



# Commodity Futures Trading Commission

## Office of Public Affairs

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## Q & A – Final Rules Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations

### What is the goal of the rulemaking?

The final rules afford greater assurances to market participants that: customer segregated funds, secured amount funds, and cleared swaps funds are protected; customers are provided with appropriate notice of the risks of futures trading and of the futures commission merchants (“FCMs”) with which they may choose to do business; FCMs are monitoring and managing risks in an effective manner; the capital and liquidity of FCMs are strengthened to safeguard their continued operations; and the auditing and examination programs of the Commission and the self-regulatory organizations (“SROs”) are monitoring the activities of FCMs in a prudent and thorough manner.

### What registrants are covered by the final regulations?

The final regulations predominantly apply to FCMs, but also cover requirements for SROs, Designated Self-Regulatory Organizations (“DSROs”), and Derivatives Clearing Organizations (“DCOs”).

### Were comments from the public received on the final regulations?

The Commission received over 120 written submissions following the publication of the proposal in the Federal Register. In addition, the Commissioners and CFTC staff met with several representatives from the industry and public, as well as, hosted multiple roundtable discussions, both prior to and following the initial proposed release.

### How does the residual interest requirement in regulation 1.22 protect customer money?

Section 4d(a)(2) of the Commodity Exchange Act expressly states that the money, securities, and property received by an FCM from a customer to margin, guarantee, or secure the trades or contracts of that customer “shall be separately accounted for and **shall not be commingled** with the funds of such commission merchant or be **used 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.**”<sup>1</sup> In other words, the Commodity Exchange Act **expressly prohibits** an FCM from using the collateral of one customer to margin, secure, or guarantee the trades or contracts of other customers. If an FCM uses the funds of customers with excess margin to collateralize the positions of undermargined customers, the customers with excess funds are subject to heightened risk of loss, and diminished availability of those excess funds for transfer in the event of a double default.<sup>2</sup>

<sup>1</sup> Emphasis added. See also section 4d(f)(2) of the Commodity Exchange Act, as well as 17 CFR 1.22, 22.2(d)(1).

<sup>2</sup> A double default is a situation where a customer defaults on its obligation to its FCM and the loss is so great that the FCM defaults on its obligation to the DCO. the DCO is permitted to use the funds held in the futures customers’ omnibus account to cover the loss of the defaulting futures customer before applying its own capital or the guaranty fund contributions of non-defaulting FCM members.

The final rule requires an FCM to maintain residual interest in its customer accounts that is at least equal to its customers' aggregate undermargined amounts for the prior trade date, thus, shifting the risk of loss in the event of a double default away from customers with excess margin.

### **How does the residual interest requirement address concerns regarding compliance costs?**

For Futures Accounts, full implementation of the rule is subject to an extended phase in period. Starting one year after the publication of the final rule, an FCM must hold the requisite residual interest by 6:00 PM Eastern Time on the next business day after the trade date.<sup>3</sup> Commenters acknowledged that the overwhelming majority of undermargined amounts are collected by this time. Within 30 months of the publication of the final rule, Commission staff will publish a report (the "Report") regarding the practicability of moving the deadline, whether and on what schedule it would be feasible to move the deadline, and associated cost and benefits of any such movement.

After considering the Report, the Commission may (1) change the phase-in period, or (2) determine that it is necessary and appropriate in the public interest to propose through rulemaking a different residual interest deadline. If the Commission takes no further action, the phase-in period will expire on December 31, 2018 and an FCM must hold the requisite residual interest prior to the time of the daily settlement with each DCO of which the FCM is a member.

### **Are there any changes to any FCM notifications or other filings with the Commission?**

Yes. Revisions to Regulation 1.12 require all notices to be filed in electronic form with the Commission and DSROs. In addition, amendments to Regulation 1.12 require prompt notification to the Commission following the occurrence of certain events, such as a failure to comply with the permitted investment provisions of Regulation 1.25.

### **What additional disclosures are FCMs required to make to prospective customers under the final regulations?**

FCMs are required to provide additional disclosures to existing and prospective customers through amendments to the standard Risk Disclosure Statement previously required under Regulation 1.55. The additional disclosures cover two areas: general risk disclosures which relate to the overall risks associated with participating in the futures and swaps markets, and firm specific disclosures which identify risks concerning the particular FCM chosen by customers.

The additional general risk disclosures address several new items, including that: (1) customer funds deposited with FCMs are not protected by insurance or by the Securities Investor Protection Corporation; and (2) customer funds are not subject to a general guarantee by any DCO upon default of the FCM. The disclosures also must provide that an FCM is not required to hold each individual customer's funds in separate accounts

The new firm specific disclosures include, but are not limited to, the general contact information of the FCM, the significant types of business activities and product lines engaged by the FCM, and the material risks to that FCM's business and an explanation of those risks. In addition, FCMs must also provide information concerning material

<sup>3</sup> For Cleared Swaps Customer Accounts, the final rule does not alter the current residual interest requirement for Cleared Swaps, although, where applicable, it does amend certain language in part 22 for consistency with the language used in other Commission regulations.

