



RESIDUAL INTEREST DEADLINE FOR FUTURES COMMISSION MERCHANTS REPORT

A REPORT BY STAFF
OF THE U.S. COMMODITY FUTURES TRADING COMMISSION
PURSUANT TO REGULATION 1.22(c)(5)

May 13, 2016

DISCLAIMER

This is a report by staff of the U.S. Commodity Futures Trading Commission. Any views expressed in this report are only the views of staff, and do not necessarily represent the positions or views of any Commissioner or the Commission.

I. Introduction and Background

On October 30, 2013, the U.S. Commodity Futures Trading Commission (“**Commission**” or “**CFTC**”) adopted and amended various regulations (“**Customer Protection Rule**”) intended, among other things, to enhance protections afforded to customers and customer funds held by futures commission merchants (“**FCMs**”).¹ As part of this rulemaking, the Commission amended Regulation 1.22, which prohibits an FCM from using the funds of one customer to purchase, margin, secure, or settle positions for another customer. The amendments specified how FCMs must demonstrate compliance with the prohibition set forth in Regulation 1.22. Specifically, the amendments require an FCM to maintain its own capital (hereinafter referred to as the FCM’s “**Residual Interest**”) in customer segregated accounts in an amount equal to or greater than its customers’ aggregate undermargined amounts.² Regulation 1.22(c)(5) defines the “Residual Interest Deadline” – *i.e.*, the point in time by which an FCM must ensure that the requisite Residual Interest amount is held.

The Commission established a phased-in compliance schedule for the new Regulation 1.22 requirements. An initial Residual Interest Deadline (“**Initial Deadline**”) of 6:00 p.m. Eastern Time on the date of the settlement referenced in Regulation 1.22(c)(2)(i) or (c)(4)³ (the

¹ Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, Final Rule, 78 FR 68506 (Nov. 14, 2013) (amending 17 CFR Parts 1, 3, 22, 30 and 140).

² See 17 CFR 1.22(c)(3)(i). As defined in Regulation 1.22(c)(1), a customer’s account is “undermargined,” when the value of the customer funds for a customer’s account is less than the total amount of collateral required by derivatives clearing organizations for that account’s contracts. See 78 FR 68513, n.30.

³ Regulations 1.22(c)(2) and (c)(4) require FCMs to compute, based on the information available to the FCM as of the close of each business day, (1) the undermargined amounts, based on the clearing initial margin that will be required to be maintained by that FCM for its futures customers, at each derivatives clearing organization (“**DCO**”) of which the FCM is a member or FCM through which the FCM clears, at the point of the daily settlement (described in Regulation 39.14) that will complete during the following business day for each such DCO (or FCM through which the FCM clears) less (ii) any debit balance referred to in Regulation 1.20(i)(4) included in such undermargined amounts. Regulation 1.22(c)(1) defines the “undermargined amount” for a futures customer’s

“**Settlement Date**”) began on November 14, 2014.⁴ The amended Regulation 1.22 directed staff to host a public roundtable and to publish a report for public comment by May 16, 2016 addressing, to the extent information is practically available, the practicability (for both FCMs and customers) of moving the Residual Interest Deadline from 6:00 p.m. Eastern Time on the Settlement Date, to the time of settlement or to some other time of day.⁵ The amended Regulation 1.22 provided further that, absent Commission action, the phased-in compliance period for the Residual Interest Deadline would automatically terminate on December 31, 2018,⁶ In the event of such automatic termination, the regulation contemplated that the Residual Interest Deadline would shift forward from the Initial Deadline to the time of settlement on the Settlement Date.

On March 24, 2015, the Commission reviewed the automatic termination issue and further amended Regulation 1.22(c)(5) to remove the December 31, 2018 automatic termination date from the regulation. The Commission provided assurance that, if it determined that a change to the Residual Deadline might be appropriate, it would make any revision to the Initial Deadline through the rulemaking process.⁷ Regulation 1.22(c)(5) still required staff of the Commission to host a roundtable on the issue of the timing of the Residual Interest Deadline and

account as the amount, if any, by which the total amount of collateral required for that futures customer’s positions in that count, at the time or times referred to in paragraph (c)(2) exceeds (ii) the value of the futures customer funds for that account (as calculated in Regulation 1.20(i)(2)).

⁴ See 17 CFR 1.22(c)(5)(ii); *see also*, 78 FR at 68578.

⁵ See 17 CFR 1.22(c)(5)(iii)(A).

⁶ See 17 CFR 1.22(c)(5)(iii)(C).

⁷ Residual Interest Deadline for Futures Commission Merchants, 80 FR 15507 (March 24, 2015).

to publish a report. Staff held the roundtable on March 2, 2016 (the “**Roundtable**”), and is now issuing this report as required by Regulation 1.22.

