SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

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Custody of Investment Company Assets With Futures Commission Merchants and Commodity Clearing Organizations

AGENCY: Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: The Commission is adopting a new rule under the Investment Company Act of 1940 to permit registered investment companies to maintain their assets with futures commission merchants and certain other entities in connection with futures contracts and commodity options traded on U.S. and foreign exchanges. Currently, investment companies generally must maintain assets relating to these transactions in special accounts with a custodian bank. The new rule will enable investment companies to effect their commodity trades in the same manner as other market participants under conditions designed to provide custodial protections for investment company assets.

EFFECTIVE DATE: The rule will become effective January 16, 1997.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission (''Commission'') today is adopting rule 17f-6 [17 CFR 270.17f-6] under the Investment Company Act of 1940 [15 U.S.C. 80a] (the ''Investment Company Act''). The new rule governs the custody of investment company assets by futures commission merchants and other entities used for settling commodity transactions. The rule does not affect the extent to which investment companies may engage in commodity trading.

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Executive Summary

The Commission is adopting rule 17f–6 under the Investment Company Act. Rule 17f–6 permits registered management investment companies, unit investment trusts (''UITs''), and face-amount certificate companies (collectively, ''funds'') to maintain assets (*i.e.*, margin) with futures commission merchants (''FCMs'') in connection with commodity transactions effected on both domestic and foreign exchanges. Currently, funds generally must maintain such assets in special accounts with a custodian bank. The new rule is designed to eliminate unnecessary regulatory burdens, and to enable funds to effect their commodity trades in the same manner as other market participants.

Rule 17f–6 permits funds to maintain their assets with FCMs that are registered under the Commodity Exchange Act (''CEA'') and that are not affiliated with the fund. Rule 17f–6 requires a written contract between the fund and the FCM to contain certain provisions. Among other things, the FCM must agree that any other FCMs used to clear the fund's trades meet the rule's requirements (other than the requirement of a contract with the fund). To protect fund assets from loss in the event of an FCM's bankruptcy, any gains on fund transactions may be maintained with an FCM only in *de minimis* amounts.

Unlike the rule as originally proposed, rule 17f–6 does not require a fund's board of directors to select and monitor the fund's FCM arrangements, nor does the rule require an FCM that holds fund assets to meet capital standards in excess of those imposed under the CEA.

Rule 17f–6 does not require that assets related to commodities transactions be maintained with an FCM. Funds may continue to maintain such assets in a special account with a custodian bank.

I. Background

A. Commodities Trading and Investment Company Act Custody

The Commission proposed rule 17f–6 under the Investment Company Act to permit management investment companies to effect their commodity trades by placing assets relating to such transactions directly with FCMs.[1] Over the last several years, fund participation in commodity markets has increased. A fund, for example, may engage in commodity trades to hedge its portfolio against declines in securities prices, changes in interest rates, or foreign currency fluctuations.[2] A fund also may enter into commodity transactions to adjust the percentage of its portfolio held in cash, debt, and stocks without having to buy or sell the actual assets.[3]

To enter into a futures contract or write a commodity option, a customer typically deposits with an FCM, as security for performance of its obligations, a specified amount of assets or cash as ''initial margin.''[4] In the case

[1] Rule 17f–6 was proposed for public comment on May 24, 1994. Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Investment Company Act Release No. 20313 (May 24, 1994) [59 FR 28286 (June 1, 1994)] [hereinafter the Proposing Release].

[2] Commodity transactions include futures contracts and options on futures contracts and physical commodities. A futures contract generally is a bilateral agreement providing for the purchase or sale of a specified commodity at a stated time in the future for a fixed price. Robert E. Fink & Robert B. Feduniak, Futures Trading 10 (1988) [hereinafter Fink & Feduniak]. A commodity option gives its holder the right, for a specified period of time, to either buy (in the case of a call option) or sell (in the case of a put option) the subject of the option at a predetermined price. The writer (seller) of an option is obligated to sell or buy the specified commodity at the election of the option holder. 1 Philip M. Johnson & Thomas L. Hazen, Commodities Regulation section 1.07 (2d ed. Supp. 1991) [hereinafter Johnson & Hazen].

[3] Taking a position in a futures contract with respect to stocks that comprise the Standard & Poor's 500 Index, for example, may be more efficient than buying and selling all of the stocks that comprise that index due to lower brokerage and transaction costs.

[4] Unlike the parties to a futures contract, only the writer (seller) of an option is subject to margin requirements; the option holder (purchaser) pays the writer a one-time premium as compensation in full for its right to compel the writer's performance. *See* Proposing Release, *supra* note, at n.44 and accompanying text.

of a fund, placing initial margin with an FCM could be viewed as placing fund assets in the custody of the FCM.[5] The FCM then clears the transaction by posting margin either directly with a clearing organization or with one or more other FCMs that will effect the transaction through the clearing organization.[6]

Section 17(f) generally permits a fund to maintain its assets only in the custody of a bank, a member of a national securities exchange, the fund itself, or a national securities depository.[7] Under no-action positions of the Division of Investment Management, a fund may, consistent with the requirements of section 17(f), place assets relating to commodity transactions in a special account with a third party custodian bank (''third party accounts'').[8] As a consequence, an FCM must use its own assets to effect fund commodity trades.

