FIA

Futures Industry Association
Futures Markets Financial Integrity Task Force

Initial Recommendations for Customer Funds Protection

The Futures Industry Association (FIA) Futures Markets Financial Integrity Task Force (Task Force) has released the following initial recommendations for the protection of customer funds. The recommendations were prepared by the Financial Management Committee (Committee), whose members include representatives of FIA member firms, derivatives clearing organizations and depository institutions.

To enhance transparency to customers and the appropriate regulatory authorities, the Committee is recommending that futures commission merchants (FCMs) provide customers with increased disclosure with respect to the relevant provisions of the Commodity Exchange Act (Act) and the rules of the Commodity Futures Trading Commission (Commission) regarding the protection of customer funds. Further, the Committee is recommending that FCMs undertake additional reporting obligations. Specifically, each FCM should be required to submit to its designated self-regulatory organization (DSRO): (i) daily the computation of segregation requirements in accordance with Commission Rule 1.32; and (ii) twice monthly a report on the investment of customer funds in accordance with Commission Rule 1.25. The balance of the Committee's recommendations, in general, reflects best practices that FCMs represented on the Committee currently follow.

The Committee believes that the majority of these recommendations can be implemented promptly by the several self-regulatory organizations (SROs). The Committee expects that the Commission would then codify certain of these recommendations through the rulemaking process. The Committee pledges to work with the Commission, the SROs, other industry participants and other interested parties to implement these recommendations and looks forward to receiving their views on the recommendations. The Committee also intends to continue its analysis of the existing regulatory structure for the protection of customer funds and FCM policies and procedures regarding internal controls and will make additional recommendations as appropriate.

Unless the context otherwise requires, any reference below to customer segregated funds should be read to include (i) cash, securities and other collateral deposited by or held for the benefit of customers, and (ii) the foreign futures and options secured amount and the sequestered amount (cleared swaps collateral amount).

I. ENHANCED DISCLOSURE ON CUSTOMER FUNDS PROTECTIONS

The Committee understands that one of the more important services an FCM can provide its customers is to assure that these customers appreciate limitations as well as the benefits of the customer funds protections set out in the Commodity Exchange Act (Act) and the Commission's rules. In order to address those elements of the protections that are of immediate concern to customers, the FIA Law and Compliance Executive Committee has undertaken to prepare a memorandum setting out responses to frequently asked questions that FIA member firms have received from their customers. This document is an appropriate first step in providing customers critical information regarding customer funds protection. FIA has posted an electronic version of this document on its website at http://www.futuresindustry.org/downloads/PCF-FAQs.pdf.

Recommendation: The Committee recommends that all FCMs make available to existing and prospective customers the document entitled Customer Funds Protection—Frequently Asked Questions promptly: http://www.futuresindustry.org/downloads/PCF-FAQs.pdf

II. REPORTING

A. Reporting of Daily Segregation Computation

Commission Rule 1.32 requires each FCM to compute as of the close of each business day, on a currency-by-currency basis:

(i) the total amount of customer funds on deposit in segregated accounts on behalf of commodity and option customers;

(ii) the amount of such customer funds required by the Act and the rules to be on deposit in segregated accounts on behalf of such commodity and option customers; and

(iii) the amount of the FCM's residual interest in such customer funds.

The computation must be completed by Noon the following business day. Commission Rule 22.2(g), effective November 8, 2012, imposes the same obligation with respect to the computation of the cleared swaps collateral that an FCM holds and is required to hold.[1]

The Commission's rules do not require an FCM to file a daily report of this computation with the Commission or with the FCM's DSRO. The computation is available for review, however, and the Commission and the relevant DSRO may require daily reporting as necessary. Moreover, the National Futures Association (NFA) requires the FCMs for which it is the DSRO to submit the computation daily through WinJammer. Consistent with Commission Rule 1.32, NFA requires that this report be filed by Noon the following business day.

