

AGENCY: Commodity Futures Trading Commission

ACTION: Amendment of Interpretation

SUMMARY: Section 4d(a)(2) of the Commodity Exchange Act (“CEA”) and related Commission regulations (hereinafter collectively referred to as “segregation requirements”) require that all funds received by a futures commission merchant (“FCM”) from a customer to margin, guarantee, or secure futures or commodity options transactions and all accruals thereon be accounted for separately, and not be commingled with the FCM's own funds or used to margin the trades of or to extend credit to any other person.¹ Further, Section 4d(a)(2) has been construed to require that customer funds, when deposited with any bank, trust company, clearing organization or another FCM, be available to the FCM carrying the customer account upon demand.²

In Financial and Segregation Interpretation No. 10, the Division of Trading and Markets (predecessor to the Division of Clearing and Intermediary Oversight (“Division”)) first addressed the issue of whether customer funds may be deposited at a bank in a safekeeping or custodial account (otherwise known as “safekeeping account” or “third-party custodial account”), in lieu of posting such funds directly with an FCM, without being deemed to violate the segregation requirements.³ Because Section 17(f) of the Investment Company Act of 1940,⁴ at the time, was interpreted by Securities and Exchange Commission (“SEC”) staff to generally bar registered investment companies (“RICs”) from using FCMs and futures clearinghouses as custodians of

¹ See note 7, *infra*.

² See note 8, *infra*.

³ Financial and Segregation Interpretation No. 10, Treatment of Funds Deposited in Safekeeping Accounts, Comm. Fut. L. Rep. (CCH) ¶ 7120 (May 23, 1984) (“Interpretation No. 10”). While specifically directed to third-party accounts of pension plans and registered investment companies, the views expressed in the interpretation applied equally to any other customer of an FCM (*e.g.*, an insurance company).

⁴ See note 12, *infra*.

fund assets, it was decided that the use of third-party custodial accounts should not be banned altogether and that Section 4d(a)(2) should be interpreted to permit customer funds to be held in such accounts, subject to standards designed to ensure the carrying FCM's right of immediate access to customer funds. Since the issuance of Interpretation No. 10, a change in the law governing the custody of fund assets now allows RICs, with a limited exception, to post customer funds with an FCM.⁵ Because it is no longer necessary for most RICs to use third-party custodial accounts to engage in futures transactions, coupled with evidence of significant risks that may impair immediate and unfettered access by FCMs, the use of third-party custodial accounts is no longer justified or appropriate, except in the limited case where the FCM is precluded from holding RIC assets.⁶ Accordingly, Interpretation No. 10 is being amended and FCMs will not be viewed as being in compliance with the requirements of Section 4d(a)(2) if they deposit, hold, or maintain margin funds for customer accounts in third-party custodial accounts, except that those FCMs not eligible to hold the assets of their RIC customers (*i.e.*, due to their affiliation with the RIC or its adviser) may use such accounts under conditions specified herein.

EFFECTIVE DATE: [Insert date nine months from the date of publication in the *Federal Register*.]

⁵ SEC Rule 17f-6, adopted 1996, permits RICs to deposit customer margin directly with FCMs and futures clearing houses. *See* Rule 17f-6, 17 CFR 270.17f-6, under the Investment Company Act, 15 U.S.C. 80a.

⁶ In February 2005, a notice was published in the *Federal Register* soliciting comments on a withdrawal of Interpretation No. 10 ("Notice of Proposed Withdrawal"). *See* 70 *Fed. Reg.* 5417 (February 2, 2005). In response thereto, the Commission received comments from the following entities: Investment Company Institute ("ICI"); National Futures Association ("NFA"); The Joint Audit Committee ("JAC"); Futures Industry Association ("FIA"); and AIG Series Trust ("AIG"). ICI and AIG opposed a withdrawal of Interpretation No. 10; NFA, JAC, and FIA supported a withdrawal of Interpretation No. 10 and an outright prohibition of third-party custodial accounts. The comment letters are available on the Internet at <http://www.cftc.gov/files/foia/comments05>.

