Commodity Futures Trading Commission
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Q & A – Proposed Amendments to Enhance Customer Protection

Why is the Commission proposing these amendments?

The recent failures of two futures commission merchants ("FCMs") and the shortfall in customer segregated funds held by these firms have highlighted a need for the Commission to revise its regulatory structure in order to provide greater protection to customers and to the funds deposited by customers with FCMs and derivatives clearing organizations ("DCOs"). In developing this proposal, the Commission sought the views of a broad cross-section of the futures industry, including market participants, FCMs, DCOs, self-regulatory organizations ("SROs"), securities regulators, foreign clearing organizations, and academics. The Commission hosted two public roundtables to solicit input on customer protection issues The first roundtables focused on issues relating to the advisability and practicality of modifying the segregation models for customer funds; alternative models for the custody of customer collateral; enhancing FCM controls over the disbursement of customer funds; increasing transparency surrounding an FCM's holding and investment of customer funds; and lessons learned from recent commodity brokerage bankruptcy proceedings. The second roundtable focused on SRO requirements for examinations of FCMs and Commission oversight of SRO examination programs. The second roundtable also focused on the role of the independent public accountant in the FCM examination process, and proposals addressing various alternatives to the current system for segregating customer funds.

The Commission also hosted a public meeting of the Technology Advisory Committee ("TAC") on July 26, 2012. Panelists and TAC members discussed potential technological solutions directed at enhancing the protection of customers funds by identifying and exploring technological issues and possible solutions relating to the ability of the Commission, SROs and customers to verify the location and status of funds held in customer segregated accounts.

As a result of the consultative process, the Commission identified several areas in which the existing customer protection regime can and should be improved, which are detailed below.

How would the proposed regulations enhance protections for customers trading on foreign futures markets?

Part 30 of the regulations governs how FCMs may hold funds for customers trading futures and options on futures that are listed on foreign boards of trade. Currently, the regulatory structure does not provide a comparable level of protection for customers trading on foreign markets as it does for customers trading on Commission designated contract markets. The proposed amendments to Part 30 are intended to better align the regulatory protections afforded customers trading on foreign boards of trade with the protections provided to customers trading on designated contract markets. The proposal would amend Part 30 to enhance customer protection in the following manner:

- FCMs would be required to set aside in Part 30 secured accounts a sufficient amount of funds to meet the net liquidating equity in the trading accounts of each customer trading foreign futures and options. Currently, an FCM is only required to set aside in Part 30 secured accounts a sufficient amount of funds to cover the margin required on open foreign futures and option positions, plus or minus any unrealized gains or losses on such positions. The proposal also would harmonize the Part 30 secured amount computation with the segregation computation for customers trading on designated contract markets and the segregation computation for cleared swap transactions, which both require an FCM to hold sufficient funds to meet the net liquidating equities of all customers;

- FCMs would be required to hold a sufficient amount of funds in secured accounts to cover the net liquidating equities of all U.S. domiciled-customers and foreign-domiciled customers. Currently, FCMs are permitted, but not obligated,

to include the account balances of foreign-domiciled customers in computing the secured amount requirements. By amending Part 30 to require FCMs to include the accounts of both U.S.-domiciled and foreign-domiciled customers, the proposal ensures greater protections are provided to both classes of customers in the event of the insolvency or bankruptcy of an FCM;

- FCMs would be prohibited from including with funds set aside in Part 30 secured accounts any funds for customer positions other than foreign futures or foreign option positions. Currently, an FCM is not prohibited from depositing funds from unregulated transactions in Part 30 secured accounts, and customers have included over-the-counter positions and other types of positions in their foreign futures or foreign options accounts;

- FCMs would be subject to restrictions regarding the amount of customer funds that could be held in depositories outside of the United States. Currently, there are no limitations on the amount of customer funds FCMs may deposit outside of the United States for customers trading on foreign markets. The proposal would limit the amount of funds FCMs could deposit outside of the United States to an amount equal to the required margin on the foreign futures and foreign options positions, plus an appropriate cushion (which is proposed to be 10% of the required margin) to ensure that the foreign positions do not become undermargined and to reduce the need for frequent wire transfers into and out of the foreign accounts. Recent events have demonstrated the challenges that are faced in recovering customer funds from foreign jurisdictions in the event of the bankruptcy or insolvency of an FCM; and

- FCMs would be explicitly prohibited from waiving any of the protections afforded under the laws or regulations of a foreign jurisdiction regarding the deposit of customer funds with a foreign broker or foreign clearing organization for the purpose of margining foreign futures or foreign options. FCMs must ensure that the customer funds deposited in a foreign jurisdiction receive the maximum protection provided in the foreign jurisdiction for such funds.