The Commission proposed rule 17f–6 to respond to certain criticisms associated with third party accounts.[9] Commenters have indicated that third party accounts create systemic liquidity risks by diverting FCM capital, which would otherwise be available for use in the marketplace, to effect fund transactions.[10] Commenters also have stated that third party arrangements are unnecessary because they are unlikely to provide any special protection to fund assets in FCM bankruptcy proceedings. The U.S. Bankruptcy Code and rules of the Commodity Futures Trading Commission (''CFTC'') provide that customer assets relating to commodity transactions generally have priority over other creditors' claims, and are subject to distribution based on each customer's *pro rata* share of the available customer property.[11] Although the issue has not been judicially determined, the CFTC staff has stated that assets in a third party account will be subject to the same *pro rata* treatment as all other assets in the FCM's custody.[12] Finally, third party accounts may be redundant in view of the safeguards for customer assets afforded by the CEA and CFTC rules.

B. Custodial Protections for Customer Assets Under the Commodity Exchange Act

The CEA and CFTC rules contain provisions designed to safeguard customer assets held by an FCM.[13] For transactions traded on domestic exchanges, extensive regulations, known as the ''segregation requirements,'' are designed to protect customer funds in an FCM's possession.[14] Under these requirements, an FCM may maintain customer assets in a single commingled bank account established for those assets. The FCM must segregate customer funds from the FCM's own assets, and may not use one customer's assets to carry another customer's trades.[15] Special provisions, which parallel the segregation requirements for domestic transactions, govern the safekeeping of margin relating to foreign exchange-traded transactions.[16] CFTC rules require an FCM engaging in foreign commodity transactions to maintain a ''secured amount,'' which generally represents the assets required to margin the foreign commodity trades of its U.S. customers.[17]

As proposed, rule 17f–6 would have permitted funds to post commodity margin with FCMs registered under the CEA, subject to certain conditions. Nineteen commenters commented on proposed rule 17f–6. Commenters generally supported the rule's adoption, while recommending certain changes to the proposed rule.

II. Rule 17f–6

The Commission is adopting rule 17f–6 with a number of changes based on commenters' suggestions. Rule 17f–6, as adopted, extends to registered investment companies.[18] The adopted

[5] Initial margin is not considered part of the contract or option price, and is returned upon termination of the position, unless used to cover a loss. Initial margin in commodity transactions thus differs from securities margin, which represents a partial payment for securities purchased by a broker on its customer's behalf. Initial margin can also be contrasted with variation margin, which is credited or assessed at least daily to reflect any gains or losses in the contract's value. In contrast to initial margin, variation margin represents the system of marking to market the contract's value. Through this system, losses on one side of a contract position are matched with and paid as profits to the other side of the transaction. *See* Proposing Release, *supra* note at nn.34–38 and accompanying text, and *infra* note.

[6] The clearing organization matches the trade on behalf of the exchange, and acts as guarantor of the opposite side of the transaction. An FCM executing trades on an exchange must be a member of that exchange; nonmembers trade by entering orders through an exchange member. To clear transactions with a clearing organization, an FCM must be both an exchange member and a member of the clearing organization. Non-clearing member FCMs must execute their transactions through a clearing member. A commodity transaction, therefore, may be effected through several FCMs.

[7] 15 U.S.C. 80a–17(f). *See also* Investment Company Act rules 17f–1 [17 CFR 270.17f–1] (custody with members of national securities exchanges); 17f–2 [17 CFR 270.17f–2] (custody by funds themselves); 17f–4 [17 CFR 270.17f–4] (custody with securities depositories); 17f–5 [17 CFR 270.17f–5] (custody of fund securities outside the United States).

[8] *See, e.g.*, Prudential Bache IncomeVertible Plus Fund, Inc. (pub. avail. Nov. 20, 1985). The third party account may be maintained in the name of the FCM, but the FCM's ability to withdraw these funds is limited. *See* Proposing Release, *supra* note, at n.55 and accompanying text.

[9] *See* Proposing Release, *supra* note, at nn.61–70 and accompanying text.

[10] According to a 1988 report, third party accounts may have been a source of liquidity stress in the clearing and credit systems during the October 1987 market break. Report of the Presidential Task Force on Market Mechanisms (1988) VI–73 to –74 (discussing statements of members of the Chicago Mercantile Exchange).

[11] 11 U.S.C. 766; CFTC rule 190.08 [17 CFR 190.08].

[12] CFTC Financial and Segregation Interpretation No. 10, *Treatment of Funds Deposited in Safekeeping Accounts*, 1 Comm. Fut. L. Rep. (CCH) § 7120 at 7130 (CFTC Division of Trading and Markets, May 23, 1984) [hereinafter Interpretation No. 10]. *See also* CFTC Advisory No. 37–96, *Responsibilities of Futures Commission Merchants and Relevant Depositories with Respect to Third Party Custodial Accounts* (July 25, 1996) (discussing Interpretation No. 10 and requesting that FCMs review their custody arrangements with depository institutions to assure that they fully accord with the requirements of the CEA and CFTC regulations).