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SUPPLEMENTAL INFORMATION:

I. Background: Section 4d and Interpretation No. 10

Section 4d(a)(2) of the CEA and related Commission regulations require that all funds received by an FCM from a customer to margin, guarantee, or secure futures or commodity options transactions and all accruals thereon be accounted for separately, and not be commingled with the FCM's own funds or used to margin the trades of or to extend credit to any other person.⁷ Further, Section 4d(a)(2) has been generally construed to require that customer funds, when deposited at a bank or other depository (*i.e.*, trust company, clearing organization, another FCM), be placed in an account subject to withdrawal upon demand by the FCM carrying the customer account.⁸ Thus, any impediments or restrictions on the FCM's ability to obtain immediate and unfettered access to customer funds are not permitted. The immediate and unfettered access requirement is intended to prevent potential delay or interruption in securing required margin payments that, in times of significant market disruption, could magnify the impact of such market disruption and impair the liquidity of other FCMs and clearinghouses.⁹

⁷ 7 U.S.C. 6d(a)(2). The Commission segregation requirements are set forth in Regulations 1.20-1.30, 1.32 and 1.36, 17 CFR 1.20-1.30, 1.32 and 1.36.

⁸ *E.g.*, Administrative Determination No. 29 of the Commodity Exchange Authority (Sept. 28, 1937) (deposit of customers' funds "under conditions whereby such funds would not be subject to withdrawal upon demand would be repugnant to the spirit and purpose of the Commodity Exchange Act"); Financial and Segregation Interpretation No. 9 – Money Market Deposit Accounts and NOW Accounts," 1 Comm. Fut. L. Rep. (CCH) ¶7119 (November 23, 1983) (at 7091-3) ("it has always been the Division's [Division of Trading and Markets] position that customer funds deposited in a bank cannot be restricted in any way, that such funds must be held for the benefit of customers and must be available to the customer and the FCM immediately upon demand").

⁹ *See, e.g.*, Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶ 7120, at 7133 ("[t]he free flow of required margin payments and the required deposits is absolutely essential to the proper functioning of the commodity exchanges. No customer, especially one who may maintain relatively large positions, can be permitted to interrupt that flow,

Interpretation No. 10 addressed the issue of whether customer funds may be deposited at a bank in a third-party safekeeping account, in lieu of posting such funds directly with an FCM, without being deemed in violation of Section 4d(a)(2).¹⁰ As was stated in Interpretation No. 10, the segregated customer funds account system, whereby customer funds are posted directly with the carrying FCM and held by the FCM on behalf of its customers, satisfies the essential requirements of Section 4d(a)(2) and is “administratively the most efficient way to treat such funds.”¹¹ At the time, however, RICs were generally precluded from using FCMs and futures clearinghouses as custodians of fund assets and third-party custodial accounts were the only permissible means available to RICs to participate in the futures market.¹² In view of this legal restriction on RICs’ custodial arrangements, the decision was made to permit the use of third-party custodial accounts to hold margin funds, without being deemed to violate Section 4d(a)(2), subject to standards designed to ensure FCMs’ immediate and unfettered access to the funds in such accounts.¹³

II. Basis for Amended Interpretation

Developments since the issuance of Interpretation No. 10 require reconsideration of the permissibility of third-party accounts by FCMs to deposit or hold margin funds for customer accounts. First, in 1996, the SEC adopted Rule 17f-6, which permitted RICs, with limited

or there will be the potential for serious adverse consequences to other market participants and the marketplace itself”).

¹⁰ See Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶ 7120.

¹¹ See Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶ 7120, at 7135.

¹² See Section 17(f) of the Investment Company Act, 15 U.S.C. 80a-17(f). At that time (but no longer), under Section 17(f) and related rules RICs were generally permitted to maintain their assets only in the custody of a bank, a member of a national securities exchange, or a national securities depository. FCMs and futures clearinghouses did not come within one of these categories.

