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DIVISION OF
TRADING & MARKETS

96-18

October 28, 1996

Re: "V" Interest Earning Facility

Dear :

This is in response to your letter dated February 29, 1996, as supplemented by letters dated April 2, April 22, May 17 and September 18, 1996 and various documentation, as well as telephone conversations with Division staff, wherein you requested a "no-action" letter concerning the "V" planned implementation of its "W" Program.1/ Essentially, you have requested that participation by "V" clearing members in the "W" involving custodianship and investment management by "X"2/ , subject to the conditions specified herein, be deemed a permissible treatment of

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1/ The documentation provided includes an overview of the "W" Program dated August 17, 1995, the "W" Program investment guidelines, a chart concerning "V's" contingent liability under the "W" Program, an excerpt from the proposed custodian and investment management agreement, representations of the custodian with respect to the sub-custodian agreement and representative disclosure provisions from various futures commission merchant (FCM) customer agreements. All of these documents were provided with the February 29, April 2, April 22, or May 17 letters except for the overview, which was provided to us on January 18, 1996.

2/ "X" acts as one of the largest custodians for the mutual fund industry, with over $200 billion under custody. It is a private bank subject to examination by the Superintendent of Banks of the State of New York, the Department of Banking of the Commonwealth of Pennsylvania and the Commissioner of Banks of the Commonwealth of Massachusetts. "X" is also a member of all principal U.S. securities exchanges and of the Securities Investor Protection Corporation, and is subject to annual review by the New York Stock Exchange, Inc. "X" is rated "A" by "A" and, similar to Depository Trust Company, carries blanket bond insurance in the amount of $500 million.

customer funds under the Commodity Exchange Act (Act) and rules promulgated thereunder.

BACKGROUND

Based upon your representations, we understand that the "W" Program would operate as follows. The "W" Program will be offered by "V" to its clearing members and their participation will be wholly voluntary.[3/] Under the "W" Program, performance bond cash and settlement funds deposited with the "V" Clearing House by "W" Participants will be pooled and invested in U.S. government securities and under reverse repurchase agreements involving such securities as the underlying collateral. "V" will establish two separate limited liability company[4/] accounts at "X", one of which will consist of investments made with "W" Participants' customer funds and the other of which will consist of investments made with "W" Participants' proprietary funds.[5/] "V" will maintain sub-accounts, on its own books and

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3/ A prospective clearing member participant in the "W" Program ("W" Participant) will be provided sufficient information about the "W" Program, through a participant agreement containing the terms and conditions of participation and a description of the "W" investment policies, to enable a clearing member to make an informed decision as to whether to become an "W" Participant.

4/ Although you indicated originally that separate limited partnerships would be formed, in your September 18 letter you stated that the "V" would like to structure the two separate "W" funds as limited liability companies. You cited as a reason for the change that "V's" Clearing House Committee and certain clearing members believe that the internal approval process at clearing member firms will be shorter and easier if the "W" Program is structured as limited liability companies rather than limited partnerships.

5/ The "W" Program's investment guidelines stipulate that these accounts may include only: (1) U.S. Treasury bills, U.S. Treasury notes, and U.S. Treasury strips with an average maturity of 90 days and the maximum maturity of an individual security of 13 months; and (2) reverse repurchase agreements which (i) have a term of overnight or demand/open not to exceed 13 months, and (ii) are collaterized by the categories of U.S. Treasury securities referred to in this footnote, with the time to maturity of underlying collateral to be less than five years and subject to the following margin requirements: (A) for a maturity of less than one year, 101.0%; (B) for a maturity of at least one but less than three years, 102.0%; and (C) for a maturity of between

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records, for each "W" Participant, indicating the amount of funds invested by "V" on behalf of the "W" Participant in each "W" account and the amount of any increment or interest earned that is attributable to such funds. The earnings will be accrued daily and credited monthly in the form of additional "W" shares. "V" will not commingle any cash, securities or other property held in the "W" account containing customer funds with any other cash, securities or other property held on behalf of clearing members' customer or proprietary accounts. You have indicated, however, that "V" would like to be able to include: (1) all clearing members' security deposits in the "W" account that includes proprietary funds of "W" Participants; and (2) "V" operating funds in either of the "W" accounts.6/