Recommendation: The Committee recommends that the DSROs require each FCM to file the computation required under Commission Rule 1.32 (and Commission Rule 22.2(g)) with its DSRO daily by Noon the following business day. Such filing may be made using WinJammer, to which all SROs and the Commission have access.

Daily reporting of the segregated funds calculation will provide the Commission and all DSROs with more up-to-date information on customer segregated funds held by each FCM, including variations in customer funds on deposit and in the amount of excess funds that the FCM holds in the customer segregated account. The Commission and the DSROs will be able to use the daily report in monitoring more closely the current segregated balances of all FCMs.

1 Although not subject to Commission Rule 1.32, the foreign futures and foreign options secured amount is also calculated as of Noon the following business day. The foreign futures and foreign options secured amount is not, and should not be, calculated on a currency-by-currency basis.

B. Reporting of Investments of Customer Funds

Commission Rule 1.27 requires each FCM to maintain detailed records of the investments of customer funds made in accordance with Commission Rule 1.25. Specifically, each FCM must make and maintain a record showing:

(i) the date on which such investments were made;

(ii) the name of the person through whom such investments were made;

(iii) the amount of money or current market value of securities so invested;

(iv) a description of the instruments in which such investments were made, including the CUSIP or ISIN numbers;

(v) the identity of the depositories or other places where such instruments are segregated;

(vi) the date on which such investments were liquidated or otherwise disposed of and the amount of money or current market value of securities received of such disposition, if any;

(vii) the name of the person to or through whom such investments were disposed of; and

(viii) daily valuation for each instrument and readily available documentation supporting the daily valuation for each instrument.[2] Such supporting documentation must be sufficient to enable auditors to verify the valuations and the accuracy of any information from external sources used in those valuations.

The records made in compliance with Rule 1.27 are available for inspection by the Commission and the FCM's DSRO at any time. Moreover, NFA requires each FCM for which it is the DSRO to file a monthly report as of each month-end identifying the sectors in which the FCM invests customer funds and the amount of customer funds the FCM has invested in each sector. In addition, an FCM must file an interim report if the percentage of customer funds invested in any sector increases or decreases of 20 percent or more. Such reports are made using WinJammer.

Recommendations: The Committee recommends that the SROs require each FCM to file twice monthly reports, as of each month-end and as of the 15th of each month (or the next business day), identifying the sectors in which the FCM invests customer funds, the amount of customer funds invested in each sector and the weighted average maturity of the assets held in each sector.

The Committee also recommends that consideration be given to requiring the filing of interim reports upon the occurrence of certain changes in the profile of an FCM's investments of customer segregated funds, e.g., a significant change in the percentage of customer funds allocated to one or more sectors.

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2 In order to prepare the daily segregation computation an FCM is required to mark to market daily each such security and confirm that such securities are readily marketable and highly liquid. See, Valuing Customer Segregated Account Securities; Responsibility for Losses, infra, p. 6.

II. INTERNAL CONTROLS/BEST PRACTICES

A. Identification of Material Weaknesses

FCMs are required to have in place necessary accounting systems, internal accounting controls, and other procedures for the safeguarding of customer and firms assets in accordance with the Act. Commission Rule 1.16 requires an FCM's outside accountant, as a part of its certified annual report, to conduct appropriate reviews and tests in order to identify any material inadequacy in such systems and controls that, if appropriate corrective action is not taken, could reasonably be expected to result in violations of the Commission's segregation or secured amount requirements. The accountant is required to file a report with the Commission and the FCM's DSRO describing any material inadequacy found to exist or to have existed since the date of the last audit. An FCM has a separate obligation under Commission Rule 1.12(d) to notify the Commission and its DSRO within 24 hours after it discovers or is notified of a material inadequacy.

