Harris
Partner

corrected copy: 8/03/06