



Protection of Customer Funds

Frequently Asked Questions

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Protection Of Customer Funds — *Frequently Asked Questions*

The Protection of Customer Funds: Frequently Asked Questions¹ was prepared by members of the FIA Law and Compliance Division. The document contains 30 questions and answers addressing the basics of segregation, collateral management and investments, capital requirements and other issues for FCMs and joint FCM/broker-dealers, and clearinghouse guarantee funds.

I. Basics of Segregation

1. What accounts do futures commission merchants (FCMs) maintain for customers that trade futures, options on futures contracts and leared swaps? What is the difference among the accounts?

FCMs may maintain up to three different types of accounts for customers, depending on the products a customer trades:

- (i) a customer segregated funds account for customers that trade futures listed on US futures exchanges;
- (ii) a foreign futures and foreign options secured amount account for customers that trade futures and options on futures listed on foreign boards of trade; and
- (iii) a sequestered account for customers trading swaps that are cleared on a derivatives clearing organization (DCO) registered with the Commodity Futures Trading Commission (Commission).

The requirement to maintain these separate accounts reflects the different risks posed by the different products. Cash, securities and other collateral (collectively, funds) required to be held in one account may not be commingled with funds required to be held in another account, except as the Commission may permit by order.

Customer segregated funds. Funds that customers deposit with an FCM, or that are otherwise required to be held for the benefit of customers, to margin futures and options on futures contracts traded on futures markets located in the US, i.e., designated contract markets, are held in a customer segregated funds account in accordance with section 4d(a)(2) of the Commodity Exchange Act (Act) and Commission Rule 1.20. Customer funds held in the customer segregated funds account may not be used to meet the obligations of the FCM or any other person, including another customer.

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All customer segregated funds may be commingled in a single account at a bank or trust company, a DCO or another FCM. Such account, i.e., an omnibus account, must be properly titled to make clear that the funds belong to, and are being held for the benefit of, the FCM's customers.

Foreign futures and foreign option secured amount. Funds that customers deposit with an FCM, or that are otherwise required to be held for the benefit of customers, to margin futures and options on futures contracts traded on foreign boards of trade are held in a foreign futures and foreign options secured amount account in accordance with Commission Rule 30.7. Funds required to be held in the foreign futures and foreign options secured amount account may be commingled in an omnibus account with: (i) a bank or trust company located within the US; (ii) a bank or trust company located outside the US that has in excess of \$1 billion in regulatory capital; (iii) an FCM; (iv) a DCO; (v) a foreign broker; or (vi) such DCO's or foreign broker's designated depositories.

As required by Rule 30.7, the funds held in the foreign futures and foreign options secured amount account must be at least sufficient to cover or satisfy all of an FCM's obligations to its foreign futures and foreign options customers. Foreign futures and foreign options secured amount funds not held by the FCM in a US depository may be deposited with a member of a foreign board of trade, the clearing organization of a foreign board of trade, their respective depositories, or a bank located outside of the US.

The foreign futures and foreign options secured amount required to be set aside must equal for each account at least the lesser of: (i) the net liquidating equity plus the market value of any securities held in the customer's account; or (ii) margin required, plus or minus the unrealized gain or loss on futures positions, plus long option value, minus short option value. If the foreign board of trade on which transactions are executed has a segregation requirement, the foreign futures and foreign options secured amount must be at least equal to the amount required by the foreign board of trade.

NOTE: Commission rules currently permit an FCM to hold customer funds deposited for other purposes in the foreign futures and foreign options secured amount account. An FCM, for example, may deposit customer funds required for unregulated foreign currency transactions or in connection with deliveries under exchange-traded futures contract. In these circumstances, the funds held in the secured amount account must be at least sufficient to cover all of the FCM's obligations to its customers with respect to all such transactions.

Sequestered amount (cleared swaps customer collateral). Funds deposited with an FCM, or otherwise required to be held for the benefit of customers, to margin swaps cleared through a registered derivatives clearing organization (DCO) are currently held in a sequestered account in accordance with applicable DCO rules. Such funds may currently be held in the foreign futures and foreign options secured amount account.



Upon the compliance date of the Commission's recently adopted Part 22 rules (November 8, 2012), funds deposited to margin swaps cleared through a DCO will be held in a cleared swaps customer collateral account in accordance with the provisions of section 4d(f) of the Act. In accordance with the provisions of section 4d(f) of the Act, funds required to be held in a cleared swaps customer collateral account may be commingled in an omnibus account at a bank or trust company, a DCO or another FCM. However, as noted above, such funds may not be commingled with funds required to be held in the customer segregated funds account, except pursuant to an order issued by the Commission.

2. What is fellow customer risk and how is that relevant in an FCM bankruptcy?

Fellow customer risk is the risk that one or more customers of an FCM will default on their obligations to the FCM and that such loss will be so great that the FCM, in turn, will default on its obligations (i) to a DCO, or (ii) a clearing FCM that carries the FCM's customer account.