For Part 30 secured accounts, starting one year after the publication of the final rule, an FCM must hold the requisite residual interest by 6:00 PM Eastern Time on the next business day after the trade date.

legal matters, and recent financial information, including specific amounts regarding the FCMs proprietary accounts, over the counter transactions and committed unsecured lines of credit.

FCMs also are required under new Regulation 1.55(o) to make available to the public on their respective Web sites certain financial information. This financial information includes:

- 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 Commodity Exchange 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;
- 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; and
- 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, and the Statement of Cleared Swaps Customer Accounts Under Section 4d(f) of the Commodity Exchange Act that are part of the futures commission merchant's unaudited Form 1-FR-FCM or Financial and Operational Combined Uniform Single Report under the Securities Exchange Act of 1934 ("FOCUS Report") for the most current 12-month period.

### **How does the final rule impact the auditors of FCMs?**

The final rule amends Regulation 1.16 to raise the overall minimum standards for certified public accountants that audit FCMs. Certified public accountants that conduct audits of FCMs must satisfy new minimum qualifications, including maintaining registration with the Public Company Accounting Oversight Board ("PCAOB") and must have undergone an inspection by the PCAOB. In addition, the governing body of the FCM must 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 Commodity Exchange Act and Commission regulations, the size and geographic location of the FCM, and the independence of the certified public accountant. The final rule also requires that the accountant's report state whether the audit was made in accordance with auditing standards adopted by the PCAOB.

## **Are FCMs required to adopt risk management programs under the final regulations?**

Yes. FCMs are required to adopt robust risk management programs centered on the risk of the FCM's business. Specifically, each FCM that carries customer funds will be required to take into account risks to which the FCM is reasonably subject, including risks relating to operations, capital, and customer fund segregation, and to develop appropriate controls around such risks. This will include adopting 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 Commodity Exchange Act and Commission regulations. The written policies and procedures must address all applicable risks of the FCM business including the following:

- A process for the evaluation of depositories of segregated funds;
- A process to establish 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 to assess the appropriateness of specific investments of segregated funds in permitted investments in accordance with Regulation 1.25;
- Procedures to require the appropriate separation of duties among individuals responsible for compliance with the Commodity Exchange 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 the 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 Commodity Exchange Act and Commission 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 Commodity Exchange Act and Commission regulations.

## **How do the final regulations enhance the Commission's and SROs' ability to monitor FCMs?**

The final rule amends Regulation 1.52 which governs the FCM examination programs administered by the SROs and the Joint Audit Committee.

Revised Regulation 1.52 requires the SROs' supervisory program over FCMs to include both controls and substantive testing. The supervisory program also must apply PCAOB audit standards in the conduct of the

examinations. In addition, the SRO supervisory program must be reviewed by a Commission-approved examinations expert at least once every 3 years concerning the substance and application of the supervisory program. The final rules clarify the substance and focus of each examinations expert's report, and provide for additional enhancements regarding how SROs and the Joint Audit Committee administer their supervisory programs.

### **Are there any changes to the requirement that FCMs and DCOs obtain a written acknowledgement from depositories holding customer funds?**

While the requirement to obtain a written acknowledgement has not changed, the final rule amends Regulations 1.20, 1.26, and 30.7 to require the use of standard template letters, which are set out in appendices to each of the regulations. The final rule also requires that FCMs deposit customer funds only with depositories that agree:

- To provide the Commission with direct, read-only electronic access to transaction and account balance information for accounts containing customer funds;
- That such accounts may be examined at any reasonable time by the director of the Division of Swap Dealer and Intermediary Oversight (DSIO) or the director of the Division of Clearing and Risk (DCR), or any successor divisions, or such directors' designees, or an appropriate officer, agent or employee of the FCM's designated self-regulatory organization (DSRO); and
- To reply promptly and directly to any request from the director of DSIO or the director of DCR, or any successor divisions, or such directors' designees, or an appropriate officer, agent or employee of the FCM's DSRO for confirmation of account balances or provision of any other information regarding or related to an account.

### **When will these final rules and amendments become effective?**

Generally, the final rules and amendments will become effective 60 days after the publication of the federal register release. However, certain provisions will become effective at alternative compliance dates as follows:

Effective date plus 90 days:

- Revised risk disclosure statements must be provided to FCM customers

June 1, 2014:

- FCMs required to file certified financial statements within 60 days of their year-end date
- Auditors of FCM must register with the PCAOB and use of PCAOB standards in the performance of FCM audits

Effective date plus 180 days:

- FCMs must obtain revised acknowledgement letters from depositories
- FCM must provide customers with specific risk disclosure requirements and post on their websites historical financial and segregation schedules including certified balance sheets and segregation schedules
- SRO must submit to the Commission their supervisory programs with examinations expert review
- FCM must file with the Commission copies of their risk management programs

One year after publication of the federal register release:

- Revised number of days to calculate undermargined capital charges
- Initial next day 6pm residual interest requirement for Futures accounts (If no further Commission action is taken after a study is performed the time for such requirement will move to settlement time with DCOs at December 31, 2018.).

December 31, 2015

- Requirement that all PCAOB registered auditors of FCMs have been examined by the PCAOB