Recommendation: The Committee recommends that the Commission propose a rule requiring each FCM to certify annually that there are (and have been since the last report) no material weaknesses in its internal controls regarding the computation of adjusted net capital and compliance with the provisions of the Act and the Commission's rules regarding the protection of customer funds.[3]

B. Separation of Duties

As a matter of proper internal controls, FCMs maintain policies and procedures that, among other things, require that certain activities must be performed by separate individuals or units within the FCM, subject to appropriate oversight and review. In particular, the individuals responsible for computing the amount of customer funds required to be held in each of the several regulated customer funds accounts (i.e., segregated funds, foreign futures and foreign options secured amount, and sequestered account), and the amount of the FCM's residual interest in each such account are separate from the individuals responsible for effecting the operational transfers of funds to and from such accounts. At many larger firms, the responsibility for calculating the amount required to be held in the several regulated customer funds accounts is placed in a separate unit.

Recommendation: The Committee recommends that the SROs require FCMs to document their policies and procedures that require an appropriate separation of duties among individuals responsible for compliance with the Act and the Commission's rules relating to the protection of customer funds, subject to appropriate oversight and review.

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3 The Securities and Exchange Commission (SEC) has proposed an amendment to its rules that would impose a similar requirement on registered broker-dealers. See, Broker Dealer Reports, 76 Fed.Reg. 37572 (June 27, 2011). The Committee encourages the Commission to work with the SEC to assure that dually registered FCM/broker-dealers are not subject to duplicative or conflicting certification requirements.

C. Qualification of Chief Financial Officer and Other Financial Personnel

Unlike the chief financial officers of registered broker-dealers, the chief financial officers of FCMs are not required to establish, through an examination or otherwise, that they understand the relevant provisions of the Act and the Commission's rules relating to the calculation of the FCM's adjusted net capital and the protection of customer funds. The Committee appreciates that many FCMs are also registered broker-dealers and that the chief financial officer acts on behalf of both sides of the business. Therefore, they have taken the proficiency examinations required by the Financial Industry Regulatory Authority (FINRA). However, those examinations do not include questions relating to the Act and the Commission's rules.

Recommendation: The Committee recommends that NFA consider whether it should develop, either in coordination with FINRA or independently, an examination for chief financial officers of FCMs and other personnel responsible for compliance with the provisions of the Act and the Commission's rules relating to the calculation of the FCM's adjusted net capital and the protection of customer funds.

D. Valuing Customer Segregated Account Securities; Responsibility for Losses

The accurate valuation of securities held in the customer segregated account, including permitted investments under Commission Rule 1.25, is essential to assure compliance with the Commission's rules relating to the segregation of customer funds and the calculation of adjusted net capital. In this regard, Commission Rule 1.32 allows a net deficit in a particular customer's segregated account to be offset against the current market value of readily marketable securities, less applicable haircuts, held in the same customer's segregated account. Similarly, Commission Rule 1.17(c)(3)(i) allows a net deficit in a particular customer account to be secured by the current market value of readily marketable securities.

The JAC has advised FCMs that, in order to be considered readily marketable, an FCM must be able to obtain independent bona fide offers to buy and sell securities so that a price, reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time. An FCM must have policies and procedures in place to assure that the FCM is able to provide evidence that all securities held in the customer segregated account, both customer-owned securities and investments in accordance with Commission Rule 1.25, are readily marketable and highly liquid.

A related issue is the responsibility for loss in the event of a reduction in the market value of a security held in the customer segregated account. To the extent a security has been deposited by a customer, the customer bears the risk of loss. To the extent a security represents an investment of customer funds in accordance with Rule 1.25, the FCM bears the risk of loss and must use its own funds to restore the value of the customer segregated account.

The Committee believes that the responsibility of an FCM for losses incurred in connection with investments under Commission Rule 1.25 is clear and is implicit in the Act and the

Commission's rules. Nonetheless, in order to remove any ambiguity, the Committee believes that the Commission's rules should make this obligation explicit.

