To be, or not to be, an FCM’s depository for customer funds?

BY EDWARD IVEY, CAIRD FORBES-COCKELL, MARK MIDDLETON AND NOAH MELNICK

The recent efforts of the Commodity Futures Trading Commission (the “CFTC”) to enhance customer protections have focused on futures commission merchants (“FCMs”) and the depositories they use to hold customer funds. FCMs must now look more critically at, and conduct ongoing monitoring of, such depositories. Simultaneously, domestic and foreign depositories willing to face FCMs must now agree to standardized template agreements with FCMs, creating new obligations, reiterating the limited permitted uses of deposited funds and the potential liability they face as holders of customers’ funds. The new enhanced customer protection regulations apply to FCMs’ futures customers’ funds, foreign futures customers’ funds and cleared swaps customers’ funds.

1. Enhancing Protections and Risk Management Programs

The CFTC’s final rule, “Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations” (the “Final Rule”), adopted new regulations and amended existing regulations in an effort to further protect customer funds entrusted to derivative clearing organizations (“DCOs”) and FCMs. The Final Rule seeks to afford greater protections to customers by providing more information to them and increasing regulatory requirements imposed on FCMs holding customer funds.1 Pursuant to the Final Rule, customers will receive more notices associated with adverse financial events and updated risk disclosures. New and amended regulations regarding capital, liquidity, audits, examinations and extensive internal compliance programs will require significant changes to how FCMs operate, monitor and comprehensively manage risks. Fortunately, such changes will be gradual. Although the effective date for the Final Rule was January 13, 2014, compliance dates are phased in through 2015.2 During this time, FCMs must update internal processes and procedures, review relationships with auditors, accountants and depositories, and potentially end such relationships if compliance with applicable regulations cannot be achieved.

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The approaching July 12, 2014 compliance date is particularly significant for both FCMs and their depositories holding futures customer funds, foreign futures customer funds and/or cleared swaps customer funds (“Permitted Depositories”). By such date, FCMs must have: (1) filed with the CFTC a new “Risk Management Program” in compliance with new CFTC Regulation 1.11; and (2) as part of the Risk Management Program, obtained new acknowledgment letters in the form of Appendix A to CFTC Regulation 1.20 (the “Acknowledgment Letter”) from Permitted Depositories that supersede the respective parties’ current acknowledgment letters obtained under pre-amended CFTC Regulation 1.20. Although certain aspects of the Risk Management Program may not necessitate significant internal changes, completing a comprehensive review, approving any obligatory changes and having material prepared for submission before July 12, 2014 will require significant time and resources. Full compliance by July 12, 2014 may be difficult for any FCM not devoting such time and resources towards compliance.

The Risk Management Program requires, in part, that FCMs holding customer funds have appropriate internal programs monitoring and managing the risks associated with the FCM’s activities as an FCM. Rather than prescribe rigid organizational structures and/or procedures, the Final Rule provides a more flexible approach by often combining an amorphous “policies and procedures” requirement with a non-exclusive list of elements that must be a part of any Risk Management Program. To implement and oversee the Risk Management Program, all FCMs must establish an independent “risk management unit” with “sufficient authority, qualified personnel, and financial, operational, and other resources” to carry out the Risk Management Program. Although many FCMs may already have internal policies and procedures similar to what the Final Rule requires, significant changes may be necessary to the relevant portions relating to Permitted Depositories.

FCMs must look actively and critically at their Permitted Depositories and ensure they meet certain baseline criteria. FCMs will also need to amend their account opening procedures to provide for the execution of the Acknowledgment Letter, confirming that the customer account is appropriately titled, and submitting copies of the Acknowledgment Letter to the CFTC. Each of the aforementioned must be a part of any account opening procedure.

Although bringing internal procedures up-to-date may not require radical changes, FCMs may experience resistance when delivering unamendable Acknowledgment Letters to their Permitted Depositories for execution. FCMs will likely face questions and concerns as to how the Acknowledgment Letter impacts liability risks, impacts existing relationship documentation and imposes new contractual obligations on Permitted Depositories. The back-and-forth that is sure to follow may result in long lag times between initial delivery and execution of the Acknowledgment Letter. FCMs, Permitted Depositories and their respective advisors that understand the Acknowledgment Letter and have considered the surrounding issues will be better suited to ensure the correct documentation is in place prior to the July 12, 2014 deadline.

2. FCMs’ Evaluation and Selection of Permitted Depositories

Traditionally, the CFTC’s regulations on the types of entities that may be Permitted Depositories were the only restriction on who could hold an FCM’s customer funds (e.g., banks, trust companies, other FCMs, foreign brokers, and money market mutual funds), with depositories located outside of the United States limited to those permitted under CFTC Regulation 1.49 (for futures and cleared swaps customer funds) and 30.7(c)(1) (for foreign futures customer funds). The Final Rule further restricts Permitted Depositories to those that can satisfy the minimum criteria set forth in the CFTC’s Risk Management Program. This new procedural requirement in the process of selecting one or more Permitted Depositories will require diligence gathering and comprehensive evaluations that meet the requirements of the Final Rule.