"W" Participants will receive their proportionate share of the income earned by the investments in each "W" account less

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5/ (...continued)
three and five years, 103.0%. All securities and collateral will be held in safekeeping at the relevant custodian or sub-custodian. "X" will perform a daily mark-to-market calculation for reverse repurchase agreement transactions having a duration of longer than one day and will call for additional collateral in the event of a diminution in the market value of the underlying collateral. Such reverse repurchase agreements comply with Division of Trading and Markets Financial and Segregation Interpretation No. 2-1, 1 Comm. Fut. L. Rep. (CCH) ¶7,112A (Dec. 15, 1993), except that under the "W" Program the collateral can have a maturity date of up to five years while Interpretation 2-1 only permits securities obtained by an FCM through reverse repurchase transactions involving customer funds to be pledged to a clearing organization to satisfy customer margin requirements provided such securities have a maturity of 180 days or less.

6/ Consistent with current practice, earnings derived from such investments would be retained by "V".

The reason why "V" may deposit operating funds in either of the "W" accounts is to comply with Internal Revenue Service (IRS) guidelines. Each account (fund) will be structured as a limited liability company, with the "V" acting as member-manager. The IRS maintains guidelines as to what constitutes a sufficient financial interest on the part of a member-manager in a limited liability company. In order to assure that "W" funds structured as limited liability companies are recognized as such by the IRS, and are not treated instead as corporations subject to a separate entity-level tax, the "V" must be able to demonstrate that it meets these guidelines.

fees earned by the "V" and by "X",[7] the custodian and investment manager of the "W" accounts. Interest on investments earned each day will be accrued daily and paid monthly, shortly after the end of each month, by crediting a sub-account of the "W" Participant at the "V" Clearing House. The "Y" will act as sub-custodian of the "W" accounts.[8] "V" intends to maintain a stable net asset value "per share" of the "W" accounts of $1.00 by virtue of the amortized cost method of valuing securities held in these accounts[9] and "V" will account for the principal invested by "W" Participants (as well as accrued earnings) as a direct obligation of the "V" and "W" Participants will reflect the principal and earnings on their books as a cash receivable from the "V".[10] An "W" Participant may notify "V" at any

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7/ Fees will be deducted from earnings on investments -- no fees will be paid from principal.

8/ Since "X" is not a member of the Federal Reserve System (Fed), it normally uses "Y" as a sub-custodian for U.S. Treasury securities. All securities related to the "W" accounts will be held by "Y" in New York.

9/ The amortized cost method values securities at acquisition cost adjusted for amortization of premium or accretion of discount, rather than at current market price. The I "W" accounts will be marked-to-market daily. If the difference between market value and amortized cost reaches ±25 basis points, the "V" Finance or Clearing House Committee will be notified. If the variance reaches ±50 basis points, or prior to such time if the "V" determines that stabilizing efforts are warranted, the "V" may take the following actions. In the event the variance exceeds -50 basis points, the "V" may either deposit funds into the account or purchase securities at amortized cost out of the account in order to reduce the negative differential to 50 basis points or less. In the event the variance exceeds +50 basis points, "V" will, in its discretion, determine how much gain to realize, sell specified securities to realize those gains and add such gains to the Participants' daily accrual. Because the "V" guarantees repayment of principal to "W" Participants, this is intended to protect "W" Participants from loss of principal.

