

Joint Audit Committee

Regulatory Update

TO: Chief Financial Officers 01-07
Chief Compliance Officers

DATE: December 27, 2001

SUBJECT: CFTC Regulation 1.25 – Allowable Investments of Customer Segregated Funds

As you are aware, CFTC Regulation 1.25 was revised effective as of December 28, 2000 to greatly expand the list of allowable investments of customer segregated funds. Through its risk based examinations of FCMs, the Joint Audit Committee has been reviewing these investments and has identified several common errors. These errors are identified below, followed by the applicable rules and explanations, to assist in your review of allowable investments of customer segregated funds.

Common Errors of CFTC Regulation 1.25 Investments:

- Concentration limits exceeded.

The investment of any single issuer may not exceed 5%, or for Government Sponsored Agency Securities 25%, of total segregated assets (excluding customer owned securities). Securities issued by entities that are affiliated shall be aggregated and deemed to be the securities of a single issuer for concentration limit purposes. These concentration limits also apply to securities owned by the FCM that are subject to repurchase agreements. Note: Concentration limits are not applicable to investments in U.S. Government Securities, Foreign Sovereign Debt, and Money Market Mutual Funds.

FCMs should note that separate concentration limits apply to collateral to reverse repurchase agreements. The concentration limits that apply to investments in reverse repurchase agreements are 10%, or for Government Sponsored Agency Securities 50%, if the counterparty is rated “Single A” or higher by two or more Nationally Recognized Statistical Rating Organizations (NRSROs) or is guaranteed by a parent/affiliate that is so rated. Otherwise, the concentration limits are the same as stated above.

- Investments not properly rated.

Investments must have the highest short-term rating of at least one NRSRO or one of the two highest long-term ratings of at least one NRSRO. Asset-backed Corporate Notes and Foreign Sovereign Debt investments must have the highest rating of at least one NRSRO. Money Market Mutual Funds are not required to be rated, but if an NRSRO has rated the security, it must be the highest rating of that NRSRO. Note: US Government securities need not be rated.

Generally, ratings of the 3 NRSROs (Moody’s Investor’s Services, Standard & Poor’s, and Fitch IBCA, Duff & Phelps) can be found on the services’ web sites, in publications, and in the Bloomberg System. Below are the two highest long-term and short-term ratings of these NRSROs:

NRSRO	Highest Long-Term Ratings		Highest Short-Term Ratings	
Moody’s	Aaa	Aa1	P-1	P-2
S&P	AAA	AA+	A-1+	A-1
Fitch	AAA	AA+	F1+	F1

Furthermore, if an instrument is downgraded by an NRSRO below an acceptable rating, the instrument must be valued at the lesser of the current market value or the market value on the day preceding the downgrade, less 20% of that value for each day since the downgrade (i.e. after 5 days the value would be \$0).

- Money Market Mutual Fund investments did not meet next day redemption rule.

The fund’s prospectus/offering circular must contain specific language stating that any redemption request made by the FCM will be honored by the fund no later than the business day following the day the redemption request is made.

- Capital haircuts were not taken on Money Market Mutual Fund investments.

Generally, SEC Rule 15c3-1(c)(2)(vi)(D) states that a haircut of 2% of the market value of investments in “money market funds” is required to be deducted from net capital.

Furthermore, a 2% haircut is applicable on the market value of money market investments in Chicago Mercantile Exchange Inc.’s Interest Earning Facility-2 (IEF2) Program.

- Customer segregated funds were improperly invested in interest earning bank accounts.

Bank accounts in which a cash balance earns interest, sometimes referred to as “Business Investment Accounts,” “Money Market Demand Accounts,” or “Money Market Deposit Accounts,” are not acceptable investments of customer segregated funds. As interest is paid on these accounts, the bank, by law (12 CFR 329.1(b)), must carry a 7 day notice clause which may postpone (for up to seven days) a requested withdrawal. Therefore, the deposits are not considered demand accounts and are unacceptable investments for customer segregated funds.

The amended CFTC Reg. 1.25 was published in the Federal Register and can be found on the CFTC’s web site at www.cftc.gov and on the Joint Audit Committee’s web site at www.wjammer.com/jac.

If you have any questions, please contact your DSRO.