As discussed below, Commission Rule 1.22 prohibits an FCM from using the funds of one customer to meet the obligations of another customer. Rather, an FCM must use its own funds to meet a defaulting customer's obligations to a DCO or clearing FCM. In general, therefore, a customer's loss would have to be substantial before other customers would be exposed to fellow customer risk. Nonetheless, an FCM's excess adjusted net capital is a factor that a customer should consider carefully in selecting an FCM to carry the customer's account.

If the loss is so great that, notwithstanding the application of the FCM's own funds, there is a shortfall in the amount of customer funds required to be held in segregation, the FCM will default and likely be placed into bankruptcy. In these circumstances, the Bankruptcy Code provides that non-defaulting customers will share in any shortfall, pro rata. A shortfall in customer segregated funds may also make the transfer of the accounts of non-defaulting customers to another FCM more difficult.

Customers are exposed to fellow customer risk in all markets for which an FCM holds customer funds, i.e., futures and options on futures traded on US exchanges, futures and options on futures contracts traded on foreign boards of trade, and cleared swaps. The Commission's recently-adopted rules governing cleared swaps customer collateral, discussed below, are intended to provide cleared swaps customers enhanced protection from fellow customer risk.

3. How does the treatment of the cleared swaps customer collateral account differ from the customer segregated funds account in the event of an FCM's bankruptcy?

The Part 22 rules governing the treatment of the cleared swaps customer collateral incorporate by reference many of the rules governing the treatment of the customer

segregated funds account. Nonetheless, the regulatory requirements for cleared swaps customer collateral differ in several important respects from the requirements applicable to customer segregated funds. In particular, the Part 22 rules are designed to provide cleared swaps customers enhanced protection from fellow customer risk in the event of an FCM's bankruptcy.

As with the customer segregated funds account, the Part 22 rules permit an FCM to maintain cleared swaps customer positions and collateral in an omnibus account, on its own books and at the relevant DCO. However, the FCM carrying the customer's account must advise the clearing FCM (if different) of the identity of each customer within the omnibus account, the portfolio of positions held by each customer and the margin required to support such positions. The clearing FCM must provide the same information to the DCO that clears the positions. In the event of the default of an FCM caused by a default of one or more customers, the defaulting FCM must notify the clearing FCM (if different), and the clearing FCM must notify the DCO (if the clearing member has defaulted), of the identity of the cleared swaps customer(s) that caused the default.

Upon the default of an FCM, the Part 22 rules prohibit the DCO from applying funds in a cleared swaps customer omnibus account attributable to non-defaulting customers to meet the shortfall owing to the DCO in connection with a defaulting customer. In contrast to this provision of the Part 22 rules, the Commission's rules governing the customer segregated funds account do not prohibit a DCO from using the funds of non-defaulting customers held by the DCO to meet the shortfall owing to the DCO arising from the bankruptcy of a clearing FCM.

It is important to understand that the Part 22 rules do not protect cleared swaps customers from all loss in the event of a shortfall in the cleared swaps customer collateral account following the bankruptcy of an FCM. For example, the rules would not protect such customers (i) if the bankrupt FCM's books and records are inaccurate, (ii) in the event of a shortfall in the cleared swaps customer collateral account arising from FCM fraud or mismanagement, or (iii) in the event a bankruptcy trustee incurs losses in liquidating collateral held in the cleared swaps customer collateral account in which the FCM had invested in accordance with Commission Rule 1.25.

4. Why is an FCM prohibited from commingling the customer segregated funds and the foreign futures and foreign options secured amount accounts?

As discussed in greater detail below, customers trading on foreign markets assume additional risks. Laws or regulations will vary depending on the foreign country in which the transaction occurs. In particular, funds held in a foreign futures and foreign options secured amount account outside of the US may not receive the same level of protection as customer segregated funds. If the foreign broker carrying the US customers' positions fails, the broker will be liquidated in accordance with the laws of the jurisdiction in which it is located, which laws may differ significantly from the US Bankruptcy Code.



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Return of the funds to the US will be delayed and likely will be subject to the costs of administration of the failed foreign broker in accordance with the law of the applicable jurisdiction, as well as possible other intervening foreign brokers if multiple foreign brokers were used to process the US customers' transactions on foreign markets.

If the foreign broker does not fail but the customer's US FCM fails, the return of the funds held outside of the US nonetheless may be delayed. If both the foreign broker and the US FCM were to fail, disputes between the trustee for the US FCM and the administrator for the foreign broker may result in significant delays and additional administrative expenses. Use of other intervening foreign brokers by the US FCM to process the trades of US customers on foreign markets may cause additional delays and administrative expenses.