Recommendations: The Committee recommends that the SROs require all FCMs to document their policies and procedures for valuing all securities held in the customer segregated account, including permitted investments under Commission Rule 1.25, to assure that such securities are accurately valued and, in particular, are readily marketable and highly liquid.

The Committee further recommends that the Commission consider amending Rule 1.25 for the purpose of confirming that an FCM investing customer funds in accordance with the rule bears the risk of loss arising from any such investment and must use its own funds to restore the value of the customer segregated account.

E. Qualification of Banks, Custodians and Other Depositories

The Commission has no rules establishing procedures that FCMs must follow in selecting banks and custodians located in the US or otherwise setting qualifications that such banks and custodians must meet in order to hold customer segregated funds.[4] Nor does the Commission have qualification requirements with respect to other FCMs, foreign derivatives clearing organizations, or foreign brokers, including affiliates of such FCM.[5] (All such banks, custodians, FCMs and foreign brokers, wherever located, are referred to collectively as depositories and individually as a depository.) Nonetheless, FCMs generally have policies and procedures that they follow in selecting depositories.

Recommendations: The Committee recommends that the SROs require each FCM to document policies and procedures for selecting the depositories, including affiliates, with which the FCM deposits and maintains customer funds. Such policies and procedures should provide, at a minimum, that an FCM must:

(i) have documented criteria that any depository used by the FCM must meet, including criteria addressing the capitalization, creditworthiness, access to liquidity, operational reliability,[6] and regulation or supervision of such depository;

(ii) complete a thorough due diligence review of each depository at least annually; and

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4 The Commission's rules provide that, if an FCM deposits customer funds in a bank located outside of the US, that bank must have regulatory capital in excess of $1 billion. See, Commission Rule 1.49(d)(3)(i) and Commission Rule 30.7(c)(1)(ii).

5 The derivatives markets are global and FCMs frequently conduct business on behalf of their customers through affiliated brokers and depositories. Provided an FCM applies comparable standards in selecting the affiliates with which it deposits and maintains customer segregated funds, the Committee believes there are considerable benefits to customers in using affiliates. Many customers choose to open accounts with a particular FCM because the FCM is part of a global company. These customers want to deal with one integrated company whose credit risk the customer can assess. They cannot assess the risk of unaffiliated depositories, which they have no role in selecting. In addition, an FCM is able to provide services to its customers more efficiently and more effectively if the FCM is able to deal with brokers and depositories over which it has the ability to exercise greater influence. For example, the FCM may be unable to offer single currency margining. Counterparty credit exposure is increased if the broker or depository is not an affiliate. Upon request, an FCM will disclose whether the FCM deposits customer funds with an affiliated foreign broker or depository.

6 In particular, an FCM should consider the depository's ability to operate in stress scenarios.

(iii) monitor each approved depository on an ongoing basis to ensure that such depository continues to meet the established criteria.

The Committee further recommends that the SROs require each FCM to advise its customers that, upon request, an FCM will disclose whether the FCM holds customer funds with an affiliated foreign broker or depository.

F. Maintenance of Residual Interest

Commission Rule 1.23 prohibits an FCM from using one customer's funds to meet the obligations of another customer. An FCM must use its own funds to make up any deficiency in a customer's account, if the customer fails to have sufficient funds on deposit with the FCM to meet the customer's obligations. In order to comply with Rule 1.23, an FCM is permitted, if not as a practical matter required, to maintain excess funds in the customer segregated account. Such excess funds represent the FCM's residual interest in the customer segregated account. All such FCM funds are held for the exclusive benefit of the FCM's customers while held in a customer segregated account.

The Committee believes that FCMs generally have policies and procedures that (i) target an amount that each FCM seeks to maintain as the residual interest, and (ii) thereafter assure that they are taking reasonable steps to maintain a sufficient amount of their own funds in the customer segregated accounts to remain in compliance with Rule 1.23. The appropriate amount that any FCM should deposit is based on a number of factors, including the type of customers an FCM carries, the type of trading conducted and the markets traded. Therefore, it may not be practical to require FCMs to maintain a fixed percentage of customer funds on deposit.

