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Division of Swap Dealer and Intermediary Oversight
Division of Clearing and Risk

To: **Derivatives Clearing Organizations, Futures Commission Merchants, Joint Audit Committee Members, and Market Participants**

Subject: **Advisory and Time-Limited No-Action Relief with Respect to the Treatment of Separate Accounts by Futures Commission Merchants**

The U.S. Commodity Futures Trading Commission's ("CFTC" or "Commission") Division of Clearing and Risk ("DCR") and Division of Swap Dealer and Intermediary Oversight ("DSIO") are providing all market participants with guidance regarding CFTC Regulation 1.56(b)[1] and time-limited no-action relief regarding Regulation 39.13(g)(8)(iii)[2] as these rules relate to the treatment of separate accounts of the same customer, a beneficial owner.

This advisory is intended to provide guidance with respect to the appropriate documentation required within customer agreements in accordance with Commission Regulation 1.56, as well as the processing of margin withdrawals consistent with Regulation 39.13(g)(8)(iii). Discussions with and written representations from the Futures Industry Association ("FIA"), the Asset Management Group of the Securities Industry and Financial Markets Association ("SIFMA-AMG"), the Joint Audit Committee ("JAC")[3], Chicago Mercantile Exchange ("CME")[4], as well as several FCMs individually have brought to light various diverse practices among FCMs and their customers with respect to the handling of separate accounts of the same beneficial owner.

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1 17 CFR § 1.56(b).

2 17 CFR § 39.13(g)(8)(iii).

3 The JAC is a representative committee of US futures exchanges and the National Futures Association. The JAC has published Regulatory Alert #14-03, dated May 21, 2014, Regulatory Alert #19-02 and #19-03, both dated May 14, 2019. Available at: http://www.jacfutures.com.

4 The FIA, SIFMA-AMG, and CME each filed separate letters (collectively, the "Industry Letters") to Commission Staff. *See* SIFMA-AMG Letter dated June 7, 2019 to Brian A. Bussey and Matthew B. Kulkin; CME letter dated June 14, 2019 to Brian A. Bussey and Matthew B. Kulkin; and FIA letter dated June 26, 2019 to Brian A. Bussey and Matthew B. Kulkin.

I. Background

Finalized by the Commission in 1981, Regulation 1.56 was adopted with the specific objective of preventing representations by an FCM that it will guarantee customers against loss.[5] In relevant part, Regulation 1.56(b) provides that an FCM may not in any way represent that it will: (i) guarantee any person against loss; (ii) limit the loss of such person; or (iii) not call for or attempt to collect required margin.[6] With this prohibition, the Commission endeavored to enhance the safety of customer funds, promote orderly resolution and transfer of open customer accounts in the event of an FCM's bankruptcy, and avoid any practice which jeopardizes the segregation requirements prescribed in Section 4d(a)(2) of the Commodity Exchange Act (the "CEA").[7]

Since its adoption, however, the Commission's regulations concerning the protection of customer funds have greatly expanded beyond Regulation 1.56. For example, regulations found in Part 190 prescribe, among other things, the method by which the business of a commodity firm is to be conducted or liquidated following the filing of a bankruptcy petition and how customer claims are to be calculated. Regulation 1.11 requires FCMs to develop and maintain specific risk management policies and procedures involving, among other things, the segregation and handling of customer funds. Regulations 1.22, 22.2, and 30.7 require specific calculations regarding the requirement of residual interest in segregated, cleared swap and secured customer fund accounts to ensure that no FCM uses or permits the use of the customer funds of one customer to purchase, margin, or settle the trades, contracts, or options of another customer.
In addition, in 2011, the Commission adopted risk management regulations for Derivatives Clearing Organizations ("DCOs") to implement DCO Core Principle D.[8] Among these regulations are a number that require a DCO to in turn require that its clearing members take certain steps to support their own risk management, thereby mitigating the risk that such members pose to the DCO.

In particular, Regulation 39.13(g)(8)(iii) requires a DCO to require its clearing members to ensure that their customers do not withdraw funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in the customer's account after the withdrawal would be sufficient to meet the customer initial margin requirements with respect to the products or portfolios in the customer's account, which are cleared by the DCO.[9]

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5 *See*, Final Rule, *Prohibition of Guarantees Against Loss*, 46 F.R. 62841, 62842 (Dec. 29, 1981).

