05-1
(2)

Futures Industry Association
2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823
202.466.5460
202.296.3184 fax
www.futuresindustry.org

FIA 50 years

COMMENT

April 4, 2005

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Withdrawal of Staff Interpretation
70 Fed. Reg. 5417 (February 2, 2005)

Dear Ms. Webb:

The Futures Industry Association ("FIA") welcomes the opportunity to submit this letter in response to the Division of Clearing and Intermediary Oversight (the "Division")'s request for comment concerning its 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 (CCH) ¶7120 (May 23, 1984) ("Interpretation No. 10") and specifically whether Interpretation No. 10 should be withdrawn. As the Commodity Futures Trading Commission ("Commission" or "CFTC") is aware, Interpretation No. 10 permits customer margin for futures or options on futures transactions to be held by futures commission merchants (each, an "FCM") in third party safekeeping accounts, without being deemed to violate Section 4d(a)(2) of the Commodity Exchange Act (the "Act"), 7 U.S.C. §6d(a)(2) et seq. and the rules and regulations thereunder.[1]

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest FCMs in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

For the reasons set forth in the Division's release, FIA agrees that Interpretation No. 10 is no longer necessary or justified and should be withdrawn, except in the limited circumstances identified in the release, as discussed below. However, in order to accomplish the Division's stated regulatory objectives and to avoid any inadvertent ambiguity concerning ongoing use of third party accounts, FIA also requests that the Division clarify that, following an appropriate transition period and subject to an exception permitting continued reliance on Interpretation No. 10 by FCMs who may not hold investment company assets under Securities and Exchange Commission ("SEC") Rule 17f-6 due to an affiliation with the investment company or its adviser, FCMs will not be permitted to hold customer margin funds in third party accounts under Section 4d(a)(2) of the Act and applicable CFTC rules. For this purpose, FIA believes that it would be appropriate for the Division to issue a new Financial and Segregation Interpretation concerning the status of third party accounts which would withdraw and supersede Interpretation No. 10 and provide the requested clarification with respect to ongoing use of these accounts.

BACKGROUND

As the Division recognizes, at the time Interpretation No. 10 was issued in 1984, the SEC staff took the position that Section 17(f) of the Investment Company Act of 1940 (the "ICA") prohibits a registered investment company from posting initial margin funds for futures trading directly with FCMs and that it was therefore necessary for registered investment companies to use third party safekeeping accounts to hold such assets. In issuing Interpretation No. 10, the Division attempted to reconcile the provisions of Section 4d(a)(2) of the Act which require an FCM to have immediate and unfettered access to customer funds with the custody restrictions then applicable to registered investment companies under the ICA. Pursuant to Interpretation No. 10, the assets held in third party safekeeping accounts are deemed to be properly segregated under Section 4d(a)(2) of the Act if maintained in accordance with the following criteria:

- the account must be maintained in the name of the FCM for the benefit of the customer;
- the FCM must have the ability to liquidate open positions in the account if the account becomes undermargined or goes into deficit without obtaining authorization from the customer or the custodian bank;
- the FCM must have the authority to withdraw funds from the account on demand with no right of the customer or the custodian bank to interfere with such a withdrawal;
- the customer may not withdraw or otherwise have access to the funds in the account without prior consent by the FCM; and
- the account may not be maintained at an affiliate of the customer.

When the Division issued Interpretation No. 10, it appeared that these criteria would assure that FCMs have possession and control of the funds held in these accounts in

accordance with the Act and that the Division's action was therefore a reasonable accommodation of the Act's segregation requirements with special custody restrictions which were then applicable to registered investment companies. However, in light of intervening developments, in particular the SEC's adoption of Rule 17f-6 in 1996 which became effective on January 16, 1997 and twenty years of experience with third party accounts, FIA agrees with the Division that it is appropriate to revisit Interpretation No. 10 and the continued use of these accounts in the futures industry. As discussed in the following section of this letter, FIA believes further that Interpretation No. 10 is no longer necessary or justified, subject to the one exception already noted, and also that third party accounts pose significant supervisory and systemic risk concerns.

DISCUSSION

Operational Concerns

Due to the tripartite nature of these arrangements, commodity customer funds held in third party accounts are not accessible to FCMs in the same manner as commodity customer funds deposited in ordinary segregated fund bank accounts pursuant to Rule 1.20 or secured amount funds deposited in bank accounts pursuant to Rule 30.7. 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 who service their regular segregated fund and secured amount fund bank accounts, even at the same bank.

