

## **Commodity Futures Archive - Selected materials, COMMODITY-FUTURES ¶22,703, Interpretative Statement, No. 85-3, Regarding the Use of Segregated Funds by Clearing Organizations upon Default by Member Firms., (Aug. 12, 1985), Commodity Futures Trading Commission, (Aug. 12, 1985)**

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### **Interpretative Statement, No. 85-3, Regarding the Use of Segregated Funds by Clearing Organizations upon Default by Member Firms.**

Commodity Futures Trading Commission, Office of the General Counsel. August 12, 1985.

**Clearing Organizations--Segregated Funds--Member Firms--Default.**--According to the Commission's Office of the General Counsel, Section 4d(2) of the Commodity Exchange Act does not prohibit a clearing organization's use of margin deposits in the member firm's customer account to discharge the member firm's obligations arising from that customer account if the member firm is in default. However, the clearing organization's right to these funds may be inferior to rights of the member firms' customers in certain circumstances due to the clearing organization's knowledge of or participation in a violation of the Act or other provisions of law by either the defaulting member firm or by other parties.

See ¶10,450, "Liabilities--Prohibitions" division, Volume 1.

#### *Use of Segregated Funds by Clearing Organizations Upon Defaults By Member Firms*

The rights of a clearing organization to make use of margin funds deposited by a clearing member firm that has defaulted on an obligation to the clearing organization are defined by the rules and by-laws of the clearing organization subject to limitations imposed by the Commodity Exchange Act ("Act") and the rules and regulations promulgated thereunder, 17 C.F.R. §1, *et seq.* (1984). Clearing organization rules and by-laws commonly provide that upon the failure of a member firm to satisfy an obligation owed the clearing organization, the clearing organization may use all margin funds and property of the member firm within the clearing organization's custody to satisfy the firm's obligations to the clearing organization. In our view, Section 4d(2) of the Act does not preclude the clearing organization from applying all margin deposits of a defaulting firm to discharge such firm's obligations on behalf of the customer account for which they were deposited with the clearing organization. The clearing organization may be precluded from exercising such rights in limited circumstances, however, by reason of its knowledge of or participation in a violation of the Act or other provision of law by the defaulting firm or other parties that renders its rights to such funds inferior to those of the clearing firm's customers.

Section 4d(2) of the Act, 7 U.S.C. §6d, defines the manner in which futures commission merchants ("FCMs"), clearing organizations, and other depositories of funds deposited by commodity customers to margin or settle futures transactions, or accruing to customers as the result of such trades, must deal with such funds. Section 4d(2) requires that FCMs "treat and deal with" funds deposited by a customer to margin or settle trades or contracts or accruing as the result of such trades or contracts "as belonging to such customer," separately account for such funds, and refrain from using such funds "to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held." Section 4d(2) specifically authorizes FCMs to commingle such funds, for purposes of convenience, in the same account or accounts with any bank, trust company or clearing organization of a contract market. This provision also authorizes withdrawals from such funds of "such share thereof as in the normal course of business shall be necessary" to margin, guarantee, secure, transfer, adjust, or settle trades or contracts, "including the payment of commissions, brokerage, interest, taxes, storage and other charges, lawfully accruing in connection with such contracts and trades."

The final sentence of Section 4d(2) defines the obligations of clearing organizations, depositories and all other recipients of customer margin funds and property in the following terms:

It shall be unlawful for any person, including but not limited to any clearing agency of a contract market and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of or use any such money, securities, or property

as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant.

This provision prohibits clearing organizations and all other depositories of customer funds from using such funds to discharge proprietary obligations of the depositing FCM or for any purpose other than to margin, guarantee, secure, transfer, adjust, or settle trades or contracts of the depositing firm's customers, including the payment of commissions and other charges "lawfully accruing in connection with" such contracts and trades.

In our view, Section 4d(2)'s provisions with respect to clearing organizations' treatment of customer funds must be construed in light of the fact that clearing organizations' direct customers are, generally, clearing firms, not the ultimate "customers" who entered into the futures contracts and options positions accepted for clearance by the clearing organization. Margin deposits posted with clearing organizations by their member firms normally consist, at least in part, of funds belonging to clearing firm customers, whose margin deposits were posted with the clearing firm and subsequently drawn upon by the clearing firm to satisfy its margin obligations to the clearing organization. The clearing organization normally has no direct dealings with such customers and has knowledge neither of their specific identities nor of the extent of their respective ownership interests in margin funds posted by its clearing firms. Consequently, to the extent that Section 4d(2) of the Act requires that clearing organizations use margin deposits on behalf of the "customers of such [depositing] futures commission merchant," we are of the view that it requires only that the clearing organization use such funds as the property of the clearing firm's customers collectively, but does not require the clearing organization to treat such funds as the property of the particular customers who deposited them or to whose positions they have accrued.

