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Gary Barnett
Director

Division of Swap Dealer and Intermediary Oversight

CFTC Letter No. 14-110
Interpretation
August 28, 2014
Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulation 30.7(c) - Staff Interpretation Regarding a Futures Commission Merchant Holding 30.7 Customer Funds in Bank Accounts with Banks Licensed in the United Kingdom

Ladies and Gentlemen:

The Division of Swap Dealer and Intermediary Oversight (the "**Division**") of the Commodity Futures Trading Commission (the "**Commission**") has been asked to provide guidance on whether a registered futures commission merchant (an "**FCM**") may deposit 30.7 customer funds in the form of cash collateral with investment firms authorized in the United Kingdom (**"U.K."**) to conduct futures and options trading for customers in bank deposit accounts when the investment firms also are U.K. licensed deposit-taking banks.[1] The Division has reviewed this issue and is providing an interpretation of Regulation 30.7(c) to address the permissibility of an FCM to elect to hold 30.7 customer funds in the form of cash collateral in

[1] The term "30.7 customer" is defined in Commission Regulation 30.1(f) to include any foreign futures or foreign options customer, as defined in Regulation 30.1(c), as well as any foreign domiciled person who trades in foreign futures or foreign options through an FCM. Regulation 30.1(c) defines the term "foreign futures or foreign options customer" to mean any person located in the United States, its territories or possessions who trades in foreign futures or foreign options. The term "30.7 customer funds" is defined in Regulation 30.1(h) to mean any money, securities, or other property received by an FCM from, for, or on behalf of 30.7 customers to margin, guarantee, or secure foreign futures or foreign option positions, or money, securities, or other property accruing to 30.7 customers as a result of foreign futures and foreign option positions. Commission regulations referred to herein are found at 17 C.F.R Chapter I.

bank deposit accounts maintained by investment firms that are U.K. licensed deposit-taking banks.

Background

Part 30 of the Commission's regulations governs the offer and sale of futures and options executed on, or subject to the rules of, a foreign board of trade to persons located in the United States. Regulation 30.7 generally addresses how FCMs may hold funds deposited by 30.7 customers for trading on foreign markets.

Based upon the Commission's experience with recent FCM insolvencies, and as part of its overall effort to enhance customer protections, the Commission published in the Federal Register final amendments to Regulation 30.7(c) on November 14, 2013. Revised Regulation 30.7(c) provides, in relevant part, that:

> "[An FCM] must deposit 30.7 customer funds under the laws and regulations of the foreign jurisdiction that provide the greatest degree of protection to such funds. [An FCM] may not by contract or otherwise waive any of the protections afforded to customer funds under the laws of the foreign jurisdiction."[2]

Thus, Regulation 30.7(c) explicitly prohibits an FCM from electing to forego protections available to 30.7 customer funds under the laws of a foreign jurisdiction when depositing such funds with a depository located in, and subject to the rules of, the foreign jurisdiction.

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[2] *See* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 FR 68,506 (Nov. 14, 2013).

Discussion

The Division previously provided time-limited no-action relief permitting an FCM to hold 30.7 customer funds in account(s) with investment firms that also were licensed deposit-taking banks in the U.K. or Hong Kong.[3] Pursuant to the no-action position, the Division directed the party requesting the relief to provide a written assessment (an "**Assessment Report**") of the protections provided to 30.7 customer funds under the laws of the U.K. and Hong Kong. The time limited no-action relief is set to expire on September 10, 2014.[4]

In addition to the party requesting the no-action relief, an additional party also has submitted to the Division an Assessment Report describing the protections provided to 30.7 customer funds deposited by an FCM with U.K. licensed banks. Based upon its review of the Assessment Reports, the Division understands from the facts presented that the U.K. has different rules for the holding of customer cash collateral deposited to margin, guarantee or secure futures and options positions executed on U.K. and other foreign futures markets depending on whether the institution holding the customer funds is an investment firm that is not a U.K. licensed bank or an investment firm that is a U.K. licensed bank. Generally, cash collateral deposited with an investment firm that is not a bank is required to be held by the investment firm as "client money" under the U.K. Financial Conduct Authority's ("**FCA**") Client Assets sourcebook ("**CASS**").

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[3] *See* CFTC Letter No. 14-08, *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-08.pdf.

[4] The Assessment Report did not address the holding of cash collateral with Hong Kong investment firms that also are licensed deposit taking banks. Therefore, this interpretive letter does not extend to 30.7 customer funds held by depositories in Hong Kong.

An investment firm that also is a licensed deposit-taking bank (a "banking investment firm"), however, may avail itself of the "bank exemption." The "bank exemption" allows a banking investment firm to hold cash collateral as a deposit rather than treating such funds as "client money" subject to the U.K. FCA's "client money" requirements.

