

MEMO# 26636

November 1, 2012

CFTC Proposes Rules to Enhance Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 40-12
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 61-12
SEC RULES COMMITTEE No. 68-12 RE: CFTC PROPOSES RULES TO ENHANCE PROTECTIONS
AFFORDED CUSTOMERS AND CUSTOMER FUNDS HELD BY FUTURES COMMISSION
MERCHANTS AND DERIVATIVES CLEARING ORGANIZATIONS

The Commodity Futures Trading Commission (“CFTC” or “Commission”) has proposed new rules and rule amendments to require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosure, and auditing and examination programs for futures commission merchants (“FCMs”). [\[1\]](#) The Proposal is intended to provide greater protections to customers and to the funds deposited by customers with FCMs and DCOs in the aftermath of the two recent failures of FCMs. [\[2\]](#) The Proposal also would require self-regulatory organizations (“SROs”) of FCMs to adopt new requirements with respect to the oversight and examination of FCMs. The Proposal follows two public roundtables on customer protection issues. [\[3\]](#)

Comments on the Proposal are due 60 days after publication in the Federal Register. We will schedule a conference call to discuss the Proposal and possible ICI comments, and detailed information about the call will be circulated shortly. This memorandum describes certain aspects of the Proposal that may be of particular interest to funds.

Customer Funds

Section 4d(a)(2) of the Commodity Exchange Act (“CEA”) requires each FCM to segregate from its own assets all money, securities, and other property deposited by futures customers to margin, secure, or guarantee futures contracts and options on futures contracts traded on DCMs. Section 4d(f) of the CEA requires each FCM to segregate from its own assets all money, securities, and other property deposited by cleared swap customers to margin transactions in cleared swaps. The CFTC regulations in Part 1 and Part 22 were adopted to implement section 4d(a)(2) and section 4d(f) of the CEA, respectively, and to safeguard funds deposited by futures and swaps customers. These regulations require FCMs to hold each of these types of customer deposited funds in separate accounts and to segregate the customer funds from the FCM’s own funds and from each other type. Section 4(b) of the CEA, among others, provides the CFTC with authority to adopt rules proscribing fraud and requiring minimum financial standards, the disclosure of risk, and the safeguarding of funds deposited by persons for trading on foreign markets. Pursuant to section 4(b), the CFTC adopted Part 30 to address foreign futures and foreign option transactions. The Proposal would amend various provisions of these CFTC regulations to provide greater protection for customers of FCMs and customer funds held by FCMs.

Segregation and Use of Customer Funds

The Proposal would prohibit an FCM from commingling futures customer funds with the FCM’s proprietary funds and prohibit the FCM from commingling funds deposited by futures customers with funds deposited by 30.7 Customers [\[4\]](#) or cleared swap customers. [\[5\]](#) The Proposal also would prohibit a DCO from commingling futures customer funds with the DCO’s proprietary funds or with any proprietary account of any of its clearing members and would prohibit the DCO from commingling funds held for futures customers with funds deposited by clearing members on behalf of their cleared swaps customers.

In addition, under the Proposal, an FCM would be prohibited from using one customer’s funds to margin or secure another customer’s positions and from using a customer’s funds to extend credit to any other person. The proposed amendments are intended to clarify that the prohibition on the FCM’s use of one customer’s funds to margin positions of another customer applies at all times (and not just at the end of the trading day). For this purpose, an FCM that operationally commingles the funds of its customers must ensure that at all times its residual interest in the accounts exceeds the sum of the margin deficits of all of its customers.

Acknowledgement Letters from Depositories

The CFTC also proposes amendments to the written acknowledgment letters that an FCM or DCO is required to obtain from a depository holding customer funds. These letters would be required to state that the depository was informed that the funds deposited belong to customers and are being held in accordance with the CEA and the CFTC regulation.

The CFTC also is proposing an additional acknowledgment letter template form for money market mutual funds when they are permissible investments for customer funds under Rule 1.25. In addition, the CFTC is proposing to add language to its proposed acknowledgment letters authorizing and requiring the depository to grant at all times read-only electronic access to the accounts to the Commission and, in the case of an FCM, to the FCM’s designated SRO (“DSRO”). [\[6\]](#)

Withdrawal of Funds from Customer Accounts

The CFTC is proposing to require additional safeguards with respect to an FCM withdrawing customer funds from segregated accounts that are part of the FCM's residual interest in such accounts. [\[7\]](#) An FCM would be prohibited from withdrawing any of its residual interest or excess funds on any given business day unless the FCM has completed the daily calculation of funds in segregation as of the close of the previous business day and the calculation showed that the FCM maintained excess segregated funds in the customer accounts as of the close of the business on the previous business day. The CFTC also proposes additional layers of authorization and documentation if the withdrawal exceeds, individually or in the aggregate with other such withdrawals, 25% of the FCM's residual interest. The Proposal also would require an FCM that has withdrawn funds from segregated customer accounts for its own purposes and such withdrawal causes the firm to fall below its targeted residual interest in such accounts to deposit proprietary funds into the accounts to restore the residual interest balance to the targeted amount.