[13] Maintaining assets in an FCM's custody is not without risk. An FCM is financially responsible for the trade obligations of its customers. Johnson & Hazen, *supra* note 2, at section 1.10. If an FCM becomes insolvent and cannot cover the obligations of a defaulting customer, the FCM's non-defaulting customers may be affected. The clearing organization has the right to use customer assets held at the clearing organization level to satisfy a commodity loss on behalf of the FCM's customers. The resulting shortfall in the customer assets may be borne by the FCM's non-defaulting customers. *See supra* note 11 and *infra* note 17, and accompanying text (regarding FCM bankruptcy provisions). To date, however, losses of customer funds have been rare. *See* Andrea M. Corcoran & Susan C. Ervin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Position Transfers From Troubled Firms*, 44 Wash. & Lee L. Rev. 849, 863–64 (1987) (''customer losses have been forestalled * * *, in significant measure, by the voluntary contributions of futures exchanges'').

[14] CEA section 4d(2) [7 U.S.C. 6d(2)]; CFTC rules 1.20 to .30 [17 CFR 1.20 to .30].

[15] Customer funds also may be maintained in a commingled bank account established by the clearing organization for the FCM's customers.

[16] CFTC rule 30.7 [17 CFR 30.7].

[17] *Id.* In the event of an FCM's bankruptcy, CFTC rules provide for the allocation of property among different types of customer accounts, which include customer assets underlying U.S. and foreign trades that are subject to the segregation and secured amount requirements, respectively. While customer assets relating to U.S. and foreign-based trades are subject to the same *pro rata* treatment in FCM bankruptcy proceedings (*see supra* note 11 and accompanying text), customers of U.S. and foreign trades may receive different proportional amounts based on the assets attributed to the respective account classes. For example, a shortfall in the secured amount (*e.g.*, due to a customer default or currency fluctuations during bankruptcy proceedings) will result in customers of foreign trades receiving a smaller percentage of their margin deposits than customers of the segregated account class underlying U.S. trades. Although the maintenance of separate customer accounts for U.S. and foreign-based trading may result in different *pro rata* distributions in FCM bankruptcy proceedings, these differences generally are attributable to the *investment* risks associated with U.S. and foreign-based commodity transactions rather than differences in custodial protections.

[18] *See* rule 17f–6(b)(3) [17 CFR 270.17f–6(b)(3)] (defining ''Fund''). The Commission notes that trading in futures contracts and commodity options ordinarily requires a significant degree of management. Since unit investment trust (''UIT'')

rule incorporates the safeguards that are provided for fund assets under the CEA and CFTC rules and, in so doing, generally permits funds to effect domestic and foreign commodity transactions in the same manner as other market participants.

A. Role of Fund Board of Directors

Proposed rule 17f–6 would have required a fund's board of directors (or the board's delegate) to find that maintaining the fund's assets with an FCM is consistent with the best interests of the fund and its shareholders. The proposed rule also would have required the board or its delegate to establish a monitoring system to ensure compliance with the requirements of the rule. Several commenters opposed this approach, stating that the level of board involvement was burdensome and unnecessary in light of the regulatory safeguards under the CEA and CFTC rules.

Upon further consideration of the issue, the Commission believes that the rule's objective standards (in particular, the requirement of FCM registration and the related CFTC segregation and secured amount requirements) make specific provisions concerning board oversight unnecessary.[19] As adopted, rule 17f–6 does not require a fund's board to select or monitor the FCMs with which the fund places margin. Like other aspects of fund operations, however, FCM arrangements will remain subject to the board's general oversight.[20] In this regard, fund boards have a particular responsibility to ask questions concerning why and how the fund uses futures and other derivative instruments, the risks of using such instruments, and the effectiveness of internal controls designed to monitor risk and assure compliance with investment guidelines regarding the use of such instruments.

B. Eligible FCM Custodians

1. FCM Registration and CFTC Net Capital Requirements

Like the proposed rule, rule 17f–6 permits a fund to place and maintain assets with an FCM that is registered under the CEA.[21] Registered FCMs are subject to the requirements of the CEA and CFTC rules thereunder, which, among other things, address the safekeeping of assets in FCM custody.[22] Rule 17f–6 does not require that the FCM be a member of a commodity exchange or clearing organization. Such a requirement would not appear necessary for the protection of fund assets and would unnecessarily limit the number of FCMs that could be used as fund custodians.[23] A registered FCM, regardless of its membership status, is subject to the CEA and CFTC safekeeping requirements.

