CUSTOMER FUND INVESTMENT IN US PERMITTED INVESTMENTS

A response paper by the Futures and Options Association

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1. Introduction

1.1 The Futures and Options Association ("the FOA") is the principal European industry association for over 170 firms and organisations engaged in the carrying on of business in futures, options and other derivatives. Its international membership includes banks, financial institutions, brokers, commodity trade houses, energy and power market participants, exchanges, clearing houses, IT providers, lawyers, accountants and consultants.

1.2 The attention of the FOA has only just been drawn to the CFTC proposal to amend its regulations regarding the investment of customer segregated funds and funds held in an account subject to Commission Regulation 30.7. Bearing in mind the limited amount of time left for submitting comments, the FOA has restricted therefore its comments to a few high-level principled observations.

1.3 For the reasons set out in Section 2, the FOA believes that it is undesirable and potentially damaging for the CFTC to remove foreign sovereign debt as a permitted investment, insofar as the major sovereign debt markets have a key "systemic" role to play in a globalised marketplace; are heavily dependent on liquidity; in times of market stress, unlike the equity markets, provide a "safe haven" for investment; and have a key role to play in the price measurement of related instruments and asset classes.

2. Reasons why US investment should not be restricted to the US sovereign debt market

2.1 The sovereign debt market has become increasingly interconnected and global in line with the trend for cross-border trading and investment. This is reflected in the fact that overall investment in sovereign debt markets held by non-domestic investors is, it is believed, in the order of 30%.

This foreign investment in sovereign debt markets is particularly important insofar as:

- during the crisis, it played a key role in maintaining liquidity and demand which, in turn, had a beneficial impact on pricing and spreads;

- it underpins investor confidence in the sovereign debt markets;

- the contribution of a diversified and non-domestic investor base enhances authentic pricing in individual sovereign debt markets;

- sovereign debt markets are, in the main, large, liquid and, subject to necessary due diligence, capable of providing a reliable and comparatively safe haven for US investors;

2.2 The proposed US restriction on US investment in foreign sovereign debt markets could trigger a "tit for tat" approach which would generate the same problems for the US sovereign debt market as has been identified in relation to the US restriction of US investment in non-US sovereign debt markets;

2.3 Bearing in mind that the world is still in the "tail" of a global economic and financial crisis, the proposed restriction would threaten liquidity in some non-US debt markets with the result that the sovereign issuers in those markets would incur higher costs on issuance because of the imposition of a consequential "illiquidity premium", which could trigger further problems in local economies and at a time when budget deficits in many member states are at historic highs.

2.4 While it is understandable that the US may wish to incentivise US investors to invest in US sovereign debt, particularly at this time, the restriction would, at the same time, deprive US investors of investment diversity – which adds both choice and investment opportunity. Further, it could be argued that, in the current climate, it is particularly important that individual investors are able to save and invest in markets which offer higher levels of safety, but which this proposed blanket prohibition will deny to them. Further, it puts US investors in a significantly less competitive position than other non-US investors, who will have greater freedom of investment choice.

2.5 The proposed US investment ban will progressively undermine the role of non-US sovereign debt markets and have the unintended consequence of increasing market volatility and therefore financial instability.

3. Specific observations on the CFTC proposed rule

3.1 The CFTC, in the view of the FOA, rightly determined to permit investments in non-US sovereign debt in December 2000 on a qualified basis, namely:

- that "the investments satisfy specified rating standards and concentration limits, and be readily marketable and subject to prompt liquidation";
- that they must be "consistent with the objectives of preserving principal and maintaining liquidity" (Regulation 1.25)

The FOA supports these dynamic "due diligence" obligations.

3.2 The FOA recognises the CFTC's observations that the financial and economic crisis has demonstrated the importance of conducting periodic reassessments of what is a permissible and safe investment, but believes that this will not be delivered through a <u>blanket</u> ban on US investment in non-US sovereign debt markets.

3.3 The FOA notes that, of the 12 letters received in response to the ANPR, eleven of them supported maintaining the current list of permitted investments; and the FOA does not share the view that merely because non-US sovereign debt markets were "used negligibly as investment vehicles", this justifies the proposed prohibition. If anything, it supports the view that there is no need for a prohibition, but rather, potentially, an investment "cap".

3.4 The FOA very much supports the Commission's view that it "seeks to increase the safety of Regulation 1.25 investments by promoting diversification". However, the FOA believes that the proposed ban on investment in sovereign debt impairs that objective significantly.

3.5 The FOA does not share the view that, as expressed by the CFTC, the ban is "in the interests of both simplifying the regulation and safeguarding customer funds". The FOA believes that a blanket ban, which does not involve any due diligence, may have the benefit of simplifying regulation, but at the price of reducing US investor capacity to access "safe haven" investment and, on that basis, by reducing diversification, will actually impair the "safeguarding" of customer funds.

3.6 The FOA supports the current qualification that foreign sovereign debt investment must be rated in the highest category, but questions the cap, which is based on the extent to which balances in segregated accounts are denominated in the specific country's currency.

However, the FOA also believes that even this limited capacity to invest in foreign sovereign debt is more beneficial to US investors than a blanket prohibition. As an aside, the FOA entirely recognises that sovereign debt of certain countries would be an unacceptable investment where it exceeds, as it is put in the Federal Register, "an acceptable level of risk".

3.7 The FOA understands the reservations of the CFTC over the value of ratings, but, while their reliability was brought seriously into question as a result of the crisis, they continue to be a key factor in the due diligence that will require to be undertaken by FCMs and DCOs in terms of measuring the credit risk involved in permitted investments. This is likely to be even more the case insofar as the rating agencies are now under significantly closer regulatory scrutiny and higher levels of transparency will be required of them in terms of their rating methodologies and applicable conflicts of interest.

4. Conclusion

4.1 The FOA would urge the CFTC to reconsider its proposed blanket prohibition on investment in foreign sovereign debt and rely instead on imposing higher standards of due diligence on FCMs and DCOs; and, in this way, preserve investment diversity and the opportunity of expanding the range of investment "safe havens", while, at the same time, requiring a significant "scale back" on foreign sovereign debt markets that do not provide a "safe haven" investment opportunity.