Investment of Customer Funds

The CFTC is proposing to provide that the 25% counterparty concentration limit for reverse repurchase agreements applies not only to a single counterparty but to all counterparties under common control or ownership. The CFTC also proposes to provide explicitly that an FCM bears sole responsibility for any losses resulting from the investment of customer funds in financial instruments permitted under Rule 1.25. An FCM may not charge or otherwise allocate any such losses to the accounts of the FCM's customers.

Daily Computation and Record

The CFTC proposes to require FCMs to file its segregation calculation with the Commission and with its DSRO each business day. The CFTC proposes to require FCMs to use the schedules contained in the Form 1-FR-FCM [\[8\]](#) to document its daily segregation calculation. The CFTC also is proposing to require FCMs to provide to the CFTC and to the FCM's DSRO twice each month a detailed listing of depositories holding customer funds and the substance of the investment of customer funds under Rule 1.25. Specifically, each FCM must list the total amount of cash, U.S. government securities, U.S. agency obligations, municipal securities, certificates of deposit, money market mutual funds, commercial paper, and corporate notes held by each depository computed at current market values.

Risk Management Program for FCMs

The CFTC proposes to require each FCM that carries customer accounts (for transacting in futures, options on futures, and swaps) to establish a risk management program designed to monitor and manage the risks associated with its activities as an FCM. The risk management program must consist of written policies and procedures approved by the governing body of the FCM and submitted to the CFTC and the DSRO. In addition, a risk management unit must be established to administer the risk management program that is independent of the business unit.

The Proposal provides for a non-exhaustive list of elements that would be required to be a part of the risk management program of an FCM. The Proposal requires that the risk management policies and procedures of an FCM relate to the risks associated with safekeeping and segregation of customer funds and include: (1) establishing and maintaining an adequate targeted amount of excess funds in customer accounts reasonably designed to ensure that the FCM is at all times in compliance with the segregation requirements for customer funds under the CEA and CFTC regulations; [\[9\]](#) (2)

the evaluation and monitoring of depositories; (3) account opening procedures that ensure the FCM obtains the acknowledgement required from the depository and that the account is properly titled as belonging to the customers of the FCM; (4) controls ensuring that withdrawals of cash, securities, or other property from accounts holding customer funds not for the benefit of customers are in compliance with the CEA and the CFTC's regulations; (5) procedures for assessing the appropriateness of investing customer funds in accordance with Rule 1.25; (6) the valuation, marketability, and liquidity of customer funds and permitted investments made with customer funds; (7) the appropriate separation of duties of personnel responsible for compliance with the CEA and CFTC regulations relating to the protection and financial reporting of customer funds; (8) procedures for the timely recording of transactions in the firm's books and records; and (9) annual training of personnel responsible for compliance with the CEA and CFTC regulations relating to the protection and financial reporting of customer funds.

The CFTC would require that the risk management program include a supervisory system that is reasonably designed to ensure that the risk management policies and procedures are diligently followed. In addition, the Proposal would require an annual review and testing of the adequacy of each FCM's risk management program by internal audit staff or a qualified external, third party service.

Financial Reporting and Net Capital Requirements for FCMs

Financial Reports of FCMs

Currently, each FCM must file with the CFTC and its DSRO an unaudited financial report each month and an annual report certified by an independent public accountant using Form 1-FR-FCM. [\[10\]](#) The financial statements also must include, among others, a statement of the computation of the minimum capital requirements, a Segregation Schedule, [\[11\]](#) and a Secured Amount Schedule. [\[12\]](#)

The CFTC is proposing to adopt a new "Statement of Cleared Swap Customer Segregation Requirements and Funds in Cleared Swap Customer Accounts Under Section 4d(f) of the Act" ("Cleared Swaps Segregation Schedule") in Form 1-FR-FCM to obtain information on the FCM's holding of cleared swap customer collateral to ensure that such funds are held in accordance with CFTC regulations and that the FCM is reporting that it has sufficient funds in segregated accounts to meet its obligations to all of its cleared swaps customers. [\[13\]](#)

The CFTC proposes amendments to require each FCM to disclose in the Segregation Schedule, Secured Amount Schedule, and Cleared Swaps Segregation Schedule a target amount of "residual interest" (denoting the FCM's proprietary funds) that the FCM would be required to maintain in customer segregated accounts, secured amounts, and cleared swaps customer accounts, respectively, based upon its written policies and procedures for computing a target amount. The FCMs also would be required to report on the schedules the sum of outstanding margin deficits of the relevant customers. The CFTC proposes to require each FCM to file with the CFTC on a monthly basis its balance sheet leverage ratio (which will provide information regarding the amount of assets supported by the FCM's capital base).