As a result of these factors, these arrangements have led to the release of customer funds from third party accounts without the FCM's knowledge or consent, notwithstanding the language in third party account agreements prohibiting such transfers pursuant to Interpretation No. 10. An FCM might therefore include funds which it believes are being held in third party accounts in its daily computations of the total amount of customer funds on deposit in segregated accounts, which also could affect the accuracy of financial reporting statements filed by the FCM with the Commission and the various self-regulatory organizations. To address this matter, the Division issued an Advisory in 1996 to remind the custodian banks of their responsibilities with respect to third party accounts.[2] However, as the Division has recognized, these concerns remain an issue that needs to be resolved.

Systemic Risk Concerns

Third party accounts create systemic liquidity risks by diverting FCM capital, which otherwise would be available for use in the marketplace, to fund futures trading for the customers who currently use these arrangements. These risks are magnified in times of heightened market volatility when initial margin requirements typically increase and liquidity is most important for FCMs. As the SEC recognized in conjunction with adopting Rule 17f-6,

---

[2] See CFTC Advisory No. 37-96 (Responsibilities of FCMs and Relevant Depositories With Respect to Third Party Custodial Accounts), Comm. Fut. L. Rep. (CCH) ¶ 26,765 (July 25, 1996).

according to a 1988 report, third party accounts may have been a source of liquidity stress in the clearing and credit systems during the October 1987 market break.[3]

FIA believes that the amount of funds in third party accounts is substantial and that these accounts are heavily concentrated among a small number of FCMs and safekeeping banks. The substantial amount of assets in these accounts, along with the concentration of these accounts among a small number of FCMs and safekeeping banks, exacerbates the systemic liquidity risks posed by these accounts, particularly during periods of market stress.

Interpretation No. 10 Is No Longer Necessary for Institutional Customers

As noted before, since early 1997 SEC Rule 17f-6 has permitted registered investment companies to discontinue using third party accounts, except in circumstances where the carrying FCM is an affiliate of the registered investment company or its adviser. For this reason, FIA agrees that it is appropriate to permit an FCM who may not rely on Rule 17f-6 to hold investment company assets due to an affiliation with the investment company or its adviser to continue to rely on Interpretation No. 10. FIA believes that the amount of assets which are held in third party accounts maintained for registered investment company customers where the FCM is an affiliate of the investment company or its adviser is not significant, so that this limited exception will not undermine the Division's regulatory objectives in connection with withdrawing Interpretation No. 10.

It is important to bear in mind that, in determining that registered investment companies generally may discontinue using third party accounts and may place their assets directly with an FCM in connection with futures trading, the SEC cited the various custodial protections under the Act and CFTC rules designed to safeguard customer assets held by an FCM.[4] FIA also notes that when the Division issued Interpretation No. 10 in 1984, the Department of Labor ("DOL") had already clarified that there is no need under the Employee Retirement Income Security Act of 1974 ("ERISA") for an ERISA plan fiduciary to maintain a third party account for futures trading and that an FCM may hold plan assets deposited as initial margin funds directly.[5] Thus, FIA is not aware of any category of institutional customers whose participation in the futures markets would be adversely affected by the withdrawal of Interpretation No. 10.

Authority to Withdraw Interpretation No. 10

FIA believes that the Division clearly has authority to interpret Section 4d(a)(2) of the Act to prohibit FCMs from depositing or maintaining customer funds in third party accounts in conjunction with issuing a new Financial and Segregation Interpretation which would withdraw and supersede Interpretation No. 10. As set forth in the Division's release, the

---

[3] See 61 Fed. Reg. 66207 at 66208 n. 10 (December 17, 1996) (citing the Report of the Presidential Task Force on Market Mechanisms (1988) VI-73 to -74).

[4] See 61 Fed. Reg. 66207 at 66208 (December 17, 1996).

[5] See DOL Advisory Opinion # 82-49A (September 21, 1982) cited in Interpretation No. 10, Comm. Fut. L. Rep. (CCH) ¶7120 at 7130 n. 3.

Division has consistently interpreted Section 4d to prohibit any impediments or restrictions on an FCM's ability to obtain immediate access to commodity customer funds deposited in a bank. Moreover, the Division's position is consistent with longstanding precedent under the Act dating back more than sixty years.[6]

More recently, the Division issued Interpretation No. 9 in which the staff took the position that Section 4d of the Act does not permit an FCM to deposit or maintain customer funds in a money market deposit account ("MMDA") or a NOW account.[7] The basis for the staff's position has been the concern that a bank might invoke the reservation of notice requirement applicable to these accounts under relevant banking regulations (which has never happened) and thereby impede an FCM's ability to obtain immediate access to the funds in such accounts. Thus, the risk that an FCM might not have immediate access to the funds in such an account has been deemed sufficient to warrant prohibiting the deposit of customer funds in that type of account under any circumstances, notwithstanding that the reservation of notice requirement has heretofore not been invoked.