Under CFTC rules, a registered FCM must maintain adjusted net capital equal to or exceeding the greatest of (i) $250,000, (ii) 4% of customer funds maintained in safekeeping, or (iii) for an FCM that also is a registered securities broker-dealer, the net capital required by rule 15c3–1(a) under the Securities Exchange Act of 1934.[24] An FCM generally must notify the CFTC of potential capital impairment if the ratio of its total adjusted net capital to CFTC required minimums falls below 150%.[25] Rule 17f–6, as proposed, would have required an FCM holding fund assets to have at least $20 million in adjusted net capital in *excess* of the CFTC's net capital requirements. In addition, the FCM's adjusted net capital would have had to equal or exceed 250% of the CFTC's required minimum.[26]

Commenters were divided on the proposed approach. Commenters opposing the additional capital requirements suggested that, because the CFTC net capital requirements serve to protect assets in an FCM's custody from loss due to misappropriation or the FCM's insolvency, additional capital standards are not necessary. The Commission agrees that the CFTC net capital requirements are designed to safeguard fund assets in an FCM's custody.[27] Therefore, rule 17f–6, as adopted, does not require FCM custodians to meet additional capital standards.

2. Affiliated FCM Arrangements

As proposed, rule 17f–6 would have broadly prohibited a fund from placing assets with any FCM that is an affiliated person of the fund or an affiliated person of such person.[28] This provision is being adopted substantially as proposed.[29] While some commenters viewed the scope of this provision as too restrictive, custody by fund affiliates raises additional investor protection concerns.[30]

C. Domestic and Foreign Commodity Transactions

As proposed, rule 17f–6 would have permitted a fund to place assets with an FCM only in connection with domestic commodity transactions. The proposed rule would not have permitted a fund to place assets with an FCM in connection

portfolios are generally unmanaged, it is unclear at present to the Commission how an investment company that engages is commodity trading could meet the requirements imposed on a UIT by the Investment Company Act, including section 4(2) thereof [15 U.S.C. 80a–4(2)].

Rule 17f–6 also is available to face-amount certificate companies that are governed by section 28 of the Investment Company Act [15 U.S.C. 80a–28]. *See* IDS Certificate Company, Investment Company Act Release Nos. 21098 (May 26, 1995) [60 FR 28818 (June 2, 1995)] (Notice of Application) and 21155 (June 21, 1995) [59 SEC Docket 1918] (Order) (regarding, among other things, a face-amount certificate company's participation in commodity markets and the use of third party accounts).

[19] Eliminating the requirement in rule 17f–6 for the board or its delegate to select and monitor FCM arrangements differs from the approach under rule 17f–5, which governs the custody of fund assets outside the United States. Custody arrangements for assets maintained outside the United States and related safeguards vary widely from one country to another. As such, it appears to be appropriate for such rule to require case-by-case evaluations. *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 21259 (July 27, 1995) [60 FR 39592 (Aug. 2, 1995)]. In contrast, domestic and foreign FCM arrangements are subject to a regulatory framework under the CEA designed to provide consistent safeguards.

[20] The Investment Company Act and state law impose oversight responsibilities on a fund's board of directors to protect the interests of fund shareholders. *See, e.g.,* Burks v. Lasker, 441 U.S. 471, 484 (1979).

[21] *See* rule 17f–6(b)(4) [17 CFR 270.17f–6(b)(4)] (defining ''Futures Commission Merchant''). The FCM may, in turn, place the initial margin with certain other market participants, such as a clearing organization, to effect the fund's transactions. *See* rule 17f–6(a)(1)(ii) [17 CFR 270.17f–6(a)(1)(ii)].

[22] *See supra* notes 13–17 and *infra* note 33, and accompanying text.

[23] *See supra* note 6 and accompanying text.

[24] CFTC rule 1.17 [17 CFR 1.17]; 17 CFR 240.15c3–1(a).

[25] CFTC rule 1.12 [17 CFR 1.12]. The CFTC recently amended rule 1.12 to strengthen its provisions concerning early warning to the CFTC in the event of FCM capital impairment. Early Warning Reporting Requirements, Minimum Financial Requirements, Prepayment of Subordinated Debt, Gross Collection of Exchange-Set Margin for Omnibus Accounts and Capital Charge on Receivables from Foreign Brokers (Apr. 25, 1996) [61 FR 19177 (May 1, 1996)] [hereinafter the CFTC Early Warning Release].

[26] *See* Proposing Release, *supra* note, at nn.97–98 and accompanying text.

[27] *See, e.g.,* CFTC Early Warning Release, *supra* note 25.

[28] *See* Proposing Release, *supra* note, at nn.104–106 and accompanying text; Investment Company Act section 2(a)(3) [15 U.S.C. 80a–2(a)(3)] (defining affiliated person).

[29] Rule 17f–6(b)(4) [17 CFR 270.17f–6(b)(4)]. The prohibition has been incorporated into the definition of ''Futures Commission Merchant.''

[30] For example, to guard against potential abuses resulting from control over fund assets by related persons in other contexts, rule 17f–2, the Commission's rule governing self-custody arrangements, has been read to require fund affiliates to comply with its provisions or establish other appropriate safeguards. *See, e.g.,* Pegasus Income and Capital Fund, Inc. (pub. avail. Dec. 31, 1977) (custody by adviser-bank). One commenter acknowledged the risks that could be presented by affiliated custody and suggested that safeguards similar to those in rule 17f–2 could be required for affiliated FCM arrangements.

with commodity transactions traded on a foreign exchange. Commenters strongly urged the Commission to expand rule 17f–6 to permit FCM custody in connection with foreign exchange-traded transactions. In support of this approach, commenters cited the custodial protections under the CEA applicable to these transactions and noted the importance of international commodity trading in achieving fund management and hedging objectives.

