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Division of Swap Dealer and Intermediary Oversight

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Interpretation
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Division of Swap Dealer and Intermediary Oversight

Staff Interpretation Regarding Regulatory Accounting for Customer Margin Payments Using Automated Clearing House Payment Processing Systems

The Division of Swap Dealer and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("Commission") is issuing this interpretation of Commission Regulations 1.17, 1.22, 22.2, and 30.7[1] to confirm the Division's view that a futures commission merchant ("FCM") may credit a customer's futures, foreign futures, and/or cleared swaps trading account for a margin payment upon the FCM's initiation of a withdrawal from the customer's bank account using the Automated Clearing House ("ACH") transaction system.[2] This interpretation is conditioned upon the FCM and customer having entered into a written agreement authorizing the FCM to initiate an ACH transaction to withdraw funds from the customer's bank account to meet a margin call. The Division's interpretation is based upon the facts set forth below, and is subject to the additional conditions discussed below.

Background

On November 13, 2013, the Commission revised its regulations to enhance protections provided to customer funds deposited with FCMs as margin for futures, foreign futures, and cleared swaps positions.[3] As part of these enhancements, the Commission amended Regulations 1.22 and 30.7(f) to explicitly prohibit an FCM from using funds belonging to one customer to

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[1] The Commission's regulations may be found at 17 CFR Chapter I, and also are available through the Commission's website.

[2] ACH is a computer based clearing and settlement facility established to process the exchange of electronic transactions between participating depository institutions. The ACH network is subject to rules of the National Automated Clearing House Association and the Federal Reserve.

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

margin or secure the futures or foreign futures, respectively, of other customers. Revised Regulations 1.22 and 30.7(f) are consistent with Regulation 22.2, which was adopted by the Commission on February 7, 2012.[4] Regulation 22.2 prohibits an FCM from using the funds of one Cleared Swaps Customer to margin the cleared swaps positions of other Cleared Swaps Customers.[5]

To comply with Regulations 1.22, 22.2, and 30.7(f), each FCM is required to compute the "undermargined amount" of each customer's trading account as of the close of business on each business day. The "undermargined amount" is defined in Regulations 1.22, 22.2 and 30.7(f) as the amount by which the total margin obligation of a customer's trading account, as computed based upon respective clearinghouses' margin requirements for the customer's end-of-day positions, exceeds the net liquidating equity of the customer's trading account, plus any margin deposits made by the customer prior to the respective clearinghouses' daily settlement on the next business day.[6]

After computing the total undermargined amount for all customer trading accounts, the FCM is required to assess whether it maintains a sufficient amount of its own capital or funds (hereinafter referred to as the FCM's "Residual Interest") in the applicable customer segregated or secured accounts to cover the total undermargined amount. If the total undermargined amount for either the futures, cleared swaps, or foreign futures accounts exceeds the FCM's Residual Interest in such accounts, the FCM is required to increase the Residual Interest amount by depositing additional proprietary funds into the customer segregated or secured accounts in an amount sufficient to ensure that the Residual Interest equals or exceeds the applicable undermargined amount.[7]

The regulations also impose deadlines for an FCM to increase its Residual Interest. An FCM is required to increase its Residual Interest for futures accounts (Regulation 1.22) and cleared swaps accounts (Regulation 22.2) prior to the clearing settlement cycle on the next

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[4] <u>Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions</u>; Final Rule, 77 FR 6336 (Feb. 12, 2012).

[5] The term "Cleared Swaps Customer" is defined in Regulation 22.1 to mean any person entering into a cleared swap, except if the person is the owner or holder of a proprietary account on the books of the FCM.

[6] The terms "settlement" and "daily settlement" are generally defined in Regulation 39.14 as the point in time when clearing organizations and clearing firms pay or receive initial and variation margin payments.

[7] The Commission set a November 14, 2014 compliance date for the Residual Interest requirements of Regulations 1.22 and 30.7(f). The compliance date for the Residual Interest requirement of Regulation 22.2 was November 8, 2012.

business day.[8] The FCM is required to increase its Residual Interest for foreign futures accounts (Regulation 30.7(f)) by 6:00 pm on the next business day. By maintaining Residual Interest in the customer segregated and secured accounts in an amount that equals or exceeds the total undermargined amount of customer trading accounts, the FCM ensures that it does not use the funds of customers with excess margin collateral to margin positions of customers with undermargined positions in violation of Regulations 1.22, 22.2, and/or 30.7(f).

FCM Requests

The Commission has received inquiries from several FCMs regarding the proper regulatory accounting for ACH transactions to meet customer margin calls.[9] These FCMs have a significant number of non-institutional customers, including farmers, ranchers, feed lots, grain elevators, and other commercial entities in the agricultural marketplace. Some of these non-institutional customers currently make margin payments using the ACH payment system, while others use wire transfers and check payments.

