

MEMO# 26814

January 3, 2013

Draft ICI Letter on CFTC's Proposal to Enhance Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Member Comments Requested by January 8.

[26814]

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TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 2-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 2-13
SEC RULES COMMITTEE No. 2-13 RE: DRAFT ICI LETTER ON CFTC'S PROPOSAL TO ENHANCE PROTECTIONS AFFORDED CUSTOMERS AND CUSTOMER FUNDS HELD BY FUTURES COMMISSION MERCHANTS AND DERIVATIVES CLEARING ORGANIZATIONS; MEMBER COMMENTS REQUESTED BY JANUARY 8.

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.

Comments on the Proposal are due to the CFTC no later than January 14. The Institute has prepared a draft comment letter, which is attached and briefly summarized below. If you have comments on the draft letter, please provide them to Jennifer Choi at jennifer.choi@ici.org by Tuesday, January 8.

Customer Funds

The draft letter generally supports the CFTC's proposal to provide greater protection to customer funds. The letter supports those provisions that would address, in part, fellow customer risk in the event of a shortfall upon a default of an FCM and prohibit FCMs and

DCOs from using customer funds for their own proprietary use or making inappropriate withdrawals. The letter states that the proposal to require filing of daily segregation calculations with the CFTC, which also will be publicly available, will facilitate monitoring of compliance by FCMs of the customer fund segregation requirements.

Moreover, the letter supports the CFTC's proposal 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. Under that proposal, an FCM may not charge or otherwise allocate any such losses to the accounts of the FCM's customers.

Depositories of Customer Funds

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. The CFTC proposes 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 self-regulatory organization ("DSRO"). [\[2\]](#) In addition to the read-only access to the accounts for the benefit of an FCM's customers, the acknowledgment letter would require depositories to agree that the accounts may be examined at any reasonable time by an appropriate officer, agent or employee of the CFTC. The CFTC 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.

The draft letter supports the policy rationale behind the proposal to require read-only access to account balances of funds held for customers of FCMs. The ability of the Commission to verify an FCM's reported account balances by comparing them to those that are reported by depositories would provide greater assurance regarding the accuracy of the amount of funds held for customers and the safety of the customer funds held by the FCM. In supporting the purpose behind the proposed requirement, the letter seeks one clarification and requests the Commission to consider whether an alternative method of obtaining account balances may be appropriate.

To apply appropriately the access requirement in the context of money market funds, however, the letter seeks one clarification and requests that the Commission consider whether an alternative method of obtaining account balances may be appropriate. First, the letter requests confirmation that the "examination or audit" of the accounts (as authorized by the acknowledgment letters) would be limited to verification of account balances held for the benefit of an FCM's customers and that further inspection of a money market fund itself (if necessary) should be referred to its primary regulator - the U.S. Securities and Exchange Commission.

Second, the letter expresses concern that providing the CFTC with direct electronic access to FCM accounts at a money market fund would require substantial and costly functionality modifications for money market funds although FCM accounts would likely be a small portion of these funds' investor base. The letter states that it would not be reasonable to require money market funds to incur such costs for a limited group of investors, particularly where an alternative method could provide the CFTC with the same information in a timely manner. The letter suggests that money market funds receiving an FCM acknowledgment letter would be required to provide to the CFTC, in electronic form account information of an FCM within 24 hours or 48 hours upon request by the CFTC.

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 letter fully supports these proposals, which would require FCMs to evaluate and monitor for risks of their businesses. The letter also supports a requirement to maintain an adequate targeted amount of excess funds in customer accounts, which would assist FCMs to maintain compliance with the segregation requirements. These provisions would reinforce the risk mitigating practices of FCMs and enhance the protection of customer funds that must be segregated.

Disclosure to Regulators

Existing CFTC regulations require FCMs to provide the Commission and the FCM's DSRO 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 would require reporting 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 letter argues that these reportable events, including the proposed additional triggering events, also should trigger a requirement to disclose the information to customers. First, this type of information is critical for customers to monitor their FCMs to determine whether they should continue to do business with their FCMs. The notice would permit customers to be aware of potential issues and to evaluate on a more informed basis the risks involved with a particular FCM. The ability to monitor closely the financial condition and other potential risks of FCMs is critically important. Second, the letter states that a requirement to disclose would provide a level playing field for all customers with respect to information about the FCMs. The letter recommends that the information be posted on the FCM's website to provide all customers with equal access to important information. The letter also requests that the CFTC specify that the information should be posted on the FCM's website in a location that would be easily accessible to customers.

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. The letter supports

these provisions that would provide important information to customers of the FCM with respect to their businesses and their financial condition. The letter requests that the information provided to customers should be posted on an easily accessible place on the FCM's website.

Jennifer S. Choi
Senior Associate Counsel – Securities Regulation

[Attachment](#)

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] 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.