FCMs must establish internal Permitted Depository assessments examining the risks associated with holding customer funds in a particular Permitted Depository by analyzing capitalization, creditworthiness, operational reliability, access to liquidity, availability of deposit insurance, and the regulation and supervision of the potential Permitted Depositories. Yet, the Final Rule does not prescribe quantitative and/or qualitative parameters for the required criteria. Instead of setting minimum thresholds, the regulator left this decision to each FCM.

As FCMs begin to tailor their Permitted Depository evaluations, they will need to independently determine minimum quantitative and/or qualitative threshold requirements. For example, whether an
FCM would utilize a Permitted Depository whose senior debt dropped below investment grade is an independent determination to be made by the FCM. Static objective requirements based on this sort of analysis may present an easier process to document and re-affirm, which is particularly beneficial in light of an FCM’s new ongoing monitoring requirements under the Final Rule. However, dynamic and subjective requirements such as a bespoke floating minimum creditworthiness requirement determined based upon various other inputs (e.g. capitalization and operational reliability) may better address the ebbs and flows of the financial markets. Such an analysis may be more costly and time-consuming, but if the CFTC ultimately finalizes regulations making it an FCM’s responsibility to cover customers’ losses in the event of a bank default, the more dynamic and bespoke analysis may better mitigate the risk that any single Permitted Depository is a bad apple.

Whether static and/or dynamic requirements are utilized by an FCM, the relevant policies and procedures will need to be submitted to the CFTC and reviewed by the CFTC as part of the CFTC’s larger review of the applicable FCM’s new Risk Management Program. The final evaluation procedures must be approved by the “governing body” of the FCM and continue to be conducted at least annually on the Permitted Depositories holding an FCM’s customers’ funds.

3. Permitted Depositories

The requirement for an FCM to obtain an acknowledgment letter from a Permitted Depository holding customer funds is not a new CFTC requirement. However, mandatory use of the new standardized template Acknowledgment Letter is a significant departure from past practices. Indeed, the new letter will expressly supersede any preexisting acknowledgment letter, but as discussed in more detail in Part 3.3 below, the operable language has a limited scope. Yet still, combine these two elements, and Permitted Depositories’ initial reactions are not likely to be favorable. Permitted Depositories will want to know (and FCMs should be prepared to explain) not only what is “new,” but what the effect is on the old acknowledgment letter’s negotiated covenants and obligations. Is this a case of “out with the old, in with the new” or something in-between?

3.1. New Acknowledgment Letter

A Permitted Depository accepting customer funds is required to agree to the Acknowledgment Letter without negotiation. After providing the full name of the customer’s account and its abbreviated name (if applicable), the remainder of the Acknowledgment Letter emphasizes the obligations of the Permitted Depository, requiring it to:

(i) acknowledge and agree that the funds cannot be used to secure any obligation of the FCM to the Permitted Depository or used by the FCM to secure or obtain credit from the Permitted Depository;

(ii) agree to reply promptly and directly to any request from the CFTC or the FCM’s designated self-regulatory organization (“DSRO”) for confirmation of account balances or provision of any other information regarding or related to an account;

(iii) agree that the Permitted Depository will allow the CFTC and the FCM’s DSRO to examine the accounts at any reasonable time; and

(iv) acknowledge and agree that the Permitted Depository will provide the CFTC with technological connectivity necessary to permit read-only electronic access to the accounts.

The old acknowledgment letter only required that the Permitted Depository acknowledge the restricted nature of the customer funds, similar to what is provided in obligation (i) above. This may cause some parties to review only superficially the implications of the acknowledgment and agreement regarding the restricted uses of customer funds. Such a cursory review would, however, be misplaced. Permitted Depositories should review and confirm that current liens and set-off rights are consistent with the CFTC’s recent interpretation of this limitation in the Final Rule. As we discuss in more detail below, for some, the recent interpretation may require significant changes to pre-funding requirements and/or the provision of overdraft protection by a Permitted Depository.

Provisions permitting the set-off between receivables and payables are not uncommon in Permitted Depository agreements in which the Permitted Depository may advance funds to an FCM or the FCM’s customer account. Typically, the Permitted Depository may make such an advance when a DCO withdraws funds directly from the applicable FCM account, but the FCM has not yet deposited the required margin. This service from the Permitted Depository mitigates the risk that an FCM will
default on a margin call, but also presents credit risk to the Permitted Depository advancing funds until the FCM deposits corresponding margin. To mitigate this credit exposure, Permitted Depositories may request certain liens or set-off rights. However, the ability to set off against a customer account is limited.