¹³ Specifically, it was explained that “[i]n view of the embryonic state of the law and regulatory requirements which may affect the ability of other institutions to participate in the commodity markets, [it] does not now wish to ban altogether the use of safekeeping accounts.” See Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶ 7120, at 7131.

exception, to deposit, hold, and maintain their assets with FCMs and certain other entities in connection with futures transactions effected on U.S. and foreign exchanges.¹⁴ With the elimination of the requirement that fund assets be held in a bank custodial account, the new rule allowed RICs to participate in futures trading generally in the same manner as other futures customers by depositing margin funds with FCMs and clearing organizations.

Second, the practical and operational factors that may impair the carrying FCM's right of immediate and unfettered access to customer funds, notwithstanding any terms and conditions stipulated in a third-party custodial agreement, have come to light. According to the comment letter of the FIA, under the tripartite agreements, customers rather than FCMs have the client relationship with custodian banks. As a result, customer funds held in third-party accounts are not as readily accessible to FCMs as they would be in a segregated customer account context and in fact, these agreements have failed to prevent the release of customer funds held in third-party accounts, without the knowledge or awareness of the carrying FCMs.¹⁵

Regulatory examinations also have found instances of releases of customer funds from third-party custodial accounts. Specifically, Commission audit staff have discovered instances of significant amounts being released from third-party custodial accounts without the knowledge or permission of the FCMs. The Joint Audit Committee, which includes the key self-regulatory organizations that perform front-line supervision of the FCMs, has reported similar instances of

¹⁴ Investment Company Act Rule 17f-6(b)(3), 17 CFR 270.17f-6(b)(3). Under the rule, a RIC is not permitted to deposit fund assets with an FCM that is an affiliate of the RIC or its adviser. Other conditions in the rule provide that the manner in which the FCM maintains fund assets must be governed by a written contract and any gains on fund transactions must be maintained with the FCM only in *de minimis* amounts.

¹⁵ FIA states that “[d]ue to the tripartite nature of these arrangements, commodity customer funds held in third-party accounts are not accessible to the FCMs in the same manner as commodity customer funds deposited in ordinary segregated bank accounts...In this regard, a third party account typically is maintained at the registered investment company's regular custodian, so that the registered investment company rather than the FCM has the client relationship with the custodian bank. Similarly, the FCM's back office personnel do not have the same regular, ongoing communications and interface with custodian bank personnel, as they do with bank personnel ...” See Comment Letter of FIA (April 4, 2005), *supra*, note 6.

unauthorized withdrawals, noting that in such cases, the FCMs may not become aware of the asset release until reconciliation is performed.¹⁶ These findings demonstrate a real and significant risk associated with third-party safekeeping arrangements that are at odds with the immediate and unfettered access standards of Section 4d(a)(2).

Third, third-party custodial accounts pose potential systemic liquidity risks by diverting FCM capital to cover customer margin obligations which would otherwise be available to prevent defaults from affecting the broader marketplace. These risks may be heightened in times of significant market volatility when liquidity is most critical.¹⁷

Finally, there remains concern over the parity of treatment between customers with segregated accounts or Regulation 30.7 accounts¹⁸ and customers using third-party custodial accounts in the context of an FCM bankruptcy proceeding.¹⁹ The Division's position is that third-party custodial accounts are subject to the U.S. Bankruptcy Code and applicable provisions in the CEA, which provide that customer assets relating to futures transactions are subject to distribution based on each customer's pro rata share of the available customer property.²⁰ Nevertheless, the Division is aware that third-party custodial account arrangements may create unnecessary confusion on the part of the customer and create the potential risk that third-party

¹⁶ See Comment Letter of JAC (April 4, 2005), *supra*, note 6. As a result, FCMs may be unaware of market exposure assumed on the undermargined customers' positions. Similarly, FIA noted that the release of customer funds without the knowledge of the FCM could lead to erroneous daily computation of the total amount of customer funds on deposit in segregated accounts, which could then lead to errors in financial reporting statements filed by the FCM with the Commission and self-regulatory organizations ("SROs"). *See Id.*

¹⁷ In addition, initial margin requirements typically rise during such periods, creating additional stress on FCM resources. FIA states that the amount of funds in third-party accounts is substantial and that these accounts are heavily concentrated in a small number of FCMs and banks, which factors further exacerbate the systemic liquidity risks. *See Comment Letter of FIA*, note 6, *supra*.

