CFTC Letter No. 98-05

January 12, 1998

Division of Trading & Markets

Re: "R" Interest Earning Facility Program

Dear :

This is in response to your letter dated September 11, 1997, as supplemented by telephone conversations among you, "A" of "R's" staff and Division staff, wherein you stated that "R" wishes to modify one aspect of its Interest Earning Facility program ("S" Program). You have requested the Division's concurrence that this modification will not affect the "no-action" relief set forth in the Division's October 28, 1996, letter concerning "R's" "S" Program.[1]"

Under the "S Program", performance bond cash deposited with "R's" Clearing House by clearing members participating in the "S" Program" ("S" Participants) is pooled and invested in U.S. government securities and under reverse repurchase agreements involving such securities. "R" established two separate limited liability company accounts at "U", one of which consists of investments made with customer funds of "S" Participants and the other for investment of such firms' proprietary funds. "U" serves as the investment manager and custodian of the "S" portfolios.[2] In a February 26, 1997, letter, the Division stated that amendments to "R" Rule 821 to include units in the "S" Program as acceptable performance bond (original margin) could be made effective immediately, subject to the conditions set forth in CFTC Interpretative Letter No. 96-78, without prior Commission approval.[3] The "S" Program commenced operations the following day.

During what you have characterized as "Phase 2" of the "S" Program, "S" Participants will be able to redeem "S" units to satisfy their settlement variation payment obligations to "R's" Clearing House.[4] In telephone conversations with Division staff, "A" stated that "R" has established controls to limit the amount of new money that can be deposited in the "S" Program on a daily basis and the amount of "S" units that can be redeemed by "S" Participants on a daily basis. "A" further stated that "R" will provide "U" with an indication at approximately 11 a.m. each day of the anticipated amount of net investment in or redemptions of "S" units for the day. "A" also stated that these actions by "R" should allow "U" to manage the "S" portfolios on most days within the existing "S" Program investment guidelines.

You stated in your letter, however, that in assessing the implementation of Phase 2 of the "S" Program, the "R" believes that "U", as the investment manager, may, in certain circumstances, require flexibility with respect to its investment options in order to satisfy "S" Participants' redemption demands without adversely affecting the investment performance of the portfolios.

There may be circumstances, either with respect to the customer funds portfolio or the proprietary funds portfolio, where more "S" units are redeemed to meet obligations to the "R" Clearing House for settlement than are purchased to meet obligations to the "R" Clearing House for performance bond, particularly with respect to the intraday settlement. When a portfolio is subject to net redemptions, it may not have sufficient cash from maturing investments to satisfy redemption demands. In these situations, it would be necessary to sell securities from the portfolio. Because the portfolios can only invest in highly liquid investments, sales from the portfolios can be easily accomplished. However, there may be occasions when, either due to the size of the position to be liquidated, the lateness in the day when the investment advisor is notified that liquidation is necessary, or both, the most desirable markets in which to sell the securities are not available.

Your letter stated that, if such circumstances arise, it would be desirable for "U" to have the authority to sell portfolio securities to meet the immediate need for cash by entering into repurchase agreements (repos) involving "S" securities.[5] The cash proceeds from the repos would flow into the "S" accounts, and "R" would instruct "U" to pay the proceeds to the "R's" concentration settlement bank for distribution to a "R" clearing member that is owed money as a result of market activity (i.e., a collect from "R's" Clearing House). An "S" participant effectively liquidates a portion of its investment in the "S" program through these procedures.

In keeping with standard industry practice, the "R" anticipates that the "S" Program portfolios would receive cash "commensurate" to the market value of the securities that are subject to the transaction.[6] It is anticipated that the repo would typically have a term of one business day. The transactions would be unwound in one of two ways: (1) cash to fund the agreed upon repurchase price of the securities subject to the repo would be raised through the sale of other securities from the "S" portfolios and the securities subject to the repo would be returned to the "S" portfolios; or (2) "U" would arrange with the repo counterparty to have the counterparty liquidate the securities subject to the repo and retain the proceeds, without affecting the "S" portfolios.[7]

The primary purpose for "U" entering into repos on behalf of the "S" portfolios would be to create the liquidity necessary to support the payment of cash redemptions from the portfolios. "U" would enter into such a repo only if it considered doing so to be economically superior to selling securities outright. As noted above, "A" indicated that he expects "U" to enter into repos involving "S" assets only on rare occasions.

Your letter stated that the "R" will provide "S" Participants 30 days prior written notice regarding the proposed change to the "S" Program. "S" Participants may, if they wish, withdraw from the "S" Program without any penalty or assessment if they are not in favor of the revision.

As noted in CFTC Interpretative Letter No. 96-78, "R" established the "S" Program as a more efficient and economical way for clearing members to handle the investment of customer funds and to provide a greater net return to participating "R" clearing members than other methods for making such investment. The Division also noted in that letter that it appreciates the "R's" goals in

establishing the "S" Program but that it must be satisfied that the safety and liquidity of customer funds are not compromised in achieving those ends.