The Permitted Depository’s right to set off against a customer account is only exercisable when such right does not represent an extension of credit secured by customer funds. This sort of permitted set-off occurs in the following two instances:

(i) a Permitted Depository setting off amounts between the cash account holding customer funds and its affiliated custodial account containing securities purchased with customer funds from such cash account; and

(ii) a Permitted Depository holding customer funds in one segregated account setting off amounts withdrawn from another account in instances where the Permitted Depository advances funds in lieu of converting cash held in different currencies.27

In the Final Rule, the CFTC stated that arrangements whereby a Permitted Depository provides intraday advances to the customer account, on the condition that the Permitted Depository would have a lien on the account or right to set off in the customer account, are prohibited.28 This interpretation is a significant change for many market participants who during the original rule’s proposal advised the CFTC that those arrangements were commonplace and facilitated the transfer of margin from a Permitted Depository to a clearing house making a margin call. Overdraft coverage was provided to account for the fact that, in the course of some margin calls, a customer may receive a margin call through an account statement, which is transmitted overnight. The customer then wires funds the following day. However, the clearing house may not wait until funds are deposited at the Permitted Depository. Instead, there may be an automatic withdrawal from the customer account at 9:00 A.M. Permitted Depositories that wish to continue advancing funds to customers to meet such 9:00 A.M. withdrawals can no longer claim a right of set-off against the customer account to which they advanced funds.29 Similar issues may arise with new transactions that are not pre-funded.

An FCM may forgo collecting margin funds from a customer prior to effecting a customer’s transaction. This sort of pre-funding of transactions is not expressly required30 by the Commodity Exchange Act (as amended, the “CEA”) but there is a risk that a DCO could withdraw funds from the Permitted Depository’s customer account related to the new transaction before the FCM has deposited the customer funds. Prior to the Final Rule, some FCMS may have arranged for their Permitted Depository to provide overdraft protection in such instances, but if that protection was secured by a lien or set-off right in the customer account, then the FCM and Permitted Depository will need to change how they plan to secure the overdraft risk.

To mitigate the risk that funds are never deposited to cover advances by a Permitted Depository, such Permitted Depository may require liens and set-off rights against the proprietary account or other property of the FCM not protected as customer funds. Such liens and/or set-off rights are permitted. However, if the FCM does not hold a proprietary account at the Permitted Depository in which such Permitted Depository can perfect its security interest by control, then the FCM may be unable to get overdraft protection without providing another form of collateral protection.31

As a practical matter, Permitted Depositories may require FCMS to maintain their proprietary accounts at such Permitted Depositories. In other instances, FCMS may begin pre-funding transactions and increasing buffers to avoid the necessity of overdraft protection. How, or if, an FCM passes on this cost to its customers, or absorbs it internally, will be a commercial issue to be resolved between the FCM and its customers. Smaller FCMS unable to absorb much of the costs and/or spread the costs among many customers may ultimately be unable to compete in such an environment, especially in light of all of the other costs of compliance stemming from increased regulation. Permitted Depositories may also lose business as some FCMS consolidate Permitted Depositories. Other FCMS unable to compete due to increased costs may leave the market. Ultimately, the Final Rule, intended to further protect customers, may further concentrate risk into fewer and fewer financially-capable market participants, at least in respect of Permitted Depositories specifically and potentially in respect of FCMS more generally.

3.2. New Obligations – Information Requests, Examination Requests and Read-Only Access

The Acknowledgment Letter also requires that the Permitted Depository provide regulators increased access and information related to the FCM’s customer accounts. This may be obtained via infor-
mation requests, examination requests and the readonly access to certain account information for appropriate government officials and representatives.32

Permitted Depositories receiving information requests and/or account examination requests must “reply promptly” with respect to any information related to the customer account.13 Additionally, the customer account(s) may be examined “at any reasonable time.” Information and/or examination requests may come from only certain officials and must be granted without requiring any further notice or consent from the FCM.34

Since the above requirements and related acknowledgment and agreements are embodied in the non-negotiable Acknowledgment Letter, Permitted Depositories should update internal policies to confirm the authority of individuals making any information or examination requests13 and engage in any usual and customary authorization verification and authentication procedures. Such an update not only mitigates the liability risk of negligently providing confidential information to an inappropriate individual, but also should ensure that the Permitted Depository can avail itself of the Acknowledgment Letter’s limitation of liability provision regarding information and examination requests.36

3.3. Out with the Old Acknowledgment Letters?

As noted above, prior to the Final Rule, acknowledgment letters were bespoke documents. The only requirement was that the Permitted Depository acknowledge that the funds deposited in the applicable account were the FCM’s customer funds and the funds were being held in accordance with the CEA and the CFTC’s regulations. Beyond these two elements, the form and substance of such an acknowledgment letter could be negotiated to provide desirable liability waivers, indemnity or other provisions to address any other risks or concerns of a particular Permitted Depository. What happens to such previously-agreed bespoke terms? Does the “new” Acknowledgment Letter supersede them?