Minimum Financial Requirements

Existing CFTC regulations require FCMs to provide the Commission and DSROs with prompt notice of potential adverse conditions at the FCM that may indicate or lead to a threat to

the financial condition of the firm or the protection of customer funds held by the FCM. The CFTC proposes amendments to include several additional reportable events and to submit reportable events to the Commission and DSROs through an electronic filing system. These amendments include notices if the FCM: (1) cannot compute or document its actual capital at the time it knows that it is undercapitalized; (2) fails to hold sufficient funds in segregated accounts for cleared swaps customers to meet its obligation; (3) discovers or is informed that it has invested funds held for customers in investments that are not permitted investments or holds permitted investments in a manner that is not in compliance with Rule 1.25; (4) does not hold an amount of funds in segregated accounts for futures customers or for cleared swaps customers or does not hold sufficient funds in separate accounts for 30.7 Customers sufficient to meet the firm's targeted residual interest in one or more of these accounts or if its residual interest is less than the sum of outstanding margin deficits for such accounts; (5) experiences a material adverse impact to its creditworthiness or its ability to fund its obligations (or of its parent or a material affiliate); and (6) receives a notice, examination report, or any other correspondence from the SEC or an SRO. In addition, an FCM would be required to provide notice in the event of a material adverse impact to the financial condition of the firm or a material change in the firm's operations.

The CFTC also is proposing amendments to authorize the CFTC to require an FCM to transfer its customer business and cease operating as an FCM if the FCM cannot immediately certify to the Commission and demonstrate with verifiable evidence, that the FCM has sufficient access to liquidity to continue operating as a going concern. The CFTC also proposes to permit an FCM that is not a dually-registered FCM/BD to develop the framework proposed by the SEC to establish, maintain, and enforce written policies and procedures for determining creditworthiness, and upon a determination that a particular type of security has minimal credit risk, to apply lower deductions to such securities in computing the FCM's adjusted net capital. The Proposal also would require an FCM to take capital charges for undermargined customer, noncustomer, and omnibus accounts that are undermargined for more than one business day after a margin call is issued.

Public Disclosures by FCMs

The CFTC proposes to enhance the disclosures provided to customers and potential customers, including certain firm specific information regarding the FCM's financial condition and operations to allow customers and potential customers to assess the risks of engaging the firm and the risk of entrusting their funds to the FCM. FCMs would be required to disclose their significant types of business activities and product lines, specific information regarding their operations, overview of customer funds segregation protections and limitations, and how they manage their collateral management and investments. The FCMs also would be required to disclose certain financial and risk management information including the firm's total equity, regulatory capital, and net worth as of the most recent month end. The FCMs also would be required to disclose information regarding: (1) the amount of the FCM's proprietary margin requirements as a percentage of the aggregate margin requirement for futures customers, cleared swap customers, and 30.7 Customers; (2) the number of futures customers, cleared swaps customers, and 30.7 Customers that comprise 50% of the FCM's total funds held for such customers, respectively; (3) the aggregate notional value, by asset class, of all non-hedged principal over-the-counter transactions into which the FCM has entered; (4) the amount, generic source and purpose of any unsecured lines of credit (or similar short-term funding) the FCM has obtained but not yet drawn upon; (5) the aggregate amount of financing the FCM provides for customer

transactions involving illiquid financial products for which it is difficult to obtain timely and accurate prices; (6) the percentage of customer receivables that the FCM had to write off as uncollectable during the prior year compared to the current balance of funds held for futures customers, cleared swaps customers, and 30.7 Customers; and (7) a summary of the FCM's current risk practices, controls and procedures.

The Commission also is proposing to require each FCM to make available on its website the daily Segregation Schedule, Secured Amount Schedule, and Cleared Swaps Segregation Schedule. The Proposal also would require each FCM to disclose on its website a summary schedule of the firm's adjusted net capital, net capital, and excess net capital for the 12 most recent month-end dates.

