CFTC Attempts to Strike Balance Between Protection of Customer Funds and Flexibility for FCMs and DCOs Investing Customer Funds

December 13, 2011

At an open meeting on December 5, 2011, the Commodity Futures Trading Commission (the CFTC) approved a final rule (the Final Rule) to amend existing CFTC Reg. § 1.25 regarding the investment of customer funds held as margin for futures and cleared swaps by derivatives clearing organizations (DCOs) and futures commission merchants (FCMs). A pre-publication copy of the Final Rule and other related information is available here.

In response to concerns arising out of the financial crisis of 2008 and 2009 and other recent events that have occurred in the futures market, the Final Rule is more restrictive than existing CFTC Reg. § 1.25. However, as a result of public comments submitted in response to the CFTC's proposed revisions to Reg. § 1.25 which were issued in October 2010, the Final Rule provides DCOs and FCMs more flexibility in investing customer funds than they would have had under the CFTC's original proposal. A chart comparing existing CFTC Reg. § 1.25, the CFTC's proposal and the Final Rule is available here.[1]

Major changes between the CFTC's proposal and the Final Rule include:

- Under the CFTC's proposal, DCOs and FCMs would not have been permitted to invest customer funds in obligations of government sponsored enterprises (GSEs) unless such obligations were fully guaranteed by the U.S. government. Under the Final Rule, DCOs and FCMs may continue to invest customer funds in obligations of GSEs, regardless of whether such obligations are fully guaranteed by the U.S. government. However, obligations of the Federal National Mortgage Association (*i.e.,* Fannie Mae) and the Federal Home Loan Mortgage Association (*i.e.,* Freddie Mac) are only permitted investments while such entities are under the conservatorship or receivership of the Federal Housing Finance Authority.

- Under the CFTC's proposal, investments in money market mutual funds (MMMFs) would have been subject to a 10% asset-based concentration limit. Under the Final Rule, investments in MMMFs that are comprised of only obligations of the U.S. government (collectively, Treasuries) and obligations fully guaranteed by the U.S. government will not be subject to an asset-based concentration limit. Investments in non-Treasury-only MMMFs that have at least $1 billion in assets and are managed by a management company that has at least $25 billion in MMMF assets under management will be subject to a 50% "asset-based" concentration limit. Investments in non-Treasury-only MMMFs that do not meet these size criteria will be subject to a 10% asset-based concentration limit.

[1] The chart is based on a chart comparing current Reg. § 1.25 to proposed Reg. § 1.25 published by CFTC staff when the revised rule was proposed. The CFTC staff's chart can be accessed here.

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- Under the CFTC's proposal, investments in MMMFs in the same "family of funds" would have been subject to a 2% "issuer-based" concentration limit. Under the Final Rule, investments in Treasury-only MMMFs will not be subject to an issuer-based concentration limit. Non-Treasury-only MMMFs in the same family of funds will be subject to a 25% issuer-based concentration limit, and individual MMMFs will be subject to a 10% issuer-based concentration limit.

The Final Rule retains the following major changes to existing Reg. § 1.25 that were contained in the CFTC's original proposal:

- DCOs and FCMs will no longer be permitted to invest customer funds in foreign sovereign debt. However, the CFTC has indicated that it will consider exemptions from this restriction on a case-by-case basis for DCOs and FCMs that have balances in segregated accounts owed to customers (or other clearing member FCMs, as the case may be) in that country's currency and that are able to demonstrate that investment of customer funds in a sovereign debt investment is appropriate in light of the objectives of Reg. § 1.25 (including, without limitation, preservation of principal and maintenance of liquidity) and the criteria of Section 4(c) of the Commodity Exchange Act. The CFTC will then consider permitting such an investment to the extent that the DCO or FCM has balances in segregated accounts owed to its customers or clearing FCMs in the currency of that particular sovereign debt that serves to preserve principal and maintain the liquidity of customer funds.

- DCOs and FCMs may no longer invest in in-house transactions, including repurchase agreements and reverse repurchase agreements with their affiliates. Repurchase agreements with third parties will be subject to a 25% counterparty concentration limit. In the preamble to the Final Rule, the CFTC clarifies that "in-house transactions" do not include in-house sales of permitted investments or collateral conversions benefiting a customer, both of which will continue to be permitted.

- DCOs and FCMs may only invest in commercial paper and corporate notes or bonds that are fully guaranteed as to principal and interest by the Temporary Liquidity Guarantee Program. In addition, any such investments will be subject to a 25% asset-based concentration limit.

Additional differences between the Final Rule and existing CFTC Reg. § 1.25 are set forth on the chart referred to above.

The Final Rule will take effect 60 days after its publication in the Federal Register but DCOs and FCMs will not be required to comply with the new investment restrictions for customer funds until 180 days after the Final Rule is published in the Federal Register. Accordingly, the new investment restrictions are expected to take effect in the middle of 2012. Until such time, DCOs and FCMs must continue to invest customer funds in accordance with existing CFTC Reg. § 1.25.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sutherland.com
Catherine M. Krupka	202.383.0248	catherine.krupka@sutherland.com
Paul B. Turner	713.470.6105	paul.turner@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
William H. Hope II	404.853.8103	william.hope@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com
Ann M. Battle	202.383.0842	ann.battle@sutherland.com
Doyle Campbell	212.389.5073	doyle.campbell@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com
Raymond A. Ramirez	202.383.0868	ray.ramirez@sutherland.com

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