CFTC Overhauls Customer Protection Requirements

On October 30, 2013, the Commodity Futures Trading Commission (“CFTC”) approved final rules intended to enhance the customer protection requirements imposed on futures commission merchants (“FCMs”) and derivatives clearing organizations (“DCOs”) (the “Final Rules”).1 The Final Rules build upon the CFTC’s existing customer protection regime, as amended by Dodd-Frank, under which FCMs and DCOs are required to segregate from their proprietary assets all money, securities and other property deposited by futures or cleared swaps customers to margin, secure, or guarantee futures or futures options contracts or to margin transactions in cleared swaps. The Final Rules are intended to enhance these protections and to specifically address the customer and systemic risks posed by the types of events that surrounded the recent insolvencies of MF Global, Inc. and Peregrine Financial Group, Inc.

The Final Rules impose considerable new requirements on FCMs and DCOs with respect to their handling of customer funds, as well as additional requirements for the self-regulatory organizations (“SROs”) that oversee such FCMs. Below is a summary of the most significant developments.

Executive Summary

• The CFTC has significantly overhauled its customer protection regime, imposing new requirements on FCMs and DCOs with respect to the handling of customer funds, as well as the SROs that oversee such FCMs.
• Each FCM will be required to maintain a “residual interest” – that is, a balance of its own proprietary funds – in its customer accounts, subject to certain minimum requirements. The FCM will be required to make additional deposits into these residual interests under certain circumstances, and the FCM’s ability to make withdrawals will be significantly restricted.
• Each FCM and DCO will need to obtain new standardized depository acknowledgment letters from the depositories in which it deposits customer funds by July 12, 2014. These letters will require such depositories to consent to new CFTC access and examination requirements.
• Each FCM will be required to establish comprehensive risk management programs with respect to its customer accounts, including the development of written procedures and the appointment of a risk management unit within the FCM to enforce the program, by July 12, 2014.
• Each FCM will be subject to numerous new reporting requirements and shortened deadlines for existing reporting obligations.

Beginning April 13, 2014, each FCM will be required to use the new model Risk Disclosure Statement. Additional firm-specific risk disclosures and website disclosures will be required by July 12, 2014. The SROs that oversee FCMs will be subject to additional oversight requirements, and the accountants that examine FCMs will be subject to new qualification requirements.

The “Residual Interest” Requirement

Residual Interest Target Amounts and Undermargined Amounts

At the heart of the CFTC’s revised customer protection regime is the requirement that each FCM maintain a “residual interest” – that is, a balance of its own proprietary funds – in the FCM’s futures customer account, cleared swap customer account, and foreign futures and options account, with the goal of ensuring that each such account always includes sufficient funds to remain in compliance with the segregation requirements. An FCM must monitor its compliance with two minimum residual interest requirements, which may overlap: (1) the target residual interest amount and (2) the undermargined amount. As part of its “Risk Management Program” – the establishment of which is a new requirement that is described below – the FCM must establish policies and procedures regarding how it will determine a residual interest target amount for each segregated account. The FCM will be required to maintain this target residual interest amount in each such account. In setting this target amount, the FCM’s senior management is intended to perform “appropriate due diligence” and consider, among other things, the nature of the FCM’s business, the general creditworthiness and trading activity of the FCM’s customer base, the volatility and liquidity of the markets and products traded by its customers, the FCM’s liquidity and capital needs, and historical trends.

As a general rule, the residual interest amount for a particular segregated account must always be greater than or equal to the “undermargined amount” of such account. That is, the FCM will be required under the Final Rules to deposit its own proprietary funds into the segregated account so that the account is not undermargined. Practically-speaking, if the FCM’s target residual interest amount is already above the undermargined amount, and the FCM is in compliance with that target amount, there will be no need for it to deposit additional funds. As of the close of each business day, the FCM will be required under the Final Rules to calculate the undermargined amount for each segregated account and, by the “Residual Interest Deadline,” deposit funds in such account to the extent the undermargined amount exceeds the FCM’s residual interest. The time of day that is to be the “Residual Interest Deadline” has been the subject of considerable debate, and the CFTC has agreed to phase it in pursuant to the following schedule:

<table>
<thead>
<tr>
<th>Date</th>
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<tbody>
<tr>
<td>November 14, 2014</td>
<td>6:00 P.M. (Eastern Time) on settlement date becomes the Residual Interest Deadline</td>
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<tr>
<td>May 16, 2016</td>
<td>Deadline for CFTC to issue for public comment a report on feasibility of an earlier Residual Interest Deadline</td>
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<td>Time of settlement becomes the Residual Interest Deadline</td>
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Restrictions on Withdrawals

