

Joint Audit Committee

REGULATORY UPDATE

TO: Chief Financial Officers
Chief Compliance Officers

#10-02

DATE: February 4, 2010

SUBJECT: FDIC Temporary Liquidity Guarantee Collateral

The Temporary Liquidity Guarantee Program (“TLGP”) operated by the Federal Deposit Insurance Corporation (“FDIC”) affords an FDIC guarantee of principal and interest to newly issued unsecured debt instruments that meet certain criteria and are issued by participating entities. For the period that the guarantee provided by the FDIC is effective, they are backed by the full faith and credit of the United States.

Joint Audit Committee Regulatory Updates #09-02, dated February 10, 2009 and #09-07, dated October 6, 2009 advised that TLGP debt instruments were deemed to be unacceptable as CFTC Regulation 1.25 or 30.7 permitted investments and unacceptable to secure or offset a debit/deficit under CFTC Regulations 1.17(c)(3)(i) and 1.32(b) as there had 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.

TLGP debt instruments have now been traded for more than a year and additional guidance has been provided by the Division of Clearing and Intermediary Oversight of the CFTC. Below are certain highlights for net capital and investment purposes. Please refer to the attached letter dated January 22, 2010 for detailed conditions. The letter may also be found at <http://www.cftc.gov/ucm/groups/public/@llettergeneral/documents/letter/10-01.pdf>.

TLGP debt instruments that meet all applicable requirements in CFTC Regulation 1.25, as well as certain additional criteria supporting a demonstration of adequate liquidity, would be permitted investments under CFTC Regulations 1.25 and 30.7 and would be acceptable to secure or offset a debit/deficit under CFTC Regulations 1.17(c)(3)(i) and 1.32(b). There are several factors that can enhance the liquidity of a debit security and as a result, not all TLGP debt securities are uniformly or similarly liquid. The additional criteria set forth in the January 22, 2010 letter are: (1) the size of the issuance must be greater than \$1 billion; (2) the debt security must be denominated in U.S. dollars; and (3) the debt security must be guaranteed for its entire term.

Although “U.S. government securities” is a term used in CFTC Regulation 1.25(a)(1)(i) which includes “obligations fully guaranteed as to principal and interest by the United States,” based on various

considerations, including their trading behavior, TLGP debt securities are more properly considered to be corporate notes and bonds. As such, TLGP debt instruments fall within the category of “corporate notes or bonds” for purposes of applying rating requirements, concentration limits and all other applicable provisions of CFTC Regulation 1.25.

For net capital purposes, the applicable haircuts are those specified in FINRA Regulatory Notice 09-38, effective July 15, 2009. A copy of the FINRA notice is available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119382.pdf>. For example, TLGP instruments in the form of commercial paper and non-convertible debt securities that are guaranteed for their full term and issued by un-affiliated entities should be reflected as a current asset and SEC Rule 15c3-1(c)(2)(vi)(A)(Government Securities) should be followed for the appropriate securities haircut. Such TLGP commercial paper and nonconvertible debt securities that are guaranteed for their full term but are issued by affiliated entities 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). In addition to these examples, the FINRA notice specifies haircuts for several other categories of TLGP instruments and should be reviewed thoroughly by the FCM.

It is the responsibility of the FCM to exercise prudent judgment in assessing the liquidity of the market for TLGP securities and compliance with all other applicable provisions of CFTC Regulation 1.25 and the strict conditions required by CFTC guidance detailed in the attached letter dated January 22, 2010.

If you have questions, please consult your DSRO.



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and
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January 22, 2010

Debra K. Kokal
Director, Audit Department
CME Group
20 South Wacker Drive
Chicago Illinois 60606

Re: Request for Guidance Regarding Commission Regulations 1.25, 30.7, 1.17, and 1.32

Dear Ms. Kokal:

This is in response to your letter dated January 5, 2010, to the Division of Clearing and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission”), written on behalf of the Joint Audit Committee (“JAC”).¹ By your letter, you have requested guidance from the Division in evaluating whether corporate debt securities guaranteed by the Federal Deposit Insurance Corporation (“FDIC”) under its Temporary Liquidity Guarantee Program (“TLGP”) are permitted investments for customer segregated or customer secured amount funds pursuant to Commission Regulations 1.25 and 30.7, respectively.² As discussed below, the Division has concluded that TLGP debt securities that meet all applicable requirements set forth in Reg. 1.25, as well as certain additional criteria supporting a demonstration of adequate liquidity, would be permitted investments under Reg. 1.25 and Reg. 30.7.