Similarly, the Committee believes that the Commission or DSRO should have authority to require an FCM to increase the amount of FCM funds held in segregation or to prevent an FCM from withdrawing its residual interest only in carefully circumscribed circumstances and in accordance with carefully articulated objective standards.

Recommendations: The Committee recommends that the SROs require each FCM to document its policies and procedures with respect to the FCM's determination of the appropriate targeted residual interest it maintains in the customer segregated account.

G. Withdrawal of Residual Interest

An FCM may withdraw its residual interest in the customer segregated account, provided such withdrawal does not cause the FCM to violate its obligation to be in continual compliance with the customer segregated funds requirement. In this regard, an FCM's residual interest in a customer segregated account will change throughout the day in response to changes in customer trading, market volatility and other factors. Therefore, an FCM's policies and procedures must be designed to reasonably assure that any withdrawals from the customer segregated account to the FCM's own account, in particular any intraday withdrawals, comprise the FCM's residual interest and will not result in a violation of the Act and the Commission's rules, or the FCM's targeted residual interest.

Recommendations: The Committee recommends, as noted above, that the SROs require each FCM to document its policies and procedures regarding the maintenance of the FCM's residual interest in the customer segregated account. Such policies and procedures must be designed to reasonably assure that any withdrawals from the customer segregated account to the FCM's own account comprise the FCM's residual interest and will not result in a violation of the Act and the Commission's rules, or the FCM's targeted residual interest. The FCM's chief financial officer or the chief financial officer's delegate must approve in writing any withdrawal from the customer segregated account in violation of the policies and procedures, as well as any material change in the policies and procedures regarding the maintenance of the FCM's residual interest in the customer segregated account.[7]

H. Foreign Futures and Foreign Options Secured Amount

The Commission's foreign futures and options rules provide FCMs with greater flexibility in the manner in which it treats customers that trade on foreign boards of trade and the funds deposited by such customers to margin transactions on foreign boards of trade. For example: (i) foreign futures and foreign options customers are defined to include only those customers located in the US; (ii) only funds received from foreign futures and foreign options customers are required to be taken into account in calculating the foreign futures and foreign options secured amount in accordance with Rule 30.7; (iii) Rule 30.7 provides for an alternative calculation of the foreign futures and foreign options secured amount that does not assure protection of customer funds as fully as the net liquidating equity calculation that is used to determine the amount required to be segregated in connection with trading on US futures markets; and (iv) there is no limit on the amount of foreign futures and foreign options customer funds that may be held in permitted depositories outside of the US (although capital charges may apply).

The Commission's rules also permit an FCM to hold funds deposited for trading products other than foreign futures and foreign options in the foreign futures and foreign options secured amount account. For example, several DCOs, with the Commission's consent, currently permit FCMs to hold cleared swaps collateral and related positions (i.e., the sequestered amount) in the foreign futures and foreign options secured amount account. (Upon the effective date of the rules governing cleared swaps customer collateral and positions, the sequestered amount will no longer be permitted to be held in the secured amount account.) In addition, an FCM may deposit customer funds required for unregulated foreign currency transactions or in connection with deliveries under exchange-traded futures contract.

Providing such flexibility was reasonable in 1987, when the foreign futures and foreign options rules (Part 30) were adopted. US participation in foreign markets was small and generally limited to commercial users. Moreover, few foreign jurisdictions had well-developed regulatory regimes for trading futures on foreign boards of trade. The Commission was concerned, therefore, that it not promise more than it could reasonably expect to deliver.

7 For the avoidance of doubt, a reduction in the FCM's residual interest arising from the application of the FCM's residual interest to meet customers' margin obligations would not be deemed a withdrawal of the FCM's residual interest.