This view accords with the legislative history of Section 4d(2) of the Act. The Act did not specifically govern the treatment of commodity customer funds by clearing organizations and other depositories of customer margin funds until the enactment of Section 4d(2)'s final paragraph, quoted above, in 1968. The legislative history of this provision reflects Congress's intention to ensure that customer funds would not be used to discharge the general obligations of the FCM or otherwise diverted from their lawful purposes. According to the Senate Report, for example, the amendment was proposed "to prohibit expressly customers' funds from being used to offset liabilities of the futures commission merchants or otherwise being misappropriated." S. Rep. No. 947, 90th Cong. 2d Sess. 7 (1968). See also H.R. Rep. No. 743, 90th Cong., 1st Sess. 4-5 (1967).

The Commodity Exchange Authority's Administrator described the 1968 amendment as one which would afford additional protection against a situation presented in the *De Angelis* salad oil case "in which one of the banks actually took over funds of customers of one of the brokerage firms to offset liabilities of the firm." *Amend the Commodity Exchange Act: Hearings on H.R. 11930 and H.R. 12317 Before the House Comm. on Agriculture 57* (1967) (Testimony of Alex C. Caldwell, Administrator, Commodity Exchange Authority). The proposed amendment would require that banks and other depositories "keep separate the funds of the customers and of the brokerage firms which they do not have to do now." *Id.* The Act's legislative history thus evinces an intention that depositories treat customers' funds as the property of the customers of the depositing FCM, as distinguished from the FCM's own property or that of any other person.

Our conclusion that Section 4d(2) generally allows clearing organizations to treat customer funds as the property of the depositing firm's customers, collectively, without regard to the respective interests of particular customers, also finds support in the legislative history of the Bankruptcy Reform Act of 1978. In recommending new provisions to govern bankruptcy liquidations of commodity firms, the Commission described the clearing house system then (and now) operant in the futures market as one in which "a clearing house deals only with its clearing members" and thus "does not know the specific customer on whose behalf a particular contract was entered into by one of its clearing members." *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights, House Comm. on the Judiciary, 94th Cong., 2d Sess. 2377, 2395* (Statement of William T. Bagley) (1976). The Commission explained that this system allows a clearing organization to use "whatever funds are on deposit with it on behalf of customers to meet variation margin calls with respect to customers' trades or contracts" and, following a clearing member default, the defaulting firm's "original margin deposits are immediately available to offset any losses the clearing house might incur" as a result of answering variation margin calls to the defaulting firm. *Id.* at 2397, 2405.

The Commission's regulations are also consistent with the view that the clearing organization's direct obligations under Section 4d(2) include an obligation to treat customer funds as the property of the depositing FCM's customers but do not include a duty to separately account for or to employ such funds as the property of particular customers. Regulation 1.20(b), 17 C.F.R. §1.20(b) (1984), for example, requires that a clearing organization separately account for and segregate all customers' funds received from a member of the clearing organization to purchase, margin, guarantee, secure or settle the trades, contracts or commodity options of the clearing member's customers and all money accruing to such customers as the result of such trades, contracts, or commodity options "as belonging to such commodity or option customers," and specifies that a clearing organization shall not hold, use or dispose of such customer funds "except as belonging to such commodity or option customers." 17 C.F.R. §1.20(b) (1984).<sup>1</sup>

Regulation 1.22, 17 C.F.R. §1.22 (1984), which precludes FCMs from using or permitting the use of "the customer funds of one commodity and/or option customer to purchase, margin, or settle the trades, contracts, or commodity options of, or to secure or extend the credit of, any person other than such customer or option customer," refers only to FCMs and, hence, does not govern clearing organizations or other depositories of customer funds.<sup>2</sup>

Our conclusion that Section 4d(2) does not preclude a clearing organization from using all margin funds deposited by a clearing member firm to satisfy obligations arising from the account for which such funds were deposited reflects the essential function of margin deposits in the futures markets' clearing system. Clearing organizations generally stand as guarantors of the net futures and options obligations of the member firms and require margin deposits as security for the performance of obligations which, in the event of a member's default, the clearing organization must discharge. Margin deposits at the clearing level thus facilitate the clearing organization's performance of its guarantee obligations, serving to confine losses stemming from a clearing firm default to the defaulting firm and preventing their spread to the market as a whole.