The CFTC refers to the Acknowledgment Letters as something that will “replace existing acknowledgment letters with new ones...”37 However, no broad language to this effect is included in the Acknowledgment Letter. Instead, the Acknowledgment Letter provides that it only takes priority and supersedes the old acknowledgment letters “to the extent that such prior agreement is inconsistent with the terms hereof.” Such language leaves parties an option to either (a) rely on old acknowledgment letters to the extent they contain provisions which continue to be enforceable even after execution of the Acknowledgment Letter or (b) negotiate new side agreements that will supplement the Acknowledgment Letter.

Permitted Depositories that wish to consider relying on old acknowledgment letters must review the letters to ensure their enforceability and certainty as to any interpretive issues due to the Acknowledgment Letter. The lack of severability provisions and/or providing provisions with questionable legality/enforceability based on changes in the customer protection regime (e.g., provisions related to liens or set-off rights which could implicate customer funds) could raise enforceability issues. This and other risks that may result from interpreting an old acknowledgment letter that never anticipated the Final Rule and the standardized template may cause many Permitted Depositories to discard the old acknowledgment letter in favor of negotiating a side agreement to supplement the Acknowledgment Letter.

Permitted Depositories uneasy about the ramifications of the Acknowledgment Letter and any prior agreements may decide to condition the execution of the Acknowledgment Letter on executing supplemental side agreements. Although the template Acknowledgment Letter may not be edited (unless parties receive express relief from the CFTC), parties may draft supplemental side agreements. Matters which may be negotiated in side agreements are limited to those not specific to the laws and regulations governing the holding of customer funds as provided in Section 4d of the CEA (“4d Matters”).38 This would permit parties to reaffirm notices, waivers and indemnification requirements not found in the Acknowledgment Letter and/or consider additional agreements not specific to 4d Matters but that may be desirable to address new customer protection requirements (e.g., residual interest requirements, permitted liens and/or set-off rights, and confidentiality waivers related to information/examination requests).

Examples of impermissible agreements related specifically to 4d Matters would be attempts to negotiate terms altering the obligation of the Permitted Depository to hold the customer funds in accordance with the CEA and applicable CFTC regulations or otherwise conflict with any terms of the Acknowledgment Letter. Based on this limitation, parties would be advised to include in any supplemental side agreement that such agreement (1) supersedes and replaces any prior acknowledgment, and (2) is subject to the Acknowledgment
Letter. Such language addresses both the legal status and priority of the agreements between the parties in connection with the customer account. With a well drafted supplemental side agreement, parties should be able to obtain greater certainty as to the impact that the Acknowledgment Letter will have on their relationship and old acknowledgment letter.

3.4. Liability Risks for Permitted Depositories?

Although the CFTC explicitly noted that it did not intend for the Acknowledgment Letter to expand the scope of a Permitted Depository’s liability to FCM account holders, the Acknowledgment Letter does reinforce the regulatory obligations imposed on a Permitted Depository holding customer funds. Regarding the use of customer funds, the Acknowledgment Letter provides, in part, that:

“[The Permitted Depository] may conclusively presume that any withdrawal from the Account(s) and the balances maintained therein are in conformity with the [CEA] and CFTC regulations without any further inquiry, provided that, in the ordinary course of [the Permitted Depository’s] business as a depository, [the Permitted Depository has] no notice of or actual knowledge of a potential violation by [the FCM] of any provision of the [CEA] or the CFTC regulations that relates to the segregation of customer funds; and [the Permitted Depository] shall not in any manner not expressly agreed to herein be responsible to [the FCM] for ensuring compliance by [the FCM] with such provisions of the Act and CFTC regulations; however, the aforementioned presumption does not affect any obligation [the Permitted Depository] may otherwise have under the [CEA] or CFTC regulations.” (emphasis added).

Are there instances where a Permitted Depository cannot presume an FCM’s withdrawal from the customer account in conformity with the CEA and CFTC regulations?

How should the Permitted Depository be monitoring the customer account?

Permitted Depositories concerned about their potential liability risks should regularly review their policies and procedures limiting the permitted uses of customer funds. As noted earlier, a Permitted Depository is prohibited from treating any segregated customer funds as belonging to any person other than the customer. Permit Depositories should also confirm that internal procedures exist that are designed to prevent an FCM from improperly utilizing customer funds. Although Permitted Depositories do not have an affirmative obligation to monitor an FCM, Permitted Depositories can be held liable for an FCM’s improper use of customer funds if the Permitted Depository “knew or should have known” of such improper use. For example, as part of the fall-out from the collapse of Peregrine Financial Group, Inc. (“Peregrine”), the CFTC has brought an action against a Permitted Depository holding Peregrine’s customer funds. The CFTC alleges that Peregrine essentially utilized the customer account as Peregrine’s commercial checking account and the Permitted Depository is liable for facilitating the transfers of millions of dollars of customers’ funds out of the customer account that paid for personal expenses of Peregrine’s owner.