For these reasons, the Commission does not permit funds held to margin foreign futures and foreign options to be held in the same account as the customer segregated funds account.

5. How does an FCM segregate customer funds and collateral? Who oversees this process?

Customer segregated funds are required to be held at a bank or trust company, a DCO or another FCM. In accordance with Commission Rule 1.20, each account holding segregated funds or collateral must be properly titled to identify it as holding customer funds or collateral and segregated as required by the Act and the Commission's rules. Except as noted below, customer funds may not be commingled with the funds of any other person, including (and in particular) the depositing FCM. Each depository is required to provide the depositing FCM with a written acknowledgment that the depository was informed that such funds belong to futures customers and are being held in accordance with the Act and the Commission's rules. Among other representations, the depository must acknowledge that it cannot use any portion of customer funds to satisfy any obligations that the FCM may owe the depository.

Commission Rule 1.32 provides that FCMs must calculate daily the amount of funds they are required to hold in segregation, the amount of funds that are actually held in segregated accounts, and the FCM's residual interest, defined below, in the segregated account.

Commission Rule 1.22 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 1.22, an FCM is permitted under Commission Rule 1.23 to maintain excess funds in the customer segregated account. Such excess funds represent the FCM's residual interest in the customer segregated account.

All FCM funds are held for the exclusive benefit of the FCM's customers while held

in a customer segregated account. An FCM may withdraw its residual interest in the customer segregated account at any time, however, provided such withdrawal does not cause the FCM to violate its requirement to maintain adequate segregated funds.

In addition, Commission Rule 1.12(h) requires an FCM to notify the Commission immediately whenever it knows or should know that the total amount of funds on deposit in segregated accounts is less than the amount required to be held in segregation. The FCM is required to file a notice concurrently with its designated self-regulatory organization.

As explained earlier, the Part 22 rules governing the treatment of the cleared swaps customer collateral account incorporate by reference many of the rules governing the customer segregated funds account, including the rules discussed above. Therefore, an FCM must comply with these rules in connection with the cleared swaps customer collateral account.

An FCM's designated self-regulatory organization (SRO) conducts periodic audits of FCMs and, in connection with such audits, confirms that customer funds are being held in properly designated accounts and that the depository has provided the FCM with a signed acknowledgment letter.

6. Would an individually segregated account provide a customer any greater protection at the FCM if the FCM becomes insolvent?

Individually segregated accounts should protect customers against FCM fraud and fellow customer risk. However, the Bankruptcy Code provides that non-defaulting public customers of an FCM will share in any shortfall in customer segregated funds, pro rata, and, consequently, under the existing segregation models, individually segregated accounts would not appear to provide customers with greater protection if the FCM were to fail. In adopting rules for the protection of cleared swaps customer collateral, the Commission determined that any increased protection that might be provided by individually segregated accounts would be minimal.

From an operational perspective, individual segregation would be difficult and expensive to implement, thereby exposing FCMs to increased operational risk. FCMs would need to establish individual accounts at each depository or DCO at which customer funds are held. DCOs, in turn, would be required to maintain individual accounts for each customer. A DCO would need authority to withdraw funds from each account daily, as necessary to meet the customer's margin obligations. To the extent a customer clears through more than one DCO, a separate account would be required for each DCO. A customer's cost of trading likely would increase significantly, as there potentially would be many individual transfers of funds on behalf of each customer between the customer account and each DCO at which the customer maintains open positions.

Although the Commission recently stated that an FCM may agree to maintain a third-party custodial account on behalf of a cleared swaps customer, such third-party accounts are not permitted for exchange-traded futures accounts. Third-party custodial accounts would require an FCM to use its own capital to post initial margin with a DCO on behalf of a customer. Consequently, such accounts may adversely affect an FCM's liquidity. Importantly, the Commission has emphasized that third-party custodial accounts do not provide any greater protection to customers under the Bankruptcy Code in the event that an FCM fails and there is a shortfall in customer funds.

7. If the FCM requires customers to deposit excess margin or the FCM maintains excess funds in the account, are those funds protected if the FCM becomes insolvent?

The Bankruptcy Code broadly defines customer property to mean cash, a security, or other property, or the proceeds of such cash, security or property received, acquired, or held by or for the account of the debtor [FCM] from or for the account of a customer. Customer property is not limited to only the funds required by the relevant exchange or DCO to margin open contracts. Consequently, in the event of an FCM's insolvency, excess margin or other excess funds deposited with the FCM for the purpose of trading futures or options on futures on US or foreign futures exchanges should be entitled to the same protections as margin that an exchange or DCO may require.

The Commission's recently adopted rules relating to the protection of cleared swaps collateral (Part 22) permit a DCO to establish a separate account at which an FCM may deposit excess customer funds. The DCO must provide a mechanism by which the FCM will advise the DCO of the identity of the customers whose funds are deposited in the account and the amount of excess funds attributable to each such customer.