¹⁸ 17 CFR 30.7.

¹⁹ In Interpretation No. 10, the Division voiced the same concern regarding FCM bankruptcy but concluded that the interest of facilitating institutional participation in the futures market supported the use of third-party custodial accounts. *See Interpretation No. 10*, Comm. Fut. L. Rep. (CCH) ¶ 7120, at 7134.

²⁰ 11 U.S.C. 766; Commission Regulation 190.18, 17 CFR 190.08. However, this issue has not been judicially determined.

custodial accounts might receive priority or preference over other customers in an FCM's bankruptcy proceeding, or at least cause additional administrative expenses to be incurred, in a manner inconsistent with the Commission regulations and regulatory objectives.²¹

Under Interpretation No. 10, FCMs were permitted to hold margin funds in third-party custodial accounts in order to avoid precluding participation by RICs in the futures market. The conflicting restriction concerning the custody of fund assets no longer exists, with a minor exception. Together with concerns regarding the risks to the general marketplace and market users, this is persuasive that third-party custodial accounts are no longer necessary or appropriate, except in the limited case where an FCM is precluded from holding RIC assets due to affiliation with a RIC or its adviser. Findings by both Commission audit staff and the SROs of actual releases of customer funds, without the required knowledge or approval of the FCMs, further demonstrate that the risks associated with third-party custodial accounts are real and material, not merely theoretical, and that the public policy benefits of ensuring the financial integrity of the clearing system outweigh any costs or inconvenience to users of third-party custodial accounts.²² Accordingly, Interpretation No. 10 is being amended to provide that, with the exception noted below, FCMs may not deposit, hold, or maintain customer margin in a third-party account, without being deemed to violate Section 4d(a)(2) of the CEA.²³

²¹ See Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶ 7120, at 7134.

²² Both ICI and AIG noted the operational efficiencies stemming from the use of a single bank custodian to manage fund assets. Further, ICI stated that the disruption and financial cost associated with restructuring of existing custodial relationships would outweigh any "theoretical" benefits. See Comment Letter of ICI (April 4, 2005) and Comment Letter of AIG (April 12, 2005), *supra*, note 6.

²³ Interpretation No. 10 is hereby withdrawn. Further, the views relating to third-party custodial accounts, set forth in related publications are also hereby withdrawn, except that an FCM that is not eligible to rely on SEC rule 17f-6 may rely on them to the extent applicable and relevant. See CFTC Advisory No. 37-96 (Responsibilities of Futures Commission Merchants and Relevant Depositories with Respect to Third Party Custodial Accounts), Comm. Fut. L. Rep. (CCH) ¶ 26,765 (July 25, 1996) and Interpretive Letters, specifically, CFTC Interpretive Letters No. 85-6 (Comm. Fut. L. Rep. (CCH) ¶ 22, 579), No. 89-1 (Comm. Fut. L. Rep. (CCH) ¶ 24, 404), and No. 90-1 (Comm. Fut. L. Rep. (CCH) ¶ 24, 579).

The limited case where the use of third-party custodial accounts will be permitted, described at Section III below, encompasses an FCM that is affiliated with a RIC or its adviser. This exception is appropriate because the relief provided by SEC rule 17f-6 from the restriction against using FCMs as the direct custodians of fund assets is not available to RICs that use affiliate FCMs to clear their futures transactions. For these RICs, and without SEC action to remedy the situation, the inability to use third-party custodial accounts would result in potentially undue disruption and cost. In addition, it appears that the overwhelming majority of the instances of the current use of third-party custodial accounts would not encompass this situation.

It should be noted that this amended interpretation regarding the use of third-party custodial accounts for purposes of Section 4d(a)(2) extends equally to secured amount funds held for foreign futures and foreign options customers in third-party accounts pursuant to Regulation 30.7. As a result, FCMs may not deposit, hold, or maintain secured amount funds held for foreign futures and foreign options customers in third-party accounts under Regulation 30.7.