The Division has reviewed the proposed change to the "S" Program to permit "U" to enter into repos using "S" assets and does not believe that the proposal is inconsistent with the "S" Program. This view is based upon the representations set forth in your September 11, 1997 letter, as supplemented by your October 16, 1997 letter and telephone conversations with Division staff, that: (1) a repo would be entered into by "U" only if that was considered to be an economically superior alternative to selling securities outright; (2) such a repo would be entered into only to fund liquidity needs so that participating clearing members can satisfy settlement variation requirements in cash; (3) virtually all of the repos would have a term of one business day;[8] (4) "R" will provide "S" Participants with 30 days prior written notice concerning this proposed change in the "S" Program and the ability to withdraw from the "S" Program without penalty or assessment if they are not in favor of the revision;[9] and (5) "R" will be responsible for maintenance of records concerning the use of repos in connection with the "S" Program as discussed herein.[10] Based upon the foregoing, the Division will not recommend that the Commission take any enforcement action against FCM clearing members of "R" under Section 4d(2) of the Commodity Exchange Act[11] and Commission Rule 1.25[12] based solely upon their investment of customer funds in the "S" Program as described in CFTC Interpretative Letter No. 96-78 and as modified in your letter dated September 11, 1997, as supplemented by your October 16, 1997 letter and telephone conversations with Division staff. This further relief is also subject to (1) the condition that the repurchase agreements in question are unwound no later than three business days after they are entered into, and (2) continued compliance with the conditions set forth in CFTC Interpretative Letter No. 96-78.

The positions taken herein apply to "U's" disposition of securities held for the benefit of "S" Participants' customers under Section 4d(2) of the Act. This letter does not excuse "S" Participants, "R", "U", "V" or any other parties who may be involved in the "S" Program from compliance with any other applicable requirements contained in the Act or in the Commission's rules promulgated thereunder. Please note that, for purposes of the requirement to segregate customer funds, an "S" Participant cannot treat an "S" investment as segregated funds once the proceeds from the sale of an "S" asset pursuant to a repo entered into by "U" have been used to satisfy the "S" Participant's settlement variation obligation.

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 "S" Program from those described to us in "R's" prior correspondence on this issue, as supplemented by telephone conversations with Division staff. 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 con-cerning this correspondence, please

contact me, Deputy Director Paul H. Bjarnason, Jr. or Associate Chief Counsel Lawrence B. Patent.

Very truly yours,

I. Michael Greenberger

Director

[1] CFTC Interpretative Letter No. 96-78, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,822 (Oct. 28, 1996).

[2] Since "U" is not a member of the Federal Reserve System, it normally uses "V" as a sub-custodian for U.S. Treasury securities.

[3] "R" Rule 821 provides that "R's" Clearing House will accept as performance bond, in addition to "S" units, cash, equity securities, shares of mutual funds, U.S. Treasury and agency securities, or letters of credit. All such items must be and remain unencumbered.

[4] Unlike performance bond, settlement variation must be paid in cash. "R" Rule 823.

[5] You have indicated that the counterparty for such repo transactions would be "U" itself or another entity. In a letter dated October 16, 1997, you set forth criteria used by "R" in determining acceptable counterparties for repo transactions. A repo counterparty will be required to execute a Master Public Securities Association Agreement, as modified in accordance with Division of Trading and Markets Financial and Segregation Interpretation No. 2-1, 1 Comm. Fut. L. Rep. (CCH) ¶7112A (Dec. 15, 1993), and transactions will be limited to $100 million. (This amount may be unilaterally modified by the "R".) In addition, the "R" will be provided with an annual report of the counterparty and the short term debt rating for the counterparty or its parent company. The "R" will generally require a rating of "Prime-1" by "Y", which you stated is the highest rating. The "R" will also consider the rating established for the counterparty by "W", balance sheet information such as equity capital and the capital/asset ratio.

[6] In a normal repo transaction, the market value of securities used as part of the transaction exceeds the amount of cash received.

[7] "U's" judgment as to how unwind a particular repo will be affected by market conditions.

[8] In a telephone conversation with Division staff on October 17, 1997, you indicated that one business day would be the term in 98 or 99 percent of the cases but that if there is a spike in interest rates, "U"

wanted some flexibility to lengthen the term of the repos to two or three business days. We have conditioned relief upon an absolute limit of three business days with the expectation that one business day would be the normal term.

[9] Participation by "R" clearing members in the "S" Program is voluntary and participants may withdraw at any time.

[10] Such records must be maintained in accordance with Commission Rule 1.31, 17 C.F.R. §1.31 (1997), and be open to inspection as set forth in that rule. You agreed to maintain such records in a telephone conversation with a Division staff member on September 19, 1997.

[11] 7 U.S.C. §6d(2) (1994).

[12] 17 C.F.R. §1.25 (1997).