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Division of Clearing and Risk

CFTC Letter No. 12-34
No-Action
November 19, 2012
Division of Clearing and Risk

[Name and address redacted]

Re: Commission Regulation 1.25 - No-Action Relief for X to Enter Into Repurchase and Reverse Repurchase Agreements Cleared by Y

Dear X:

This is in response to your letter dated July 16, 2012, submitted on behalf of X, a registered futures commission merchant ("FCM"), to Ananda Radhakrishnan, Director of the Division of Clearing and Risk ("DCR"), and Dan Berkowitz, General Counsel, of the Commodity Futures Trading Commission ("Commission"). By your letter, you have asked whether X may enter into repurchase and reverse repurchase agreements (collectively, "repos") cleared by Y, a securities clearing agency registered with the Securities and Exchange Commission ("SEC") under section 17A of the Securities Exchange Act.

DCR confirms by this letter that it will not recommend that the Commission commence an enforcement action against X with respect to investing customer funds pursuant to repos cleared by Y, notwithstanding the fact that Y would become X's counterparty, and Y, a securities clearing agency, is not a permitted counterparty under Commission Regulation 1.25(d)(2).

As represented in your letter, X is a clearing member of the Z Division of Y. X intends to invest customer funds, as defined by Commission Regulation 1.3(gg), by buying and selling "government securities," as defined by subparagraphs (A), (B), and (C) of section 3(a)(42) of the Securities Exchange Act,[1] in exchange for cash, pursuant to repos entered into with other Y clearing members. X proposes to bilaterally execute such repos with other Y clearing members and then, as required by Z Rule 5, X and its counterparties would submit the repos for clearing

[1] These securities are: securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the U.S.; securities which are issued or guaranteed by the Tennessee Valley Authority or by corporations in which the U.S has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors; or securities issued or guaranteed as to principal or interest by any corporation the securities of which are designated, by statute specifically naming such corporation, to constitute exempt securities within the meaning of the laws administered by the SEC.

by Y.[2] Upon clearing a repo, Y would become the counterparty to each of X and the other Y clearing member. Y remains the counterparty to each of its clearing members for the duration of the repo.

Regulation 1.25(d) permits an FCM to invest customer funds by buying and selling the permitted investments listed in Regulation 1.25(a)(1)(i) through (vii)[3] pursuant to a repo, provided that the FCM complies with the requirements set forth in Regulation 1.25(d). Paragraph (d)(2) requires that an FCM enter into a repo only opposite a "permitted counterparty" which, generally speaking, is a bank or a securities broker or dealer.[4] Y, a securities clearing agency, is not a permitted counterparty under Regulation 1.25(d)(2). Thus, Regulation 1.25(d)(2) prohibits X from investing customer funds in a repo that is cleared by Y.[5]

DCR has determined that it will not recommend that the Commission commence an enforcement action against X for investing customer funds in Y-cleared repos. When the Commission amended Regulation 1.25 to permit an FCM to buy and sell permitted investments pursuant to a repo, the Commission promulgated paragraph (d)(2) as that provision is in effect today.[6] In that initial rulemaking, the Commission noted that an FCM's counterparty to a repo must be "a regulated financial institution."[7] This restriction furthers a crucial principle underlying Regulation 1.25, *i.e.*, that "customer segregated funds must be invested in a manner that minimizes their exposure to credit, liquidity, and market risks."[8] Each party to a repo incurs the credit risk of its counterparty, and a counterparty that is a regulated financial institution is expected to present less credit risk than one that is not. As an SEC-registered securities clearing

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2 Z Rule 5 requires a Y clearing member to report "trade comparison data" to Y concerning each repo it executes involving a government security. Then, pursuant to Z Rule 11B, Y will clear that repo.

3 Securities issued by the United States, a U.S. government corporation, or an enterprise sponsored by the U.S. government, are permitted investments under Regulation 1.25(a)(i) and (iii).

4 Regulation 1.25(d)(2) lists the following permitted counterparties: a bank, as defined by section 3(a)(6) of the Securities Exchange Act; 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 SEC or which has filed notice pursuant to section 15C(a) of the Government Securities Act of 1986.

5 X has represented to DCR that with respect to a repo it would clear through Y, X would execute the transaction only with a Y clearing member that meets the definition of permitted counterparty under Regulation 1.25(d)(2).

6 Rules Relating to Intermediaries of Commodity Interest Transactions, 65 Fed. Reg. 77,993, 78,011 (Dec. 13, 2000).

7 *Id.*, 78,001-78,002. Precedent for this concept was found in Customer Authorized Bank Treasury Bill Repurchase Program, CFTC Staff Letter No. 84-24 [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,449 (Dec. 5, 1984). This CFTC Staff Letter permitted an FCM to enter into a repo with a bank. Pursuant to that repo, the FCM would sell customer-owned U.S. Treasury Bills to the bank in exchange for cash. According to the CFTC Staff Letter, the bank had to remain "a primary dealer of U.S. government securities reporting to the Board of Governors of the U.S. Federal Reserve System."

8 Rules Relating to Intermediaries of Commodity Interest Transactions, 65 Fed. Reg. 77,993, 78,001 (Dec. 13, 2000) and Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78,776 (Dec. 19, 2011).

agency, Y is a regulated financial institution that can be expected to present no greater credit risk than banks or broker dealers that are permitted counterparties. Indeed, clearing can reduce credit risk to X by eliminating the risks presented by individual counterparties that are subject to financial stress associated with their activities in the financial markets. DCR therefore believes that it is consistent with the purpose of Regulation 1.25(d)(2) for X to be permitted to invest customer funds in a repo that is cleared by Y and for which Y becomes the counterparty.

The position taken herein is based upon the representations that have been made by X to DCR. Any different, changed, or omitted facts or conditions might require DCR to reach a different conclusion. You must notify DCR immediately in the event that there is any change from the facts as presented to DCR. DCR notes further that this letter does not provide no-action relief to X from any provision of Regulation 1.25 other than paragraph (d)(2). In particular, this letter does not provide no-action relief from the counterparty concentration limit set forth in paragraph (b)(3)(v),[9] and DCR is not expressing a view as to whether the government securities X will purchase or sell pursuant to a cleared repo are permitted investments under Regulation 1.25(a)(1)(i) or (iii). Finally, this letter represents the position of DCR only and does not necessarily represent the views of the Commission or any other division or office of the Commission.

Sincerely,

Ananda Radhakrishnan
Director

[9] Pursuant to Regulation 1.25(b)(3)(v), securities purchased by an FCM from a single counterparty, subject to a repo, may not exceed 25% of total assets held in segregation by the FCM. Because Y becomes X's counterparty to each repo, the amount of securities X purchases through a Y-cleared repo may not exceed 25% of total assets held in segregation by X.