Oversight of FCMs

SROs

Currently, an SRO is required to conduct periodic examinations of member FCMs' compliance with CFTC and SRO financial and related reporting requirements. The CFTC proposes that the supervisory program for FCMs would explicitly require, among other things, control testing as well as substantive testing and that the examination process for each FCM be driven by the risk profile of each FCM. The SRO also must engage an examination expert to review its supervisory program and the application of the supervisory program at least once every two years. The SRO must receive a written report from the examinations expert describing certain items. Upon receipt of the written report, the SRO must provide such report to the CFTC.

Audits

Under CFTC regulations, FCMs must have their annual financial statements audited by an independent certified public accountant. The CFTC is proposing amendments to require that the public accountant be registered with the Public Company Accounting Oversight Board ("PCAOB") and must have undergone an examination by the PCAOB. The Proposal also would require a public accountant to state in the audit opinion whether the audit was conducted in accordance with U.S. GAAS after full consideration of the auditing standards adopted by the PCAOB.

Foreign Futures or Foreign Options Secured Amount

The CFTC proposes to revise the regulations governing an FCM's holding of funds deposited by a customer for trading on foreign futures markets to make the regulatory approach and customer protections consistent with the FCM's segregation requirements for customers trading on a DCM or engaging in cleared swap transactions. As discussed above, the CFTC is proposing to require, among other things, FCMs to set aside a sufficient amount of funds in secured amounts to repay the total account balances of all of its 30.7 Customers (which would align the requirement with the segregation requirements for both futures customers and cleared swaps customers). The CFTC also is proposing to limit the amount of 30.7 Customers' funds that an FCM could hold in non-U.S. jurisdictions. The Proposal also extends the prohibition against commingling to any funds of account holders of an FCM unrelated to trading foreign futures or foreign options except as permitted by the CFTC.

endnotes

[1] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, (Oct. 23, 2012) (“Proposal”), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister102312.pdf>. The Proposal also addresses certain issues concerning derivatives clearing organizations (“DCOs”) and chief compliance officers (“CCOs”).

[2] On October 31, 2011, MF Global, Inc. was placed into a liquidation proceeding, and the trustee has reported a potential \$900 million shortfall of funds to repay the account balances to customers trading futures on designated contract markets (“DCMs”) and an approximately \$700 million shortfall in funds immediately available to repay the account balances of customers trading in foreign futures markets. On July 10, 2012, the CFTC also filed a civil injunctive complaint against Peregrine Financial Group, Inc. and its chief executive officer for, among others, misappropriation of customer funds and violation of customer fund segregation laws.

[3] The CFTC held a public roundtable on February 29 and March 1, 2012 with a broad cross-section of market participants and another roundtable on August 9, 2012. The CFTC also hosted a public meeting of the Technology Advisory Committee on July 26, 2012.

[4] The term “30.7 Customer” is proposed to be defined to mean both U.S. domiciled customers and foreign-domiciled customers trading foreign futures or foreign options.

[5] The CFTC is proposing a similar provision for funds of 30.7 Customers. See also Rule 22.3(c)(2) (commingling requirements for cleared swaps).

[6] A DSRO is the SRO that is appointed to be primarily responsible for conducting ongoing financial surveillance of an FCM under a joint agreement submitted to and approved by the CFTC.

[7] These proposed amendments are consistent with the new FCM financial requirements proposed by the National Futures Association and adopted by the CFTC on July 13, 2012.

[8] An FCM that is dually-registered as a BD may file a Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934 (“FOCUS Report”) in lieu of the Form 1-FR-FCM.

[9] Under the Proposal, senior management of the FCM must perform appropriate due diligence in setting the amount of the excess funds in customer accounts and must consider the nature of the FCM’s business including the type and general creditworthiness of its customer base, the types of markets and products traded by the firm’s customers, the proprietary trading activities of the FCM, the volatility and liquidity of the markets and products traded by the customers and the FCM, and the FCM’s own liquidity and capital needs, and historical trends in customer fund balances, and customer debits and margin deficits.

[10] The CFTC is proposing to require that an FCM submit its certified annual report to the CFTC and to its DSRO within 60 days (rather than the current 90 days) of its year-end date. The CFTC believes that the shortened deadline would permit the Commission and the DSRO

staff to review the financial statement on a more timely basis to identify and address accounting or auditing issues that may impact the financial condition of the FCM.

[\[11\]](#) A “Segregation Schedule” is a statement of segregation requirements and funds in segregation for customers trading on U.S. commodity exchanges.

[\[12\]](#) A “Secured Amount Schedule” is a statement of secured amounts and funds held in separate accounts for foreign futures and foreign options customers.

[\[13\]](#) The Cleared Swaps Segregation Schedule would be publicly available as are the Segregation Schedule and Secured Amount Schedule.

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