(44 U.S.C. 3506(c)(1); 5 U.S.C. 553)

Dated: August 1, 1997.

Sadye E. Dunn,

Secretary, Consumer Product Safety Commission.

[FR Doc. 97–20725 Filed 8–6–97; 8:45 am]

BILLING CODE 6355–01–P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants

AGENCY: Commodity Futures Trading Commission.

ACTION: Final Rules.

SUMMARY: The Commodity Futures Trading Commission (''Commission'') is amending Rules 1.23 and 1.25 to allow futures commission merchants (''FCMs'') to make direct transfers into segregated accounts of permissible, unencumbered securities of the types set forth in Section 4d(2) of the Commodity Exchange Act (''Act'') and Rule 1.25 promulgated thereunder. This will provide FCMs a more efficient means to increase or decrease their residual interest in funds segregated for the benefit of commodity customers than heretofore permitted. In addition, the revised rules will permit FCMs to deposit the proceeds from the sale or maturity of any such investments directly into a nonsegregated bank account, provided that the FCM maintains a sufficient residual financial interest in the funds segregated for commodity customers to assure that all of an FCM's obligations to its customers are covered. The Commission's expectation is that these rule changes will reduce the number of transactions required to manage an FCM's segregated cash and securities balances, thus reducing operating costs for the industry. To assure that there will be a clear audit trail for the increased types of permitted transactions, Rule 1.27 also is being amended to require that the description of the investment securities, required by the rule, includes the security identification number developed by the Committee on Uniform Security Identification Procedures (''CUSIP Number''). Also, Rule 1.25 is being amended to require identification, in the record of investments required to be maintained by Rule 1.27, of the manner in which the proceeds from the sale or maturity of any segregated securities are disposed of.

EFFECTIVE DATE: September 8, 1997.

FOR FURTHER INFORMATION CONTACT: Paul H. Bjarnason, Jr., Chief Accountant, or Lawrence B. Patent, Associate Chief Counsel, Division of Trading and Markets (''Division''), Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, N.W., Washington, D.C. 20581. Telephone (202) 418–5430.

SUPPLEMENTARY INFORMATION:

I. Investment of Customers' Segregated Funds

At all times, an FCM is required to have sufficient funds in segregation to meet its obligations to customers. As a consequence, to protect against a customer account going into deficit, an FCM must deposit funds of its own to cover any customer account deficits, and such funds must remain in segregation until more funds are remitted to the FCM by the customers who hold such deficit accounts. Thus, maintaining an adequate cushion of its own in segregation is a part of routine FCM funds management operations. FCM operational funding needs often dictate that any unneeded excess funds in segregation be moved so that they can be used in other aspects of the firm's operations. Therefore, prudent and efficient funds management typically requires an FCM to make frequent transfers of funds into and out of segregation.

Prior to these rule changes, FCMs were only allowed to increase or decrease their interest in customers' segregated funds by direct transfers of cash. That is, securities owned by the FCM and held in a non-segregated account could not be transferred to a segregated account. Moreover, to assure an audit trail, if an FCM wished to move funds represented by securities into segregation, the securities had to be sold and the cash proceeds transferred into a segregated account. The FCM could, then, use the segregated cash to purchase more securities that would be held in segregation. The effect of these requirements was that any segregated securities, except for securities purchased and specifically owned and deposited by individual customers, always had to be purchased with cash from a segregated cash account. Likewise, the proceeds from any sale of segregated securities always had to be deposited into a segregated account, even if there was no longer a need for the funds to be in segregation. That is, such funds could only be moved to a non-segregated account after the securities were converted to cash and the cash had been deposited into a segregated account.

On March 21, 1997, the Commission published for comment proposed amendments to Rules 1.23, 1.25, and 1.27.[1] The proposed changes would permit FCMs to transfer their own unencumbered securities from a non-segregated account directly into a customer segregated safekeeping account. This would enable an FCM to increase the amount of funds segregated for the benefit of commodity customers more quickly and economically. To be eligible for direct transfer, such securities were required to be unencumbered and to qualify as permitted investments of customer funds under Rule 1.25. The proposed rule amendments also would permit an FCM to transfer such securities from a segregated customer safekeeping account directly to the FCM's own non-segregated account, to the extent the FCM had excess funds available in segregation. The 30-day public comment period on the proposed rule changes expired on April 21, 1997. The Commission received one written comment letter on this proposal from the Joint Audit Committee (''JAC'').[2] The JAC raised two issues.