We believe that Interpretation No. 9 provides a compelling precedent for the Division in the circumstances presented here. Although third party accounts which are documented to comply with the requirements of Interpretation No. 10 do not on their face impose potential impediments to an FCM's ability to obtain immediate access to the funds in those accounts analogous to the type of restriction applicable to an MMDA or a NOW account, as a practical matter FCMs do not always have immediate and unimpeded access to the funds therein, as we have already explained and as the Division is aware. If the Division has authority to interpret Section 4d of the Act to prohibit an FCM from depositing or maintaining customer funds in an MMDA or a NOW account, it must therefore also be the case that the Division has authority to interpret Section 4d to prohibit an FCM from depositing or maintaining customer funds in a third party account, as FIA strongly believes.

FIA also believes that the same analysis is applicable to secured amount funds held for foreign futures and foreign options customers in third party accounts pursuant to Rule 30.7. As interpreted by the Division, such funds may not be held in the same third party accounts as segregated customer funds for domestic futures and options transactions, but must be held in separate third party accounts.[8] FIA therefore requests that the Division clarify in the same Financial and Segregation Interpretation to be issued withdrawing and superseding Interpretation No. 10 that, consistent with the view taken with respect to Section 4d(a)(2) of the Act, following an appropriate transition period and subject to an exception permitting continued reliance on Interpretation No. 10 by FCMs who may not hold investment company assets under Rule 17f-6 due to an affiliation with the investment company or its adviser, FCMs will not be permitted to deposit or maintain secured amount funds held for foreign futures and foreign options customers in third party accounts under Rule 30.7.

---

[6] See Administrative Determination No. 29 of the Commodity Exchange Authority, the Commission's predecessor agency, dated September 28, 1937.

[7] See Financial and Segregation Interpretation No. 9, Money Market Deposit Accounts and NOW Accounts, Comm. Fut. L. Rep. (CCH) ¶7119 (November 23, 1983).

[8] See CFTC Advisory No. 37-96, supra at n. 2.

The Division's Request for Comments

The Division has requested comments on whether withdrawal of Interpretation No. 10 would have any adverse impact on institutional customers or their ability to participate in the futures markets and whether there are any legal or prudential considerations supporting the use by institutional customers of third party accounts for futures trading. The Division also requested comments on the costs and expenses incurred by FCMs, including financing and potential opportunity costs in connection with maintaining these accounts. Finally, the Division requested comment on a whether six month transition period would be sufficient for FCMs and banks to make the necessary adjustments to third party accounts.

As noted before, FIA believes that the withdrawal of Interpretation No. 10 would not have any adverse impact on institutional customers and that there are no legal or prudential considerations that support the use by institutional customers of third party accounts for effecting futures transactions.

Third party accounts impose significant costs and expenses, including financing and potential opportunity costs, relative to regular customer accounts. Most notably, these include financing costs associated with covering initial margin requirements for third party account customers at the clearing house level. In addition, there can be increased personnel and legal costs and regulatory exposure associated with maintaining third party accounts relative to regular customer accounts. In this regard, because they require negotiation with both the customer and the custodian, third party accounts generally require a significant amount of additional resources from in-house counsel and typically take a longer period of time to conclude. While the time to negotiate and implement varies, in some circumstances such negotiations can take weeks or months to complete.

FIA believes that a six month time period is appropriate and sufficient for affected parties to make the necessary adjustments with respect to third party accounts.

CONCLUSION

FIA appreciates the opportunity to comment on the Division's proposed withdrawal of Interpretation No. 10. For the reasons set forth in this letter, FIA urges the Division to withdraw Interpretation No. 10, subject to an exception permitting continued reliance on Interpretation No. 10 by FCMs not eligible to hold investment company assets under SEC Rule 17f-6 due to an affiliation with the investment company or its adviser. In doing so, in order to accomplish its stated regulatory objectives and to avoid any inadvertent ambiguity concerning ongoing use of third party accounts, FIA also requests that the Division clarify that FCMs are not permitted to hold customer margin funds or secured amount funds in third party accounts under Section 4d(a)(2) of the Act and Rule 30.7, respectively, following a six month implementation period and subject to the one exception already noted. As also noted before, FIA believes that it would be appropriate for the Division to issue a new Financial and Segregation Interpretation concerning the status of third party accounts which would withdraw and supersede Interpretation No. 10 and provide the requested clarification with respect to ongoing use of third party

accounts. If you have any questions concerning this letter, please contact FIA's General Counsel, Barbara Wierzynski, at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Fred Hatfield, Commissioner
Honorable Michael V. Dunn, Commissioner
Division of Clearing and Intermediary Oversight
James L. Carley, Esq., Director
Carlene S. Kim, Esq., Senior Special Counsel