Upon further consideration of the issue, the Commission has decided to permit a fund to place assets with a registered FCM in connection with commodity trades effected on both domestic and foreign exchanges.[31] As in the case of domestic transactions, an FCM holding the assets of U.S. customers in connection with foreign commodity transactions is subject to CFTC regulations designed to protect those assets.[32] These regulations require the FCM to be registered under the CEA, and thus subject to, among other things, the secured amount and CFTC net capital requirements.[33] Consistent with commodity trading practices, the rule permits FCMs to place fund assets with a clearing organization and certain other market participants as appropriate to effect foreign commodity transactions.[34]

D. Assets Held in FCM Custody

1. Initial Margin

As proposed, rule 17f–6 would have permitted a fund to place and maintain assets with an FCM in amounts necessary to effect its commodity trades. Consistent with commodity settlement practices, the proposed rule would have allowed a fund to maintain assets with an FCM to meet exchange-imposed minimum margin requirements, as well as any additional requirements imposed by the FCM. Three commenters supported the proposed approach. One commenter recommended that the rule limit FCM custody of fund margin to the minimum requirements established by an exchange.

The Commission is adopting this provision of the rule as proposed. Rule 17f–6 permits funds to meet FCM margin requirements that exceed those of an exchange.[35] Limiting FCM custody of initial fund margin to exchange requirements is not necessary to safeguard fund assets. Such a limitation also would be inconsistent with commodity settlement practices, since FCMs typically impose higher margin requirements than the margin requirements established by exchanges.[36]

2. Gains on Commodity Transactions

Once a customer establishes a position with an FCM, it is marked to market at least daily to reflect gains and losses in the position's value. Gains on commodity transactions are available for collection by commodity customers on the next business day following the crediting of the gain by the clearing organization.[37] In the event of an FCM's bankruptcy, if there are insufficient assets to cover all customer claims, commodity gains in the FCM's possession may be distributed on a *pro rata* basis to all of the FCM's customers. Allowing unlimited amounts of commodity gains to be maintained in an FCM's custody would subject fund assets to unnecessary risks.[38]

As proposed, rule 17f–6 would have permitted a fund to maintain with the

[31] *See* rule 17f–6(b)(2)(i) and (ii) [17 CFR 270.17f–6(b)(2)(i) and (ii)] (defining ''Exchange-Traded Futures Contracts and Commodity Options'' for purposes of domestic and foreign transactions, respectively). Certain foreign-related commodity transactions trade on U.S. exchanges. These transactions, which may involve placing fund margin outside the United States, include futures contracts and commodity options involving foreign currencies and those effected through electronic links between U.S. and foreign exchanges. Consistent with CFTC rules and commodity settlement practices, a fund engaging in foreign currency transactions on domestic exchanges or placing margin overseas in connection with domestic trades may enter into subordination agreements. In these agreements, commodity customers agree that, if their FCM becomes insolvent and there is a margin shortfall, claims to margin securing their trades will be subordinated to the claims of customers whose accounts are denominated in U.S. dollars or held in the United States. *See* CFTC Financial and Segregation Interpretation No. 12 [53 FR 46911 (Nov. 21, 1988)] (the subordination requirement seeks to tie the risks of a particular jurisdiction or currency to customers engaging in commodity transactions relative to that jurisdiction or currency). *See also* Proposing Release, *supra* note , at nn.148–152 and accompanying text. In the case of commodity transactions effected on foreign exchanges, a subordination agreement is not required. In FCM bankruptcy proceedings, when a fund's assets relating to foreign exchange-traded transactions are held in one or more foreign currencies, the fund may be subject to the risks of foreign currency fluctuations of assets held on behalf of other customers in other foreign currencies.

[32] CFTC rules 30.1 to .11 [17 CFR 30.1 to .11]; *see supra* notes—and accompanying text. In early 1995, Barings PLC, a British investment bank, failed after suffering losses of approximately $1 billion from commodity transactions effected on the Singapore Monetary Exchange. Following Barings' collapse, commodity regulators from sixteen countries agreed in the ''Windsor Declaration'' on principles aimed at improving communications among commodity regulators and enhancing surveillance of risks taken by commodity market participants. Among the issues addressed was the protection of customer assets. *See* Suzanne McGee, *Futures Regulators Agree to Cooperate Globally*, Wall St. J. C18 (May 18, 1995); Brett D. Fromson, *Regulators Adopt Crisis Measures*, Wash. Post D15 (May 18, 1995). Earlier this year, commodity exchanges and regulators from various countries agreed on specific information-sharing measures. Suzanne McGee, *Two Information-Sharing Pacts Signed By 50 Exchanges and 13 Regulators*, Wall St. J. A7B (Mar. 18, 1996).