10/ Even though the principal invested by "W" Participants (as well as accrued earnings) will be included in "V's" financial statements as a direct obligation of the "V" and "W" interests will be included in "V's" financial statements as a corresponding asset, you have represented that, subject to the exception stated below, income generated by "W" investments will not be reflected in "V's" financial statements (either for financial or tax

(continued...)

time that it wishes to withdraw from the "W" Program and request that "V" remit to it amounts owed from the "W" accounts, including deposits and earnings on investments. Such redemptions would be available on a daily basis, with the deposits returned immediately and the accrued interest up to the time of withdrawal paid at the end of the month. An "W" Participant may not transfer any interest it may hold in an "W" account. "W" Participants will have no voting rights with respect to the "W" Program,[11/] and no direct right to redeem interests, but must act with respect to entering and exiting the "W" Program through "V". Further, the sole remedy of an "W" Participant dissatisfied with its investment in the "W" Program will be to withdraw from the "W" Program.

"V" also uses the services of "X" and "Y" as custodian and sub-custodian for U.S. Treasury securities of clearing members that are passed up to the "V" Clearing House by the clearing

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10/ (...continued)
reporting purposes) because "W" Participants, rather than the "V", will be the beneficial owners of "W" interests. You have further represented that this treatment is consistent with the treatment of performance bonds and security deposits currently held by the "V". An exception exists insofar as "V" will also be a minor beneficial owner of "W" interests. "V" may invest in "W", and separately subaccount for, non-segregated funds such as clearing members' security deposits, as well as the portion of intra-day settlement funds (both customer and house origin) that "V" currently retains under its existing settlement procedures. Any investment income accrued with respect to "V's" beneficial interests will be reflected on "V's" financial statements as income earned by "V".

The IEF accounts will be structured as limited liability companies. The principal and accrued interest credited to the IEF participants will be reflected in the same manner as CME currently reflects performance bonds and other deposits on its financial statements -- as an asset of the CME with a corresponding liability to clearing member firms.

11/ Among other provisions, the Participant Agreement that clearing members will sign in order to participate in the "W" Program may provide that a fund may terminate upon the bankruptcy or voluntary withdrawal of the "V" as member-manager from the "W" Program. However, the Participant Agreement may provide that the remaining "W" Participants may vote to continue operation of the fund with a substitute member-manager. Aside from such a fund continuation vote, none of the "W" Participants would, as a result of their participation in the "W", have any voting rights with respect to the Program.

members outside of the "W" Program. In such cases, "X" maintains the securities in "V"-titled accounts on its books and records.[12/]

DISCUSSION

Permissibility Under Section 4d(2) of the Act

The investment of customer funds by an FCM or clearing organization is governed by Section 4d(2) of the Act, which provides in pertinent part that such funds "may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe."[13/] Under the "W" Program, an "W" Participant's customer funds will be pooled for investment by "X" and each "W" Participant's interest in the "W" accounts will be reflected on the books and records of "V". As you noted in your letter, an "W" Participant will not have invested customer funds directly under the "W" program in the types of permissible investments set forth in Section 4d(2) of the Act and Commission Rule 1.25 promulgated thereunder.[14/] However, each "W" participant will have an interest in a pool of securities held in a common customer and/or proprietary origin account, as appropriate, through "V", each of which would be a permissible investment under Section 4d(2) of the Act, Commission Rule 1.25 and applicable interpretations thereof, except with respect to the provision

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12/ Since "Y" is a Fed member, it has only two accounts at the Fed, one for its own proprietary account and the other for customers. "X" and "V" are considered customers of "Y" and thus "Y" will not maintain sub-accounts in the manner of "X" and "V" with respect to the "W" Program. This would be no different, however, if "V" maintained accounts with "Y" outside of the "W" Program. Further, "X" and "Y" will acknowledge in writing that (1) the "W" accounts will not constitute general assets of "X" or "Y", and (2) after the securities acquired for the portfolios have been paid for, the property in the portfolios will not be subject to any lien, security interest or right of set-off by "X" or "Y". All securities held by the sub-custodian will be fully paid and held in safekeeping and thus will be distinct from deposits and not subject to hypothecation by the custodian.

13/ 7 U.S.C. §6d(2) (1994).

