

CFTC letter No. 04-06
January 21, 2004
Interpretation
Division of Clearing and Intermediary Oversight

Mr. Eric A. Bloom
President & CEO
Sentinel Management Group, Inc.
Edens Corporate Center
650 Dundee Road, Suite 460
Northbrook, IL 60062

Re: Segregation and Net Capital Treatment of Funds Held on Deposit at Sentinel

Dear Mr. Bloom:

This letter responds to your request concerning Sentinel Management Group, Inc. (“Sentinel”). Specifically, you have asked the Division of Clearing and Intermediary Oversight (“Division”) of the Commodity Futures Trading Commission (“Commission” or “CFTC”) to confirm its views concerning the application of the Commission’s segregation and net capital regulations to certain accounts managed by Sentinel. Based upon your representations and the documents you have submitted, the Division understands the relevant facts to be as follows.

Sentinel is registered with the CFTC as a futures commission merchant (“FCM”) and with the Securities and Exchange Commission (“SEC”) as an investment adviser. Sentinel is a member of National Futures Association (“NFA”) but is not a member of any futures exchange. As such, NFA exercises primary financial surveillance of Sentinel under CFTC oversight. The CFTC, SEC, and NFA regulatory compliance programs include financial reporting requirements and periodic direct compliance examinations by SEC and NFA staff, as well as annual audits by independent public accountants.

Sentinel does not engage in all of the activities that are permitted for a person registered as an FCM. In this regard, Sentinel does not solicit or accept orders for commodity interest transactions and does not carry commodity interest positions for itself or for any of its clients. Rather, Sentinel’s business plan is to provide services to other FCMs (“Client FCMs”) in the investment of customer funds, as well as for other types of entities. Sentinel’s services to Client FCMs include, primarily, investment of excess margin funds, protected by the Commodity Exchange Act (“CEAct”). Client FCMs also invest proprietary funds with Sentinel.

Under the Sentinel investment management program, Client FCMs deposit commodity customer funds in a custody account maintained at the Bank of New York (“BONY”), which is referred to as the “Seg I Account”. Client FCMs also may deposit proprietary funds in a custody account at BONY, referred to as

the “Seg III Account”.^[1] The custody accounts require BONY to segregate the funds in the Seg I and Seg III accounts from BONY’s own assets and prohibits BONY from using the funds in the Seg I and Seg III accounts for BONY’s own purposes. The Seg I Account is titled in the name of Sentinel as agent on behalf of Sentinel’s Client FCMs. In compliance with Commission Regulation 1.26, Sentinel has obtained from BONY a letter acknowledging that the funds maintained in the Seg I Account are held pursuant to Section 4d(a)(2) of the CEAct and CFTC regulations for the benefit of Sentinel’s commodity customers. The acknowledgement letter further provides that BONY will not offset any obligation owed to BONY by Sentinel by any of the funds maintained in the Seg I Account.

Under the investment management agreements with the Client FCMs, Sentinel directs the investment of the funds maintained in the Seg I Account in accordance with Commission regulations governing the investment of commodity customer funds, including Regulation 1.25. Client FCMs do not obtain a direct interest in any particular security or other investments maintained in the Seg I or Seg III Accounts. Client FCMs share in the profits and losses on the investments made by Sentinel on a pro-rata basis, according to each Client FCM’s proportionate share of the total assets held in the respective Seg I and Seg III Accounts.

Sentinel meets, on a same-day basis, client redemption requests from the Seg I and Seg III Accounts received by 4:00 pm. Redemption requests received after 4:00 pm, but prior to the 6:00 pm closing of the Fed Wire, also will be met on a same-day basis, subject to the client incurring bank overdraft charges (i.e., interest costs associated with Sentinel’s borrowings necessary to satisfy such redemption request). Sentinel estimates that approximately 85 percent of the total investments held in the Seg I and Seg III Accounts could be liquidated in order to satisfy redemption requests received from all of its clients on a same-day basis. Sentinel further estimates that the remaining 15 percent of the Seg I and Seg III Accounts could be liquidated and the funds returned to the clients within three business days of the redemption request.

