Joint Audit Committee

REGULATORY UPDATE

TO: Chief Financial Officers
Chief Compliance Officers

#09-07

DATE: October 6, 2009

SUBJECT: Investments in Securities

In response to market conditions and events of the past year, FCMs have begun investing in several different types of investments. Through its risk based examinations of FCMs, the Joint Audit Committee members have reviewed these investments and have identified several issues to highlight to ensure compliance with CFTC regulations.

CFTC Regulation 1.25

CFTC Regulation 1.25 outlines permitted investments of customer segregated funds and places restrictions on these investments with regards to rating requirements, concentration limits, and dollar-weighted average of the time-to-maturity of the portfolio:

- Rating requirements are detailed in CFTC Regulation 1.25(b)(2) and are applicable for direct investments as well as collateral of reverse repurchase transactions and repurchase transactions. Each security must be properly rated for compliance with the regulation. Municipal and government sponsored agency securities must have the highest short-term rating of at least one Nationally Recognized Statistical Rating Organization ("NRSRO") or one of the two highest long-term ratings of at least one NRSRO. There is no implied rating based on the issuer of these securities and, therefore, unrated Federal National Mortgage Association and Federal Home Loan Mortgage Corporation agency securities are not in compliance with the regulation.

Long-Term Ratings				
NRSRO	Highest Rating	Second Highest Rating		
Moody's	Aaa	Aa1	Aa2	Aa3
S & P	AAA	AA+	AA	AA-
Fitch	AAA	AA+	AA	AA-

Short-Term Ratings			
NRSRO	Highest Rating		Second Highest Rating
Moody's	P-1		P-2
S & P	A – a+	A – 1	A – 2
Fitch	F1+	F1	F2

- Concentration limits as defined in CFTC Regulation 1.25(b)(4) are based on total segregated assets excluding customer owned securities. The limits are computed on an issuer by issuer basis, and collateral for repurchase or reverse repurchase transactions are combined with direct investments when determining compliance with concentration limits. The investment in securities of any single issuer may not exceed 5% or, for government sponsored agency securities, 25% of total segregated assets.

- The dollar-weighted average of the time-to-maturity of investments of segregated assets may not exceed 24 months on a portfolio basis.

    - An instrument may be treated as having a one-day time-to-maturity when it is deposited solely at a derivatives clearing organization ("DCO") in a collateral management program on an overnight basis and meets other conditions specified in CFTC Regulation 1.25(b)(5)(ii).

    - Instruments collateralizing reverse repurchase transactions conducted with a third party may be treated as having a one-day time-to-maturity provided that the agreement has a term of one business day, or the transaction is reversible upon demand.

    - For Joint FCM/BDs, unlike reverse repurchase transactions conducted with third parties, securities received from internal exchanges of cash which are "functionally equivalent" to reverse repurchase transactions should be included in the time-to-maturity calculation with the maturity date of such securities.

    - Instruments collateralizing a repurchase transaction should be included in the time-to-maturity calculation with the maturity date of such instruments.

    - Money market mutual funds are not included in the time-to-maturity calculation.

Additionally, while violations of CFTC Regulation 1.25 are considered serious and require immediate correction, investments which are held in good segregated accounts (i.e. properly labeled customer segregated and covered by a satisfactory acknowledgment letter) and are held separately from an FCM's own proprietary accounts should still be included in segregated assets despite the violation of CFTC Regulation 1.25.

It should be noted that investments that comply with the requirements of CFTC Regulation 1.25 are also acceptable for investments of secured amounts.

Counterparty and Depository Relationships for Repurchase and Reverse Repurchase Transactions

For house repurchase and reverse repurchase transactions, the collateral must be held at a depository outside the control of the counterparty to the transaction to be allowed for capital. Generally, if the depository and counterparty are affiliated, the transaction is not allowed for capital purposes. The relationship between the counterparty and depository is examined on a case by case basis and, if necessary, the CFTC should be consulted for guidance.

For customer segregated and secured amount transactions, the counterparty and the depository may be affiliated provided the safekeeping account is properly titled and a satisfactory acknowledgment letter is maintained from the depository as to the nature of the account and disallowing any right of setoff.