14/ 17 C.F.R. §1.25 (1996).

of Interpretation 2-1 noted above concerning the maturity date of collateral involved in reverse repurchase transactions.[15]

You stated that the "W" Program will be a more efficient and economical way for clearing members to handle the investment of customer funds and will provide a greater net return to participating "V" clearing members than do current margin handling procedures.[16] The Division appreciates the importance of these objectives but must assure that the safety and liquidity of customer funds are not compromised in achieving those ends.[17] Given "X's" rating, insurance coverage and examinations to which it is subject as noted above, as well as the repurchase agreement collateral requirements, it would appear that the custodianship and investment management arrangement with "X" for the "W"

15/ Interpretation 2-1 also states that the capital charge on reverse repurchase agreements should be computed in accordance with 17 C.F.R. §240.15c3-1(c)(2)(iv)(F), which generally requires a charge equal to the difference between the contract price for resale of the securities and the market value of those securities (if less than the contract price), which is known as the reverse repurchase agreement deficit. As you note, the "W" Program investment guidelines can be deemed more conservative in this area since the value of collateral received by "X" under a reverse repurchase agreement will be at least 101 percent of the cash tendered to the counterparty, "X" will perform a daily mark-to-market calculation for reverse repurchase agreement transactions having a duration of longer than one day, and "X" will call for additional collateral in the event of a diminution in market value of the underlying collateral. For example, if the underlying collateral has a maturity of five years, the collateral amount will be 103 percent, which will be consistent with the haircut for government securities of like maturities under 17 C.F.R. §240.15c3-1(c)(2)(vi)(A)(*1*)(1996).

16/ "X" will seek to achieve a return approximating the three-month U.S. Treasury bill yield, net of expenses. Commission Rule 1.29, 17 C.F.R. §1.29 (1996), provides that:

> The investment of customer funds in obligations described in §1.25 shall not prevent the futures commission merchant or clearing organization so investing such funds from receiving and retaining as its own any increment or interest resulting therefrom.

17/ <u>See</u> <u>e.g.</u>, CFTC Interpretative Letter No. 86-21, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,266 (Sept. 17, 1986) (investment of customer funds in municipal securities).

Program is consistent with the prudential responsibilities of the clearing house with respect to the treatment of "V" margin deposits -- be they proprietary or customer origin. You also have noted that the portfolio's high quality assets, combined with the depth of the U.S. Treasury securities market, should permit the "W" accounts under most circumstances to be converted to cash within 24 hours if necessary, thereby providing at least equivalent liquidity to direct investments in similar assets.

Haircut

You noted that another issue which has arisen concerning the proposed "W" Program is the appropriate charge against net capital that should be taken by an "W" Participant based upon "W" interests. Commission Rule 1.17(c)(5)(v)[18/] states that an FCM, in computing its adjusted net capital, should generally take a charge against net capital with respect to securities[19/] based upon the Securities and Exchange Commission's (SEC's) "securities haircuts."[20/] A "money market fund" is subject to a haircut of two percent of the market value of the greater of the long or short position.[21/] U.S. Treasury securities with a maturity of 13 months, the maximum maturity for an individual security in the "W" portfolio, would be subject to a haircut of 1.5 percent.[22/] However, "V" asserts that the portfolio's maximum average dollar-weighted maturity would be 90

18/ 17 C.F.R. §1.17(c)(5)(v) (1996).

19/ Your February 29, 1996 letter stated that "V's" counsel, "Z", has advised you that a participation in an "W" account would be deemed a security under the Securities Act of 1933, although it is exempt from registration under that statute because it does not involve a public offering.

20/ See 17 C.F.R. §240.15c3-1(c)(2)(vi) (1996).

21/ 17 C.F.R. §240.15c3-1(c)(2)(vi)(D)(*1*) (1996). The "V" counsel's opinion indicates, however, that neither "W" account would be an investment company under the Investment Company Act of 1940 because neither account will ever have more than 100 participants.