What risk management programs would FCMs be required to adopt under the proposal?

The proposal would require FCMs to implement risk management policies, procedures and controls around the risk of the FCM's business. Specifically, the Commission is proposing to require each FCM that carries customer funds to take into account all risk applicable to the FCM, including risks relating to operations, capital, and customer fund segregation, and to develop appropriate controls around such risks. For example, with respect to segregation risk, an FCM would be required to adopt written policies and procedures reasonably designed to ensure that customer funds are separately accounted for and segregated or secured as belonging to customers as required by the Act and Commission regulations. The written policies and procedures must, at a minimum, include or address the following:

- A process for the evaluation of depositories of segregated funds;

- A process for establishing a targeted amount of residual interest that the FCM seeks to maintain as its residual interest in the segregated funds accounts. The process for establishing a targeted amount must be designed to reasonably ensure that the FCM maintains the targeted residual amounts and remains in compliance with the segregated funds requirements at all times;

- A process to establish internal control and clear management approval for the withdrawal of cash, securities, and other property from accounts holding segregated funds, where the withdrawal is not for the purpose of payments to or on behalf of the FCM's customers;

- A process for assessing the appropriateness of specific investments of segregated funds in permitted investments in accordance with Regulation 1.25;

- Procedures requiring the appropriate separation of duties among individuals responsible for compliance with the Act and Commission regulations relating to the protection and financial reporting of segregated funds, including the separation of duties among personnel that are responsible for advising customers on trading activities, those approving or overseeing cash receipts and disbursements (including investment operations), and those recording and

reporting financial transactions. Also, the policies and procedures must require that any movement of funds to affiliated companies and parties are properly approved and documented; and

- A program for conducting annual training of all finance, treasury, operations, regulatory, compliance, settlement, and other relevant officers and employees regarding the segregation requirements for segregated funds required by the Act and regulations, the requirements for notices under Regulation 1.12, procedures for reporting of suspected breaches of the policies and procedures required by the proposed regulations to the chief compliance officer, without fear of retaliation, and the consequences of failing to comply with the segregation requirements of the Act and regulations.

In addition to these specific requirements around segregation risk, the proposal also addresses operational risk and capital and liquidity risk. For instance, in the case of operational risk, the proposal requires the FCM's risk management program to include automated financial risk management controls reasonably designed to prevent the placing of erroneous orders, including those that exceed pre-set capital, credit, or volume thresholds, and policies and procedures that govern the use, supervision, maintenance, testing, and inspection of such programs.
With respect to capital risk, the proposal would require the FCM to develop written policies and procedures that are reasonably designed to ensure that the FCM has sufficient capital to be in compliance with the Act and the regulations, and sufficient capital and liquidity to meet the reasonably foreseeable needs of the FCM.

How does the proposal impact the oversight and examination of FCMs?

In summary, the proposal would raise the minimum standard which certified public accountants that audit FCMs must meet, and change the orientation of the FCM examination programs administered by the SROs, to require more attention to quality control over examination program contents, administration, and oversight.

In this regard, proposed amendments to Regulation 1.16 would require, among other things, that a certified public accountant must satisfy new minimum qualifications to qualify to conduct audits of Commission registrants. More specifically, the public accountant would need to be registered with the Public Company Accounting Oversight Board ("PCAOB") and have undergone at least one examination by the PCAOB. Furthermore, any deficiencies noted by the PCAOB during such examination must have been remediated to the satisfaction of the PCAOB within three years of that report.

In addition, proposed amendments to Regulation 1.16 would require the governing body of the FCM to ensure that the certified public accountant engaged is duly qualified to perform an audit of the FCM, including considering factors such as the firm's experience in auditing FCMs, the depth of the certified public accountant's staff, the certified public accountant's knowledge of the Act and Regulations, the size and geographic location of the FCM, and the independence of the certified public accountant.

The proposed amendments to Regulation 1.16 also would require that the accountant's report not only state whether the audit was made in accordance with U.S. generally accepted auditing standards, but also that full consideration was given to the auditing standards adopted by the PCAOB.

With respect to SRO examinations, the proposal would amend Regulation 1.52 to require that the examination programs administered by the SROs apply controls testing as well as substantive testing of FCMs and that the SRO exam program be reviewed by a Commission-approved examinations expert every 2 years concerning the substance and application of the supervisory program. Furthermore, for SROs that wish to delegate the supervision and oversight of common FCMs to a designated self-regulatory organization, the proposal would require a more formal treatment of the Joint Audit Committee than is currently applied by SROs.