Although the CFTC’s accusations against Peregrine’s Permitted Depository may provide an extreme example, all Permitted Depositories will want to ensure appropriate restrictions are in place and any red flags are quickly resolved. If a Permitted Depository knows or suspects that funds held in a customer account have been improperly withdrawn or otherwise improperly used, the Permitted Depository is expected to “immediately” report its concern to the Division of Swap Dealer and Intermediary Oversight of the CFTC (the “DSIO”), the Division of Clearing and Risk of the CFTC (the “DCR”), the CFTC’s Division of Enforcement, or the CFTC’s Whistleblower Office.

4. International Depositories

The use of Permitted Depositories not located in the United States (“International Depositories”) is not uncommon, although the use of an International Depository is subject to the additional requirements in CFTC Regulations 1.4944 and 30.7 (for foreign futures customer accounts). International Depositories’ reaction to the non-negotiable Acknowledgment Letter may present the largest hurdle for FCMs seeking to have executed Acknowledgment Letters in place prior to July 12, 2014. Similar concerns were voiced to the Financial Conduct Authority (“FCA”) in the United Kingdom when it also recently proposed a standardized acknowledgment letter for certain regulations regarding customer/client accounts. Comments to both the CFTC and the FCA highlighted the fact that some foreign banks would not only refuse to execute the letters, but in fact would not be legally permitted to do so because of terms therein that could not be modified.

The FCA’s and the CFTC’s acknowledgment templates are similar in many respects and common
concerns among international entities are warranted. Both letters require the applicable bank to acknowledge the separate and segregated nature of the customer/client account(s) and agree to the limited rights such bank has against funds deposited in such account(s). Both also lack any exception permitting amendments to the template letter, even if necessary to comply with applicable law. However, the CFTC recognizes that there may be valid reasons for an International Depository to require amendments to the Acknowledgment Letter. In such instances, the CFTC is willing to consider “alternative approaches, including no-action relief, on a case-by-case basis.”48 What the CFTC will consider to be “valid reasons” is currently unclear. We anticipate that the CFTC would take a narrow view of what constituted a valid reason, restricting amendments to those that can be shown to be necessary.

For example, parties requesting an amendment should be prepared to evidence why such amendment represents a required change to address applicable law. However, even if this is possible, the time it takes to prepare the appropriate request for relief from the CFTC and have such relief reviewed and granted, may very well reach beyond the July 12, 2014 deadline. In the short term, International Depositories and FCMs may wish to consider whether particular issues or concerns can be addressed by supplementing the Acknowledgment Letter with a side agreement as discussed above in Part 3.3 of this article.

Those FCMs prepared to explain the content and implications of the Acknowledgment Letters to International Depositories, and to work with them to address issues unique to their international status, will be best positioned to ensure Acknowledgment Letters are executed and in place before July 12, 2014. If parties ultimately wish to amend the Acknowledgment Letter to address issues that cannot be dealt with in a side letter, reassurance that such amendments are necessary and will not compromise any customer fund protections will be critical to the obtaining of any variance or relief from the CFTC.

5. To Be a Permitted Depository?

In our experience, counterparty reactions to execution requests for a template document on a “take it or leave it basis” are not often described as positive. We do not expect initial reactions to the Acknowledgment Letter to be much different.

However, as market participants begin to better understand the document and get comfortable with it, executing and filing49 the Acknowledgment Letter may just become part of standard compliance operations. However, whether parties will attempt to negotiate new supplemental side agreements, continue to rely on terms in old acknowledgment letters or simply amend old acknowledgment letters to account for the Acknowledgment Letter will be a decision for each market participant. We expect this to be one of the more significant hurdles to having the Acknowledgment Letters executed before the July 12, 2014 deadline. In a changing regulatory environment, relying on older terms, even where allowed, that were based on the regulatory environment pre-Dodd-Frank, MF Global and Peregrine may be unwise.

Other significant changes to the market will result from the CFTC’s determination that Permitted Depositories cannot rely on set-off rights or liens on the customer funds to secure advances in respect of such accounts. Whether FCMs will require pre-funding of certain transactions and/or increase margin requirements, customer costs will undoubtedly increase and may prove a barrier to entry for customers lacking sufficient capital to meet the FCM’s funding/margin requirements (e.g., smaller corporates and agricultural businesses), thus limiting the ability for such potential customers to engage the services of an FCM. Smaller FCMs who served these customers with more limited capital constraints may also exit the market or consolidate due to a shrinking pool of potential clients. Permitted Depositories will also wish to reconsider current arrangements and relationships with FCMs. Not only will the FCMs review a Permitted Depository based on its Risk Management Program, but Permitted Depositories will wish to review their FCMs and have in place active policies and procedures that could identify questionable withdrawals or uses of customer funds.