The FCMs request that the Division confirm that an FCM may credit a customer's trading account for a margin payment upon the FCM's initiation of an ACH transaction to withdraw funds from the customer's bank account, as opposed to recording a credit only upon the FCM's actual receipt of the customer's funds. The FCMs further request that the Division confirm that an FCM may recognize the customer's margin deposit in performing the undermargined computation required by Regulations 1.22, 22.2, and 30.7(f) upon the FCM's initiation of the ACH transaction from the customer's bank account.

In support of their requests, the FCMs state that they currently credit a customer's trading account upon the receipt of a customer's margin check, and are not required by Commission regulations to delay crediting the customer's trading account until the check clears the customer's bank account. The FCMs also note that it may take one or more days for the customer's check to settle such that funds are unconditionally received by the FCM.

[8] The timing of compliance with the Residual Interest requirement for futures accounts under Regulation 1.22 is on a phased-in basis. The first compliance date for the requirement is November 14, 2014 (i.e., one year after publication of the final rules). As of that date, FCMs will be required to hold the required Residual Interest amount by 6:00 p.m. (Eastern Time) the business day following the trade date. In adopting the requirement, the Commission also directed staff to complete and publish for public comment by May 16, 2016, a report addressing, to the extent information is practically available, the practicability (for both FCMs and customers) of moving that deadline from 6:00 p.m. Eastern Time on the date of the settlement to the time of settlement that day. Staff was further directed to solicit public comment and to conduct a public roundtable regarding the specific issues to be covered by the report.

[9] Staff received letters from three FCMs supporting the issuance of an interpretation.

The FCMs state that the use of checks and the ACH payment systems to meet margin requirements are comparable from a regulatory perspective and, therefore, checks and ACH payments should be subject to comparable regulatory accounting treatment. In this regard, the FCMs state that there is a one day settlement for ACH payments. Thus, if an FCM initiates an ACH withdrawal from a customer's bank account on Monday, the funds should be received into the FCM's customer segregated or secured bank account on Tuesday.

The FCMs also state that they would like to encourage their customers to use the ACH system and convert customers that currently meet margin calls by check to the electronic ACH system by having their customers' execute written authorizations permitting the FCMs to initiate margin withdrawals from the customers' bank accounts using ACH transactions. The FCMs note that ACH payments provide an efficient and cost effective means for customers to satisfy margin calls. The FCMs also state that clearing of ACH payments is faster than that for checks and, unlike wire transfers, banks often do not charge fees for each transaction. In discussions with Division staff, the FCMs also stated that wire transfer fees can become costly as many of their non-institutional customers maintain a small cushion of excess margin funds on deposit in their trading accounts. These customers, depending upon market conditions, may be required to make multiple deposits to their trading accounts each week to meet margin calls.

Discussion

The Division confirms that it is permissible under Regulations 1.22, 22.2, and 30.7 for an FCM to credit a customer's trading account for a margin payment upon the FCM's initiation of an ACH withdrawal from the customer's bank account, provided that the customer has entered into a written agreement with the FCM authorizing the FCM to initiate ACH withdrawals from the customer's bank account to meet margin obligations. As noted above, FCMs currently record a check received from a customer as equity to the customer's trading account upon the receipt of the check. Commission regulations do not require an FCM to delay crediting the customer's trading account until the check clears the customer's bank account.

The FCMs' regulatory accounting treatment for checks is consistent with Financial and Segregation Interpretation No. 13: "Accounting for Checks Received From a Parent or an Affiliated Entity for Regulatory Compliance Purposes" (1991) ("Financial and Segregation 13"), issued by the Division's predecessor, the Division of Trading and Markets.[10] Financial and Segregation Interpretation 13 states that an FCM may not record a check received from an affiliate for a margin payment until the check has actually cleared the affiliate's bank account and the funds are available in the FCM's bank account. The Division of Trading and Markets, however, further stated in Financial and Segregation Interpretation 13 that "[a]s a general matter in connection with checks received from unaffiliated third parties, the convention of recognizing

[10] Financial and Segregation Interpretation No. 13 is available at the following link on the Commission's website: http://www.cftc.gov/tm/finseginterp_13.htm.

checks received as the equivalent of cash is entirely appropriate, unless, of course, there is reason to believe that a check may not clear the [customer's] bank in the normal course of business or is otherwise part of a scheme to report false or misleading financial information [to the FCM]."[11] Similarly, the Instructions Manual to the Form 1-FR-FCM directs FCMs to report margin checks received from customers that are not deposited by the FCM because banking facilities are closed as a segregated asset.[12]

The Division believes that ACH transactions are sufficiently comparable to checks with respect to the timing of the receipt of the customers' funds by the FCM such that ACH transactions may be afforded the same regulatory accounting treatment. Accordingly, an FCM may credit a customer's trading account upon the FCM's initiation of an ACH withdrawal from the customer's bank account to meet a margin call. Thus, if the FCM initiates the ACH withdrawal prior to the applicable Residual Interest deadline, the FCM may recognize the ACH transaction as a margin deposit by the customer.