TLGP

The FDIC’s final regulations implementing the TLGP became effective on November 21, 2008. The TLGP was designed to promote confidence and liquidity in the banking and financial sectors by guaranteeing both interest and principal on newly-issued senior unsecured short-term debt issued by eligible entities. Eligible entities include banks, thrift institutions and certain holding companies. Although the duration of the guarantee for any specific security depends on a number of factors including the issuance date of the debt, as of now, the FDIC has determined that TLGP coverage for any security will not extend beyond December 31, 2012. In light of the

¹ The JAC is a voluntary, cooperative organization comprised of representatives of the financial surveillance staff of designated contract markets and the National Futures Association and was formed for the purpose of coordinating the monitoring and examination of common members of such entities.

² The Commission regulations discussed in this letter are found at 17 C.F.R. Chapter 1 and are referred to herein as “Reg. ____.”

various factors affecting the duration of the FDIC's guarantee, some but not all securities may be guaranteed for their entire term, *i.e.*, from the date they are issued until their maturity date. For the period that the guarantee provided by the FDIC is effective, they are backed by the full faith and credit of the United States.

TLGP Debt Securities as Reg. 1.25(a)(1)(vi) Investments

Paragraph (a)(1)(vi) of Reg. 1.25 permits a futures commission merchant ("FCM") to invest in "corporate notes or bonds," and the Division considers the TLGP debt securities to fall within that category for purposes of applying rating requirements, concentration limits, and all other applicable provisions of Reg. 1.25 including the prohibition on investment in affiliate-issued securities. The Division recognizes that "U.S. government securities," as that term is used in Reg. 1.25(a)(1)(i), includes "obligations fully guaranteed as to principal and interest by the United States." However, based on various considerations including their trading behavior, the Division has determined that TLGP debt securities are more properly considered to be corporate notes or bonds.

Reg. 1.25 Requirements

Reg. 1.25 sets forth a number of specific requirements that are intended to mitigate credit, market and liquidity risk, *e.g.*, rating requirements, issuer concentration limits, and a ready marketability requirement.³ In addition, under Reg. 1.25(b), there is a general requirement that investments must be managed "consistent with the objectives of preserving principal and maintaining liquidity."

From the standpoint of preserving principal, the TLGP debt securities are backed by the full faith and credit of the U.S. government and therefore pose minimal credit risk to the buyer for the period during which the guarantee is effective. The concern you have identified in the JAC Regulatory Updates relates to whether these securities are readily marketable and sufficiently liquid so that the holders of such securities would be able to liquidate them quickly and easily without having to incur a substantial discount.

³ Reg. 1.25(b)(1) requires that permitted investments, other than money market mutual funds, be "readily marketable" as defined in Securities and Exchange Commission ("SEC") Rule 15c3-1 (17 C.F.R. 240.15c3-1). SEC Rule 15c3-1(c)(11)(i) defines "ready market" as including "a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom."

The SEC regulations discussed in this letter are found at 17 C.F.R. Part 240 and are referred to herein as "SEC Rule ____."

Analysis of Compliance with Reg. 1.25

Similar to the secondary market for U.S. Treasuries, the trading of outstanding debt securities is accomplished on the over-the-counter (“OTC”) market. The bond dealers in the OTC market provide liquidity in the market by providing both buy and sell quotes. Price and quote data are generally available through a number of different sources, which include market data vendors as well as brokers and firms that provide an electronic trading platform.

Among the sources of pricing information is the Trade Reporting and Compliance Engine (“TRACE”), a system used by members of the Financial Industry Regulatory Authority (“FINRA”) to report OTC transactions in eligible fixed income securities. TLGP debt securities are TRACE-eligible securities.⁴ As a result, FINRA members must report transactions in these bonds so that the data can be recorded and disseminated. This greatly increases the level of transparency in the OTC bond market for TRACE-eligible securities.

Since trading began in November 2008, many TLGP debt securities have established liquid secondary markets, enabling them to be readily bought and sold in the OTC bond market via multiple bond dealers. In addition, they appear to behave and trade like most other corporate bonds, distinguished primarily by the enhancing feature of an FDIC guarantee.

The Division notes that recently there was a change in the TLGP risk weight for the purposes of regulatory capital requirements. Initially, the senior unsecured debt guaranteed under the TLGP had a risk weighting of 20%, but after further review, the FDIC determined that TLGP debt may have a risk weight of 0%, effective September 29, 2009. Because many of the TLGP debt securities have the highest rating of one or more nationally recognized statistical rating organizations and the 0% risk weighting, both factors would only help to enhance their desirability and, hence, liquidity in the market. Moreover, based on actual information from TRACE, some of the TLGP debt securities represent some of the most actively traded investment-grade bonds in the OTC market.