6 17 CFR § 1.56(b).

7 *See* Proposed Rule, 46 F.R. 11668, 11669 (Feb. 10, 1981).

8 CEA §5b(c)(2)(D), 7 U.S.C. §7a-1(c)(2)(D). *See* Final Rule, 76 F.R. 69334, 69335 (Nov. 8, 2011).

9 In proposing this provision, the Commission stated that this requirement was consistent with the definition of "Margin Funds Available for Disbursement" in the Margins Handbook prepared by the JAC. *See* 76 F.R 3698, 3706 (Jan. 20, 2011).

II. Staff Action

A. Customer Agreements

The Division of Swap Dealer and Intermediary Oversight confirms that, in accordance with Regulation 1.56, FCM customer agreements or other documents must not: (i) preclude the FCM from calling the beneficial owner of an account for required margin; (ii) in the event the beneficial owner fails to meet the margin call, preclude the FCM from initiating a legal proceeding to recover any shortfall; or (iii) otherwise guarantee a beneficial owner against, or limit a beneficial owner's, loss.

To address any shortfall, the FCM must retain the ability to ultimately look to funds in other accounts of the beneficial owner, including accounts that may be under different control, as well as the right to call the beneficial owner for additional funds.

B. Withdrawals from Separate Accounts

In addition, the Division of Clearing and Risk is addressing concerns with respect to Regulation 39.13(g)(8)(iii) in the context of separate accounts. Staff believes that, in the context of separate accounts, the risk management goals that this regulation is designed to address may effectively be addressed if an FCM carrying a customer (*i.e.*, the beneficial owner of an account) with separate accounts instead meets the conditions set forth below. The Division of Clearing and Risk will accordingly not recommend that the Commission take enforcement action against a DCO if the DCO permits its FCM clearing members to treat certain separate accounts as accounts of separate entities for purposes of Regulation 39.13(g)(8)(iii) under the following circumstances, which are derived from the Industry Letters. This no-action relief will extend until June 30, 2021, in order to provide Staff with time to recommend, and the Commission with time to determine whether to conduct, and if so, to in fact conduct, a rulemaking to implement appropriate relief on a permanent basis.

Specifically, a DCO may permit the FCM to treat the separate accounts of a customer as accounts of separate entities for purposes of Regulation 39.13(g)(8)(iii) where the FCM clearing member's written internal controls and procedures require it to, and it in fact does, comply with all of the conditions listed below.

1) The FCM permits disbursements on a separate account basis only during the Ordinary Course of Business. For these purposes, Ordinary Course of Business means standard day to day operation of the FCM's business relationship with its customer. The following events are inconsistent with the Ordinary Course of Business and would require the FCM to cease permitting disbursement on a separate account basis. The occurrence of any one of these events should be communicated promptly to the FCMs DSRO.

i) Such customer (including any separate account of such customer) fails timely, as set out in paragraph 5 below, to deposit or maintain initial or maintenance margin or make timely payment of variation margin or option premium (a failure to deposit, maintain, or pay margin or option premium due to administrative errors or operational constraints would not constitute a failure for these purposes).

ii) The occurrence and declaration by the FCM of an event of default as defined in the account documentation executed between the FCM and the customer.

iii) A good faith determination by an FCM's chief compliance officer, senior risk managers or other senior management, following its own internal escalation procedures, that (a) the customer is in financial distress or (b) there is significant and bona fide risk that the customer will be unable promptly to perform its financial obligations to the FCM, whether due to operational reasons or otherwise.

iv) The insolvency or bankruptcy of the customer or a parent company of the customer.

v) The FCM receives notification from an exchange, DCO, a self-regulatory organization ("SRO") or the CFTC that the customer is in financial distress.

vi) The FCM is under financial or other duress as determined in good faith by its chief compliance officer, senior risk managers or other senior management.

vii) The bankruptcy of the FCM or the parent company of the FCM..

viii) The FCM is notified by an exchange, DCO, SRO or the CFTC that it believes the FCM is in financial or other distress.

ix) The FCM is directed to cease permitting disbursements on a separate account basis (with respect to this customer or all customers) by an exchange, a DCO, an SRO or the CFTC, pursuant to, as applicable, exchange or DCO rules, government regulations or law.