The international derivatives markets have changed significantly in the past twenty-five years, and FCMs have generally adopted policies and procedures designed to provide protections to all customers trading on foreign boards of trade that is comparable to the protections afforded customers trading of US futures markets. In this regard, the Committee understands that most FCMs' written policies and procedures:

(i) do not distinguish between customers located in the US and customers located outside of the US that trade on foreign boards of trade;

(ii) treat all funds received from US and non-US customers for trading on foreign boards of trade as required under Rule 30.7;

(iii) calculate the foreign futures and foreign options secured amount using the net liquidating equity calculation; and

(iv) hold most funds deposited with the FCM for the purpose of trading foreign futures and foreign options in the US, except as permitted under Commission Rule 1.49 or as reasonably required to meet margin obligations on foreign boards of trade (a reasonable amount of excess is also held outside of the US to facilitate the payment of margin requirements).

To the extent practicable, the Committee believes that customer funds deposited with an FCM to margin foreign futures and foreign options transactions should receive the same protections as funds deposited to margin transactions on US markets, with appropriate modifications to account for the fact that, as necessary, customer funds will be held outside of the US and be subject to the regulatory regime of the jurisdiction in which the market is located.[8]

Recommendations: The Committee recommends that the Commission publish for comment proposed amendments to the Part 30 rules that would:

(i) revise the definition of a foreign futures and foreign options customer to include all customers, wherever located;

(ii) require all FCMs to calculate the foreign futures and foreign options secured amount using the net liquidating equity calculation;

8 On September 30, 2003, the Commission issued an order authorizing firms that are subject to regulation by the United Kingdom Financial Services Authority (FSA) and have qualified for an exemption from registration as an FCM in accordance with Commission Rule 30.10 to offer their customers that meet the definition of an eligible contract participant to opt out of the applicable UK segregations requirements. See, 68 Fed. Reg. 58583 (October 10, 2003). As noted below, the Committee recommends that the Commission withdraw this relief.

(iii) hold funds deposited with the FCM for the purpose of trading foreign futures and foreign options in the US, except as reasonably expected to meet margin obligations on foreign boards of trade;[9] and

(iv) provide that, except as the Commission otherwise provides by order, only funds deposited or otherwise required to be held for the purpose of trading foreign futures and foreign options should be held in the foreign futures and foreign options secured amount.

The Committee further recommends that the Commission withdraw that portion of the Commission's September 30, 2003 order that authorizes firms that are subject to regulation by the FSA and have qualified for an exemption from registration as an FCM in accordance with Commission Rule 30.10 to offer their customers that meet the definition of an eligible contract participant to opt out of the applicable UK segregations requirements.

Finally, the Committee recommends that the SROs require FCMs to advise customers that, upon request, an FCM will disclose whether the FCM deposits customer funds with an affiliated foreign broker or depository.

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9 FCMs should deposit Part 30 funds with foreign brokers only as necessary to cover the amount of required margin on customers' positions, with an appropriate excess to minimize the chance the account becomes undermargined. The appropriate excess is not amenable to a prescriptive rule, but should be reasonable in the circumstances of an FCM's foreign futures and foreign options business. The appropriate amount will depend, for example, on the volatility from time-to-time of the products traded, the type of collateral (cash or securities) deposited with the foreign broker, the time-zone in which the market is located, and the jurisdiction of the markets traded. For example, certain exchanges, such as the Korean Exchange, require customers to pre-margin transactions. Therefore, excess will be required to be held at the broker before a trade is executed.

To the extent that a numerical standard is deemed necessary, the Committee suggests that it should be no less than 50 percent of the amount that an FCM is required to deposit with a foreign broker to maintain customer foreign futures and foreign options positions. This number is consistent with the provisions of Commission Rule 1.17(c)(5)(xiii)(C), which requires an FCM to take a five percent capital charge to the extent unsecured receivables with a foreign broker is greater than 150 percent of the current amount required to maintain futures and option positions in accounts with the foreign broker.

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