First, JAC suggested that Rule 1.25 be amended by removing the requirement contained in the rule that the proceeds from any sale of segregated securities be redeposited into a segregated account. JAC indicated that by eliminating this restriction, FCMs would be able to sell segregated securities directly out of the segregated account and deposit the funds to a non-segregated account. Since it was the Commission's aim to permit cash and securities to be treated the same way, thus reducing the number of transactions required to administer segregated funds and reduce transaction costs, the Commission agrees with this suggestion. Therefore, to adopt the JAC's suggestion, Rule 1.25 is further amended in two respects: 1) the requirement to deposit the proceeds from the sale of segregated securities to a segregated account is eliminated; and 2) a requirement to identify, in the record of investments required to be maintained by Rule 1.27, the manner in which the proceeds from the sale or maturity of any segregated securities are disposed of, is added to the rule. That is, if proceeds are not redeposited in a segregated account, the record must

[1] *See* 62 FR 13564 (March 21, 1997).

[2] JAC is comprised of representatives from each commodity exchange and National Futures Association which coordinate the industry's audit and ongoing surveillance activities to promote a uniform framework of self-regulation.

reflect that the proceeds were deposited to an identified non-segregated account.

These changes to the rules are achieved without any sacrifice of the audit trail related to segregated funds transfers. Also, the rules do not impose any significant costs or other undue burdens upon FCMs, because the additional information required to be maintained by the rule should be available to FCMs in the internal records they already maintain.

The Commission's proposed amendment to Rule 1.23 would have modified the restrictions to allow the transfer of the types of securities set forth in Rule 1.25 between segregated and nonsegregated accounts. These proposed changes would permit transfers between segregated and non-segregated accounts, whether made in cash or securities, to be treated the same way. Therefore, the Commission has determined to adopt the amendment to Rule 1.23 as originally proposed, but to add the amendment to Rule 1.25 to assure that the Rule 1.23 rule changes achieve the desired result.

In its second comment, JAC pointed out that the proposed amendments to Rules 1.23 and 1.25 would restrict the transfer of securities to those held in a segregated safekeeping account with a bank or trust company. JAC's original request for the proposed rule change was to allow FCMs the ability to transfer segregated securities held by any permitted segregation depository, including contract market clearing organizations and other FCMs. The Commission agrees. Therefore, the final amendments to Rules 1.23 and 1.25, as adopted, refer to securities held in segregated safekeeping at any permitted custodian of segregated funds, that is a bank, trust company, contract market clearing organization, or another FCM. It should be noted that clearing organizations and FCMs ultimately deposit customer funds in a segregated safekeeping account with a bank or trust company.[3] In this connection the Commission notes that to be considered properly segregated, pursuant to the Act and the rules promulgated thereunder, securities must be held in safekeeping.

For purposes of Rules 1.26, 1.27, 1.28 and 1.29, all permissible investments, when deposited into segregated accounts, will be deemed to be securities and obligations which represent investments of customers' funds until such time as the FCM withdraws or otherwise disposes of such investments.

Also, the Commission is adopting as proposed amendments to Rule 1.27, which require FCMs to maintain records of permissible investments held in segregated accounts. Rule 1.27 now will require the record to include the CUSIP number of such securities as a part of the description of such investments, and Rule 1.25 will require the FCM's record to indicate if securities were liquidated and the non-segregated account where the proceeds were transferred. The Commission is not adopting any other changes to Rule 1.27, but wants to remind FCMs that Rule 1.27 requires them to include in the investments record, among other information, the name of the person through whom such investments were made and the name of the person to or through whom such investments were disposed of. Therefore, this record should identify permissible investments owned by the FCM which were deposited into segregation and any investments withdrawn from segregation and deposited in the FCM's own account. Securities owned by the FCM, used to meet its segregation requirements, must be identified as customer securities and properly segregated, whether physically deposited or deposited by book entry.

The Commission also invited comments on whether custodians for these purposes should be limited to banks and trust companies not affiliated with the FCM. The Commission asked this question, in part, as a follow-up to issues raised during the Barings crisis. Many firms had deposited their cash with affiliates of the Barings bank, which in turn used the Barings bank as a depository for those assets. During the Barings crisis, these firms found that their assets, notwithstanding some interpretations that the segregation laws in the United Kingdom impose a complete trust on customer funds, would not necessarily be considered segregated for their benefit in any impending liquidation in bankruptcy of the Barings group. In this connection, the Commission notes that the International Organisation of Securities Commissions issued guidance on client asset protection, which is contained in a report published in August 1996, that recommends to regulatory authorities that they should: ''. . . carefully consider the circumstances in which authorised firms may be permitted to meet the requirements of a client asset protection regime by holding client assets with a related custodian.''

