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

[27695]

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TO:

BROKER/DEALER ADVISORY COMMITTEE No. 52-13
CLOSED-END INVESTMENT COMPANY MEMBERS No. 91-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 78-13
INVESTMENT ADVISER MEMBERS No. 72-13
OPERATIONS COMMITTEE No. 53-13
SEC RULES MEMBERS No. 102-13
TRANSFER AGENT ADVISORY COMMITTEE No. 81-13 RE: CFTC ADOPTS 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 adopted new regulations and rule amendments to require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosures, and auditing and examination programs for futures commission merchants ("FCMs"). [1] These new regulations and rule amendments ("Final Rules") are 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] According to the CFTC, these recent incidents highlighted weaknesses in the customer protection regime prescribed by the CFTC's regulations and through the self-regulatory system.

This memorandum briefly summarizes the Final Rules.

Customer Funds

Segregation and Separate Accounting of Futures Customer Funds

The Final Rules, among other things, require an FCM to account separately for all futures customer funds and to segregate futures customer funds from its own funds. An FCM must deposit customer funds with a depository under an account name that clearly identifies the funds as futures customer funds and shows that the funds are segregated as required by the Commodity Exchange Act ("CEA") and CFTC rules. An FCM also is required to perform due diligence of each depository holding customer segregated funds and to update its due diligence at least on an annual basis.

Depository Acknowledgement Letter and Read-Only Access

Under Rule 1.20, FCMs currently are required to obtain a written acknowledgment letter from a depository that holds futures customer funds. Rule 1.26 requires an FCM or DCO that invests customer funds in instruments described in Rule 1.25 to obtain an acknowledgment letter from the depository holding such instruments. [3]

Under the Final Rules, the CFTC adopted standard template acknowledgment letters, including a specific template for FCM investments of customer funds in money market funds. [4] Despite opposition by commenters, including ICI, the CFTC decided to require depositories to provide 24-hour, read-only electronic access to the CFTC with respect to accounts maintained by an FCM. [5] The CFTC does not anticipate that its staff would access FCM accounts on a regular basis to monitor account activity. Instead, the CFTC expects that its staff would make use of the read-only access only when necessary to obtain account balances and other information that the staff could not obtain via the National Futures Association ("NFA") and CME Group, Inc. ("CME") automated daily segregation confirmation system or otherwise directly from the depositories. [6] The CME and NFA will provide the CFTC on a daily basis with the account balances reported to them by each depository holding customer funds under the CME's and NFA's daily confirmation process.

The CFTC's decision to impose the read-only access requirement is particularly disappointing, given ICI's efforts over the course of the consultation period to educate the CFTC and its staff regarding the challenges and costs this requirement would impose and to recommend alternatives. In the Adopting Release, the CFTC acknowledged ICI's concerns regarding the costs to create electronic access to FCM accounts at money market funds and how such costs would be borne by all investors and not just FCMs, which would likely constitute a small percentage of a money market fund's investor base. Moreover, although the Adopting Release noted the ICI's suggestion to require money market funds alternatively to provide FCM account data promptly (i.e., within 48 hours) upon request, the CFTC declined to adopt ICI's recommendation.

In the Adopting Release, the CFTC did provide some helpful clarifications that ICI requested in its comment letter. The CFTC confirmed that examination of accounts authorized by an acknowledgment letter would not involve regulation or examination of the money market fund itself over which the CFTC does not have supervisory or regulatory authority. The examination would be limited to verification of the account shares of the FCM or DCO. In addition, the CFTC confirmed, as requested by ICI, that the template letters are applicable solely to directly-held investments in money market funds rather than those held through intermediated positions, such as omnibus accounts or intermediary-controlled accounts. Similarly, a money market fund would be required to provide the CFTC with read-only

access to accounts holding customer funds only if the FCM directly deposits customer funds with the money market fund.

The CFTC is providing FCMs, DCOs, and depositories 180 days from the effective date of the Final Rules (60 days after publication in the Federal Register) to replace existing acknowledgement letters with new ones to conform to the template.

In addition, the CFTC clarified that it does not intend to use the template acknowledgement letters as a means to expand the scope of a depository's liability to FCM or DCO account holders or to alter the responsibility that an FCM or DCO bears for its own compliance with the customer fund segregation requirements under the CEA or CFTC rules. Therefore, the CFTC has revised the language in the template acknowledgment letters to provide that the depository may conclusively presume that any withdrawal from the account and the balances in the account are in conformity with the CEA and CFTC regulations without any further inquiry, provided the depository has no notice of or actual knowledge of a potential violation of any provision of the CEA or CFTC regulations that relate to the segregation of customer funds.

