

MEMO# 18541

February 15, 2005

CFTC PROPOSAL TO WITHDRAW INTERPRETATION THAT PERMITS USE OF THIRD-PARTY CUSTODIAL ACCOUNTS FOR FUTURES MARGIN

[18541] February 15, 2005 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 7-05 SEC RULES COMMITTEE No. 14-05 RE: CFTC PROPOSAL TO WITHDRAW INTERPRETATION THAT PERMITS USE OF THIRD-PARTY CUSTODIAL ACCOUNTS FOR FUTURES MARGIN The Commodity Futures Trading Commission has issued a notice¹ in which its Division of Clearing and Intermediary Oversight (Division) proposes to withdraw a 1984 staff interpretation.² Interpretation No. 10 permits customers of a future commission merchant (FCM), including registered investment companies, to use third-party bank custodial accounts to maintain futures margin under specified conditions. The Notice is summarized below. Comments on the proposal are due by April 4th. If there are any issues you would like the Institute to consider addressing in a comment letter, please contact me at 202/326-5822 or frances@ici.org by Tuesday, March 1st. Interpretation No. 10 addresses a conflict between the segregation requirements applicable to FCM customer funds under the Commodity Exchange Act (CEA) and the custody requirements applicable to registered investment companies under the Investment Company Act of 1940. The Notice explains that, at the time Interpretation No. 10 was issued, Section 17(f) of the Investment Company Act prohibited registered investment companies from using FCMs and futures clearinghouses as custodians of their assets.³ The CFTC staff issued Interpretation No. 10 to allow third-party custodial accounts to be deemed properly segregated within the meaning of the CEA under a series of conditions designed to ensure that FCMs have immediate and unfettered access to customer funds maintained in such accounts. 1 Commodity Futures Trading Commission, Proposed withdrawal of staff interpretation, 70 Fed. Reg. 5417 (February 2, 2005) ("Notice"). The Notice is available at <http://a257.g.akamaitech.net/7/257/2422/01jan20051800/edocket.access.gpo.gov/2005/pdf/05-1907.pdf>. 2 CFTC Division of Trading and Markets, Financial and Segregation Interpretation No. 10, Treatment of Funds Deposited in Safekeeping Accounts, Comm. Fut. L. Rep. (CCH), paragraph 7120 (May 23, 1984) ("Interpretation No. 10"). 3 Pursuant to SEC exemptive orders and SEC staff no-action letters, investment companies were permitted to maintain a bank custodial account under the name of an FCM to hold initial margin under an arrangement whereby the FCM would be permitted to dispose of the funds in the account upon default by the investment company in making a required margin payment. 2 According to the Notice, the Division believes that Interpretation No. 10 is no longer necessary or justified, except in limited circumstances, due to developments since 1984.

For example, Rule 17f-6, adopted in 1996, permits registered investment companies to maintain assets with an FCM in connection with futures transactions effected on U.S. and foreign exchanges, provided that the FCM is not an affiliate of the investment company. The Notice cites concerns about potential systemic liquidity risks that could result, particularly in times of market volatility, from any potential diversion of FCM capital to cover undermargined customer accounts. In addition, it indicates that third-party custodial accounts present some uncertainty as to the treatment of funds in the event of an FCM insolvency and some potential for funds to be released without the prior knowledge or consent of the FCM. For these reasons, the Division proposes to withdraw Interpretation No. 10, except to the extent that an FCM would not be eligible to hold investment company assets under Rule 17f-6 (i.e., because the FCM is an affiliate of the investment company or its adviser). The Notice requests comment on: • whether withdrawal of Interpretation No. 10 would have any adverse impact on institutional customers, such as registered investment companies, or their ability to participate in the futures market; • whether there are any legal or prudential considerations that support the use by institutional customers of third-party custodial accounts in effecting futures transactions; • the costs and expenses incurred by FCMs, including financing and potential opportunity costs, in connection with maintaining third-party accounts relative to regular customer accounts; and • whether a six-month transition period would be sufficient for FCMs and banks to make the necessary adjustments with respect to third-party custodial arrangements if the Division withdraws Interpretation No. 10. Frances M. Stadler Deputy Senior Counsel

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