Participants at the Roundtable included customers that use the futures markets and maintain accounts with FCMs, industry groups that represented customers that use the futures markets and maintain accounts with FCMs, designated self-regulatory organizations including the National Futures Association and Chicago Mercantile Exchange, FCMs and other market participants. The discussions focused on their respective experiences with the regulation to date and their views about the practicality and appropriateness of moving the Residual Interest Deadline to the time of settlement or to some other time. Following the Roundtable, participants and other members of the public were invited to submit written comments on the issues raised with respect to the timing of the Residual Interest Deadline. The comment period closed on March 31, 2016.

This report focuses on the comments and industry feedback received by the Commission to date. In the interest of providing ample opportunity for consideration of public input on the relevant policy issues, and to ensure that the Commission has as much information and data as practicable for purposes of analyzing whether a change to the timing of the Residual Interest Deadline may be warranted, staff is issuing and seeking public comment on this report as required under Regulation 1.22.

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A. Comments

Comments on this report must be received on or before June 13, 2016. You may submit comments, identified by “Comments on Residual Interest Deadline for FCMs Report,” by any of the following methods:

- Agency Web Site: <http://www.cftc.gov>.
- Mail: Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.
- Hand Delivery/Courier: Same as mail above.

Please submit your comments using only one method. All comments must be submitted in English or accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you would like to submit information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedure established in Regulation 145.9.

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the report will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

This report was prepared by staff from the Division of Swap Dealer and Intermediary Oversight. **For further information contact:** Eileen Flaherty, Director, 202-418-5326, eflaherty@cftc.gov; Thomas Smith, Deputy Director, 202-418-5495, tsmith@cftc.gov; Larry Eckert, Special Counsel, 646-746-9704, leckert@cftc.gov, Joshua Beale, Special Counsel, 202-

418-5446, jbeale@cftc.gov, Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, Three Lafayette Center, 1155 21st Street N.W., Washington, DC 20581.

II. Public Comments on Rule Proposal

In response to concerns of commenters to the Commission's proposal to the Customer Protection Rule ("**Proposal**"), the Commission adjusted its final rule with regard to the timing when the requisite amount of Residual Interest must be held in segregation.⁸ In particular, the Commission adopted a "point in time" approach -- that is, a requirement that Residual Interest must be held in segregation at a specific point in time (i.e., the "**Residual Interest Deadline**"). The language of the Proposal, on the other hand, stated that the Residual Interest requirement was to be adhered to "at all times." Commenters on the Proposal were concerned that the rule would have required continuous monitoring of the Residual Interest amount in order to ensure compliance with this requirement.⁹ While the Commission noted that it believed the adjustments made to the final rule (including the change to a "point of time" approach) should significantly reduce burdens and costs related to the Residual Interest requirement, particularly during the phase-in period, it recognized that the rule would, nonetheless, likely create significant additional costs for FCMs and their customers.¹⁰ These costs and concerns about additional FCM risks that could result from the Residual Interest Deadline were raised by the public in comments to the Proposal and were discussed at length by the Commission in the Customer Protection Rule.¹¹

⁸ See 78 FR 68506, 68631.

⁹ See 78 FR at 68544-49.

¹⁰ See 78 FR at 68593.

¹¹ See, e.g. 78 FR at 68544-49 and 68593.

These costs and risks also emerged as the primary theme in connection with discussions regarding the appropriateness of a further shortening of the Residual Interest Deadline.

III. Public Roundtable and Written Comment

The participants at the Roundtable expressed their views that the industry had adapted well to the new Residual Interest Deadline, but that any further movement of the deadline would likely create additional costs to end users and additional operational risks for FCMs without any commensurate benefit.¹² Specifically, participants noted their concerns that imposing any earlier deadline may result in FCM customers being required to pre-fund their margin or, alternatively, that FCMs and their customers would need to finance the increased Residual Interest obligations.¹³ Additionally, participants noted that other enhanced customer protections implemented by the Commission, as described below, mitigate the need to move the Residual Interest Deadline to an earlier time.¹⁴

Written commenters to the Roundtable reiterated these views. The Commission received written comment submissions from Futures Industry Association (“**FIA**”), The Commercial Energy Working Group (“**CEWG**”), and Chris Barnard.¹⁵ All three supported maintaining the deadline at the T+1 at 6:00pm deadline.

¹² See Residual Interest Deadline Roundtable Transcript (“Transcript”) available, along with the comment file and the video recording of the Roundtable on the Commission’s Web site at: http://www.cftc.gov/PressRoom/Events/opaevent_cftcstaff030316.

¹³ See, e.g. Letter from FIA (March 31, 2016) at 2.

¹⁴ See, e.g. Transcript at 22.

¹⁵ See Comment file available at: <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1672>.

