U.S. COMMODITY FUTURES TRADING COMMISSION
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Division of Swap Dealer and
Intermediary Oversight

Eileen T. Flaherty
Director

CFTC Letter No. 17-18
No-Action
March 29, 2017
Division of Swap Dealer and Intermediary Oversight

Re: No-Action Relief Regarding the Application of Commission Regulation 75.14(a) to the Provision of Clearing Services by an FCM to a Covered Fund

Dear :

This is in response to your letter dated March 22, 2017, to the Division of Swap Dealer and Intermediary Oversight ("**Division**") of the Commodity Futures Trading Commission ("**Commission**"). By your letter, you requested that the Division clarify whether it would recommend that the Commission initiate enforcement action against "A" with respect to Regulation 75.14(a) if "A", as a futures commission merchant ("**FCM**"), provides futures, options and swaps clearing services to customers that are "covered funds" (as defined in Regulation 75.10(b)).[1] "A" is affiliated with other "banking entities" (as defined in Regulation 75.2(c)).

Regulatory Background

A banking entity and its affiliates (including affiliated FCMs) are generally prohibited by Regulation 75.14(a) from engaging in "covered transactions" with covered funds if the banking entity engages in any of the following activities ("**Fund Activities**"): (1) serving, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor or sponsor to a covered fund; (2) organizing and offering a covered fund pursuant to Regulation 75.11; or (3) continuing to hold an ownership interest therein in accordance with Regulation 75.11(b). As used in Regulation 75.14, a "covered transaction" is any transaction with the covered fund that would be a covered transaction as defined in Section 23A of the Federal Reserve Act (12 U.S.C. 371c(b)(7)) ("**FRA Section 23A**"), as if such banking entity and the affiliate thereof were each a "member bank" and the covered fund were an affiliate thereof. A "covered transaction" under FRA Section 23A includes:

1. a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;
2. a purchase of or an investment in securities issued by the affiliate;

[1] Part 75 of the Commission's regulations implements the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that are commonly referred to as the "Volcker rule."

3. a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company;
5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate;
6. a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.

Analysis

Many FCMs are affiliated with banking entities, some of which undertake Fund Activities with respect to covered funds. The FCMs often provide futures, options and swaps clearing services to the covered funds through derivatives clearing organizations ("**DCOs**"). If the clearing services routinely provided by such an FCM would be prohibited covered transactions under Regulation 75.14(a), the FCM may need to terminate its FCM clearing services relationship with all covered fund customers for which an affiliate continues to provide Fund Activities.

In its letter, "A" specifically identifies for consideration two obligations of FCMs under DCO requirements. First, each FCM is required to make aggregate margin payments upon request of a DCO for all customer positions. "A" asks whether the aggregate margin payment obligations of the FCM to DCOs would be considered covered transactions solely with respect to FCM clearing services for purposes of Regulation 75.14(a).

Second, each DCO member must guarantee to the DCO the aggregate obligations of the member, including obligations undertaken in aggregate for the member's customers. The DCO member guarantee serves as part of the system of protections at the DCO to ensure that the appropriate amount of funds are available for the continued operation of the DCO.

In analyzing whether these FCM activities should constitute covered transactions under Regulation 75.14(a), it is necessary to consider the distinct relationships between 1) an FCM and each customer and 2) an FCM and each DCO.

An FCM provides clearing services as an agent for each customer for futures, options and swaps ("**Derivatives Contracts**") that are cleared at a DCO. The Derivatives Contracts transactions are for the account of the customer and the customer is obligated to make all payments, including margin payments, required in connection with the Derivatives Contracts carried for the customer by the FCM.

To clear Derivatives Contracts at a DCO, an FCM must become a member of the DCO. An FCM's obligations are governed by the DCO's member requirements, which include making the aggregate margin payments to the DCO and guaranteeing to the DCO the aggregate obligations of the member as described above.

The Commission treats the relationship between a FCM and a DCO as a principal-to-principal relationship. As such, this relationship and the obligations thereunder, are separate and distinct from the agency obligations of the customer to the FCM. In effect, the FCM's aggregate margin payment and guarantee obligations are direct obligations of the FCM to the DCO and are ultimately to be satisfied with the FCM's own funds and not on behalf of any covered fund.

The Commission has similarly addressed this issue in the context of Commission Regulation 1.22. That regulation imposes on each FCM, as principal, an obligation to make contributions to a segregated customer account using proprietary funds of the FCM to the extent needed to satisfy the aggregate margin payments to the DCO. The Commission has stated:

> ". . . the requirement in § 1.22 for an FCM to cover an undermargined account with its own funds is intended to ensure that the FCM complies with section 4d of the Act by not using the funds of one futures customer to margin or guarantee the commodity interests of another customer. The FCM is obligated under section 4d to maintain sufficient funds in segregation to cover undermargined accounts. ***The FCM, however, is not loaning funds to a particular customer as performance bond is contemplated by § 1.30. When the FCM deposits proprietary funds into segregated accounts under § 1.22, the FCM is not loaning any particular customer funds, and the customers with an undermargined account are not credited with an increase in their cash balance***." Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506, 68557 (Nov. 14, 2013) (emphasis added).

No-Action Relief

"A" represents in its letter that the no-action relief would prevent significant disruption of its FCM operations and client relationships. Furthermore, "A" represents that without the relief, covered fund clients for which affiliates of "A" undertake Fund Activities would need to transfer their accounts to other unaffiliated FCMs, which likely could result in a loss to the covered funds of tested clearing processes and systems, a loss of operational and risk management efficiencies, and potential exposure to higher credit risk. Finally, "A" asserts that if the relief requested is not granted, covered funds would be precluded from using FCMs affiliated with investment managers of covered funds thereby narrowing the choice of those fiduciaries in meeting their optimal execution obligations for FCM services.

Based on the foregoing and the representations made by "A", and without making a determination as to whether the activity in question is a "covered transaction" as used in Regulation 75.14, the Division believes that granting no-action relief is warranted. Accordingly, the Division will not recommend that an enforcement action against "A" be initiated in connection with Regulation 75.14(a) if "A", acting in its capacity as a registered FCM, provides futures, options and swap clearing services to covered funds for which affiliates of "A" engage in Fund Activities. This relief includes the fulfillment by "A" of its obligations under each DCO's

requirements to make timely aggregate margin payments to the DCO and guarantee to the DCO the aggregate obligations of "A" as described above.

This letter, and the positions taken herein, represent the views of Division staff and do not necessarily represent the positions or views of the Commission or of any other office or division of the Commission. The relief issued by this letter does not excuse persons relying on it from compliance with any other applicable requirements contained in the Act or in the regulations issued thereunder. This letter does not create or confer any rights or obligations on any person or persons subject to compliance with the Commodity Exchange Act that bind the Commission or any of its other offices or divisions. As with all no-action letters, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, at its discretion.

Should you have any questions, please do not hesitate to contact me at 202-418-5326.

Very truly yours,
Eileen T. Flaherty

Director
Division of Swap Dealer