The Final Rules also restrict an FCM’s ability to make withdrawals from its residual interest in each segregated account. Withdrawals will be permissible under the Final Rules only if: (i) the FCM has completed its required daily segregation calculation with respect to the close of the previous business day; (ii) the withdrawal will not cause the FCM’s residual interest to fall below the target residual interest amount; and (iii) the withdrawal, whether made in a single transaction or a series of transactions, will not exceed 25% of the FCM’s residual interest in the account. If the withdrawal will exceed 25%, preapproval of a senior official of the FCM is necessary, and the FCM must file such preapproval with the CFTC and the FCM’s SRO.

Standardized Depository Acknowledgment Letters

Under current CFTC rules, each FCM and DCO is required to obtain a written acknowledgment from each of its depositories before it deposits customer funds with that depository. The Final Rules require FCMs and DCOs to now use standardized template letters for these acknowledgments, which are provided as appendices to the applicable CFTC rules. Additionally, FCMs must conduct annual due diligence checks at all depositories where they deposit customer funds. In conjunction with these requirements, an FCM is only permitted to deposit customer funds with a depository that agrees to: (i) provide the CFTC with direct, read-only electronic access to transaction and account balance information for the customer accounts; (ii) allow accounts containing customer funds to be examined at any reasonable time by the CFTC; and (iii) reply promptly and directly to any request from the CFTC for confirmation of account balances or any other information regarding an account. Additionally, all futures customer funds deposited by an FCM or DCO with a bank or trust company must be immediately available for withdrawal upon the demand of the FCM or DCO. Each FCM and DCO must obtain a new acknowledgment letter from each of its depositories within 120 days of any change in the FCM or DCO’s name, the depository’s address, or the account numbers under which customer funds are held.

These requirements will become effective July 12, 2014.

FCM Risk Management Programs

Under the Final Rules, each FCM that carries customer accounts will be required to establish a Risk Management Program that is designed to monitor and manage the risks associated with the FCM’s activities. This involves (1) the development of written policies and procedures designed to address the FCM’s risks, which must be approved by the FCM’s governing body and filed with the CFTC, and (2) the establishment of a risk management unit within the FCM that will be tasked with administering the program. This risk management unit must be independent from the business unit of the FCM and must report directly to the FCM’s senior management.

Enhanced Reporting Requirements

The Final Rules impose new FCM reporting requirements in addition to substantially revising existing obligations. The most significant of these reporting requirements include the following:

- **Daily Segregation Reports.** Each FCM will be required make a daily calculation of: (i) the total amount of futures customer funds on deposit in segregated accounts; (ii) the amount of such futures customer funds required to be on deposit in the segregated accounts; and (iii) the amount of the
FCM’s residual interest in such accounts. These calculations must be documented on the segregation schedules filed with the CFTC and the FCM’s SRO, and must be completed as of the close of each business day and filed electronically by noon the following business day. Similar calculations and reports with respect to the segregation of the customer funds supporting settlement of foreign futures and cleared swaps will also be required.

- **Annual Certified Financial Statement Deadline.** The annual deadline for an FCM to file its certified financial statement with the CFTC and its SRO will be moved up to 60 days after the close of the fiscal year, from the current 90 days. The purpose of this deadline change is to conform both to the filing deadline imposed on dually registered broker-dealers and to certain accounting standards. This shorter deadline will be effective for fiscal years ending after June 1, 2014.

- **CCO’s Annual Report.** The deadline for the FCM’s chief compliance officer’s annual report is moved up to 60 days after the end of the fiscal year, from the current 90 days. This report is meant to be submitted simultaneously with the FCM’s annual certified financial statement.

- **Leverage Ratio Calculations.** Each FCM is required to file with the CFTC a measure of its leverage\(^2\) as of the close of business each month, with such filing due to the CFTC within 17 business days after each month-end.

- **Customer Fund Depository/Investment Reports.** On the fifteenth day of the month, or the first business day thereafter, and on the last business day of each month, the FCM will be required to submit to the CFTC a report listing all depositories where it has deposited futures customer funds, along with information regarding the amounts deposited and the particular investments held at each, the total amount of futures customer-owned securities held by the FCM as margin, and the total amount of such funds that have been used in reverse repo transactions.

- **Risk Exposure Reports.** FCMs will be required to prepare quarterly reports assessing all applicable risks to the FCM. These must be filed with the CFTC within 5 business days after they are presented to the FCM’s senior management. The Final Rules, however, do not impose an explicit deadline for delivery of these quarterly reports to the FCM’s senior management.