III. Conditional Exception for FCMs Not Eligible for SEC Rule 17f-6

An FCM that is not eligible to rely on SEC Rule 17f-6 due to an affiliation with a RIC or its advisor may use a third-party custodial account for purposes of holding margin funds for such a customer, without being deemed to be in violation of Section 4d(a)(2) or Regulation 30.7, if the following conditions are and continue to be met:²⁴

First, the account must be maintained in the name of the FCM, for the benefit of the customer. Examples of acceptable titles are “[Name of FCM] Customer Funds for the Benefit of

²⁴ These conditions are generally consistent with those set forth in Interpretation No. 10.

X Investment Company.” On the other hand, a third-party custodial account may not be maintained in the name of the RIC customer or its adviser.²⁵

Second, the FCM must have the ability to liquidate open positions in an account which goes into deficit or becomes undermargined without getting clearance from any third-party custodian of the account or the customer.

Third, the FCM must have the right to withdraw funds from the third-party custodial account with no right of the customer (or its fiduciary) to stop, interrupt or otherwise interfere with such withdrawal. An FCM which is forced to await pre-clearance for margin withdrawals has neither possession nor control of the funds which may be needed for margin purposes. Also, the customer (and its fiduciary) may not withdraw or otherwise have access to the funds in the account except through the FCM. Although a provision in a third-party custodial account agreement for a notice to the customer (or to its fiduciary) would not necessarily be inconsistent with the FCM’s right of access, a requirement that a customer pre-approve margin withdrawals by the FCM would be deemed inconsistent with the FCM’s right of access.²⁶ Finally, third-party custodial accounts will be considered subject to the customary provision in a commodity customer account agreement to the effect that all money, securities or property in the customer’s account, or held for the customer by the FCM or by any clearing organization for a contract market upon which trades of the customer are executed, are pledged with the FCM and are

²⁵ The FCM also must comply with all applicable requirements in Section 4d(a)(2) and related Commission regulations, including Regulation 1.20(a) which provides that an FCM must obtain and retain an acknowledgement from the depository that it was informed that the customer funds deposited therein are those of FCM customers and are being held on accordance with the provisions of the CEA and Commission regulations. *See* 17 CFR 1.20(a).

²⁶ Similarly, the FCM could agree in a third-party custodial agreement that before it directs the custodian of a third-party custodial account to dispose of customer funds held therein, the FCM will state that all conditions precedent to its right to direct disposition of customer funds in the account have been met, provided that the only condition which an FCM must satisfy in order to have access to the funds in the account is to state that there has been a default by the customer in making a margin payment or any other required deposit.

subject to a security interest in the FCM's favor to secure any indebtedness at any time owed by the customer to the FCM.

Fourth, a third-party custodial account may not be located at an affiliate of the customer or a fiduciary thereof. Thus, for example, a fund may not maintain a third-party custodial account at a bank with which the fund has other relationships that make the bank an affiliate or fiduciary of the fund.

These conditions are designed to ensure, among other things, that the FCM has free and ready access to margin funds held in a third-party custodial account, with the customer restricted from access to such funds except through the FCM. If the conditions are met, and only in the case of an affiliate FCM for so long as SEC prohibitions exist, a third-party custodial account for a RIC will be deemed to be a segregated account of the FCM within the meaning of Section 4d(a)(2) of the CEA or permissible under Regulation 30.7, as the case may be, and the FCM may include the funds in such account in the calculation of the total amount of customer funds on deposit in segregated accounts or Regulation 30.7 accounts, as the case may be.

IV. Transition Period

In order to ensure that impacted parties, including the FCMs and RICs, are provided with adequate time to make necessary adjustments to their existing custodial arrangements, the

amendment to Interpretation No. 10 will not be made effective until nine months following publication in the *Federal Register*.²⁷

Issued in Washington, D.C. on May 5, 2005, by the Division of Clearing and Intermediary Oversight.

/s/

James L. Carley
Director

²⁷ ICI requested that in the event that Interpretation No. 10 is withdrawn, such withdrawal should be made effective no less than nine months following the publication of a final notice. *See* Comment Letter of ICI, note 6, *supra*.