Residual Interest Requirement

The Final Rules require that an FCM maintain residual interest in segregated accounts in an amount that exceeds the sum of all futures customers' margin deficits (i.e., undermargined amounts) with certain modifications. The term "residual interest" refers to a cushion of proprietary funds in customer segregated accounts to protect against being undersegregated by failing to hold a sufficient amount of funds in such accounts to meet regulatory requirements. The residual interest requirement is intended to help ensure that the collateral of one customer is never used to margin the positions of another customer. The requirement would shift the risk of loss in the event of a double default [7] back to the customer whose positions caused the loss and away from those customers with excess margin at the FCM.

In response to significant comments by the FCM community that continuous calculation and monitoring would not be technologically feasible, the CFTC will require the calculations using a point in time approach. An FCM is required to perform the residual interest buffer calculations at the close of each business day based on the information available to the FCM at that time. For futures accounts, starting one year after the publication of the Final Rules, for a phase-in period, an FCM must hold the requisite residual interest by 6:00 p.m. ET on the next business day after the trade date. [8]

Within 30 months of the publication of the Final Rules, CFTC staff must publish a report ("Report") regarding the practicability of moving the deadline from 6 p.m. ET on the next business day after the trade date to the time of that settlement (or to some other time of day), including whether and on what schedule it would be feasible to do so and any associated costs and benefits of such potential alternatives. The CFTC staff will solicit public comment and conduct a public roundtable regarding specific issues to be covered by the Report. Within nine months after the publication of the Report, the CFTC may (1) terminate the phase-in period, in which case the phase-in shall end as of a date established by order or (2) propose through rulemaking a different residual interest deadline. If the Commission takes no further action, the phase-in period will expire on December 31, 2018 and an FCM must hold the requisite residual interest prior to the time of the daily settlement with each DCO of which the FCM is a member.

Additions and Withdrawals of Futures Customer Funds

The CFTC also adopted additional documentation and authorization requirements if an FCM withdraws more than 25 percent of the FCM's residual interest. The Final Rules also require that the FCM's CEO, CFO, or other senior official that is listed as a principal on the firm's Form 7-R registration statement and is knowledgeable about the FCM's financial requirement pre-approve the withdrawal in writing. The written notice also will be required to be filed with the CFTC and with an FCM's DSRO electronically.

Investment of Customer Funds

The Final Rules explicitly provide that an FCM or DCO is responsible for any losses incurred on the investment of customer funds. Investment losses cannot be passed on to futures customers. FCMs also must file detailed information regarding depositories and the substance of the investment of customer funds under Rule 1.25.

Risk Management Programs for FCMs

The Final Rules require each FCM that carries customer accounts to establish a risk management program designed to monitor and manage the risks associated with the FCM's activities as an FCM. The risk management program must consist of written policies and procedures that have been approved by the "governing body" of the FCM and furnished to the CFTC and establish a risk management unit that is independent from an FCM's business unit. The Final Rules provide for a non-exclusive list of elements that must be part of an FCM's risk management program and require that the risk management policies and procedures of an FCM related to the risks associated with safekeeping and segregation of customer funds include certain enumerated elements. The Final Rules also require an annual review and testing of the adequacy of each FCM's risk management program.

Financial Reports of FCMs

FCMs currently are required to file with the CFTC and with their DSRO an unaudited financial report each month and an annual financial report certified by an independent public accountant. The financial reports require additional schedules, including a schedule to demonstrate that the FCM is in compliance with customer fund segregation requirements. [9]

The Final Rules amend the segregation schedules to include an FCM's targeted amount of residual interest that the FCM seeks to maintain in customer segregated accounts. FCMs also will be required to submit to the CFTC monthly balance sheet leverage information to enhance the CFTC's ability to conduct financial surveillance of FCMs. In the Final Rules, the CFTC aligned the definition of "leverage" with the rules of a registered futures association. [10]

Maintenance of Minimum Financial Requirements by FCMs

Under Rule 1.12, FCMs currently are required to provide the CFTC and SROs with prompt notice of potential adverse conditions at FCMs that may indicate a possible threat to the financial condition of the firm or to the safety of customer funds held by the FCM. The Final Rules include several additional reportable events and revise the process for submitting reportable events to the CFTC and DSRO. With respect to the timing of the notices, in the Adopting Release, the CFTC stated that it expects immediate notice by an FCM when a reportable event is financial in nature (e.g., not in compliance with capital or segregation requirements). Despite requests for public disclosure of reportable events by commenters, including ICI, the CFTC has determined that the regulatory notices should not be made

publicly available.