How does the proposal enhance the Commission's and SROs' ability to monitor FCMs?

The Commission believes that FCM oversight needs to have a more risk-based and forward-looking perspective than it currently has. To accomplish this, the Commission and SROs need more forward looking information than is currently received. This risk oriented perspective, with greater information, increases the likelihood that the Commission and SROs can intervene earlier when an FCM becomes distressed – a stage in which customer funds are more likely to be put at risk.

Accordingly, the Commission is proposing to require FCMs to file all financial and regulatory notices electronically via the WinJammer electronic system. The proposal also requires the filing of, among other things, a new segregation schedule for cleared swaps that is modeled on the existing segregation schedule for customers trading futures contracts on designated contract markets. The proposal would further require FCMs to report their targeted residual interest and the balance sheet leverage ratio with the Commission and with the firms' designated self-regulatory organization ("DSRO").

The Commission also is proposing to revise Regulation 1.12 to implement a more effective early warning system by requiring FCMs to provide electronic notifications to the Commission and the DSROs upon the occurrence of events that cause the risk profile of the FCMs to change, such as undersegregated or undersecured accounts and a material decrease in the creditworthiness of the FCM.

The Commission also is proposing to amend Regulations 1.20 and 1.26 to require FCMs and DCOs to provide the Commission and DSROs, as applicable, with read-only direct electronic access to accounts holding customer funds in depositories. While the Commission intends to pursue more automated, ongoing review of customer funds, the direct-access to customer accounts is a first step, but an important tool, to allow for the direct verification of account balances with depositories at any time.

What additional information would FCMs be required to provide or make available to existing and prospective customers under the Proposal?

The proposal would require FCMs to provide greater transparency to existing and perspective customers regarding the risks of engaging in futures transactions, and would require FCMs to provide firm specific risk disclosures to enable customers to assess the risk of entrusting their funds to a particular FCM. Specifically, the proposal would require FCMs to provide additional disclosures under the Risk Disclosure Statement currently required by Regulation 1.55. The additional disclosures are based upon the Commission's experience during the recent FCM failures. The additional general risk disclosures would include:

- A statement that customer funds are not covered by insurance in the event of an FCM bankruptcy;
- A statement that DCOs do not insure or guarantee customer funds held by an FCM in the event of an FCM bankruptcy;
- A statement that a customer's funds may be commingled by an FCM with the funds of other customers, and that there is fellow customer risk;
- A statement that an FCM may invest customer funds in Regulation 1.25 permitted investments; and
- A statement that an FCM may deposit customer funds with affiliated depositories.

The proposed firm specific disclosures would require an FCM to disclose information regarding the FCM in order to provide existing and prospective customers with information to make an informed decision as to whether to use the services of a particular FCM. The additional firm specific disclosures would require each FCM to disclose firm specific information including the following:

- The significant types of business activities and product lines engaged in by the FCM, and the approximate percentage of the FCM's assets and capital devoted to each business activity;
- The FCM's business on behalf of its customers, including types of accounts, markets traded, international businesses, and clearinghouses and carrying brokers used, and the FCM's policies and procedures concerning the choice of bank depositories, custodians, and other counterparties;
- The material risks, accompanied by an explanation of how such risks may be material to the FCM's customers, of entrusting funds to the FCM, including, without limitation, the nature of investments made by the FCM (including

credit quality, weighted average maturity, and weighted average coupon); the FCM's creditworthiness, leverage, capital, liquidity, principal liabilities, balance sheet leverage and other lines of business; risks to the FCM created by its affiliates and their activities, including investment of customer funds in an affiliated entity; and any significant liabilities, contingent or otherwise, and material commitments; and

- Any material administrative, civil, enforcement, or criminal action then pending, and any enforcement actions taken in last three years.

Would FCMs be required to make available to the public additional financial information under the proposal?

The proposal would require FCMs to make additional financial information available to the public. Specifically, the proposal would require each FCM to make the following information available on its website:

- The daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Exchanges for the most current 12-month period;

- The daily Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Regulation 30.7 for the most current 12-month period;

- The daily Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Act for the most current 12-month period;

- A summary schedule of the futures commission merchant's adjusted net capital, net capital, and excess net capital, all computed in accordance with Regulation 1.17 and reflecting balances as of the month-end for the 12 most recent months; and

- The Statement of Financial Condition, the Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Exchanges, the Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Regulation 30.7, the Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Act, and all related footnotes to the above schedules that are part of the futures commission merchant's most current certified annual report pursuant to Regulation 1.16.