The "client money" rules under CASS require a non-bank investment firm that receives customer funds to place those funds with one or more third-party banks,[5] with the investment firm acting as the trustee.[6] In this manner, the "client money" rules create a statutory trust over the client funds, which would be the funds deposited by an FCM, placed with an investment firm so that beneficial ownership of the funds remains with the FCM. To effectuate this, an investment firm must send a trust acknowledgment letter to any third-party depository bank with which it opens a customer bank account, requesting the bank to acknowledge that (1) the investment firm is the trustee for that customer bank account, and (2) the bank cannot combine the account with any other account or exercise any right of set-off or counterclaim against money in that customer bank account in respect of any sum owed to the bank by the investment firm.

An investment firm would choose bank depositories based on certain factors including, the need to diversify risks, the credit rating of a bank, the amount of customer funds placed with the bank as a proportion of the bank's capital and deposits, and, to the extent the information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliates.

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[5] An investment firm is permitted to place up to 20 percent of the customer funds it holds with a bank or number of banks within its affiliated group.

[6] There is no obligation for an investment firm to inform its customers of the identity of the depositories.

An investment firm, acting as the trustee, and not the FCM, would have a direct claim against the third-party bank depository over customer funds under the "client money" rules. The statutory trust only protects customers from the insolvency of the trustee (*i.e.,* the investment firm) and that protection does not extend to an insolvency of any third-party depository banks that hold the customer funds.[7] As presented, upon the failure of an investment firm the client money rules would pool all client funds before distribution and the FCM would receive its customer funds only after a clarification of the entire "client money" position.

In contrast, if a banking investment firm elects the "bank exemption," the customer funds held by the banking investment firm would be treated as any other deposit of a bank. In this case, the banking investment firm takes full legal and beneficial title to the FCM's funds immediately upon deposit, and the FCM retains a contractual claim against the banking investment firm for the repayment of those funds. Therefore, the Division understands that an FCM, whose 30.7 customer funds are held at a U.K. investment firm that elects the "bank exemption," would have a direct claim over those customer funds in the insolvency of the banking investment firm.

Under Commission Regulation 30.7, the U.K. bank would be required to provide an acknowledgment letter to the FCM acknowledging that the account holds funds deposited by customers of the FCM for trading foreign futures.[8] The U.K. bank also would be required to acknowledge that it will account for the 30.7 customer funds separately from the funds of the

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7 In the event of an insolvency of a third-party bank, the customers would rank as general creditors of that bank along with the bank's other depositors.

8 *See* 17 CFR 30.7(d).

FCM, and that the bank will not use any of the funds maintained in the account to secure or guarantee any obligations that the FCM may have to the bank.[9]

Banking investment firms that elect the "bank exemption" also are required to provide disclosure to FCMs advising them that their funds are held as deposits (*i.e.*, that the firm will hold the funds as a bank and not as a trustee) and that the funds will not be held in accordance with the FCA's "client money" rules.[10]

Conclusion

Based on the facts presented in the Assessment Reports, it is the Division's view that an FCM is not waiving rights or protections otherwise available to its 30.7 customers, if the FCM deposits 30.7 customer funds at a banking investment firm that elects the "bank exemption." Thus, the Division believes that an FCM could, on behalf of its 30.7 customers, maintain customer omnibus accounts with a U.K. investment firm that elects the "bank exemption" and that qualifies as a depository for holding 30.7 customer funds.

The Division reminds FCMs that Regulation 1.11 requires FCMs to monitor the segregation risks associated with holding customer funds with a particular depository.[11] In this

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9 *See* 17 CFR Part 30, Appendix E.

10 *See* CASS 7.1.8R and 7.1.9G.

11 *See* 17 CFR 1.11(e)(3)(i). Regulation 1.11 requires an FCM to formulate criteria with respect to choosing a depository, including criteria that address the depository's supervision, capitalization, creditworthiness, operational reliability, and access to liquidity, the availability of deposit insurance, and the extent to which segregated funds are concentrated with any depository or a group of depositories. *See* 17 CFR 1.11(e)(3)(i)(A). In addition, an FCM is also required to establish procedures to ensure its satisfaction that the depository continues to meet the FCM's criteria and conduct at least annually a thorough due diligence review of each depository. *See* 17 CFR 1.11(e)(3)(i)(B).

respect, the Division stresses that an FCM must select a depository, including an affiliated depository, after a consideration of the factors set forth in Regulation 1.11. Particular to this context, an FCM would need to consider how those factors would inform its choice of a depository, including, if applicable, whether it would ask the depository to act as a trustee and follow the "client money" rules or whether, if the "bank exemption" were available, the depository could rely on the "bank exemption" to directly hold customer funds. As a related matter, the Division notes that it may be appropriate for an FCM to conduct a comparison of the risk profiles of the U.K. banks that are eligible depositories for 30.7 customer funds as part of its process of selecting depositories.

This letter does not excuse an FCM from compliance with any other requirements applicable to it contained in the Commodity Exchange Act or in the Commission's regulations issued thereunder. This letter represents the views of the Division only and does not necessarily represent the views of the Commission or of any other division or office of the Commission.

If you have any questions concerning this correspondence, please feel free to contact Francis Kuo, Attorney-Advisor, at (202) 418-5695, or Thomas Smith, Deputy Director, at (202) 418-5495.

Sincerely,

Gary Barnett