Under the Final Rules, all financial and regulatory notices will now be required to be filed electronically through the CFTC’s WinJammer Online Filing System.

**Enhanced Disclosure Requirements**

The Final Rules make substantial amendments to the “Risk Disclosure Statement” that all FCMs and introducing brokers must deliver to prospective customers. The Risk Disclosure Statement will be required to educate customers regarding the general risks of engaging in futures trading through an FCM and the potential specific risks resulting from the bankruptcy of an FCM. FCMs will be required to use the new Risk Disclosure Statement beginning April 13, 2014.

In addition to the generic Risk Disclosure Statement, each FCM will also be required to provide firm-specific disclosures to prospective customers, including additional information regarding the FCM, its business, operations, risk profile and affiliates. The requirement to make these disclosures is aimed at providing customers with access to sufficient material information regarding the FCM to allow customers to

\(^2\) For purposes of this calculation, the CFTC intends to define “leverage” the same way the National Futures Association does with respect to its monthly leverage reports – i.e., as “the FCM’s total balance sheet assets, less any instruments guaranteed by the U.S. government and held as an asset or to collateralize an asset (e.g., a reverse repurchase agreement) divided by the FCM’s total capital.” 78 Fed. Reg. at 68516.
independently assess the risk of entrusting funds to the firm or using the firm for the execution of orders. FCMs will be required to include these firm-specific risk disclosures beginning July 12, 2014.

Starting July 12, 2014, each FCM will also be required to post additional disclosures on its website, including its daily segregation calculations for the preceding 12 months and other historical data regarding the holding and segregation of customer funds, such as the segregation schedules from its unaudited regulatory filings for the most current 12-month period.

Treatment of Foreign Futures and Foreign Options Customers

CFTC Rule 30.7 requires an FCM to set aside in separate accounts (“30.7 Accounts”) for the benefit of its “foreign futures or foreign options customers” an amount of funds defined as the “foreign futures or foreign options secured amount.” This requirement parallels the segregation requirements imposed on FCMs with respect to domestic futures customer accounts. The Final Rules amended Part 30 of the CFTC rules to provide for a more coordinated approach to the regulations governing domestic and foreign futures. Among other conforming changes, the Final Rules amended the accepted methodology for determining the foreign futures or foreign options secured amount, eliminating the “Alternative Method” for calculating the secured amount and now only permitting the “Net Liquidating Equity Method” – i.e., the FCM is now required to hold a sufficient amount of funds in segregation to meet the total amount of account equities of all of its customers at all times. Adopting the Net Liquidating Equity Method for 30.7 Accounts brings the regulatory regime for foreign futures into greater conformity with the requirements imposed on FCMs regarding domestic futures.

Treatment of Cleared Swaps Customers

The Final Rules do not alter the existing Part 22 rules regarding the residual interest requirement and larger customer protection regime for cleared swaps. With the exception of the “legal segregation with operational commingling” rules, which apply only to cleared swaps customers, the customer protection regime for cleared swaps under the Final Rules largely parallels the Final Rules’ requirements with respect to futures customers. The Final Rules implement several conforming changes to Part 22, in an effort to amend certain language for consistency with the other CFTC regulations.

Oversight of FCMs

Reportable Events

CFTC rules require FCMs to notify the CFTC and their designated SRO upon the occurrence of certain significant events – e.g., a drop in the FCM’s adjusted net capital below certain “early warning” thresholds, or undersegregation with respect to a futures customer account. The Final Rules add new “reportable events,” including undersegregation with respect to a cleared swap customer account, discovery of a non-permitted investment of customer funds, failure to meet the FCM’s target residual interest amount with

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3 For the avoidance of doubt, when referring to a “foreign futures or foreign options customer” in the CFTC Part 30 rules, the futures and options are what is foreign – not necessarily the customer.

4 Pursuant to the “Alternative Method,” Rule 30.7 previously required FCMs to maintain only an amount of funds sufficient to cover the margin required on open foreign futures contracts, plus or minus any unrealized gains or losses on such open positions, plus any funds representing premiums payable or received on foreign options (including any additional funds necessary to secure such options, plus or minus any unrealized gains or losses on such options).
respect to a customer account, and any event that would have a materially adverse impact on the financial condition of the FCM.

These reportable event notifications will be required to be made to the CFTC and the relevant SRO immediately, except for “material adverse impact” events, which must be reported within 24 hours. While notification of “reportable events” does not need to be shared with the public, an FCM may determine to disclose the occurrence of certain events in its firm-specific risk disclosure statement.

