

CFTC Letter No. 00-59**May 2, 2000****No-Action****Division of Trading & Markets**

Re: Use of Debt Securities issued by The Federal National Mortgage Association or The Federal Home Loan Mortgage Corporation to Offset a Deficit in a Customer Account for Segregation Purposes

Dear :

This is in response to your letter dated February 10, 2000, to the Division of Trading and Markets ("Division") of the Commodity Futures Trading Commission ("Commission"). You requested on behalf of your client, "X", a registered futures commission merchant ("FCM") under the Commodity Exchange Act ("Act"),¹ that the Division not recommend that the Commission commence any enforcement action against "X" for using customer-owned debt securities issued by The Federal National Mortgage Association ("Fannie Mae") or The Federal Home Loan Mortgage Corporation ("Freddie Mac") to offset net liquidating deficits in customers' accounts when "X" computes its segregation requirement under Section 4d(2) of the Act and Commission Regulation 1.32.²

Background

Section 4d(2) of the Act provides, in relevant part, that an FCM: (1) must segregate from its own assets all money, securities and other property contributed by customers to margin commodity futures and option contracts as well as any gains accruing to such customers from open futures and option positions; and (2) may not use money, securities, or property of one customer to margin or secure futures or option positions of another customer. Regulation 1.32 requires each FCM to compute daily the amount of customer funds that it holds in segregated accounts and the amount of funds that it is required to segregate under Section 4d(2) (the "segregation computation") to assure compliance with the segregation requirement.³

The Commodity Exchange Authority ("CEA"), predecessor of the Commission, issued Administrative Determination ("AD") No. 171 that provided that an FCM must have in segregation sufficient money (or securities purchased with customer funds) to cover the net liquidating equity of all customers to preclude the FCM from being "undersegregated".⁴ AD No. 171 further provided that any net liquidating deficit in the account of a customer who deposited securities as margin was required to be covered by a deposit in

segregation of an equivalent amount of the FCM's own money. The CEA reasoned that while money was fungible, securities were not. Therefore, if an FCM became insolvent, a customer whose securities could be identified to that customer might be in a position to reclaim those securities free of any pro rata distribution. If the customer who deposited these "specifically identifiable" securities had been allowed to build up a deficit in his account and the FCM had not deposited enough of its own money in segregation to cover the deficit, the amount of money needed to pay other customers would be insufficient.

The prevailing concept of the right to reclaim "specifically identifiable property" from a bankrupt estate, which motivated the issuance of AD No. 171, was changed with the enactment of the Bankruptcy Reform Act of 1978, which became effective on October 1, 1979.⁵ In recognition of this change, in November 1980 the Division issued an advisory whereby it set forth a no-action position applicable to FCMs with respect to the segregation computation when customers' accounts incur net liquidating deficits.⁶ In the advisory, the Division stated that it would not recommend that the Commission commence enforcement action against an FCM based solely upon the FCM's use of customer-owned U. S. Treasury Bills, U.S. Treasury Notes, or U.S. Treasury Bonds (collectively "Treasuries") in connection with the segregation computation provided that certain conditions were met, including the following.

1. The FCM maintained a security interest in the Treasuries, which included the written authorization to liquidate the Treasuries at the FCM's discretion in order to protect the FCM and to cover any deficit in the customer's account; and
2. The Treasuries were segregated in safekeeping accounts with a bank, trust company, clearing organization of a contract market or another FCM as provided by the Act and Commission regulations.

Analysis

Based upon the representations made in your letter and subsequent conversations, we understand the facts to be as follows. To the extent permitted by contract market rules, "X" accepts debt securities issued by Fannie Mae and Freddie Mac and deposited by customers to margin futures and option positions.⁷ "X", in computing its segregation requirement under Section 4d(2) of the Act and Regulation 1.32, does not offset a net liquidating deficit in a customer's account by the value of any Fannie Mae or Freddie Mac debt securities deposited by such customer. In such situations, "X" contributes a sufficient amount of its own cash or other permissible assets into the segregation account to cover the net liquidating deficit in the customer's account.

You represent that the debt securities issued by Fannie Mae and Freddie Mac have the characteristics of liquidity, marketability, and high credit quality that should ensure that "X" can liquidate the securities quickly and realize the market value to cover the related customer deficit. You further represent that "X" will use Fannie Mae or Freddie Mac debt securities to offset a net liquidating deficit in a customer's

account provided that the following conditions are met.