22/ 17 C.F.R. §240.15c3-1(c)(2)(vi)(A)(*1*)(*i*) (Category 2) (1996).

days, and U.S. Treasury securities of up to three months maturity are not subject to any haircut.23/

In arguing against the imposition of any haircut charge for "W" interests, you stated that an "W" Participant will have the ability to redeem its interests daily as described above and that "V" will reflect and treat its obligation to "W" Participants with respect to principal deposited as a direct obligation on its books.24/ Although the instruments in which the "W" accounts are invested will be highly liquid U.S. Treasury securities with an average dollar-weighted maturity that does not exceed 90 days, this would not preclude a haircut under securities rules. However, the principal will be a direct obligation of "V", and "V" effectively will owe "W" participants the cash amount on its books, not the amount invested at "X". An "W" Participant will reflect a cash receivable in respect of an "W" account. The Division therefore does not believe that it is necessary to require a haircut on an "W" Participant's interest in an "W" account.25/

We wish to emphasize that just as is required where customer cash is used to purchase securities directly, the FCM would be required to calculate segregation requirements based upon the amount of funds deposited by customers, not the current value of its "W" account. Of course, it is the clearing FCM, not the customer, which bears the risk of any decline in the value of such investments purchased with customer funds.26/

23/ 17 C.F.R. §240.15c3-1(c)(2)(vi)(A)(*1*)(*i*) (Category 1) (1996). SEC rules also provide that a money market fund cannot maintain a dollar-weighted average portfolio maturity that exceeds ninety days. 17 C.F.R. §270.2a-7(c)(2)(iii)(1996).

24/ Further discussion of "V's" estimate of its potential liability is set forth below.

25/ The CFTC has consulted with relevant SEC staff and they have no objection to this interpretation.

26/ Craig v. Refco, Inc., 624 F. Supp. 944, 947 (N.D. Ill. 1985), *aff'd per curiam*, 816 F.2d 347 (7th Cir. 1987). In any event, given the "V's" guarantee of principal discussed elsewhere in this letter, it is extremely unlikely that an "W" Participant would be more likely to suffer any loss of its deposits under the "W" Program than if such deposits were directly placed in the underlying securities by "V".

Disclosure

We have had several discussions concerning whether disclosure to customers is necessary or appropriate concerning the "W" Program.[27/] You express "V's" belief that such a disclosure requirement is unnecessary because there is no material risk to participants or their customers created by participation in the "W" program other than that involved when permissible investments under Section 4d(2) of the Act and Commission Rule 1.25 are made, and that such a requirement would create administrative burdens because it would require either a repapering of existing customer agreements for inclusion of required disclosures or negative consent language in customer account statements. In support of "V's" position concerning the risks of the "W" program, you noted that the "V's" responsibility with respect to "W" investments will be that of a direct obligation of "V" to the extent of the invested principal, which is similar to that of "V" with respect to other "V"-held margin invested on behalf of customers. As the "V" intends to reserve against this obligation, the "W" Program may in fact constitute an additional protection that customers may not receive when their funds are invested directly in government securities by their FCM. You represent that the "V" has evaluated its expected risk of loss and has concluded that the risk of a default in the repayment of principal in respect of an "W" account is extremely remote. The "V" will at all times have immediate access to the securities held in each of the "W" accounts, as well as the collateral deposited with "X" by counterparties to repurchase agreement transactions which exceeds the principal amount. This limits the "V's" potential default risk to the risk associated with losses attributable to extreme changes in interest rates.[28/] Under a "worst-case" scenario, the "V's" potential risk associated with repayment of principal on a $500,000,000 portfolio of securities where interest rates have risen 100 basis points overnight, assuming an average dollar-weighted portfolio maturity of 90 days, would not exceed $1,250,000 assuming the collateral is held in safekeeping as required by the relevant agreements and thus is not an asset of

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27/ See, e.g., Commission Rule 1.55(f), 17 C.F.R. §1.55(f) (1996), which states that the rule, which governs distribution of a risk disclosure statement to customers by FCMs, "does not relieve [an FCM] . . . from any other disclosure obligation it may have under applicable law."

28/ Of course, an FCM's direct investment of customer funds in government securities creates a possibility of losses attributable to extreme changes in interest rates.