This interpretation is conditioned upon the FCM and customer having entered into a written agreement whereby the customer authorizes the FCM to initiate ACH withdrawals from the customer's bank account in order to meet margin calls. This interpretation also is conditioned upon the FCM conducting adequate due diligence of the customer's credit risk and the FCM's establishment of a sufficient amount of Residual Interest to meet its regulatory requirements as required under Regulation 1.11. The Division further expects that FCMs will establish criteria to determine under what circumstances certain customers must meet margin calls via wire transfer or other methods to ensure same-day receipt of funds.

In addition, if an FCM has information that a customer's account will not have sufficient funds to meet an ACH withdrawal, or any other information that indicates that the customer will not meet a margin call, the FCM may not credit the customer's account upon the initiation of the ACH transaction. Furthermore, if an ACH transaction is rejected by the customer's bank for any reason, including insufficient funds in the customer's bank account, the FCM must reverse the margin credit to the customer and only credit the customer's account upon the actual receipt of the customer's margin payment.

The Division also confirms that for the purpose of computing undermargined capital charges set forth in Regulation 1.17(c)(5)(viii), an FCM may consider a customer's margin obligation as having been met upon the FCM initiating an ACH withdrawal from the customer's

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[11] Id. at p. 1.

[12] See p. 10-10 of the Form 1-FR-FCM Instructions Manual. The Form 1-FR-FCM Instructions Manual is available on the Commission's website at the following link: http://www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/1fr-fcminstructions.pdf.

bank account.[13] Accordingly, the FCM is not required to take a capital charge for pending ACH transactions from a customer's bank account. However, if the ACH transaction fails to clear due to insufficient funds in the customer's account or for any other reason, the FCM must take a capital charge for the full amount of the customer's undermargined amount.

FCMs also have requested that the Division clarify how FCMs should compute their Residual Interest requirements under Regulations 1.22, 22.2, and 30.7 on business days when the futures markets are open and the U.S. banking system is closed. With respect to Regulations 1.22 and 22.2, the relevant point in time for an FCM to be in compliance with the obligation to maintain Residual Interest in amount equal to or in excess of the total undermargined amount is at the time of settlement cycle on the next business day. Accordingly, if the U.S. banking system is closed, U.S. derivatives clearing organizations do not conduct a settlement cycle until the next business day when the banking system is open.[14]

With respect to Regulation 30.7, an FCM is required to maintain Residual Interest in the customer secured accounts in an amount sufficient to cover the total customer undermargined amount computed as of the close of business each day by 6 pm Eastern Time on the next business day. Since foreign markets are subject to varying holidays, it is the responsibility of each FCM to manage its foreign futures customers and their trading accounts to ensure that the FCM maintains sufficient Residual Interest in the secured accounts to cover potential undermargined customer accounts.

In addition, the Division believes that FCMs also may credit a customer's account for a check or upon the initiation of an ACH withdrawal from the customer's banking account even in situations where the banks are closed on the next day and the FCM will not be credited for the

[13] Regulation 1.17(c)(5)(viii) requires an FCM to take a capital charge in computing its adjusted net capital equal to the amount of funds required in a customer's trading account to meet maintenance margin requirements of the applicable board of trade or clearing organization applicable to the positions in the customer's trading account, after application of calls for margin or other required deposits to the customer that are outstanding no more than one business day.

[14] For example, U.S. futures markets have trading hours on Tuesday, November 11, 2014, while the U.S. banks are closed for the Veterans Day holiday. Consistent with the requirements of Regulations 1.22 and 22.2, an FCM is required to compute the total undermargined accounts for futures accounts and cleared swaps accounts as of the close of business on the Monday, November 10, 2014. The FCM also is required to maintain Residual Interest in an amount sufficient to cover the total amount of customer undermargined accounts (after adjusting for any deposits received or disbursements made from such accounts since the close of business on Monday, November 10, 2014) by 6 pm Eastern Time on Wednesday, November 12, 2014 under Regulation 1.22 for futures accounts, and by the settlement cycle on Wednesday, November 12, 2014 under Regulation 22.2 for cleared swaps accounts.

check deposit or ACH transaction until the banks reopen. The FCM also may include the check and the pending ACH transaction in determining the margin balance of the customer's account in computing the undermargined capital charge under Regulation 1.17(c)(5)(viii).

This interpretation and the views expressed herein, represent the views of the Division only, and do not necessarily represent the positions or views of the Commission or of any other office or division of the Commission. If you have any questions, please contact Thomas Smith, Deputy Director, at 202-418-5495 or Larry Eckert, Special Counsel, at 646-746-9704.

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