Roundtable participants and commenters reiterated comments received on the Customer Protection Rule Proposal in this regard. A participant representing a user of the markets noted that in light of the absence of legally segregated operationally commingled protection in the futures industry, they would be unwilling to pre-fund margin.¹⁶ Another participant representing grain elevator users indicated that for the average grain elevator about twice as much money would need to be sent to FCMs should they require pre-funding, and that most of this money would likely be borrowed, thereby limiting the use of those funding sources for other operational needs in existence today.¹⁷ Other participants also noted that large investment managers often utilize multiple FCMs, which results in ongoing daily monitoring of daily calls and treasury operations balancing wire payments.¹⁸ Accelerating this daily monitoring would operationally change the mechanics of these operations at a significant expense without adding any benefits under the current segregation regime.

A number of FCMs provided information about their experiences with the timing of receipt of margin payments. In general, they noted that margin payments often are not, and for operational reasons often cannot be, received until late in the day following the trade date, and that moving the Residual Interest Deadline to any earlier time would be impracticable.

FIA similarly noted in their comment letter that customers would be required to finance increased Residual Interest obligations that are caused by any further shortening of the deadline, resulting in an increase in clearing costs and a drain on liquidity from the futures markets,

¹⁶ See Transcript at 13.

¹⁷ See Transcript at 38.

¹⁸ See Transcript at 13-29.

making it more expensive for FCM customers, particularly small customers, to hedge risk.¹⁹ CEWG noted their concern that a change to the Residual Interest Deadline to an earlier time would effectively force FCMs to require their customers to pre-margin their accounts or to resort to intraday margin calls, either of which would result in customers having to reserve scarce capital to satisfy margin requirements.²⁰ CEWG noted further that a change to an earlier deadline would increase operational complexity and costs for FCMs that could be passed on to customers.²¹

In its comment letter, FIA cited to a previous survey of FCMs which found that 90% of all margin deficits are collected by close of business (“**COB**”) on the day following the trade date (“T+1”). A majority of those FCMs represented by the survey stated that more than 95% of margin deficits were collected by COB T+1. The survey also found that the bulk of margin funds collected from customers are received late in the day. In addition, all FCMs at the Roundtable agreed that the vast majority of institutional and commercial customers use wires as the funding mechanism for margin collection, while the small and mid-size customers (farmers, ranchers, etc.) can maintain relationships with small community banks and utilize the ACH process to meet margin payments, which can require multiple steps and correspondent regional banks.²² One FCM with agricultural clients indicated that they had approximately sixteen (16) bank accounts across the U.S. that support the agricultural community located in various time

¹⁹ See Letter from FIA (March 31, 2016) at 2.

²⁰ See Letter from CEWG (March 31, 2016) at 2.

²¹ *Id.*

²² See Transcript.

zones.²³ In highlighting some of the operational difficulties with margin collection, the representative noted that many of the west coast banks utilized by some in the agricultural industry don't even begin to send wires until 2:00pm central time.²⁴

A number of Roundtable participants and FIA in its comment letter stressed that in considering whether the timing of the Residual Interest Deadline should be moved forward, the Commission should consider the issue in context with the additional customer protections that are already in place and which mitigate operational risks at an FCM, including those adopted by the Commission in the Customer Protection Rulemaking.

At the Roundtable, several FCMs and the DSROs highlighted that: (1) FCMs are subject to a minimum capital requirement equal to 8% of Risk-Based Margin, which requires continual monitoring to ensure compliance with Commission early warning reporting requirements; (2) FCMs must establish a targeted Residual Interest and notify its DSRO in the event their Residual Interest goes below its designated targeted amount;²⁵ (3) FCMs are now required to input their daily segregation calculations into a reporting system for monitoring; (4) DSROs perform daily checks of daily segregation reports using swift messages confirming depository bank balances;²⁶ and (5) the period for capital charges for margin deficiencies has been reduced from three

²³ See Transcript at 44.

²⁴ *Id.*

²⁵ See Regulation 1.11 (e)(3)(i)(D) and corresponding notification requirements in Regulation 1.12 (j).

²⁶ See Transcript at 41-42. Daily Segregation Investment Detail Reports are now required to be filed daily with the Commission and DSROs under Regulation 1.32.

business days to one.²⁷ In addition, participants noted that notwithstanding the current T + 1 at 6:00 p.m. deadline, FCMs typically are engaged in earlier monitoring of uncollected margin.²⁸

IV. Conclusion

Based on the information available to the staff, including the public comments at the Roundtable and subsequent written comments, the staff has no basis to believe that changing the Initial Deadline to the time of settlement or to some other time of day would be practicable for FCMs and their customers at this time. Staff will continue to monitor the issues addressed by this report and will review comments submitted thereto. Should it appear that any changes to the Residual Interest Deadline might be appropriate based on new or changed information or facts, any such proposed changes would be done through the rulemaking process.

²⁷ See 1.17(c)(5)(viii) and (ix).

²⁸ See Transcript at 55.