[33] CEA section 4d(1) [7 U.S.C. 6d(1)]; CFTC rules 3.10, 30.4 [17 CFR 3.10, 30.4]. The CFTC grants to certain foreign commodity brokers exemptions from requirements under the CFTC's rules relating to transactions effected on foreign exchanges, including FCM registration. CFTC rule 30.10 [17 CFR 30.10]. The CFTC grants the exemption based on a determination that the foreign broker is subject to comparable regulation in its home country. Because of uncertainties arising from differing regulatory schemes among various jurisdictions, especially those involving the bankruptcies of commodities brokers, rule 17f–6 permits funds to use only registered FCMs.

[34] *See infra* note and accompanying text (discussing provisions of rule 17f–6 that permit an FCM to transfer fund margin to another registered FCM, a clearing organization, a member of a foreign board of trade, or a U.S. or foreign bank).

[35] Rule 17f–6(a) [17 CFR 270.17f–6(a)]. Currently, only the writer of a commodity option is required to post margin with an FCM. Rule 17f–6, therefore, does not apply to funds that purchase commodity options through payment of an option premium. *See supra* note and accompanying text.

[36] Fink & Feduniak, *supra* note, at 137. An FCM, for example, may impose higher initial margin requirements based on market volatility or to retain a cushion in the event an exchange subsequently raises its margin requirements. *Id.* at 137–138.

Exchange rules or the procedures of the FCM also may restrict the types of assets that may be used to satisfy margin requirements. A fund may borrow assets from an FCM to meet margin requirements so long as the arrangement is consistent with section 18 of the Investment Company Act [15 U.S.C. 80a–18]. Section 18 restricts the circumstances under which funds may borrow from other persons. Borrowing assets from an FCM will not be deemed to violate section 18, in the case of an open-end fund, or be subject to that section's asset coverage requirements, in the case of a closed-end fund, if the fund sets aside or provides the FCM with liquid assets that collateralize 100% of the market value of the loan. *See, e.g.*, Merrill Lynch Asset Management, L.P. (pub. avail. July 2, 1996). *See also* 1 Thomas P. Lemke *et al.*, Regulation of Investment Companies, section 8.06[1][a][ii] (1996) (by setting aside fund assets or otherwise covering its exposure, a fund avoids the restrictions of section 18(f)); 1 Thomas A. Russo, Regulation of the Commodities Futures and Options Markets section 1.20 (1983 & Supp. 1993) (FCM asset lending arrangements typically are fully collateralized).

[37] A party to a futures contract suffering a loss on its position makes a payment (variation margin) in the amount of the loss, which is available for collection by the other party to the contract on the next business day. *See supra* note 5. While an option writer suffering a loss on its position similarly makes a payment covering the loss, the payment is held by the clearing organization on behalf of the option holder until the option is exercised; in the event of subsequent gains in the writer's position, the writer would be entitled to collect the gains from its previous payments held by the clearing organization.

[38] *See* Interpretation No. 10, *supra* note 12, at 7133 n.15 (indicating that gains on commodity transactions should be collected daily). *See also supra* note 11 and accompanying text. For funds that use third party accounts, gains on commodity positions are paid directly by an FCM to the fund without flowing through or being held in the third party account. Goldman Sachs & Co. (pub. avail. May 2, 1986). Consequently, the rule's *de minimis* limitation on the amount of gains in an FCM's custody effectively is required for third party arrangements.

FCM *de minimis* amounts of gains on fund commodity transactions; gains exceeding the *de minimis* threshold could be held by an FCM only until the next business day. One commenter supported the proposed approach. Four other commenters indicated that the amount of commodity gains held by an FCM should be determined by the FCM and the fund on an individual basis.

Rule 17f–6, as adopted, retains the proposed requirement governing commodity gains in FCM custody.[39] This approach gives funds the flexibility of not having to withdraw *de minimis* amounts of gains from FCM custody, while limiting the potential for fund assets to be used to satisfy the claims of other customers in the event of the FCM's bankruptcy.

E. Contract Requirements and Custodians Used To Effect Commodity Transactions

As proposed, rule 17f–6 would have required a fund to enter into a written contract with an FCM custodian, in which the FCM would agree to adhere to the CEA and CFTC segregation requirements and to furnish the Commission with information concerning the FCM's custody of fund margin. The proposed rule also would have required certain contract provisions relating to the transfer of fund assets for clearing purposes.[40]

The adopted rule retains these requirements, modified to reflect the use of FCM custodians in connection with foreign exchange-traded transactions.[41] Thus, in addition to requiring compliance with the segregation requirements for domestic trades, the contract must require the FCM to comply with the secured amount requirements in connection with any foreign transactions.[42] The FCM also must agree that any other FCM used to effect transactions will be registered with the CFTC, comply with the CFTC segregation or secured amount requirements, and not be affiliated with the fund. Consistent with commodity settlement practices, rule 17f–6 permits an FCM to place fund margin with a clearing organization, a member of a foreign board of trade, or a U.S. or foreign bank. The FCM must agree to obtain from each entity used for clearing purposes, including any other FCM, an acknowledgment that the fund's assets are held on behalf of the FCM's customers in accordance with provisions under the CEA.[43]