SRO Supervision

The Final Rules require that SROs adopt additional rules that direct each FCM member to adopt a Risk Management Program that, at a minimum, meets the new requirements set forth in the Final Rules. Each SRO will also be required to maintain an adequately sized and independent examination staff, conduct ongoing surveillance of its members’ regulatory filings, give special attention to members that are deemed to be “high risk” firms, and conduct regular on-site examinations. Additionally, each SRO will be required to assess whether each member FCM is in compliance with CFTC rules regarding minimum net capital and financial requirements, the segregation of customer funds, risk management (including policies and procedures relating to the receipt, holding, investment and disbursement of customer funds), financial reporting, recordkeeping, sales practices, and other obligations. SROs will be required to submit their written supervisory programs to the CFTC by July 12, 2014 and, at least once every three years, each SRO will be required to retain an “examinations expert” to review and evaluate the efficacy of its FCM supervisory program.

Qualifications for Accountants

CFTC rules set forth the required qualifications of any accountant that is permitted to conduct the examination of an FCM. Under the Final Rules, such accountants will additionally be required to register with the Public Company Accounting Oversight Board (“PCAOB”), to undergo an examination by the PCAOB, and to not be permanently or temporarily barred by the PCAOB. Beginning June 1, 2014, FCM audits will also have to be conducted in accordance with PCAOB standards. Prior to engaging any accountant, an FCM’s governing body will be required to conduct an evaluation of the accountant’s qualifications, considering, among other criteria, the experience, knowledge and independence of the accountant.

Other Changes

FCM Net Equity Requirements

CFTC rules require each FCM to meet certain minimum capitalization requirements. In the event an FCM cannot meet those requirements, the FCM must cease operating and transfer its customers’ positions to another FCM. The Final Rules authorize the CFTC to request certification in writing from an FCM that it has sufficient liquidity to continue operating as a going concern. If the FCM is unable to immediately provide this written certification, the CFTC will have the authority to require the FCM to transfer all of its customer accounts and immediately cease doing business as an FCM.

The Final Rules also modify the adjusted net capital formula with respect to the capital charges that apply to undermargined accounts. The FCM will be required to take a capital charge if an account is undermargined
one business day after the margin call is issued – the previous version of the rule allowed the FCM to wait three business days before taking the charge.

**Permitted Investments**

CFTC rules prescribe what investments an FCM or DCO may make with futures customer funds. The rules permit investments in certain repurchase agreements, subject to a 25% counterparty concentration limit. The Final Rules add an aggregation component to this limit, so that the concentration limit will apply not just to a single counterparty but to all counterparties under common control or ownership.

Additionally, the Final Rules clarify that, while an FCM or a DCO is entitled to retain as its own any incremental income or interest income resulting from investments made with futures customer funds in permitted investments, any losses on such investments must be borne solely by the FCM or DCO and cannot be passed on to customers.

**Important Dates**

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<tr>
<th>Date</th>
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<tr>
<td><strong>January 13, 2014</strong></td>
<td>General effective date for Final Rules</td>
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<tr>
<td><strong>April 13, 2014</strong></td>
<td>FCMs must begin using the new Risk Disclosure Statement</td>
</tr>
<tr>
<td><strong>June 1, 2014</strong></td>
<td>For FCM fiscal years ending after June 1, 2014, filing deadline for annual FCM certified financial statements shortens from 90 to 60 days after fiscal year end</td>
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<td></td>
<td>FCM accountants must be PCAOB-registered, and FCM audits must be PCAOB-compliant</td>
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<tr>
<td><strong>July 12, 2014</strong></td>
<td>FCMs must file risk management programs with CFTC</td>
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<td></td>
<td>SROs must file FCM supervisory programs with CFTC</td>
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<td></td>
<td>Use of standardized depository acknowledgment letters is required, and depositories must be compliant with CFTC access/examination requirements</td>
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<tr>
<td></td>
<td>FCMs must use revised firm-specific risk disclosures</td>
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<tr>
<td></td>
<td>FCMs must update websites to disclose historical segregation and other financial information</td>
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<tr>
<td><strong>November 14, 2014</strong></td>
<td>Phase-in of Residual Interest Deadline begins. FCMs must make deposits of undermargined amounts by 6:00 PM on settlement date.</td>
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<tr>
<td></td>
<td>Changes to net capital calculation regarding capital charges to undermargined amounts apply</td>
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<tr>
<td><strong>December 31, 2015</strong></td>
<td>FCM accountants must have undergone PCAOB inspection</td>
</tr>
<tr>
<td>Date</td>
<td>Event Description</td>
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