You have also represented that in the event of the insolvency of BONY, the funds held in the Seg I and Seg III Accounts would be transferred to a solvent banking institution and would not be subject to the claims of BONY’s creditors. In the event of the insolvency of Sentinel, funds held in the Seg I account would be distributed to the Client FCMs pursuant to CFTC regulations governing the bankruptcy of an FCM and funds held in the Seg III Account would be distributed directly to the Client FCMs that deposited funds held in the Seg III Account in accordance with provisions set forth in SEC regulations, the Advisers Act, and applicable federal bankruptcy law.

The CFTC’s Division of Trading and Markets issued a no-action position, which provided Sentinel with relief from the Commission’s minimum net capital requirements for an FCM.^[2] The no-action position effectively exempted Sentinel from the requirement to maintain minimum adjusted net capital equal to four percent of the commodity customer funds it held, provided Sentinel met certain other conditions, including maintaining minimum adjusted net capital equal to the minimum dollar amount required by Regulation 1.17 (currently \$250,000). This letter does not alter the Division’s previous no-action position.

Based upon the foregoing, including your representations, it is the Division staff's view that the Seg I Account at BONY satisfies the requirements of Section 4d(a)(2) of the CEAct and Commission Regulation 1.20 governing the segregation of customer funds. Accordingly, a Client FCM may include its proportionate interest in the total funds held in the Seg I Account in performing the daily segregated funds computation required by Regulation 1.32, subject to the appropriate haircuts set forth in Regulation 1.17(c)(5)(v) and Securities and Exchange Commission ("SEC") Rule 15c3-1.^[3]

Furthermore, based upon the facts and representations as set forth above, in particular the representation that Sentinel can liquidate and return to its clients, including Client FCMs, approximately 85 percent of the total investments held in the Seg III Account on a same-day basis and the remaining investments within three days, a Client FCM may include proprietary funds held in the Seg III Account as a current asset in computing its minimum adjusted net capital pursuant to Regulation 1.17. This opinion is conditioned upon Sentinel informing each Client FCM that it should report its proportionate interest in the Seg III Account as an investment on financial reports filed with the Commission and self-regulatory organizations. The Division's opinion is further conditioned upon Sentinel calculating the haircuts on all investments held in the Seg III portfolio in accordance with Regulation 1.17(c)(5)(v) and SEC Rule 15c3-1 and reporting to each Client FCM, on a daily basis, the Client FCM's proportionate interest in the investments held in the Seg III Account, the Client FCM's proportionate interest in the total haircut for all of the investments in the Seg III Account, and any other information that is necessary for each Client FCM to recognize its proportionate interest in the Seg III Account, less applicable haircuts, as a current asset in calculating its adjusted net capital pursuant to Regulation 1.17.

The Division's opinions herein are based upon the documents submitted and the representations that Sentinel has made regarding its operations. Any different, changed, or omitted facts or conditions might cause the Division to come to a different conclusion. Moreover, the opinions expressed herein are that of the Division only. They are not necessarily the opinion of the Commission or of any other unit of the Commission. If you have any questions regarding this letter, please feel free to contact me, Thomas Smith, Associate Director and Chief Accountant, at 202-418-5495, or Carlene Kim, Special Counsel, at 202-418-5613.

Very truly yours,

James L. Carley
Director
Division of Clearing and Intermediary Oversight

cc: Michael Macchiaroli, Associate Director, Division of Market Regulation, U.S. Securities and Exchange Commission

Joseph Sanguedolce, Chairman, Joint Audit Committee, and Director Financial Surveillance, New York Mercantile Exchange

[1] Sentinel also provides investment management services to non-FCM clients. The funds received from such non-FCM clients are deposited in the Seg III Account maintained at BONY.

[2] Letter from John L. Manley, Director, Division of Trading and Markets, Commodity Futures Trading Commission, to Terry L. Claassen, Esquire, O'Neal & Claassen, Chartered, dated May 7, 1981.

[3] The Division of Trading and Markets has provided guidance to Client FCMs as to how the concentration limits set forth in Regulation 1.25(b)(4) and the haircut requirements set forth in 1.17(c)(5) (v) could be applied to investments in the Seg I Account. (See, letter to Susan C. Ervin, Esq., Law Offices of Dechert Price & Rhoads, from John C. Lawton, Acting Director, Division of Trading and Markets, dated July 30, 2001.) This letter does not supercede the previous guidance and the July 30, 2001 letter is still effective.