8. How frequently is the segregation computation prepared (e.g., daily or weekly) in the US? What are FCMs required to do in terms of reporting if there is a deficiency in customer funds?

Commission Rule 1.32 provides that FCMs must calculate daily the amount of funds they are required to hold in segregation, the amount of funds that are actually held in segregated accounts, and the FCM's residual interest in the segregated account. (As discussed above, Commission Rule 1.23 permits an FCM to maintain excess funds, i.e., the residual amount, in the customer segregated accounts in order to comply with Commission Rule 1.22.) This latter rule 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.

All FCM funds are held for the exclusive benefit of the FCM's customers while held in a customer segregated account. An FCM may withdraw its residual interest in the customer segregated account at any time, however, provided such withdrawal does not cause the FCM to violate its requirement to maintain adequate segregated funds.

In addition, Commission Rule 1.12(h) requires an FCM to notify the Commission immediately whenever it knows or should know that the total amount of funds on deposit in segregated accounts is less than the amount required to be held in segregation. The FCM is required to file a notice concurrently with its designated self-regulatory organization. In order to assure that it is not required to file such a notice, FCMs generally maintain excess funds in the customer segregated account.

9. Is there insurance for any shortfall in customer funds?

There is no industry-wide insurance fund to compensate customers in the event of a shortfall in customer funds upon the insolvency of an FCM. However, the CME Group recently announced that it will establish a \$100 million fund to further protect US family farmers and ranchers who hedge their business in CME Group futures markets. The Family Farmer and Rancher Protection Fund will provide up to \$25,000 to individual farmers and ranchers and \$100,000 to co-ops that hedge their risk in CME Group futures markets as a means to help offset losses arising from the failure of a CME Group clearing member or other market participant. The fund will not be available to customers who have lost money as a result of the bankruptcy of MF Global Inc.

10. What is the purpose of the FCM depositing its own money in a customer segregated or secured account and how does the FCM determine how much that deposit should be?

As noted above, an FCM deposits a portion of its own funds in the customer segregated account to assure that the FCM is always in compliance with the provisions of Commission Rule 1.22, which prohibit an FCM from using the funds of one customer to meet the obligations of another customer. In addition, by depositing a portion of its own funds in the segregated account, the FCM seeks to assure that there is not a deficiency in the customer segregated account arising from a deficiency in one or more customers' accounts, which would oblige the FCM to provide immediate notice to the Commission, as required in Commission Rule 1.12(h).

Each FCM determines how much of its own funds it will hold in the customer segregated account based on the FCM's analysis of the nature of its customers, the products the customers trade and the volatility of the markets at any one time.

11. What type of financial information concerning an FCM is publicly available?

Since March 2002, the Commission has posted on its website a monthly report providing certain non-confidential information concerning each registered FCM.



Such information has included: (i) the FCM's adjusted net capital; (ii) the FCM's net capital requirement; (iii) the FCM's excess net capital; (iv) the amount of customer funds required to be segregated in accordance with section 4d(a) of the Act; and (v) the amount of funds required to be held in the foreign futures and foreign options secured amount account.

Beginning with the report for the month of December 2011, the Commission also includes information regarding: (i) the total amount of funds held in the customer segregated account; (ii) the amount of excess held by the FCM in the customer segregated account; (iii) the total amount of funds held in the foreign futures and foreign options secured amount account; and (iv) the amount of excess funds held by the FCM in the foreign futures and foreign options secured amount account.

NOTE: If an FCM uses the alternative method to compute the foreign futures and foreign options secured amount, all or a portion of the excess identified as being held in such account may belong to foreign futures and foreign options customers.

The report is created from financial reports that each FCM must file with the Commission within 17 business days following each month end and is generally posted on the Commission's website within six weeks following each month end. The reports may be found at <http://www.cftc.gov/MarketReports/FinancialDataforFCMs/index.htm>.

12. How do customer statements reflect what portion of the customer's funds are held at the DCOs or in segregated or secured bank accounts?

Customer statements do not indicate where a customer's funds are held.

II. Collateral Management and Investments

13. Can a customer maintain its funds and/or collateral with a third party?

Commission Financial and Segregation Interpretation No. 10-1 prohibits an FCM from maintaining a third-party custodial accounts on behalf of a futures customer, except in limited circumstances. Although the Commission recently stated that a cleared swaps customer may agree with its FCM to maintain a third-party custodial account, the Commission emphasized its view that, under the Bankruptcy Code, such accounts would not receive preferential treatment in the event of the FCM's insolvency.

14. Can a customer select the depository at which its segregated funds are held? Can a customer find out which banks an FCM uses to hold customer funds.