The additional reportable events include if the firm: (1) is undercapitalized; (2) fails to hold sufficient funds in segregated accounts for cleared swap customers to meet its obligation to such customers; (3) discovers or is informed that it has invested funds held for customers in investments that are not permitted investments under Rule 1.25; (4) does not hold an amount of funds in segregated accounts for futures customers or for cleared swap customers or does not hold sufficient funds in secured accounts for 30.7 Customers [11] sufficient to meet the firm's targeted residual interest or if its residual interest in one or more of these accounts is less than the sum of the outstanding margin deficits (i.e., undermargined amounts) for such accounts; and (5) experiences an event causing material adverse impact in the financial condition of the firm or a material change in the firm's operations. [12] In addition, an FCM is required to file a notice with the CFTC if the FCM: (1) is informed by the SEC or an SRO that it is the subject of a formal investigation; (2) is provided with an examination report issued by the SEC or an SRO and the FCM is required to file a copy of such examination report with the CFTC; and (3) receives notice of any correspondence from the SEC or a securities SRO that raises issues with the adequacy of the FCM's capital position, liquidity to meet its obligations, or otherwise operate its business or internal controls.

Minimum Financial Requirements for FCMs

The Final Rules authorize the CFTC to request certification in writing from an FCM that it has sufficient liquidity to continue operating as a going concern. If an FCM is not able to provide immediately the written certification or is not able to demonstrate adequate access to liquidity with verifiable evidence, the FCM must transfer all customer accounts and immediately cease doing business as an FCM.

The Final Rules also would reduce the time period for FCMs to incur a capital charge for undermargined accounts. Specifically, the Final Rules 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. [13] The CFTC believes that timely collection of margin is a critical component of an FCM's risk management program. This requirement is intended to ensure that an FCM holds sufficient funds deposited by customers to meet their potential obligation to a DCO. To provide greater protection to the customers that are fully margined or maintain excess margin on deposit and to provide greater assurance that the FCM can continue to meet its financial obligations to DCOs, the CFTC believes that the FCM should maintain a sufficient amount of capital to cover the potential shortfall in undermargined customer accounts.

Public Disclosure by FCMs

The CFTC adopted amendments to Rule 1.55 to require several additional disclosures regarding the potential general risks of engaging in futures trading through an FCM and the potential specific risks resulting from the bankruptcy of an FCM. The CFTC also adopted rules to require each FCM to provide customers and potential customers with information about the FCM, including its business, operations, risk profile, and affiliates that would be material to the customer's decision to entrust funds to and otherwise do business with the FCM and that is otherwise necessary for full and fair disclosure. The firm-specific disclosures are intended to provide customers with access to material information regarding an FCM to allow customers to assess independently the risk of entrusting funds to the firm or to use the firm for the execution of orders.

The firm-specific disclosures include, among others: (1) the name and business addresses of the FCM's principals under Rule 3.1; (2) the significant types of activities and product lines that the FCM engages in and the approximate percentage of assets and capital that are contributed to each type of business activity or product line; (3) the FCM's business on behalf of customers; (4) material risks of entrusting funds to the FCM, accompanied by an explanation of how such risks may be material to its customers; (5) the name of the FCM's DSRO and the DSRO's website and the location of where the FCM's annual financial statement is made available; (6) any material administrative, civil, enforcement, or criminal complaints or actions filed against the FCM and any enforcement actions taken in the last three years; (7) basic overview of customer fund segregation, collateral management and investments; (8) how a customer may obtain information regarding filing a complaint with the CFTC or the FCM's DSRO; and (9) certain enumerated financial information for the most recent month end, including the number of futures customers, cleared swap customers and 30.7 Customers that comprise 50 percent of the funds held for such customers and the aggregate notional value, by asset class, of all non-hedged principal over-the-counter transactions into which the FCM has entered.

The CFTC adopted rules to require each FCM to make the following information available to the public on its website: (1) the daily segregation schedules for the most current 12-month period; (2) a summary schedule of the FCM's adjusted net capital, net capital, and excess net capital; (3) statement of financial condition and the segregation schedules and all related footnotes contained in the FCM's most recent certified annual report; and (4) segregation schedules that are part of the FCM's unaudited Form 1-FR-FCM or Financial and Operational Combined Uniform Single Report ("FOCUS Report") for the most current 12-month period.

Foreign Futures or Foreign Options Secured Accounts

The CFTC adopted various regulations in part 30 (which governs the offer and sale in the United States of futures contracts and options traded on or subject to the rules of a foreign board of trade) to align the protections provided to funds for customers trading on non-U.S. markets with requirements for customers trading on U.S. markets. According to the CFTC, these amendments will greatly enhance the protection of customer funds and avoid competitive imbalances between trading on domestic and foreign contract markets that might result in regulatory arbitrage.