2) The customer or, as applicable, the manager of a separate account, provides the FCM with information sufficient for the FCM to assess the value of the assets dedicated to such separate account.

3) No later than July 1, 2020, the FCM's internal risk management policies and procedures shall be updated and include stress testing and credit limits which shall be performed both on an individual separate account and on a combined account basis.

4) The margin requirement for each separate account is calculated independently from all other separate accounts of the same beneficial owner with no offsets/spreads recognized across the separate accounts.

5) Each such separate account must be on a one business day margin call. Situations of administrative error or operational constraints which prevent the call from being met within a one-day period will not be considered a violation of this condition. In no case can customers and FCMs contractually arrange for longer than a one business day period for a margin call to be met.

6) The FCM shall record each separate account independently in the FCM's books and records, i.e., the FCM shall record each separate account as a receivable (debit/deficit) or payable with no offsets between the other separate accounts of the same customer.

7) Similarly, the receivable from a separate account shall only be considered secured (a current/allowable asset) based on the assets of that separate account, not on the assets held in another separate account of the same customer.

8) Each receivable from a separate account shall be "grossed up" on the applicable segregation, secured or cleared swaps customer statement; thus, an FCM shall use its own funds to cover the debit/deficit of each separate account.
9) The FCM shall factor into its residual interest target customer receivables as computed on a separate account basis.
10) The FCM shall include the margin deficiency of each separate account, and cover with its own funds as applicable, for purposes of its Residual Interest and LSOC compliance calculations.[10]
11) Where the beneficial owner has appointed a third-party as the primary contact to the FCM, the FCM shall obtain and maintain current contact information of an authorized representative(s) at the beneficial owner.[11]
12) The FCM shall provide each beneficial owner using separate accounts with a disclosure that under CFTC Part 190 rules all separate accounts of the beneficial owner will be combined in the event of an FCM bankruptcy. The disclosure statement required by this paragraph will be delivered separately to the beneficial owner via electronic means in writing or in such other manner as the FCM customarily delivers disclosures pursuant to applicable CFTC regulations and as permissible under the FCM's customer documentation. The FCM must maintain evidence that such disclosure was delivered directly to the beneficial owner. The FCM shall also include the disclosure on its website or within its disclosure document required by Regulation 1.55(i).[12]
13) The FCM shall disclose in its Disclosure Document required under CFTC Regulation 1.55(i) that it permits the separate treatment of accounts for the same beneficial owner under the terms and conditions of this letter.
14) The FCM shall apply this treatment consistently over time (e.g., cannot repeatedly change back and forth based primarily on preferable margin or offset treatment to the separate accounts).
15) The FCM shall, on a one-time basis, provide notification to its DSRO if it will apply the treatment permitted under this letter to any separate accounts.
16) The FCM shall maintain a list of all separate accounts (indicating the beneficial owner and account numbers) receiving such treatment.

Nothing herein would prohibit the application of portfolio margining or cross-margining treatment within a particular separate account.

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This letter, and the position taken herein, represent the views of DSIO and DCR only, and do not necessarily represent the position or view of the Commission or of any other office or division of the Commission. The interpretation with respect to Regulation 1.56 and the no-action relief with respect to Regulation 39.13(g)(8)(iii) set forth in this letter does not excuse persons relying on them from compliance with any other applicable requirements contained in the CEA or in Commission Regulations. Further, this letter, and the positions taken herein, is based upon the

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[10] *See, e.g.*, Regulations 1.22, 22.2, and 30.7.

[11] With respect to separate accounts that exist as of August 1, 2019, the FCM will have until January 1, 2020 to obtain such information.

[12] FCMs must make this disclosure to all separate accounts as soon as feasible but no later than February 1, 2020.

representation made to DSIO and DCR. Any different, changed, or omitted material facts or circumstances might render the positions herein void.

All questions regarding this advisory and no-action relief can be directed towards either the Division of Clearing and Risk (Eileen Donovan (202) 418-5096 or Bob Wasserman (202) 418-5092) or the Division of Swap Dealer and Intermediary Oversight (Tom Smith (202) 418-5495 or Josh Beale (202) 418-5446).

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