In this connection, the only commenter, the JAC, stated that such a limitation on affiliated depositories would not seem warranted. In most jurisdictions, funds in securities held in safekeeping can be separated from funds amenable to the claims of a creditor of the custodian, as well as a creditor of the FCM. Amendments added to the Act in 1968, to impose the requirement to segregate directly on the custodian, are intended to achieve that effect.[4] The adoption of the rules in this release is intended to facilitate maintaining segregated funds in the form of securities. The Commission, therefore, believes that there is no compelling reason to impose a condition, at this time, that such funds be held at non-affiliated custodians. The Commission notes that it intends to keep this conclusion under review. This is because legislative and regulatory changes in the U.S. or in other countries, developments in risk assessment systems or cooperative arrangements with domestic and/or international regulators and encountering new types of custodianship problems in connection with a failed firm could at some future time suggest that the Commission consider a change in its current rules and policies in this connection.

Under the Act, an FCM may segregate commodity customers' funds at a bank or trust company, another registered FCM, or a clearing organization of a contract market. Each of these depositories is, itself, required by the Act to treat and deal with such funds as belonging to the FCM's customers and not as the FCM's own funds. Each of these persons is also liable under the Act for any misuse of, or failure to segregate, such funds. Such liability accrues whether or not the depository is related to the FCM. When customer funds are deposited with another FCM or contract market clearing organization, the funds, ultimately, are deposited

[3] In proposing these rule amendments, the Commission noted that their adoption would also require the Division to revise Financial and Segregation Interpretation No. 7, which includes the following statement:

Under Regulations 1.23 and 1.25 such obligations must be: (1) purchased with money deposited in an account used for the deposit of customers' funds; (2) made through such an account; and (3) the proceeds from any sale of such obligations must be redeposited in such an account. Thus, all additions to and withdrawals from customer segregated funds which represent topping up by the FCM to cover actual or expected customer deficits must be in the form of cash.

1 Comm. Fut. L. Rep. (CCH) ¶ 7117, at 7124 (July 23, 1980).

The Division will delete this text from the interpretation shortly and will publish an amended interpretation on its Internet web site (http://www.cftc.gov) and request Commerce Clearing Housng to publish the revised interpretation in the Commodity Futures Law Reporter.

[4] Pub. L. No. 90–258, § 6, 82 Stat. 26, 28 (1968), now codified as the concluding paragraph of § 4d(2) of the Act, 7 U.S.C. 6d(2) (1994).

with a bank or trust company by such FCM or clearing organization.

With respect to net capital compliance issues, the Commission's staff has previously informally advised the Joint Audit Committee and individual registrants that deposits of funds with affiliates would be deemed by staff to be returns of capital by an FCM and, therefore, such deposits could not be treated as regulatory capital by an FCM, unless such funds represented either: (1) Funds segregated or set aside in safekeeping under the Commission's rules for commodity or foreign futures or foreign options customers; (2) funds held pursuant to the Securities and Exchange Commission's customer protection rules (17 CFR 240.15c3–3); or (3) amounts to be used for normal operating expenses. The Commission is in agreement with that policy and does not believe any additional limitation needs to be imposed at this time. Unusually large amounts of cash held in segregation will be reviewed as part of Commission and SRO audit programs.

II. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601–611 (1988), requires that agencies, in proposing rules, consider the impact of those rules on small businesses. The rule amendments discussed herein would affect registered FCMs. The Commission has previously established certain definitions of ''small entities'' to be used by the Commission in evaluating the impact of its rules on such entities in accordance with RFA.[5] The Commission previously determined that registered FCMs are not small entities for the purpose of the RFA.[6]

Further, the amendments discussed herein do not impose any significant new burdens upon FCMs. These amendments facilitate the use of firm-owned obligations to enhance funds segregated for commodity customers by allowing the direct transfer of said obligations into and out of segregated accounts. As a result, the Commission anticipates that adoption of the amendments will reduce the burden of compliance with segregation requirements by FCMs. Accordingly, when these rule amendments were proposed, the Chairperson, on behalf of the Commission, certified, pursuant to 5 U.S.C. 605(b), that the rule amendments would not have a significant economic impact on a substantial number of small entities. The Commission, nonetheless, invited comment from any registered FCM that believed these rules would have a significant impact on its operations, but none was received.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (Pub. L. No. 104–13, May 13, 1995) (''PRAct'') imposes certain requirements on federal agencies (including the Commission) in connection with their conducting or sponsoring any collection of information, as defined by the PRAct. While these rule amendments have no burden, the group of rules (3038–0024) of which the rules proposed to be amended are a part has the following burden:

Average burden hours per response.....18.00
Number of Respondents 1,662.00
Frequency of response.....19.00

Copies of the OMB approved information collection package associated with these rules may be obtained from the Desk Officer, CFTC, Office of Management and Budget, Room 10202, NEOB, Washington, DC 20503, (202) 395–7340.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and Recordkeeping requirements, Segregation requirements.