In sum, we conclude that clearing organization rules and by-laws awarding clearing organizations the right to apply all customer margin funds within their custody to satisfy nonproprietary obligations of defaulting clearing firms are not inconsistent with Section 4d(2) of the Act or the Commission's regulations. Clearing organizations' rights with regard to the use of customer margin deposits of their member firms are not, however, wholly unlimited. A clearing organization may not use the margin deposits of one clearing member firm to satisfy obligations of another clearing firm or of any other person. In addition, as noted above, the final paragraph of Section 4d(2) of the Act was enacted to prevent use of customer funds to satisfy the FCM's own obligations. Consequently, customer margin funds deposited by a member FCM may not be used to margin, guarantee or settle the futures or options transactions or to satisfy any other proprietary obligation of the depositing firm. Such funds must be used to margin, guarantee, secure, or settle trades or contracts of the depositing FCM's customers or for charges "lawfully accruing in connection with" such contracts and not for any other purpose.<sup>3</sup> Finally, a clearing organization's rights with respect to the use of customer margin funds may be limited in particular circumstances by reason of the clearing organization's knowledge of or participation in a violation of the Act or other provision of law that precludes it from obtaining rights to such funds superior to those of one or more customers of the defaulting clearing member. Such a violation could occur, for example, in circumstances in which the clearing organization received particular margin funds with actual knowledge that the depositing firm has breached its duty under Section 4d(2) to segregate and separately account for customer funds and that the funds in question have been deposited with it to margin, secure, guarantee or settle the trades or contracts of a person other than the customer who deposited such funds or to whom they have accrued. The clearing organization's knowing participation in such use of customer funds could subject it to aiding and abetting liability under Section 13(a) of the Act and would preclude it from obtaining rights to such funds superior to those of the innocent customer.

<sup>1</sup> To the extent that the final sentence of Regulation 1.20(a), 17 C.F.R. 1.20(a) (1984), may be read to require that clearing organizations treat customer funds as the property of the particular customer who deposited them, we consider it inconsistent with Regulation 1.20(b), which more specifically addresses the obligations of clearing organizations, and with this agency's view of clearing organizations' obligations. The current language of Regulation 1.20(a)'s final sentence apparently reflects an unintentionally broad modification of that provision made in connection with amendments of a number of Commission regulations to reflect

establishment of the Commission's exchange-traded options program. Until these 1981 revisions of the Commission's regulations, Regulation 1.20(a)'s last sentence referred to "customers" in the plural, made no express reference to clearing organizations and was substantially consistent with the final sentence of Section 4d(2). The Commission's proposed rules regarding exchange-traded options would have modified this language only to the extent of including option customers within its protections: "Nor shall any such funds be held, disposed of, or used as belong [sic] to the depositing futures commission merchant or any person other than the commodity or option customers of such futures commission merchant." 46 F.R. 33315 (1981). As adopted, however, the Commission's final rules concerning the regulation of exchange-traded commodity options included Regulation 1.20(a)'s final sentence in its current form, a modification that apparently was not intended to be substantive. In the preamble to these rules, the Commission stated that it was adopting revised Regulations 1.20 through 1.30 "essentially as proposed." 46 F.R. 54508 (1981). We suggest that a technical amendment to Regulation 1.20(a) be proposed in the near future to conform its final sentence to its intended meaning.

<sup>2</sup> See also Regulation 1.36, which governs recordkeeping concerning securities and other property received from customers and option customers. Regulation 1.36 requires FCMs to maintain a record, showing "separately for each customer or option customer" the securities or property received, name and address of the depositing customer and other pertinent information. By contrast, clearing organizations with which clearing member firms deposit securities or property belonging to particular customers or option customers of such members in lieu of cash margin are required to maintain records "which will show separately for each member" the date of receipt of such securities and property and other pertinent data but are not required to maintain records of the names of the particular customers of the member firm from whom such securities and property were received.

<sup>3</sup> This prohibition includes a proscription against the use of customer margin funds deposited in connection with futures or option transactions to discharge obligations, including customers' obligations, incurred in connection with transactions that are not within the purview of the Act or the rules and regulations promulgated thereunder.