F. Withdrawal of Assets From FCM Custody

As proposed, rule 17f–6 would have required a fund to withdraw its assets from an FCM *promptly* in the event the fund's FCM arrangements no longer complied with the requirements of the rule. The Proposing Release suggested that asset withdrawals would be expected to be made within five days of the event triggering the withdrawal.[44] Rule 17f–6, as adopted, requires asset withdrawals to be made *as soon as reasonably practicable*.[45] Although a five-day standard appears to be a generally appropriate length of time,[46] any asset withdrawals under the rule would be subject to circumstances (such as the size or number of a fund's positions) that indicate a longer period of time would be reasonable.

III. Cost/Benefit Analysis

Rule 17f–6 should not impose any burdens on funds. Rather, the rule should benefit funds by permitting, but not requiring, fund margin to be maintained directly with FCMs instead of in third party accounts. The requirements of rule 17f–6 are consistent with those of the CEA and CFTC rules. The rule gives funds the option of placing with FCMs margin in the same manner as other participants in the commodity markets.

IV. Summary of Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis, which was prepared in accordance with 5 U.S.C. 603, was published in Investment Company Act Release No. 20313. No comments were received on this analysis. The Commission has prepared a Final Regulatory Flexibility Analysis in accordance with 5 U.S.C. 604. The Analysis states that the new rule will permit funds to maintain their assets with FCMs and other entities used for settlement purposes in connection with futures contracts and commodity options traded on a U.S. or foreign exchange. The Analysis explains that the rule provides flexibility and custodial protections in a way that should minimize any impact on, or cost to, small business. Cost-benefit information reflected in the ''Cost/Benefit Analysis'' section of this Release also is reflected in the Analysis. A copy of the Final Regulatory Flexibility Analysis may be obtained by contacting Nadya B. Roytblat, Mail Stop 10–2, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

V. Statutory Authority

The Commission is adopting rule 17f–6 under sections 6(c) and 38(a) of the Investment Company Act [15 U.S.C. 80a–6(c), –37(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Adopted Rule

For the reasons set out in the preamble, Title 17, Chapter II of the

[39] Rule 17f–6(a)(2) [17 CFR 270.17f–6(a)(2)]. Losses paid to an FCM due to declines in a fund's commodity positions represent discharged liabilities and not fund assets under section 17(f). Montgomery Street Income Securities, Inc. (pub. avail. Apr. 11, 1983). Losses paid to an FCM, therefore, are not subject to rule 17f–6.

[40] The proposal would have required the FCM to agree that any transfer of fund assets for clearing purposes would be to another FCM that met the requirements of the rule (other than the requirement of a contract with the fund). The FCM also would have been permitted to place fund margin with a clearing organization or a bank.

[41] Rule 17f–6(a)(1)(i) to (iii) [17 CFR 270.17f–6(a)(1)(i) to (iii)].

[42] Last year, the CFTC adopted rules creating a new market for eligible professional investors. Section 4(c) Contract Market Transactions; Swap Agreements, 60 FR 51323 (Oct. 2, 1995); CFTC rules 36.1 *et seq.* [17 CFR 36.1 *et seq.*] Transactions in the new market by eligible investors, which include funds with total assets exceeding $5 million, are exempt from many of the requirements under the CEA and related CFTC rules. The CFTC rules applicable to the new professional trading market, however, do not affect requirements relating to, among other things, segregation and FCM net capital. Consequently, funds may participate in the new professional trading market and use FCM custodians under rule 17f–6.

[43] Rule 17f–6(a)(1)(ii) [17 CFR 270.17f–6(a)(1)(ii)]. *See* CFTC rules 1.20, 30.7(c) [17 CFR 1.20, 30.7(c)] (requiring this acknowledgment). *See also* rule 17f–6(b)(1) [17 CFR 270.17f–6(b)(1)] (defining ''Clearing Organization''); rule 17f–6(b)(5) [17 CFR 270.17f–6(b)(5)] (defining ''U.S. or Foreign Bank''). Proposed rule 17f–6 would have required that any bank used to hold fund assets have a minimum capitalization of $500,000. The adopted rule does not impose this requirement because the CFTC addresses the credit-worthiness of these depositories. *See, e.g.*, CFTC Advisory 87–5 (Dec. 17, 1987). The Proposing Release requested comment on requiring a number of other contract provisions. In particular, the Proposing Release requested comment whether fund contracts should require FCMs: (i) to provide information at the request of the fund's accountants, (ii) to maintain specific records or furnish funds with specific reports concerning their margin accounts, and (iii) to indemnify funds or insure fund assets against non-trading margin losses. While one commenter favored these additional requirements, most commenters indicated that they are unnecessary. Rule 17f–6 does not include these requirements, since either CFTC regulations address these issues (such as recordkeeping) or these matters (such as accountants' access and indemnification) can be negotiated between the fund and the FCM.

[44] Proposing Release, *supra* note 1, at n. 129 and accompanying text.