In consideration of the foregoing and pursuant to the authority contained in the Act and, in particular, Sections 4d, 4g and 8a (5) thereof, 7 U.S.C. 6d, 6g and 12a(5), the Commission hereby amends Chapter I of Title 17 of the Code of Federal Regulations as follows:

PART 1—GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for Part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 2a, 4, 4a, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6j, 6k, 6l, 6m, 6n, 6o, 6p, 7, 7a, 7b, 8, 9, 12, 12a, 12c, 13a, 13a–1, 16, 16a, 19, 21, 23, and 24.

2. Section 1.23 is revised to read as follows:

§ 1.23 Interest of futures commission merchant in segregated funds; additions and withdrawals.

The provision in section 4d(2) of the Act and the provision in § 1.20(c), which prohibit the commingling of customer funds with the funds of a futures commission merchant, shall not be construed to prevent a futures commission merchant from having a residual financial interest in the customer funds, segregated as required by the Act and the rules in this part and set apart for the benefit of commodity or option customers; nor shall such provisions be construed to prevent a futures commission merchant from adding to such segregated customer funds such amount or amounts of money, from its own funds or unencumbered securities from its own inventory, of the type set forth in § 1.25, as it may deem necessary to ensure any and all commodity or option customers' accounts from becoming undersegregated at any time. The books and records of a futures commission merchant shall at all times accurately reflect its interest in the segregated funds. A futures commission merchant may draw upon such segregated funds to its own order, to the extent of its actual interest therein, including the withdrawal of securities held in segregated safekeeping accounts held by a bank, trust company, contract market clearing organization or other futures commission merchant. Such withdrawal shall not result in the funds of one commodity and/or option customer being used to purchase, margin or carry the trades, contracts or commodity options, or extend the credit of any other commodity customer, option customer or other person.

3. Section 1.25 is revised to read as follows:

§ 1.25 Investment of customer funds.

No futures commission merchant and no clearing organization shall invest customer funds, except in obligations of the United States, in general obligations of any State or of any political subdivision thereof, or in obligations fully guaranteed as to principal and interest by the United States. This shall not prohibit a futures commission merchant from directly depositing unencumbered securities, of the type specified in this section, which it owns for its own account, into a segregated safekeeping account or from transferring any such securities from a segregated account to its own account, up to the extent of its residual financial interest in customers' segregated funds; *provided, however,* that such investments, transfers of securities, and disposition of proceeds from the sale or maturity of such securities are recorded in the record of investments, required to be maintained by § 1.27. All such securities may be segregated in safekeeping only with a bank, trust company, clearing organization of a contract market, or other registered futures commission merchant. Furthermore, for purposes of §§ 1.25, 1.26, 1.27, 1.28 and 1.29, investments permitted by § 1.25 that are owned by the futures commission merchant and deposited into such a segregated account shall be considered

[5] 47 FR 18618–18621 (April 30, 1982).
[6] 47 FR 18619–18620.

customer funds until such investments are withdrawn from segregation.

4. Section 1.27 is amended by revising paragraphs (a)(4) and (b)(2) to read as follows:

§ 1.27 Record of investments.

(a) * * *

(4) A description of the obligations in which such investments were made, including the CUSIP numbers;

* * * * *

(b) * * *

(2) A description of such documents, including the CUSIP numbers; and

* * * * *

Issued in Washington D.C. on July 28, 1997, by the Commission.

Jean A. Webb,

Secretary of the Commission.

[FR Doc. 97–20766 Filed 8–6–97; 8:45 am]

BILLING CODE 6351–01–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. IC–22775, IS–1095; File No. S7–7–96]

RIN 3235–AG61

Exemption for the Acquisition of Securities During the Existence of An Underwriting or Selling Syndicate

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to the rule under the Investment Company Act of 1940 that permits an investment company that is related to certain participants in an underwriting to purchase securities during an offering, if certain conditions are met. The amendments increase the percentage of an underwriting that investment companies having the same investment adviser may purchase in reliance on the rule, and expand the scope of the rule to include securities of certain foreign and domestic issuers that are not registered with the Commission under the Securities Act of 1933. The amendments respond to changes in the investment company and underwriting industries that have occurred since the rule last was substantively amended in 1979.