An FCM may agree to hold a portion of its customer segregated funds at a depository selected by the customer. However, a customer must recognize that, in accordance with the provisions of Commission Rule 1.20, such funds are held in the name of the FCM for the benefit of its customers generally and not for the benefit of the requesting customer. Further, for operational efficiency, an FCM may limit the number of banks at which it maintains customer segregated accounts. In the event of the FCM's bankruptcy

and a shortfall in customer funds available for distribution, the requesting customer would receive no greater protection than all other customers of the FCM.

Upon request of a customer, an FCM should identify for the customer the banks at which the FCM holds customer funds.

15. What is the customer's risk if the custodian bank holding the segregated funds fails? Is there any greater insurance provided by the bank for customer funds?

The Commission has expressed no view regarding the potential liability of an FCM or DCO to its customers in the event a custodian bank were to fail. However, in 1971, the Commodity Exchange Authority, the predecessor to the Commission, held that an FCM or DCO would not be liable if it had used due care in selecting the bank, had not otherwise breached its fiduciary responsibilities toward the customers, and had fully complied with the requirements of the Commodity Exchange Act and the regulations thereunder relating to the handling of customers' funds.

Nonetheless, the party that will bear the risk if a bank at which customer funds are deposited were to fail may be subject to negotiation between the FCM and the customer when an account is opened.

If a custodian bank that is a member bank of the FDIC were to fail and provided the FCM's records are in order, each of the customers whose funds are held in a properly designated account should be entitled to FDIC insurance, subject to the applicable limits.

16. Can a customer maintain its own custody account at the bank as long as it is in the name of the FCM?

Such an account would be similar in effect to a third-party custodial account and, as discussed above, is not permitted for futures accounts.

17. If a customer does not trade foreign futures, can the customer require that the FCM hold all customer funds and collateral in the United States?

Assuming that the customer is located in the US and has deposited US dollars or securities denominated in US dollars to margin futures and options on futures contracts traded on US futures exchanges, the FCM is required under Commission Rule 1.49 to hold such funds or securities in depositories located in the US and may not transfer funds outside of the US, except as a customer may otherwise instruct the FCM.

18. When an FCM opens an omnibus account with a foreign broker, what steps does the FCM take to protect those funds?

When an FCM opens an account with a foreign broker, the FCM obtains from the broker a written acknowledgment as required by Commission Rule 30.7, pursuant to



which the foreign broker confirms that it has been advised that the funds are held for and on behalf of the FCM's customer and agrees that the funds will be held in accordance with applicable Commission rules. In particular, the broker confirms that such funds will not be used to secure or guarantee the obligations of, or extend credit to, the FCM or any proprietary account of the FCM.

19. Are there any special factors or risks that a customer should take into consideration before choosing to trade futures and options on futures contracts listed for trading on foreign boards of trade?

As with trading on US futures exchanges, the risk of loss in trading foreign futures and foreign options can be substantial. Consequently, a customer should carefully consider whether such trading is appropriate in light of the customer's financial condition and investment goals. Customers trading on foreign markets also assume additional risks and, therefore, should understand those risks before trading.

Customer funds protection may be different. Customer funds used to margin transactions on foreign markets are deposited with a foreign broker located outside of the US. Although an FCM will receive an acknowledgment from the foreign broker that such funds are held for or on behalf of customers, it is important to understand that customer funds held outside of the US to margin transactions on foreign boards of trade are held in accordance with the client assets protection regime and the insolvency laws of the applicable jurisdiction. As such, they will not receive the same protections under the Commodity Exchange Act and the US Bankruptcy Code as funds held by a US FCM to margin transactions on US futures exchanges. If the foreign broker carrying the US customers' positions fails, the broker will be liquidated in accordance with the laws of the jurisdiction in which it is located. If the foreign broker does not fail but the customer's US FCM fails, the return of the funds held outside of the US may nonetheless be delayed.

A customer that chooses to effect transactions on foreign boards of trade, therefore, is encouraged to consider carefully the client assets protection regimes in the jurisdictions in which the customer's funds will be held. In March 2011, the Technical Committee of the International Organization of Securities Commissions (IOSCO) released a Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets, which provides an overview of the protections that various jurisdictions — including, among others: Australia; Brazil; Canada; China; France; Germany; Hong Kong; India; Japan; Mexico; Singapore; Switzerland; the United Kingdom; and the US — afford to client assets, both before and after the bankruptcy of broker. The Survey may be found at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD351.pdf>. Although this is an important resource, a customer may wish to make additional inquiries to determine whether the laws of any relevant jurisdiction have changed.