[45] Rule 17f–6(a)(3) [17 CFR 270.17f–6(a)(3)]. *See* Custody of Investment Company Assets Outside the United States, *supra* note 19 (proposing a similar approach for custody arrangements involving foreign securities).

[46] *Cf.* CFTC rule 190.02(e) [17 CFR 190.02(e)] (giving a trustee in FCM bankruptcy proceedings four days to transfer open commodity positions).

Code of Federal Regulations is amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

2. By adding § 270.17f–6 to read as follows:

§ 270.17f–6 Custody of investment company assets with Futures Commission Merchants and Commodity Clearing Organizations.

(a) A Fund may place and maintain cash, securities, and similar investments with a Futures Commission Merchant in amounts necessary to effect the Fund's transactions in Exchange-Traded Futures Contracts and Commodity Options, *Provided that:*

(1) The manner in which the Futures Commission Merchant maintains the Fund's assets shall be governed by a written contract, which provides that:

(i) The Futures Commission Merchant shall comply with the segregation requirements of section 4d(2) of the Commodity Exchange Act (7 U.S.C. 6d(2)) and the rules thereunder (17 CFR Chapter I) or, if applicable, the secured amount requirements of rule 30.7 under the Commodity Exchange Act (17 CFR 30.7);

(ii) The Futures Commission Merchant, as appropriate to the Fund's transactions and in accordance with the Commodity Exchange Act (7 U.S.C. 1 through 25) and the rules and regulations thereunder (including 17 CFR part 30), may place and maintain the Fund's assets to effect the Fund's transactions with another Futures Commission Merchant, a Clearing Organization, a U.S. or Foreign Bank, or a member of a foreign board of trade, and shall obtain an acknowledgment, as required under rules 1.20(a) or 30.7(c) under the Commodity Exchange Act [17 CFR 1.20(a) or 30.7(c)], as applicable, that such assets are held on behalf of the Futures Commission Merchant's customers in accordance with the provisions of the Commodity Exchange Act; and

(iii) The Futures Commission Merchant shall promptly furnish copies of or extracts from the Futures Commission Merchant's records or such other information pertaining to the Fund's assets as the Commission through its employees or agents may request.

(2) Any gains on the Fund's transactions, other than de minimis amounts, may be maintained with the Futures Commission Merchant only until the next business day following receipt.

(3) If the custodial arrangement no longer meets the requirements of this section, the Fund shall withdraw its assets from the Futures Commission Merchant as soon as reasonably practicable.

(b) For purposes of this section:

(1) *Clearing Organization* means a clearing organization as defined in rule 1.3(d) under the Commodity Exchange Act (17 CFR 1.3(d)) and includes a clearing organization for a foreign board of trade.

(2) *Exchange-Traded Futures Contracts and Commodity Options* means commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of:

(i) Any contract market designated for trading such transactions under the Commodity Exchange Act and the rules thereunder; or

(ii) Any board of trade or exchange outside the United States, as contemplated in Part 30 under the Commodity Exchange Act.

(3) *Fund* means an investment company registered under the Act (15 U.S.C. 80a–1 *et seq.*).

(4) *Futures Commission Merchant* means any person that is registered as a futures commission merchant under the Commodity Exchange Act and that is not an affiliated person of the Fund or an affiliated person of such person.

(5) *U.S. or Foreign Bank* means a bank, as defined in section 2(a)(5) of the Act (15 U.S.C. 80a–2(a)(5)), or a banking institution or trust company that is incorporated or organized under the laws of a country other than the United States and that is regulated as such by the country's government or an agency thereof.

Dated: December 11, 1996.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–31891 Filed 12–16–96; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8692]

RIN 1545–AR57

Reissuance of Mortgage Credit Certificates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the reissuance of mortgage credit certificates. Changes to the applicable law were made by the Tax Reform Act of 1984. The regulations provide guidance to issuers and holders of mortgage credit certificates.

EFFECTIVE DATE: These regulations are effective December 17, 1996.

FOR FURTHER INFORMATION CONTACT: L. Michael Wachtel, (202) 622–3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document adds final regulations to the Income Tax Regulations (26 CFR part 1) to provide guidance under section 25(e)(4) of the Internal Revenue Code (Code) with respect to the reissuance of mortgage credit certificates. Section 25(e)(4) was added to the Code by section 612 of the Tax Reform Act of 1984, 98 Stat. 494, 905.

On December 22, 1993, temporary regulations (TD 8502) relating to refinancing under section 25(e)(4) were published in the Federal Register (58 FR 67689). A notice of proposed rulemaking (REG–209574–92, previously FI–47–92) cross-referencing the temporary regulations was published in the Federal Register for the same day (58 FR 67744).

Written comments responding to these notices were received. There were no requests to appear in response to publication of a notice of a hearing in the Federal Register (61 FR 15204). Therefore, no public hearing was held. After consideration of all the comments, the proposed regulations under section 25(e)(4) are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. The comments and revisions are discussed below.

Explanation of Provisions and Summary of Comments

The temporary regulations permit the reissuance of a mortgage credit