Oversight of FCMs

Under the Final Rules, the CFTC has adopted several amendments to enhance the qualifications that a public accountant must meet to conduct an examination of an FCM. Specifically, the public accountant must be registered with the Public Company Accounting Oversight Board ("PCAOB") and have undergone an examination by the PCAOB. In addition, a public accountant that, as a result of the PCAOB disciplinary process, is subject to a sanction that would permanently or temporarily bar the public accountant from engaging in the examination of a public issuer or broker-dealer may not conduct an examination of an FCM.

The Final Rules also require that the accountant's report state whether the examination of the FCM was conducted in accordance with the auditing standards issued by the PCAOB. Moreover, the governing body of the FCM should review the inspection report of the public accountant and discuss inspection findings as appropriate with the public accountant.

The CFTC also adopted rule amendments to enhance and strengthen the minimum

requirements that SROs must abide by in conducting financial surveillance of FCMs.

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endnotes

[1] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, (Nov. 1, 2013) ("Adopting Release"), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister103013b.pdf. The Final Rules also address certain issues concerning derivatives clearing organizations ("DCOs") and chief compliance officers ("CCOs"). See 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. For a summary of the Proposal, see ICI Memorandum No. 26639 (Nov. 1, 2012), available at http://www.ici.org/my_ici/memorandum/memo26639.

[2] On October 31, 2011, MF Global, Inc. was placed into a liquidation proceeding. The trustee appointed to oversee the liquidation of MF Global has reported a potential $900 million shortfall of funds to repay the account balances due 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 on foreign futures markets. The shortfall in customer segregated accounts was attributed by the trustee to significant transfers of funds out of the customer accounts that were used by MF Global for various purposes other than to meet obligations to, or on behalf of, customers. On July 10, 2012, the CFTC also filed a civil injunctive complaint against Peregrine Financial Group, Inc. and its chief executive officer for, among other things, misappropriation of customer funds and violation of customer fund segregation requirements.

[3] The written acknowledgment from the depository must state that the depository was informed that the instruments belong to futures customers and that the instruments are being held in accordance with the provisions of the CEA and CFTC rules.

[4] Under the Final Rules, depositories also will be required to agree that the accounts may be examined at any reasonable time by the director of the Division of Swap Dealer and Intermediary Oversight ("DSIO") or the director of the Division of Clearing and Risk ("DCR") or any successor divisions or such directors' designees, or an appropriate officer, agent, or employee of the FCM's designated self-regulatory organization ("DSRO"). 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. The depositories also must agree to reply promptly and directly to any request from the director of DSIO or the director of DCR or any successor divisions, or such directors' designees, or an appropriate officer, agent or employee of the FCM's DSRO for confirmation of account balances or provision of any other information regarding or related to an account.

[5] The Final Rules will require the depository to agree to provide the CFTC with the technological connectivity, which may include provision of hardware, software, and related

technology and protocol support, to facilitate direct, read-only electronic access to transactions and account balance information. The Final Rules do not require read-only electronic access for an FCM's DSRO. The CFTC has decided not to adopt the electronic access requirement with respect to depositories holding customer funds in accounts maintained by a DCO because the DCOs hold omnibus customer accounts that are not subdivided by clearing member or individual customer.

[6] In July 2012, the NFA and CME adopted rules requiring FCMs to instruct each depository holding futures customer funds to report such balances on a daily basis to the NFA or CME, respectively. Initially, the NFA and CME retained the services of a third-party vendor that received account balance information directly from certain banks, custodians of securities, and money market funds and passed such information on to the NFA and CME. The CME took over the role of the third-party vendor on October 29, 2013 and now receives account information directly from all depositories holding futures customer funds. The CME also provides NFA with daily account information for the FCMs for which NFA is the DSRO.

[7] A double default is a situation in which a customer defaults on its obligations to its FCM and the loss is so great that the FCM defaults on its obligation to the DCO.

[8] For cleared swaps customer accounts, the Final Rules do not alter the current residual interest requirement for cleared swaps. For part 30 secured accounts, starting one year after the publication of the Final Rules, an FCM must hold the requisite residual interest by 6:00 p.m. ET on the next business day after the trade date.

[9] The Final Rules also include a new segregation schedule for cleared swaps.

[10] For purposes of the Final Rules, the term "leverage," will be defined by a registered futures association of which the FCM is a member.

[11] The term "30.7 Customer" is defined as both U.S. domiciled customers and foreign-domiciled customers trading foreign futures or foreign options.

[12] Under the Final Rules, for events causing material adverse financial impact or material change in operations, the CFTC will require FCMs to file notice promptly, but not later than 24 hours after the event, instead of immediately.

[13] Therefore, if an account carried by an FCM became undermargined on Monday, the operation of the rule assumes that the FCM would issue a margin call on Tuesday, and the FCM would have to incur a capital charge at the close of business on Wednesday if the margin call was still outstanding.
