

Joint Audit Committee

Regulatory Update

TO: Chief Financial Officers
Chief Compliance Officers

0002

DATE: May 18, 2000

SUBJECT: Regulatory Treatment of Various Investment Instruments

Recently, we have received several questions regarding the valuation and recording of various investment instruments. The purpose of this update is to summarize the current regulatory treatment of these instruments.

Securities

Firm owned securities (including investment of segregated and secured funds) *must be stated at market value plus accrued interest on the financial statements*. Due to the increase in interest rates, be advised that other methods of valuing securities, such as the amortized cost method, may no longer approximate market value. Further, accrued interest and any gain or loss on the market value of securities must be reported in income.

For convenience, U.S. Treasury obligations that are owned by customers or noncustomers may be stated at their face value if face value exceeds market value.

Reverse Repurchase and Sale-and-Buy-Back Transactions

Attached is a Guide that summarizes various issues regarding reverse-repurchase type transactions. In particular, we would like to highlight:

- Customer segregated and secured reverse-repurchase type transactions must be stated at the lower of transaction cost plus accrued interest *or* market value plus accrued interest of the underlying collateral on the segregation and secured statements.
- A counterparty to a house reverse repurchase transaction cannot hold the underlying collateral. A separate depository must be used. The counterparty may hold the collateral for customer segregated and secured reverse-repurchase type transactions, provided the account is titled as segregated or secured and the appropriate acknowledgement letter is obtained.

If you have any questions, please contact your DSRO.

Guide to Reverse Repurchase and Sale-and-Buy Back Transactions

This Guide provides general information regarding the regulations and interpretations pertaining to reverse repurchase-type transactions. This Guide is intended to supplement, not replace, the regulatory requirements of the CFTC. It is the responsibility of the FCM to keep informed of, and to comply with, the requirements of the CFTC. The Joint Audit Committee is not responsible for any errors or omissions contained in this Guide.

Counterparty and Depository Issues

| Issue | Treatment of House Transactions | Treatment of Customer Transactions |
|---|--|---|
| Counterparty and Depository – Unaffiliated (Generally) | Any counterparty and depository is allowable as long as the collateral is within the “possession or control” of the FCM and “outside control of the counterparty” (i.e. the counterparty cannot hold the collateral). | The counterparty and depository are limited to a bank, domestic branch of a foreign bank insured by the FDIC, a securities broker-dealer, a government broker-dealer or an FCM. The depository may also be a clearing house. The collateral may be held by a bank counterparty as long as the account is properly titled and an acknowledgment letter is on file from the counterparty/depository as to the nature of the account and disallowing a right of setoff. |
| Counterparty - Affiliate of FCM Depository - Unaffiliated | Allowed | Allowed |
| Counterparty - Unaffiliated Depository - Affiliate of FCM | Securities held in safekeeping accounts at an affiliate are allowable. | See Depository (generally) above. |
| Counterparty and Depository are Affiliated FCM - Unaffiliated | Must examine the relationship (parent/subsidiary vs. sister companies) between the affiliates on a case by case basis to determine if the collateral is “outside control of the counterparty”. Consult the local CFTC Branch for guidance. | Allowed if the depository account is properly titled and an acknowledgment letter is on file from the depository as to the nature of the account and disallowing a right of setoff. |

Guide to Reverse Repurchase and Sale-and-Buy Back Transactions

Financial Statement Issues

| Issue | Treatment of House Transaction | Treatment of Customer Transaction |
|--|--|---|
| Financial Statement Presentation and Reverse Repurchase Deficiencies | <p>The contract price plus accrued interest should be classified as a current asset on the financial statement.</p> <p>Generally, the amount that the contract price plus accrued interest exceeds the market value of the underlying collateral should be reflected as a charge against capital. See SEC Rule 15c3-1(c)(2)(iv)(F) for details.</p> <p>Note also:</p> <p>(1) If the counterparty is the Federal Reserve Bank of New York and the market value is less than the contract price of the underlying securities, the charge may be disregarded.</p> <p>(2) No charge to capital need be taken if at the time of the origination of an overnight transaction, the contract was properly collateralized; however, the burden is on the FCM to provide supporting documentation if no charge is taken.</p> <p>(3) All customer and house reverse repurchase agreements with the same counterparty should be combined to determine if a capital charge is appropriate. Any capital charge should be reflected on the appropriate line on the net capital computation.</p> | <p>For segregation and secured statement purposes of calculating a reverse repurchase deficiency, the FCM may net all customer segregated or all customer secured reverse repurchase transactions with the same counterparty.</p> <p>The lesser of the contract price plus accrued interest <i>or</i> the market value plus accrued interest of the underlying collateral by counterparty should be reflected as an asset on the segregation or secured statements.</p> <p>The amount that the contract price plus accrued interest exceeds the market value plus accrued interest of the underlying collateral should be classified as current or allowable Other Assets on the financial statement of the Form 1-FR or FOCUS Report. However, the FCM may reflect this difference as a noncurrent or nonallowable asset and adjust the net capital computation accordingly.</p> <p>Refer to Treatment of House Transaction for calculation of reverse repurchase deficiency for net capital purposes.</p> |

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Other Issues

| Issue | Treatment of House Transaction | Treatment of Customer Transaction |
|---|---|---|
| Securities Allowed for Underlying Collateral of Agreement | Any readily marketable securities | Segregated investments are limited to obligations of the United States, general obligations of any State or political subdivision or to obligations guaranteed as to principal and interest by the United States Customer 30.7 investments can be any readily marketable securities. |
| Delivery of Securities | The purchased securities must be transferred to the FCM against the transfer of the purchase price to the account of the seller; subsequent sale of the securities must also be done on a <i>delivery-vs-payment</i> basis. | The purchased securities must be transferred to the FCM's customer safekeeping account against the transfer of the contract price from the FCM's customer cash account to the seller's account (delivery-vs-payment in immediate available funds); subsequent sale of the securities must also be done on a delivery-vs-payment basis. Note that cash and securities must be transferred from and into customer accounts of the FCM. |
| Term of Transaction | As agreed upon between the parties | No more than one business day or, if for more than one day, reversal of the transaction must be upon demand of the parties. |
| Identification in Firm's Records | The transaction must be identified as a reverse repurchase or reverse repurchase-type transaction in the general ledger. | The transaction must be identified as a reverse repurchase or reverse repurchase-type transaction in the general ledger. |

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Other Issues (continued)

| Issue | Treatment of House Transaction | Treatment of Customer Transaction |
|--------------------------------|--|--|
| Written Agreement Requirements | Commodity regulations do not specifically require a written agreement between the FCM and the counterparty or confirmation of the individual transactions, however, it is recommended. | <p>CFTC Interpretation 2-1 requires a written agreement between the FCM and the counterparty stating (a) the agreement is intended to be treated as a purchase and sale of securities; (b) the counterparty may not hold the collateral (except as noted above) and may not substitute the securities; (c) the underlying securities cannot be used in a repurchase agreement, substituted, hypothecated or pledged (except to a clearing organization for customer margin); and (d) that in the event of the FCM's bankruptcy, the counterparty cannot compel liquidation of the securities or make a priority claim for the difference between the market value of the securities and the contract value of the transaction at resale.</p> <p>The Public Securities Association (PSA) Master Repurchase Agreement may be used if it is modified to conform to the above. However, in lieu of the modified PSA Agreement, the FCM may obtain an "11-point comfort letter" covering the items specified in CFTC Interpretation 2-1.</p> <p>In addition, a written confirmation to the FCM specifying the terms of the agreement and/or a safekeeping receipt must be issued upon entering into the transaction and upon subsequent resale.</p> |