



6351-01-P

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AE22

Residual Interest Deadline for Futures Commission Merchants

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“Commission” or “CFTC”) is amending its regulations to remove the December 31, 2018 automatic termination date for the phased-in compliance schedule for futures commission merchants (“FCMs”) and provides assurance that the residual interest deadline, as defined in the regulations (“Residual Interest Deadline”), will only be revised through a separate Commission rulemaking.

DATES: The final rule is effective [**INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER**].

FOR FURTHER INFORMATION CONTACT:

Division of Swap Dealer and Intermediary Oversight: Thomas Smith, Acting Director, 202-418-5495, tsmith@cftc.gov; Jennifer Bauer, Special Counsel, 202-418-5472, jbauer@cftc.gov; Joshua Beale, Attorney-Advisor, 202-418-5446, jbeale@cftc.gov, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

Division of Clearing and Risk: Kirsten V. K. Robbins, Associate Chief Counsel, 202-418-5313, krobbins@cftc.gov, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

Office of the Chief Economist: Stephen Kane, Research Economist, 202-418-5911, skane@cftc.gov, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

I. Background

On October 30, 2013, the Commission amended Regulation 1.22 to enhance the safety of funds deposited by customers with FCMs as margin for futures transactions.¹ 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 The Commission established a phased-in compliance schedule for Regulation 1.22 with an initial Residual Interest 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)(the "Settlement Date"), beginning November 14, 2014.³ Amended Regulation 1.22 also directs staff to host a public roundtable and 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

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 See 17 CFR 1.22(c)(5)(ii); See 78 FR at 68578.

time of settlement or to some other time of day.⁴ Furthermore, amended Regulation 1.22 provides that, absent Commission action, the phased-in compliance period for the Residual Interest Deadline automatically terminates on December 31, 2018.⁵ In the case of such automatic termination, the Residual Interest Deadline would change to the time of settlement on the Settlement Date.

II. The Proposal

On November 3, 2014, the Commission proposed to revise Regulation 1.22 to remove the December 31, 2018 automatic termination of the phase-in compliance period.⁶ In the NPRM, the Commission stated the intention to retain the Residual Interest Deadline⁷ at 6 p.m. Eastern Time, unless the Commission takes further action via rulemaking.

In the NPRM, the Commission stated that the removal of the automatic termination of the phase-in compliance period would provide the Commission with a greater degree of flexibility to assess all relevant data, including the costs and benefits of revising the Residual Interest Deadline. The Commission also retained in Regulation 1.22 the requirement for Commission staff to publish for public comment a report addressing the practicability and costs and benefits of revising the Residual Interest Deadline, and the additional requirement for Commission staff to conduct a public roundtable on the issue.

⁴ See 17 CFR 1.22(c)(5)(iii)(A).

⁵ See 17 CFR 1.22(c)(5)(iii)(C).

⁶ Residual Interest Deadline for Futures Commission Merchants, Notice of Proposed Rulemaking, 79 FR 68148 (Nov. 14, 2014) (amending 17 C.F.R. Part 1).

⁷ See 17 CFR 1.22(c)(3)(i). The term “Residual Interest Deadline” is defined in Regulation 1.22(c)(5). If an FCM is required to increase its Residual Interest as a result of customer undermargined accounts, the FCM must deposit additional funds into the customer segregated accounts by the specified Residual Interest Deadline.

The Commission invited comments on all aspects of the amendments, particularly those regarding the practicability and costs and benefits of revising the Residual Interest Deadline.

III. Comments and Response

The Commission received ten comments on the NPRM. The comments were submitted by the Futures Industry Association (“FIA”), CME Group (“CME”), National Futures Association (“NFA”), National Introducing Brokers Association (“NIBA”), Managed Funds Association (“MFA”), Coalition of National Producers and Agribusiness (“Agribusiness Coalition”)⁸, National Grain and Feed Association (“NGFA”), National Council of Farmer Cooperatives (“NCFC”), the Honorable Heidi Heitkamp, United States Senate, and Chris Barnard.⁹ All ten comments supported the proposed amendments.

The FIA and its member firms supported the amendments, stating their willingness to participate in the study and citing concerns that a residual interest deadline earlier than 6:00 p.m. Eastern Time on the Settlement Date might impose significant financial and operational burdens on both customers and FCMs. The NFA encouraged the Commission to consider industry comment on the timing and parameters of the study to ensure the Commission has the most complete information available. The NIBA, NCFC, NGFA, Agribusiness Coalition, and MFA added that an earlier Residual Interest Deadline could force the pre-funding of margin by FCMs, in turn causing increased

⁸The Commission received two comment letters filed by the Coalition of National Producers and Agribusiness. The second comment letter was identical to the first with the exception of an amendment adding two additional signatories.