"X" or "Y".[29] The "V" will reserve a portion of the fees collected by it under the program in order to meet any such liability and, additionally, "V" operating funds would be available to meet any shortfall.[30]

You contend that current FCM account documents provide adequate disclosure to customers that their funds may be invested in a manner consistent with Rule 1.25, that the FCM may retain interest earned on such investments under Rule 1.29 and that no additional disclosure is needed to address the risks of the "W" Program which would be substantially the same for clearing customers. "X" investments will meet Rule 1.25 standards except as noted above with respect to the provision concerning the maturity date for collateral involved in reverse repurchase transactions set forth in Interpretation 2-1, and FCMs are currently permitted to retain interest on such investments, subject to a duty to return the full amount deposited by customers (and invested by the FCM) to customers even if the investments lose value. You further expressed the belief that, for purposes of disclosure to customers, income earned by "W" Participants under the "W" Program should not be treated differently from income earned through other investments of customer funds available to FCMs, in that the principal invested under the "W" Program will be a direct obligation of "V" even though customer funds are indirectly invested in government securities. You further noted "V's" understanding that the majority of FCMs do, in fact, disclose in their customer agreements that they may retain interest earned on invested customer funds.[31]

For practical purposes, the issuance of this no-action letter will permit the "W" program to be treated as if it were a permissible investment of customer funds under Section 4d(2) of

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29/ "V" research indicated that the largest single-day move in the 90-day Treasury Bill over the last 30 years occurred on August 27, 1982 when the value of the bill dropped due to a rise in the interest rate of 43 basis points, significantly less than the 100 basis point move assumed in the example.

Such a 43 basis point increase in the interest rate would create a potential contingent liability of $537,500 using the same assumptions as the example above.

30/ The "V's" Guaranty Fund would not be affected by the "W" Program.

31/ As noted above, you enclosed with your letter representative disclosure provisions from various FCM customer agreements.

the Act and Commission Rule 1.25.[32] Courts have upheld Commission Rule 1.29, which permits an FCM to retain earnings from investments of customer funds described in Commission Rule 1.25 subject to adequate disclosure.[33] To the extent the "V" guarantees principal deposited and the "W" Participant reflects such principal as a cash receivable, the risks of the "W" Program should not be substantially different from direct investment of those deposits. To the extent the "W" Program could, however, entail additional risk to customers as compared to direct investment as set forth in Commission Rule 1.25, prudent business practice may call for additional disclosure to customers concerning the "W" Program, although we do not consider a special regulatory requirement to this effect to be necessary at this time.[34]

In this connection, the Division raised the issue, in telephone conversations with "V" staff, of whether the "W" Program could be an incentive for firms to retain and deposit additional excess customer performance bond funds with the "V" Clearing House, thereby potentially increasing the risk that in the event of a customer origin default at a "V" clearing member that is an "W" Participant, increased funds of nondefaulting customers would be available to satisfy the firm's nonproprietary obligations.[35]

32/ Indeed, the Division is conditioning this relief upon, among other things, treatment of investment of customers funds in the "W" Program in accordance with the Commission's other rules pertaining to permissible investments, as described below.

33/ See Craig v. Refco, Inc., supra; see also Marchese v. Shearson Hayden Stone, Inc., 822 F.2d 876 (9th Cir. 1987).

34/ See note 27, supra; see also Commission Rule 1.65(a)(3)(i), 17 C.F.R. §1.65(a)(3)(i) (1996); 58 Fed. Reg. 17495, 17500 (Apr. 5, 1993) (the Commission believes that prudent business practice may call for complete "repapering," including execution of new account agreements and appropriate disclosures, of transferred accounts but does not consider a general regulatory requirement to this effect to be necessary where the transferee firm can establish that the customer has received and acknowledged receipt and understanding of required disclosures).

35/ See CFTC Interpretative Statement No. 85-3, "Use of Segregated Funds by Clearing Organizations upon Defaults by Member Firms," [1984-1986 Transfer Binder], Comm. Fut. L. Rep. (CCH) ¶22,703 (Office of the General Counsel, Aug. 12, 1985).