NOTE: Transactions on certain foreign boards of trade are cleared through a clearing organization that is registered with the Commission as a derivatives clearing

organization (DCO). In these circumstances, funds held for or on behalf of customers to margin contracts executed on the foreign board of trade may not always be held in the foreign futures and foreign options secured amount account maintained by the FCM and clearing organization. Rather, at the request of the DCO and pursuant to Commission order, the funds deposited by customers to margin such transactions executed on the foreign board of trade and cleared by a registered FCM may be permitted to be held in a customer segregated funds account under section 4d(a)(2) of the Commodity Exchange Act. In the event of the default of a US FCM, such funds will receive the same protections under the Commodity Exchange Act and the US Bankruptcy Code as funds held by a US FCM to margin transactions on US futures exchanges.

For example, certain futures contracts listed for trading on the Dubai Mercantile Exchange are cleared through the Chicago Mercantile Exchange (CME). Pursuant to Commission order, FCMs and the CME hold funds deposited to margin such customer positions in the customer segregated funds account.

Transactions on foreign boards of trade are not subject US law. Transactions entered into on a foreign board of trade are governed by applicable foreign laws and regulations. Moreover, such laws or regulations will vary depending on the country in which the foreign futures or foreign options transaction occurs. Neither the Commission nor the National Futures Association regulates activities of any foreign board of trade, including the execution, delivery and clearing of transactions. Similarly, they have no the power to compel enforcement of the rules of a foreign board of trade or any applicable foreign laws.

Foreign brokers are not subject to US law. Generally, foreign brokers are not subject to the jurisdiction of the Commission or any other US regulatory body; nor is the Commission able to compel a foreign jurisdiction or foreign board of trade to enforce applicable foreign laws or regulations. It is especially important, therefore, that an FCM carefully choose the foreign broker that will carry and clear transactions executed on behalf of the FCM's customers. A customer may request an FCM to (i) identify the foreign brokers that will carry and clear its customers' transactions in the applicable foreign jurisdiction, and (ii) explain the criteria the FCM follows in selecting such foreign brokers, including any affiliates of the FCM.

NOTE: Foreign brokers that deal directly with US customers in accordance with an exemption from registration as an FCM granted pursuant Commission Rule 30.10 consent to the jurisdiction of the US. Foreign brokers that have received an exemption under Rule 30.10 are identified on the National Futures Association's Background Affiliation Status Information Center System (BASIC), which may be accessed at <http://www.nfa.futures.org/basicnet/>.



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The use of affiliates to carry and clear foreign transactions provides benefits but also presents risks. Many FCMs use affiliates to carry and clear transactions on foreign boards of trade, including in major markets such as the United Kingdom, Hong Kong and Singapore. A customer is encouraged to consider the risks as well as the benefits of effecting transactions on foreign boards of trade through the FCMs' affiliates.

Many FCMs believe customers receive significant benefits if trades are executed through affiliated foreign brokers. FCMs will necessarily have far more information about an affiliated foreign broker, e.g., its internal controls, investment policies, customer protection regime, finances and systems, and are better able to exert influence over an affiliated foreign broker. Customers, for their part, often prefer to deal with one integrated company, whose unified balance sheet and financial statement permit the customers to assess more easily, the potential risk of trading through that FCM.

In addition, an FCM generally is able to provide services to its customers more efficiently and more effectively if trades are executed and cleared through one or more affiliates. An FCM and its affiliates customarily use the same systems, which permits straight-through processing of trades, thereby enhancing certainty of execution and reducing errors (or the time necessary to resolve errors). Straight-through processing also facilitates an FCM's ability to (i) manage the risks of carrying its customers' positions, and (ii) comply with position limit and large trader reporting requirements, both in the US and in foreign jurisdictions. Moreover, an FCM that executes transactions on foreign boards of trade through an affiliate may be able to offer certain value-added services, including direct access to certain markets and single currency margining.

Nonetheless, the use of affiliates also poses certain risks. Standing alone, the likelihood that an affiliated foreign broker will fail is no greater than the risk that a non-affiliated foreign broker will fail. However, because the activities of a US FCM and its affiliates are integrated, the failure of one such entity may cause all of the affiliated companies to fail or be placed in administration within a relatively brief period of time. As is the case if an unaffiliated foreign broker were to fail, each of these companies would be liquidated in accordance with the bankruptcy laws of the local jurisdiction. Customer funds held with such entities would not receive the same protections afforded customer funds under the US Bankruptcy Code. If, on the other hand, a defaulting US FCM had cleared its customers' foreign futures and foreign options transactions through unaffiliated foreign brokers, the foreign broker likely would not have failed as a result of the FCM's failure, and the defaulting FCM's trustee in bankruptcy could have directed the foreign broker to liquidate all customer positions and return the balance to the trustee for distribution to customers.

20. What types of investments may an FCM make with segregated funds? With secured funds? With swaps collateral?

Commission Rule 1.25 sets out the instruments and transactions in which an FCM is permitted to invest customer funds, however held, i.e., customer segregated funds, cleared swaps customer collateral, and foreign futures and foreign options secured amount. The Commission recently adopted amendments to further restrict the types of permitted investments under Rule 1.25 and to impose the same restrictions on the investment of the foreign futures and options secured amount and cleared swaps collateral.