1. The Fannie Mae and Freddie Mac debt securities are segregated from any securities belonging to the FCM or any other person not within the meaning of the term "commodity customer" as defined by Regulation 1.3(k). The Fannie Mae and Freddie Mac debt securities are segregated with a bank, trust company, clearing organization of a contract market, or another FCM, in an account which is titled in a manner to clearly identify the account as containing regulated commodity customers' funds and which is covered by an acknowledgment from the depository, as required by Regulation 1.20;
2. "X" retains a security interest in the Fannie Mae and/or Freddie Mac debt securities which includes written authorization from the customer to liquidate the debt securities at "X"'s discretion in order to protect "X" and cover any deficit in the customer's account; and
3. The amount of the net liquidating deficit to be offset will be limited to the current market value of the Fannie Mae and Freddie Mac debt securities less applicable haircuts as set forth in Rule 240.15c3-1(c)(2)(vi) of the Securities and Exchange Commission (17 C.F.R. § 240.15c3-1(c)(2)(vi)).

Conclusion

In light of the foregoing, the Division will not recommend that the Commission initiate an enforcement action against "X" based solely upon Section 4d(2) of the Act and/or Commission Regulation 1.32 if, in computing its segregation requirement, "X" offsets a net liquidating deficit in a customer account with Fannie Mae or Freddie Mac debt securities deposited by such customer.⁸ Furthermore, "X" must comply with the reporting and recordkeeping requirements set forth in Interpretative Letter No. 86-16 in offsetting a customer net liquidating deficit with Fannie Mae or Freddie Mac debt securities.⁹ In this regard, with respect to balance sheet presentation, "X" must report the deficit as a secured receivable (as a current asset only to the extent of market value of the securities less applicable haircuts) rather than offsetting the deficit against the securities. In addition, "X" must maintain a reconciliation of deficits reflected on its daily segregation statement to that shown in its supporting records, such as daily customer equity printouts.

Because this position is based upon facts and representations contained in your letter and subsequent conversations with Division staff, it should be noted that any different, omitted or changed facts or conditions might require a different conclusion. This letter represents the views of the Division only and does not necessarily represent the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact Thomas J. Smith, Special Counsel, at (202) 418-5495, or Henry J. Matecki, Chicago Branch Chief, at (312) 886-3217.

Very truly yours,

John C. Lawton
Acting Director

1 7 U.S.C. § 1 *et seq.* (1994).

2 Commission regulations cited herein may be found at 17 C.F.R. Ch. I. (1999).

3 Regulation 1.32 requires that a segregation computation be completed prior to 12:00 p.m. on the next business day and be maintained, together with all supporting data, in accordance with Regulation 1.31.

4 *See* CEA Administrative Determination No. 171 (Aug. 13, 1959).

5 The provisions of that statute relevant to the futures industry have been amended since that time and current law is codified in 11 U.S.C. §§ 362, 546, 548, 556 and 761-766 (1994). The Commission's bankruptcy Rules are contained in 17 C.F.R. Part 190 (1999).

6 Division of Trading and Markets Advisory on Treatment of Government Securities Deposited as Customer Funds, reprinted in [1980 -1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,101 (Nov. 3, 1980) (the "November 1980 Advisory").

7 Fannie Mae and Freddie Mac are publicly-held corporations that operate under Federal government charters. Fannie Mae and Freddie Mac purchase mortgages from lending institutions and repackage them as mortgage-backed securities. Both companies fund their respective activities through the issuance of equity and debt securities. Fannie Mae and Freddie Mac debt securities have been assigned the highest Aaa or AAA rating from the major credit-rating agencies (Moody Investor Services and the Standard and Poor Corporation, respectively).

8 The Joint Audit Committee ("JAC") recently submitted to the Division a request to expand the relief provided by the November 1980 Advisory to permit an FCM to offset net liquidating deficits in customer accounts with customer-owned readily marketable securities, as defined by SEC Rule 15c3-1 (c)(11) (17 C.F.R. § 240.15c3-1(c)(11)), provided that the securities were subject to appropriate haircuts. The Division is currently reviewing the JAC's request. Any subsequent interpretation, advisory, or rulemaking issued by the Commission or any division thereof addressing an FCM's use of securities, including U.S. Treasuries, to offset net liquidating deficits in customer accounts will supersede this no-action letter and "X" will be subject to the terms and conditions of such subsequent interpretation, advisory, or rulemaking.

9 CFTC Interpretative Letter No. 86-16 (Treatment of Deficits in Customers' Accounts), [1986-1987

Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,193 (Division of Trading and Markets, July 22, 1986) ("Interpretative Letter").