Although the Final Rule may present a win for customer protections, the CFTC has also made clear that in the post-MF Global and post-Peregrine environment, one way to incentivize market participants to ensure customer funds are appropriately protected is make sure market participants are aware of regulatory obligations and to hold them accountable for their failures. The Acknowledgment Letter achieves the goal of awareness. A Permitted Depository will need to independently consider accountability, to what extent it can operationally mitigate risks associated with information/examination requests, permitted uses of customer funds and activities of the customers’ FCM. Ultimately, the Permitted Depository must determine whether it still wants...
to continue holding customer funds in this new paradigm of increased regulation and related costs.

NOTES

1. The Final Rule also added protections to funds held at DCOs and depositories utilized by DCOs, and although not covered herein extensively, note 21 provides some requirements unique to DCOs regarding acknowledgment letters.

2. Final Rule at 68577.

3. 17 C.F.R. § 1.20(b) (futures customer funds), 22.4 (cleared swaps customer funds) and 30.7(c) (foreign futures customer funds). Permitted Depositories for an FCM generally include a bank or trust company, a DCO or another FCM. The use of a Permitted Depository outside of the United States is generally covered in CFTC Regulations 1.49 and 30.7(c)(1).

4. An FCM’s “Risk Management Program” must: (1) consist of written policies and procedures that have been approved by the “governing body” of the FCM (see note 18 infra) and furnished to the CFTC; and (2) establish a risk management unit that is independent from an FCM’s “business unit” to administer the Risk Management Program. 17 C.F.R. §§ 1.11(c) and 1.11(d).

5. A copy of the Acknowledgment Letter is provided in the Final Rule at 68629-30.

6. See note 38 infra.

7. The July 12, 2014 compliance date is for legacy accounts opened before January 13, 2014. For any customer account opened on or after January 13, 2014, the Acknowledgment Letter should already have been obtained.

8. FCMs will also be required to obtain an Acknowledgment Letter from any depository holding instruments described in CFTC Regulation 1.25 in which such FCM has invested customer funds. However, if an FCM invests funds with a money market mutual fund, the FCM must use the template letters in the appendices of CFTC Regulation 1.26, rather than the Acknowledgment Letter provided in CFTC Regulation 1.20. See 17 C.F.R. § 1.26.

9. The CFTC noted that the requirements in CFTC Regulation 1.11 only apply to “FCMs that accept money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result from soliciting or accepting orders for the purchase or sale of any commodity interest. FCMs that do not accept or hold customer funds to margin, guarantee or secure commodity interests are generally not operating as FCMs, and are not subject to § 1.11. To clarify, the [CFTC] notes that it would expect registered FCMs that do not accept customer funds to establish a Risk Management Program that complies with § 1.11 and file such program with the [CFTC] and with the FCMs’ DSROs prior to changing their business model to begin accepting customer funds.” Final Rule at 68517.

10. CFTC Regulation 1.11(e) provides that the elements that must be a part of the Risk Management Program of an FCM include: (1) identifying risks (including risks posed by affiliates, all lines of business of the FCM, and all other trading activity of the FCM) and setting of risk tolerance limits; (2) providing periodic risk exposure reports to senior management and the governing body; (3) operational risk controls; (4) capital controls; and (5) establishing a risk management program that takes into account risks associated with the safekeeping and segregation of customer funds.

11. 17 C.F.R. § 1.11(d).

12. Submission must be made within three business days of opening an account or obtaining a new Acknowledgment Letter for an existing account. 17 C.F.R. §§ 1.20(d)(7) and (g)(4) (v) and 30.7(d)(7). Permitted Depositories must also agree to provide a copy of the Acknowledgment Letter to the CFTC (and the FCM’s DSRO) within the same time frame. 17 C.F.R. §§ 1.20(d)(4) and (g)(4)(v) and 30.7(d)(4). The acknowledgment letter must be executed upon the opening of the account, regardless of when customer funds are deposited in the account. Final Rule at 68538 (n. 231).

