A Layman's Guide to Regulation 1.25

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Commodity Futures Trading Commission (CFTC) Regulation 1.25 - Investment of Customer Funds, has been at the top of the news these past couple of weeks. In the wake of the MF Global bankruptcy scandal, the focus has been on the treatment of customer funds at the failed futures commission merchant/broker-dealer, and its soured investments in European sovereign debt. In the midst of the investigation of MF Global and the search for $1.2 billion in missing customer segregated funds, the CFTC approved its final set of rule changes to Reg. 1.25 related to the Dodd-Frank Act.

While many press stories have gotten it "mostly right" in terms of Reg. 1.25 and MF Global, there is much misinformation floating about. Following is a short primer on Reg. 1.25 - its history, a summary of the new changes, how the rules relate to MF Global, and the future impact of Reg. 1.25 on the FCM community.

History of Regulation 1.25

Before 2000, FCMs and clearing houses were quite limited in where customer excess funds could be invested. Basically, the choices were U.S. Government securities, municipal bonds, or cash. Beginning in December 2000, the CFTC moved to expand the choices of permitted investments. By 2005, the list included obligations of government sponsored entities ("GSE debt"), bank certificates of deposit (CDs), commercial paper, corporate notes, general obligations of a sovereign nation, ("sovereign debt"), and interests in money market mutual funds (MMMFs). Additionally, the 2005 modification permitted FCMs to invest in short-term repurchase agreements, time-to-maturity transactions, and, in the case of firms such as MF Global, who are also registered broker-dealers, certain in-house ("affiliate") transactions.

The main stipulation was that such investments must, in most cases, possess the highest credit rating from one of the nationally-recognized statistical ratings organizations (NRSROs) such as Fitch, Moody's or Standard & Poor's). Additionally, the investments must be "readily marketable" and capable of being promptly liquidated.

In 2007, the commission began conducting a review of Regulation 1.25 and the effects of the changes. The review included meetings and requests for comment from market participants, independent and internal research. As the commission was concluding its review in 2008, a severe financial crisis significantly altered the regulatory landscape. Subsequent to the market turmoil, NRSROs took a lot of heat for their role in the subprime mortgage meltdown. As a result, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 included in its mandates a requirement that regulators create a framework that removes a reliance on credit ratings, in favor of other criteria such as asset concentration limits. The CFTC combined the results of its review with the mandates of Dodd-Frank and submitted a list of proposed changes to Reg. 1.25 at its October 26, 2010 open meeting. The proposals are summarized in a table HERE.

CFTC Final Rules, December 5, 2011

The final Dodd-Frank related changes to Reg. 1.25 were approved at the commission's December 5, 2011 meeting.

Much of the rulemaking focused on imposing certain concentration limits on money market mutual funds (MMMFs). It retained GSE debt and corporate debt as acceptable investments, but only if such investments contain a U.S. guarantee. The rule also eliminated foreign sovereign debt, in-house transactions and repurchase agreements with affiliates as permitted investments. Repurchase agreements with third-parties will still be allowed but subject to a 25 percent counterparty concentration limit.

MF Global and Regulation 1.25

From a Reg. 1.25 standpoint, the bankruptcy of MF Global could not have come at a worse time. The rules had been proposed but not finalized. It has been argued that, because of the MF Global fallout, the final rules were obsolete before the ink dried. Although the new rules eliminate foreign sovereign debt - the alleged culprit of the firm's equity meltdown - it remains unclear whether the new rules would have precluded the firm from making such investments. The dual registration as both FCM and broker-dealer "muddies the water" in this regard.

What is clear, however, is that no Reg. 1.25 restrictions will prevent accounting lapses or outright fraud. It appears at this point that MF Global transferred funds from the FCM side to the broker-dealer side, without simultaneously replacing the funds with other forms of collateral, as required by commission rules. As Commissioner Jill Sommers stated in her testimony before the House Agriculture Committee on December 8, 2011, "An FCM cannot take money out of a segregated account, invest it, and then return the money to the segregated account at some later time. CFTC regulation 1.25 has never allowed a firm to treat customer funds in this manner."

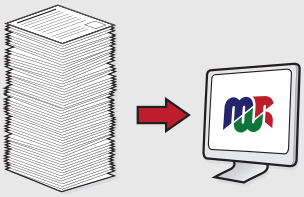
For more information on MF Global, visit the John Lothian Newsletter special section on MF Global bankruptcy news.

The "FCM Model" and the Future of Regulation 1.25

Futures commission merchants have faced an uphill battle over the past decade. The migration of trading from pit to screen not only required substantial investment in infrastructure, but also led to a squeezing of commissions. The chief source of revenue, then, became the "float" - earnings on excess customer segregated funds. Post-crisis, as short term interest rates approached zero, many FCMs simply could not function with returns at the risk-free rate. For MF Global, "moving out the risk curve" became a do-or-die proposition. In late October 2011, it died.

The FCM community will need to alter its business model, that much is clear. Commissions will rise. Customers will require additional layers of transparency. The key issue will be whether FCMs will be capable of sustaining higher commissions. This would seem a tall order - higher margins generally require product differentiation, yet electronic platforms are rapidly approaching "commoditization." In all likelihood, an FCM's commitment to transparency and capital management will become sources of competition.

We may see additional changes to Regulation 1.25 as a result of the MF Global debacle. The real changes, however, will come from the industry and its participants. This may lead to a "SIPC-like" guaranty fund for the industry, or it may simply lead to internal changes driven by customer demand for openness and better risk management practices. Futures trading involves considerable risk, risk that is generally accepted as the trade-off for potential reward. The risk of one's FCM playing fast and loose with segregated funds must not be among those risks.



The financial markets are facing hundreds of rule changes from the Dodd-Frank Act, as well as from the European Union and across Asia. MarketsReformWiki aim to pull all rule filings, news releases, comment letters, position papers, white papers and other publicly available information together in one central location that is easily accessed and searched. ***Visit MarketsReformWiki.com for more information.***