Internal Exchanges of Cash and Securities Transactions for Joint FCM/BDs

CFTC Regulation 1.25(a)(3) allows FCMs that are dually registered as broker/dealers to exchange customer money for securities that are permitted investments and that are held by the FCMs in connection with their broker/dealer activities. These transactions, which result in an internal transfer of cash and securities (i.e. cash is sent from a customer segregated bank account to the broker/dealer's repo desk and there is a simultaneous transfer of securities into a segregated safekeeping account), are "functionally equivalent" to reverse repurchase transactions and should be reported at the lower of the cost of the transaction or market value of the securities on the segregation statement.

Unlike reverse repurchase transactions conducted with third parties, CFTC Regulation 1.25(e) does not require a written agreement for these internal transactions. However, a sufficient audit trail must be maintained to indicate the terms under which the transfer of cash and securities occurred.

CFTC Regulation 1.25(e) supersedes the CFTC Interpretive Letter dated March 8, 1993 on internal repurchase and reverse repurchase transactions.

It should be noted that investments that comply with the requirements of CFTC Regulation 1.25 are also acceptable for investments of secured amounts.

SEC Rule 144A Private Placements

SEC Rule 144A contains rules as to the private resale of unregistered securities to qualified institutional buyers. As these private placements cannot be publicly offered and sold without registration, the securities are not considered readily marketable and sufficiently liquid for purposes of investing customer funds. Under the terms of CFTC Regulation 1.25, investments must be consistent with the objectives of preserving principal and maintaining liquidity. These same objectives should be followed with respect to investments of customer secured amount funds under CFTC Regulation 30.7. Therefore, private placements are not considered acceptable investments of customer segregated or secured amount funds. SEC Rule 144A securities are, however, included as current assets for net capital purposes, to the extent provided in applicable SEC no-action letters and subject to the haircuts specified in such letters.

FDIC Temporary Liquidity Guaranteed Collateral

The Temporary Liquidity Guarantee Program ("TLGP") operated by the Federal Deposit Insurance Corporation ("FDIC") affords a FDIC guarantee of principal and interest to newly issued unsecured debt that meet certain criteria and are issued by participating entities. As of yet, there has been no comprehensive demonstration that these TLGP issued debt instruments are highly liquid or have immediate quotations from independent bona fide offers to meet the objectives of preserving principal and maintaining liquidity under CFTC Regulations 1.25 and 30.7. Therefore, this debt is not an acceptable investment of customer segregated or customer secured amount funds, and is not an acceptable security to offset or secure a debit/deficit on the segregation/secured amount statement or balance sheet, as applicable.

In addition, the following criteria should be used in determining the capital treatment of TLGP issued debt held in the firm's inventory:

- Debt securities issued by un-affiliated entities which meet the conditions of the TLGP should be reflected as a current asset. SEC Rule 15c3-1(c)(2)(vi)(A)(Government Securities) should be followed for the appropriate securities haircut.

- Debt securities issued by affiliated entities which meet the conditions of the TLGP should be reflected as a non-current asset unless conditions are met as required by SEC Rule 15c3-1(c)(2)(vi)/061 (Intercompany Securities Holding-Redeemable Debt Instruments).

Cash 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 may, by law, postpone a requested withdrawal for up to seven days. Therefore, these deposits are not considered demand accounts and are not acceptable investments for customer segregated or secured amount funds.

Recently, several banks have worked with the CFTC to create interest-bearing trust accounts that do not contain withdrawal restrictions, and therefore appear to meet the requirements of a demand account. These trust accounts are cash balances maintained with the bank's institutional trust department and recorded in the bank's trust ledger. CFTC Interpretive Letter # 03-31 has detailed several requirements for interest-bearing trust accounts to be an acceptable investment of customer segregated or secured amount funds. All account agreements should be reviewed for compliance prior to investing customer funds in interest-bearing trust accounts.

FCMs are reminded to carefully and continuously review their investment portfolios to ensure compliance with all CFTC regulations.

If you have any questions, please consult your DSRO.