13. 17 C.F.R. § 1.11(e)(3)(ii)(C). FCMs must establish an account opening process that: (1) ensures the Permitted Depository acknowledges that funds in the account are customers’ funds before any deposits are made to the account; and (2) ensures accounts are appropriately titled by the Permitted Depository to reflect that such account is holding segregated customer funds. The account opening procedures must also include authorization, verification and signature authentication policies related to obtaining an executed Acknowledgment Letter. Additionally, FCM compliance procedures must be implemented to confirm that the Acknowledgment Letter is executed by an individual authorized to bind the Permitted Depository and that the signature that appears on the letter is authentic. As an example, the CFTC provided that an FCM may request from the Permitted Depository “a list of authorized signatories, a duly executed power of attorney, or other such documentation.” Final Rule at 68538. An FCM cannot deposit customer funds into an account prior to execution of the Acknowledgment Letter. 17 C.F.R. § 1.11(i)(C).

14. The Final Rule amended 30.7, and now the limitations on Permitted Depositories are gen-
21. Similar to FCMs, DCOs will also be required to obtain acknowledgment letters from their Permitted Depositories holding customer funds ("DCO Template Letter"). 17 C.F.R. § 1.20(g)(4). The DCO Template Letter is largely similar to the FCM’s Acknowledgment Letter except that: (1) it does not require read-only electronic access; and (2) it does not require the Permitted Depository to agree to CFTC or DSRO examinations of customer accounts. DCOs designated as “systemically important” by the U.S. Financial Stability Oversight Council may elect to use the Federal Reserve Bank as a Permitted Depository. In such instances, Federal Reserve Banks are not required to execute a DCO Template Letter, but instead need only execute a written acknowledgment meeting the requirements set forth in CFTC Regulation 1.20(g)(4)(ii). Abbreviated names may be used when the full name is too long for the Permitted Depository’s operational system. However, the abbreviated name, like the full name, must clearly identify the account as a CFTC-regulated segregated/secured account that holds customer funds. Examples of possible abbreviations suggested by the CFTC include “segregated” being shortened to “seg,” “customer” being shortened to “cust” and “account” being shortened to “acct.” Final Rule at 68535.

22. 7 U.S.C.A. § 4d. For example, in In re JPMorgan Chase Bank CFTC 12-17 (April 4, 2012), the

23. Notwithstanding the Acknowledgment Letter, such limitation is imposed on a Permitted Depository pursuant to CEA at 7 U.S.C.A. §§ 4d(b) and 4d(f)(6); see also 17 C.F.R. § 1.20(f)(3).

24. Such agreement is required from the Permitted Depository pursuant to 17 C.F.R. §§ 1.20(d)(6) and 30.7(d)(6).

25. Such agreement is required from the Permitted Depository pursuant to 17 C.F.R. §§ 1.20(d)(5) and 30.7(d)(5).

26. Such agreement is required from the Permitted Depository pursuant to 17 C.F.R. §§ 1.20(d)(3) and 30.7(d)(3).

27. See Final Rule at 68541; see also CFTC Interpretative Ltr. No. 86–9 (April 21, 1986).

28. Schwartz & Ballen LLP asserted in their comment letter that because many FCMs hold only cash assets in the accounts, the language in the Acknowledgment Letter should be expanded to permit banks to recover funds they advance that result in overdrafts in the accounts. Final Rule at 68540. The CFTC went on to explain that INTL FCStone, Inc. ("FCStone") further elaborated on this issue, "a customer receives a margin call through an account statement, which is transmitted overnight, and the customer wires funds the following day. The DCO, however, automatically drafts the funds from the FCM's account at 9:00 A.M. on the basis of a depository's intraday daylight overdraft. Without granting a depository a lien on customer funds, FCStone stated that an FCM would be required to 'front' all funds for customers until the customer has wired funds to the FCM." Id. In another comment letter, the CFTC noted that a group of depositories and custodian banks warned that as a result of the CFTCs interpretation "a depository may not be willing to provide intraday advances to the customer segregated account without the right to take a lien on the account." Id.
CFTC settled an action against a Permitted Depository because it unlawfully used customer funds when the CFTC found that the Permitted Depository permitted an intraday extension of credit to an FCM (Lehman Brothers) based upon customer funds the FCM had deposited with a bank (JPMorgan Chase).

30. See CFTC Letter No. 96-12 (January 31, 1996). Although pre-funding is not required, CFTC rules do prohibit an FCM from representing that it will not call for or attempt to collect initial margin and an FCM also must know that it will be able to collect initial margin from a customer as a matter of internal controls. Additionally, under revised CFTC Regulation 1.17, FCMs have an incentive to receive margin within one business day of an account being undermargined. CFTC Regulation 1.17 requires an FCM to take a capital charge for undermargined accounts that are undermargined for more than one business day (e.g., account is undermargined on Monday, FCM makes margin call on Tuesday, FCM incurs capital charge at close of business on Wednesday).

31. Some Permitted Depositories may require actual title transfers of collateral, particularly outside the United States such as the United Kingdom.