Permitted investments include:

- (i) Obligations of the United States and obligations fully guaranteed as to principal and interest by the United States (U.S. government securities);
- (ii) General obligations of any State or of any political subdivision thereof (municipal securities);
- (iii) Obligations of any United States government corporation or enterprise sponsored by the United States government (U.S. agency obligations) **NOTE:** Obligations issued by the Federal National Mortgage Association or the Federal Home Loan Mortgage Association are permitted only while these entities operate under the conservatorship or receivership of the Federal Housing Finance Authority with capital support from the United States);
- (iv) Certificates of deposit issued by a bank (certificates of deposit) as defined in section 3(a)(6) of the Securities Exchange Act of 1934, or a domestic branch of a foreign bank that carries deposits insured by the Federal Deposit Insurance Corporation;
- (v) Commercial paper fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program as administered by the Federal Deposit Insurance Corporation (commercial paper);
- (vi) Corporate notes or bonds fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program as administered by the Federal Deposit Insurance Corporation (corporate notes or bonds); and
- (vii) Interests in money market mutual funds.

The duration of the securities in which an FCM invests customer funds cannot exceed, on average, two years.

An FCM may also engage in repurchase and reverse repurchase transactions with non-affiliated registered broker-dealers, provided such transactions are made on a delivery versus payment basis and involve only permitted investments. In these circumstances, FCMs not only possess and deposit in the appropriate customer accounts collateral or

cash at least equal in value to the customers' original deposits, they also have a claim against the repurchase or reverse repurchase counterparty in the event the value of any securities received decrease in value.

NOTE: Effective as of February 17, 2012, an FCM may not engage in repurchase and reverse repurchase transactions with affiliates or engage in so-called internal repurchase transactions.

21. Can the customer direct the investment of its funds and collateral or impose restrictions on their use?

A customer is not able to direct the investment of the cash it deposits with an FCM. Investments of customer funds are made on an omnibus basis and FCMs cannot identify specific investments for the benefit of specific customers.

22. Why does the FCM need the ability to hypothecate and re-hypothecate funds and collateral? What limitations are there on the FCM's ability to do so?

Frequently, customers post securities as margin that are not permitted to be deposited with a DCO to margin the customer's positions. An FCM needs the ability to hypothecate and re-hypothecate securities in order to convert customer-owned securities to securities that are accepted by the DCO. This process is commonly referred to as collateral transformation. If a customer deposits securities that are permitted to be deposited with a DCO, the FCM nonetheless must be authorized to hypothecate and re-hypothecate securities in order to transfer customer securities to a DCO to meet customer margin requirements and to enter into repurchase and reverse repurchase transactions with permitted third-parties. Because customer funds are held in an omnibus account, an FCM must have the authority to hypothecate and re-hypothecate the funds and collateral of all customers whose funds are held in that account.

23. If the FCM engages in a repurchase or a reverse repurchase transaction, where are the funds or collateral received in that transaction held?

All funds or securities received in repurchase and reverse repurchase transactions are held in the appropriate customer account, i.e., customer segregated account, secured amount account or cleared swaps collateral account. Further, as noted above, in accordance with the provisions of Commission Rule 1.25, all such funds or collateral must be received in the appropriate account on a delivery versus payment basis in immediately available funds.

24. What happens to the gains and losses associated with the investment of customer funds?

Section 4d(a)(2) of the Act authorizes FCMs to invest customer segregated funds in obligations of the United States, in general obligations of any State or of any political

subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States. Section 4d(f) authorizes FCMs to invest cleared swaps customer collateral in similar instruments. Commission Rule 1.25 authorizes FCMs to invest customer segregated funds, cleared swaps customer collateral and the foreign futures and foreign options secured amount in instruments of a similar nature.

In accordance with Commission Rule 1.29, the FCM is entitled to all gains earned and is responsible for losses incurred in connection with the investment of customer funds. However, the FCM and customer may agree that the FCM will pay the customer interest on the funds deposited.

The responsibility of an FCM for all losses incurred in connection with the investment of customer funds was confirmed by the US District Court in *Marchese v. Shearson Hayden Stone, Inc.* 644 F.Supp. 1381(C.D. Cal. 1986), *aff'd*, 822 F.2d 876 (9th Cir. 1987). In *Marchese*, the District Court noted that Commission Rule 1.28 requires an FCM that invests customer funds in accordance with Rule 1.25 to include such obligations in segregated account records and reports at values which at no time exceed current market value. The Court then held:

Since the FCM must maintain funds in an amount equal to the amount deposited by the customer and the profits realized on the customer's futures transactions, the FCM must add its own funds to the account [i.e., top up] if the value of the obligations decreases. . . . The FCM, therefore, bears the risk of a decline in the value of the investments. Fn. 15.