There are several factors that can enhance the liquidity of a debt security, including the size and currency of issuance. As a result, not all TLGP debt securities are uniformly or similarly liquid. Therefore, in order to ensure ready marketability and adequate liquidity, the Division would require that a TLGP debt security meet the following criteria in addition to satisfying the pre-existing requirements imposed by Reg. 1.25:

- (1) the size of the issuance must be greater than \$1 billion;
- (2) the debt security must be denominated in U.S. dollars; and
- (3) the debt security must be guaranteed for its entire term.

⁴ As defined by FINRA, the term “TRACE-eligible security” means “all United States dollar denominated debt securities that are depository eligible securities under NASD Rule 11310(d).” See FINRA Rule 6710(a).

Compliance with Reg. 30.7

The investment guidelines for 30.7 secured amount funds are general in nature, although the Commission considers Reg. 1.25 permitted investments to offer a “safe harbor.” In this regard, Commission Form 1-FR-FCM Instructions provide that “[i]n investing funds required to be maintained in separate section 30.7 account(s), FCMs are bound by their fiduciary obligations to customers and the requirement that the secured amount required to be set aside be at all times liquid and sufficient to cover all obligations to such customers. Regulation 1.25 investments would be appropriate, as would investments in any other readily marketable securities.”⁵ Thus, TLGP debt securities that satisfy the requirements of Reg. 1.25 will also satisfy the requirements of Reg. 30.7.

Capital Treatment of TLGP Debt Securities

Reg. 1.17 requires the deduction from FCM net capital of certain “haircuts” from the market value of the FCM’s proprietary securities and the securities the FCM has acquired with customer funds and holds in segregation pursuant to Section 4d of the Commodity Exchange Act or in secured amount accounts under Part 30 of the Commission’s regulations. The applicable haircuts are those specified in SEC Rule 15c3-1(c)(2)(vi) for marketable securities, and the 100 percent deduction that SEC Rule 15c3-1(c)(2)(vii) requires for non-marketable securities. The applicable haircuts for TLGP debt securities are addressed in a regulatory notice issued by FINRA, after consultation with SEC staff, in July 2009.⁶ For example, commercial paper and nonconvertible debt securities issued under the TLGP, if guaranteed for their entire term and issued by entities that are not affiliated with the purchasing broker-dealer, are subject to the same deductions applicable to securities “issued or guaranteed as to principal or interest by the United States or any agency thereof” under SEC Rule 15c3-1(c)(2)(vi)(A). TLGP debt securities that are issued by affiliated entities, that are not guaranteed for their entire term, or that are in the form of convertible debt securities, are subject to greater deductions or not included as allowable assets under SEC regulations, as described in the FINRA regulatory notice.

The guidance set forth in this letter restricts investments of customer funds to TLGP debt securities satisfying certain specific criteria, which, among other things, would limit permitted investments of customer funds to commercial paper and nonconvertible debt securities that are not issued by affiliates and that are guaranteed for their entire term. Accordingly, the applicable haircuts for TLGP debt securities acquired as permitted investments under Reg. 1.25 would be the haircuts specified in SEC Rule 15c3-1(c)(2)(vi)(A).

⁵ See Form 1-FR-FCM Instructions at 12-9 (Mar. 31, 2007).

⁶ See FINRA Regulatory Notice 09-38, effective July 15, 2009 and available electronically at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119382.pdf>.

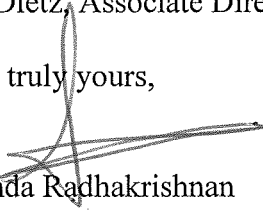
TLGP Debt Securities as Acceptable Collateral to Secure or Offset a Debit/Deficit

Reg. 1.32 requires a daily computation and record by each FCM of the total amount of customer funds on deposit in segregated accounts on behalf of commodity and option customers, as compared to the amount of customer funds required to be deposited in such segregated accounts. An FCM making the computations required by Reg. 1.32(b) may offset any net deficit in a particular customer's account against the current market value, minus the applicable haircut described above, of TLGP debt securities that have been deposited by the same customer for its account and which meet all of the same criteria set forth in this letter for the investment of customer funds under Reg. 1.25.

In conclusion, the Division notes that each FCM continues to be responsible for exercising prudent judgment in assessing the liquidity of the market for TLGP debt securities and compliance with all other applicable provisions of Reg. 1.25. This letter is based upon the structure and operation of the TLGP as it is currently authorized and any new, different or changed material facts or circumstances might render this letter void. Moreover, this letter represents the position of the Division only and does not necessarily represent the views of the Commission or those of any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Thelma Diaz, Associate Director, at (202) 418-5137, or Phyllis Dietz, Associate Director, at (202) 418-5449.

Very truly yours,



Ananda Radhakrishnan
Director