32. See note 34 infra.

33. See the Acknowledgment Letter.

34. The Acknowledgment Letter provides that potential information requests may come from the director of the DSIIO or the director of the DCR, or any successor divisions, or such directors’ designees, or an appropriate officer, agent, or employee of the FCM’s DSRO. Examination requests may come from the director of the FCM’s DSRO, or any successor divisions, or such directors’ designees, or an appropriate officer, agent or employee of the FCM’s DSRO.

35. Permitted Depositories will be able to verify and authenticate any individual making a request for information or electronic access by visiting the CFTC’s website where an up-to-date list of names (including title and contact information) of the directors of the DSIO and DCR will be provided. Final Rule at 68537. Such list will also include any successor divisions, and the directors’ designees, if any.

36. In the Acknowledgment Letter, the FCM expressly provides that it would not hold the Permitted Depository responsible for “acting pursuant to any information or access request,” provided that the Permitted Depository acted “in accordance with [the Permitted Depository’s] applicable policies and procedures to assure that such request was provided to [the Permitted Depository] by an individual authorized to make such a request.”

37. Final Rule at 68538.

38. The Acknowledgment Letter expressly provides that it supersedes any other agreement regarding 4d Matters. The applicable language provides that “In the event of any conflict between this letter agreement and any other agreement between the parties in connection with the Account(s), this letter agreement shall govern with respect to matters specific to Section 4d of the Act and the CFTC’s regulations thereunder, as amended.”

39. 7 U.S.C.A. §§ 4d(b) and 4d(f)(6).

40. Final Rule at 68539.


42. Id.

43. Final Rule at 68539.

44. CFTC Regulation 1.49 generally provides that customer funds may be held in either the United States, Canada, France, Italy, Germany, Japan, the United Kingdom or the country of the origin of the currency. Customer funds may be held elsewhere, but appropriate authorizations from the customer are necessary and the country in which the customer funds are held cannot be subject to sanctions by the Office of Foreign Assets Control of the U.S. Department of Treasury. International Depositories are also limited to FCMs, DCOs and banks or trust companies that have in excess of $1 billion of regulatory capital. Even with the use of International Depositories, an FCM still must have sufficient United States dollars held in the United States to meet all of its United States dollar obligations. CFTC Regulation 1.49.

45. CFTC Regulation 30.7(b) provides the permitted location of 30.7 customer funds to be: (1) a bank or trust company located in the United States; (2) a bank or trust company located outside the United States that has in excess of $1 billion of regulatory capital; (3) an FCM; (4) a DCO; (5) the clearing organization of any foreign board of trade; (6) a member of any foreign board of trade; or (7) such member’s or clearing organization’s designated depositories. 30.7 customer funds maintained outside the United States must be margin utilized to meet margin requirements, including pre-funding margin requirements, established by rule, regulation, or order of foreign boards of trade or foreign clearing organizations, or to meet margin calls issued by foreign brokers carrying the 30.7 customers’ foreign futures and foreign option positions. 17 C.F.R. 30.7(c).

47. Final Rule at 68536. The CFTC discussed comments received from Eurex Clearing AG, who believed that foreign depositaries would not be permitted to legally execute the Acknowledgment Letter. Eurex Clearing AG simply noted as a general matter that it believed some International Depositaries would not be legally permitted to execute the Acknowledgment Letter, but did not provide facts/examples to support this claim. Comments to the FCA’s proposal had similar concerns, although the FCA’s template limited choices of governing law and provided that England and Wales or Scotland or Northern Ireland must have the exclusive jurisdiction to settle any related disputes. The FCA received comments that some foreign depositaries are prohibited from agreeing to an exclusive jurisdiction clause. See British Bankers’ Association, “BBA Response to CP13/5 Review of the client assets regime for investment business,” available at https://www.bba.org.uk/wp-content/uploads/2013/10/BBA01-420816-v1-BBA_Response_to_CP13_5_Review_of_the_Client_As-...pdf; see also PricewaterhouseCoopers LLP, “Feedback on Consultation Paper 13/5 – Review of the client assets regime for investment business (the CP),” available at http://www.pwc.co.uk/en_UK/uk/assets/pdf/pwc-response-cp-13-5-11-october-2013.pdf.

48. Final Rule at 68536. The FCA has not finalized its standardized letter or concluded how it will ultimately address issues raised regarding International Depositaries.

49. Supra n. 13. Permitted Depositaries executing the Acknowledgment Letter must also provide copies to the CFTC and their applicable DSRO within three business days of execution. 17 C.F.R. §§ 1.20(d)(7) and 30.7(d)(7). For more on the procedures for filing the Acknowledgment Letter, see the “Division of Swap Dealer and Intermediary Oversight (DSIO) Notice to Futures Commission Merchants and Depositaries of Procedures for the Filing of Acknowledgment Letters for Accounts Holding Customer Funds and Other Financial Reporting Requirements” available at http://www.cftc.gov/ucm/groups/public/@forms/documents/files/dsonotice_20140205.pdf.