You stated that "V" does not believe that this is a material issue requiring disclosure. Customers routinely maintain excess performance bond with their clearing member firms which, in turn, routinely maintain excess performance bond collateral in the customer origin account with the "V" Clearing House. Further, you stated that it is not clear that the availability of the "W" Program will significantly increase the amount of excess performance bond funds deposited by customers with FCMs and by clearing member firms at the "V" Clearing House. Nonetheless, in that the Commission does not regard a clearing venue as equivalent to a customer's private bank account and discourages using such accounts for purposes not related to transactions in futures and options thereon, you further stated that "V" will monitor the "W" Program to determine whether any correlation exists between participation and the amount of excess performance bond funds deposited with clearing members and the "V" Clearing House and if a high degree of correlation is established, "V" will consult with Division staff to determine whether regulatory direction as to further customer disclosure would be warranted at that time. Although the Division will not condition no-action relief upon a disclosure requirement at the outset, it is a condition of relief for the "V" to monitor the "W" Program so that this issue can be revisited in the future.

CONCLUSION

Based upon the foregoing, the Division will not recommend that the Commission take any enforcement action against FCM clearing members of "V" under Section 4d(2) of the Act and Commission Rule 1.25 based solely upon their investment of customer funds in the "W" Program described above. This relief is based upon the representations of the "V" as to the operation of the "W" Program, upon our understanding that no failure by the "W" custodian or sub-custodian arising in connection with services provided pursuant to the "W" Program will impact "V" clearing members that do not participate in the "W" Program, and is subject to the conditions that: (1) any FCM who becomes an "W" Participant must comply, except as set forth herein, with the provisions of the Commission's rules related to permissible investment and segregation of customer funds set forth in Commission Rules 1.20, 1.25, 1.26, 1.27, 1.28 and 1.29[36/] with respect to the "W" Program as if an "W" account were specifically covered by Section 4d(2) of the Act and Commission Rule 1.25; (2) "V" records on its books the principal invested by "W" Partici-

36/ 17 C.F.R. §§1.20, 1.25, 1.26, 1.27, 1.28 and 1.29 (1996). These rules relate to how investments of customer funds must be made, how such investments must be deposited, required record-keeping, and how such investments are appraised.

pants (as well as accrued earnings) as a direct obligation of "V"; (3) "V" calculates on a daily basis the aggregate deposits of "W" Participants and compares that amount to the value of the investments of the "W" Program, and notifies the Commission if "V" becomes obligated on its guarantee of repayment of principal to "W" Participants; and (4) "V" reports to the Division, as of the end of the first full quarter after the commencement of the "W" Program (such report to be submitted to the Division within a week of that date), as to the amount of excess customer performance bond funds deposited by clearing members with the "V" Clearing House as compared to the amount of such deposits as of the commencement of the "W" Program, in the aggregate and by clearing member, and thereafter reports similarly on a quarterly basis during the life of the "W" Program.

The positions taken herein apply to FCM clearing members of "V" solely in connection with the issue of whether an investment of customer funds in the manner stated for this "W" Program may be deemed a permissible investment under Section 4d(2) of the Act and Commission Rule 1.25. This letter does not excuse such FCMs, "V", "X", "Y" or any other parties who may be involved in the "W" Program from compliance with any other applicable requirements contained in the Act or in the Commission's rules promulgated thereunder. The positions taken herein are based upon your representations and any different, changed or omitted facts or circumstances might require us to reach different conclusions. In that connection, please advise us immediately of any change in the operations of the "W" Program from those described to us in your letter as supplemented. Please be advised that the Division reserves the right to revisit the issue of appropriate guidance or disclosure to customers if, among other things, the "W" Program results in a significant increase in excess customer performance bond funds deposited with "V" clearing members and the "V" Clearing House based upon the reports to us required herein.

Further, the positions taken herein represent the views of this Division only and do not necessarily reflect the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact me or Deputy Director Susan C. Ervin.

Very truly yours,

Andrea M. Corcoran
Director