The Commission recently reaffirmed this view in adopting rules governing the protection of cleared swaps customer collateral.

III. Basics of FCMs

25. What is the purpose of the FCM's capital requirement? Can it be used to cover a shortfall in customer funds?

The purpose of the FCM's capital requirement is to assure that the FCM has sufficient capital to protect customers in the event of any inadequacy in customer funds arising from the default of one or more customers, adverse market conditions, or for any other reason. As discussed above, in accordance with the provisions of Commission Rule 1.22, an FCM is required to use its own capital to make up any deficiency, if the customer fails to have sufficient funds on deposit with the FCM to meet the customer's obligations. In the event an FCM's capital is insufficient to make up for the shortfall caused by one or more defaulting customers or for any other reason, non-defaulting customers (or all customers) should share in any loss pro rata.

The FCM's capital is also designed to assure that the FCM has the resources to maintain the infrastructure, e.g., personnel, recordkeeping systems, risk management systems, and supervisory and compliance procedures, necessary to operate its business in accordance with applicable laws and rules for the protection of customers.

26. What is the time difference between when the DCO or DCM calls the FCM for margin and the FCM collects from the customers?

An FCM may require a customer to meet a margin call intraday. Institutional customers generally meet margin calls by wire transfer within one business day. However, an FCM generally is not required to take a capital charge as a result of the failure of a customer to meet a margin call, unless the customer fails to meet the call within three business days following the date on which the call is made. Notwithstanding this general rule, an FCM must take a capital charge with respect to cleared credit default swaps (CDS), if a customer does not meet a margin call within one business day following the date on which the call is made.

As discussed above, if a customer does not have sufficient funds on deposit with the FCM to meet a margin call, the FCM must use its own capital to meet the call.

27. If a customer has excess funds or collateral in its account, and a different customer has a margin call, can the FCM use a customer's excess funds to meet the other customer's margin call? What do FCMs do to prevent that from happening?

As discussed above, Commission Rule 1.22 prohibits an FCM from using the funds of one customer to meet the obligations of another customer. To prevent this from happening, an FCM will generally maintain a portion of its own capital in the customer omnibus account.

28. Why must a customer meet a margin call within three business days after the call is made?

A customer's failure to meet a margin call within the time prescribed by the FCM may expose that FCM and its other customers to unnecessary risk. To encourage a customer to meet margin calls promptly, when an account is undermargined for more than three business days after a margin call has been made, the FCM may only accept orders from the customer that serve to reduce the risk of existing positions in the account. In addition, as discussed above, an FCM must take a charge against its capital if a customer fails to meet a margin call within three business days after the call is made.

IV. Joint FCM/Broker-Dealers

29. If an FCM is also a BD, is there a single capital pool or is there a separate capital requirement for each function?

If an FCM is also a broker-dealer, the FCM is required to maintain capital equal to or greater than the higher of its capital requirement as an FCM and its capital requirement as a broker-dealer. An FCM-broker-dealer, therefore, maintains a single pool of capital.

30. If a customer has a securities account and a futures account at a joint BD/FCM, why can't a customer leave the money in the securities account but allow the FCM to count it as covering a futures margin call so that it is covered by SIPC?

The Act and Commission rules require an FCM to hold funds deposited to margin futures and options on futures contracts traded on US designated contract markets in customer segregated accounts. Similarly, FCMs must hold funds deposited to margin cleared swaps and futures and options on futures contracts traded on foreign boards of trade in a cleared swaps collateral account or a foreign futures and foreign options secured amount account, respectively. In computing its segregation requirements under the Act and relevant Commission rules, an FCM may only consider those funds actually held in the applicable accounts. In this regard, the Joint Audit Committee's Margins Handbook confirms that an FCM may not apply free funds in an account under identical ownership but of a different classification or account type (e.g., securities, customer segregated, foreign futures and foreign options secured) to an account's margin deficiency. The funds must actually transfer to the identically owned undermargined account in order for them to be used for margin purposes.

Although Commission rules permit an FCM/broker-dealer to loan the required margin to the customer, any such loan would be required to be secured by the assets held in the customer's securities account. SIPC insurance would not be available to the extent of such security interest.

V. DCO Guarantee Fund

31. Will a DCO's guarantee fund compensate a customer in the event the customer's FCM becomes insolvent and there is a shortfall in the customer segregated account maintained by the insolvent FCM?

A DCO's guarantee fund does not compensate customers of a defaulting FCM. The purpose of the guarantee fund is to meet the DCO's obligations to other clearing members arising from the default of the clearing member FCM.



**Futures Industry Association
2001 Pennsylvania Avenue, NW
Suite 600
Washington, DC 20006
202.466.5460 / 202.296.3184 fax
www.futuresindustry.org**