EFFECTIVE DATE: The rule amendments will become effective October 6, 1997.

FOR FURTHER INFORMATION CONTACT: C. Hunter Jones, Special Counsel, Office of Regulatory Policy, or Nadya B. Roytblat, Assistant Director, Office of Investment Company Regulation, Division of Investment Management, at (202) 942–0690, U.S. Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 10–2, Washington, D.C. 20549.

Requests for formal interpretive advice should be directed to the Office of Chief Counsel at (202) 942–0659, Division of Investment Management, U.S. Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop 10–6, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Commission today is adopting amendments to rule 10f–3 (17 CFR 270.10f–3) under the Investment Company Act of 1940 (15 U.S.C. 80a) (the ''Investment Company Act'').

Table of Contents

Executive Summary
I. Background
  A. Introduction
  B. Proposed Amendments to Rule 10f–3
II. Discussion
  A. Quantity Limitations
  1. Percentage of Offering Purchased
  2. Percentage of Fund Assets
  B. Foreign Offerings and Rule 144A Securities
  1. Eligible Foreign Offerings
  2. Rule 144A Offerings
  3. Calculation of Percentage Limit in Global Offerings
  C. Price and Timing of the Purchase
  D. Group Sales
  E. Role of Fund Board of Directors
  F. Reporting and Recordkeeping
  G. U.S. Government Securities
III. Cost–Benefit Analysis
IV. Paperwork Reduction Act
V. Summary of Regulatory Flexibility Analysis
VI. Statutory Authority
Text of Rule

Executive Summary

The Commission is adopting amendments to rule 10f–3 under the Investment Company Act. Rule 10f–3 provides an exemption from section 10(f), which prohibits any registered investment company (''fund'') from purchasing securities for which an underwriter having certain relationships with the fund (''affiliated underwriter'') is acting as a principal underwriter during the existence of an underwriting or selling syndicate for the securities. The amendments are intended to provide funds with additional flexibility, consistent with the protection of investors, to make investments that may be in the best interests of investors.

The amendments will permit a fund subject to the rule, together with other funds that have the same investment adviser, to purchase, during the existence of an underwriting or selling syndicate:

- Up to 25% of the principal amount of an offering;
- Securities of foreign issuers or of domestic reporting issuers in an ''Eligible Foreign Offering''; and
- Certain securities that are exempt from registration and are eligible for resale pursuant to rule 144A under the Securities Act of 1933 (''Securities Act'').

The Commission is not adopting the amendment that would have permitted a fund subject to the rule to purchase municipal securities in a group sale (*i.e.*, a purchase for which all members of an underwriting syndicate, including the affiliated underwriter, receive credit). Rather, in light of the comments, the Commission has concluded that there is insufficient justification at this time to alter the treatment of group sales of municipal securities under rule 10f–3.

I. Background

A. Introduction

Section 10(f) of the Investment Company Act was designed to address one of the major abuses noted in the period before enactment of the Investment Company Act—the use of funds by underwriters that controlled these funds as a ''dumping ground'' for unmarketable securities.[1] An underwriter could, for example, ''dump'' unmarketable securities on its controlled fund, either by causing the fund to purchase the securities from the underwriter itself, or by encouraging the fund to purchase securities from another member of the underwriting syndicate. Fund assets also could be used to absorb the risks of an underwriting in more subtle ways, such as by facilitating price stabilization in connection with an underwriting.

Section 10(f) prohibits any fund from purchasing any security for which an affiliated underwriter is acting as a principal underwriter,[2] during the existence of an underwriting or selling syndicate for that security.[3] Congress

[1] *See Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 35 (1940) (statement of Commissioner Healy).

[2] ''Principal underwriter'' is defined in section 2(a)(29) of the Investment Company Act [15 U.S.C. 80a–2(a)(29)] to mean (in relevant part) an underwriter who, in connection with a primary distribution of securities, (A) is in privity of contract with the issuer or an affiliated person of the issuer, (B) acting alone or in concert with one or more other persons, initiates or directs the formation of an underwriting syndicate, or (C) is allowed a rate of gross commission, spread, or other profit greater than the rate allowed another underwriter participating in the distribution.

[3] Section 10(f) [15 U.S.C. 80a–10(f)] prohibits a fund from purchasing a security during the

Continued