⁹ The comments are available on the Commission’s web site, <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1537>.

operational costs on FCMs and their customers, which could result in the possible exit of certain customers from the marketplace. Senator Heitkamp also supported the proposed amendments and stated that the rule would provide end users with the certainty they need to run their businesses.

All commenters supported the position that any future revisions should be done through separate rulemaking. The FIA and CME further stated that the opportunity to provide input on the setting of the Residual Interest Deadline was something consistent with the goals of, if not required by, the Administrative Procedure Act. Chris Barnard asked for certainty on the proposed retention of the existing deadline absent further Commission rulemaking, stating that such a requirement is open-ended.

The Commission has considered the comments and is adopting the amendments as proposed. Amending Regulation 1.22 to require the Commission to conduct a separate rulemaking prior to revising the Residual Interest Deadline will provide market participants with an opportunity to review and comment on the Commission's staff's roundtable and public report. The amendments also provide market participants with an opportunity to review and to provide comments, via a rulemaking process, on any Commission proposed revisions to the Residual Interest Deadline.

IV. Cost-Benefit Considerations

Section 15(a) of the Commodity Exchange Act ("CEA") requires the Commission to consider the costs and benefits of its actions before promulgating a regulation under the CEA or issuing certain orders.¹⁰ Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1)

¹⁰ 7 U.S.C. 19(a).

protection of market participants and the public; (2) efficiency, competitiveness, and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission considers the costs and benefits resulting from its discretionary determinations with respect to the section 15(a) factors.

As noted in the NPRM, the status quo baseline with which the costs and benefits are compared is the Residual Interest Deadline of 6:00 p.m. Eastern Time on the Settlement Date, which would apply until the Commission takes further action or, in the absence of further action, until December 31, 2018. The status quo baseline includes the automatic termination of the phase-in compliance period at December 31, 2018, which, absent Commission action, would move the Residual Interest Deadline to the time of settlement referenced in Regulation 1.22(c)(2)(i), or as appropriate, 1.22(c)(4).

As also noted in the NPRM, the status quo baseline is similar to this final rulemaking and, as such, the Commission believes that there is not likely to be any material differences between this final rulemaking and the status quo baseline in terms of the first four section 15(a) factors. The Commission notes that the amendments will alter the procedure followed with regard to the removal of the automatic termination of the phase-in period, which could alter the cost and benefit with respect to the fifth section 15(a) factor. The Commission specifically invited comment on the cost and benefit implications related to the fifth section 15(a) factor (“other public interest considerations”). However, the Commission received no comments that contained any quantitative data regarding the monetary value of any public interest considerations. As such, the Commission has considered the fifth section 15(a) factor qualitatively.

All commenters supported the termination of the automatic phase-in compliance period. The CME stated that removing the automatic moving of the residual interest deadline will allow impacted market participants, including customers and FCMs, to provide comments on any proposed rule change that results from the study. In addition, the FIA stated the adoption of the amendment will also afford the Commission the opportunity to carefully consider the results of the staff study without being bound by an unnecessary deadline.

The Commission agrees with commenters that a separate rulemaking prior to revising the Residual Interest Deadline will afford the public an opportunity to participate in any future decision-making concerning any possible movement of the Residual Interest Deadline. The termination of the automatic phase-in compliance period will grant the Commission more opportunity to consider the study and the public roundtable, as well as an opportunity to receive and evaluate additional public comment on any proposed rule change.

V. Related Matters

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (“RFA”)¹¹ requires Federal agencies, in promulgating regulations, to consider the impact of those regulations on small entities. The Commission has previously established certain definitions of “small entities” to be used by the Commission in evaluating the impact of its rules on small entities in accordance with the RFA.¹² The final amendments would affect FCMs. The Commission previously has determined that FCMs are not small entities for purposes of

¹¹ 5 U.S.C. 601 *et seq.*

¹² 47 FR 18618 (Apr. 30, 1982).

the RFA, and, thus, the requirements of the RFA do not apply to FCMs.¹³ The Commission's determination was based, in part, upon the obligation of FCMs to meet the minimum financial requirements established by the Commission to enhance the protection of customers' segregated funds and protect the financial condition of FCMs generally.¹⁴ Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the final amendments will not have a significant economic impact on a substantial number of small entities.

B. Paperwork Reduction Act

The Paperwork Reduction Act ("PRA") provides that a Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget ("OMB"). This rulemaking amends requirements that contain a collection of information for which the Commission has previously received a control number from OMB. The title for this collection of information is "Regulations and Forms Pertaining to Financial Integrity of the Market Place, OMB control number 3038-0024". This collection of information is not expected to be impacted by the rule amendment approved herein, as the calculations which are already reflected in the burden estimate are not expected to change; the phase-in period for assessing compliance relative to such calculations is the sole aspect of the collection of information that will be altered. The PRA burden hours associated with this collection of information are therefore not expected to be increased or reduced as a result of the final amendments.

¹³ Id. at 18619.

¹⁴ Id.

Accordingly, for purposes of the PRA, these final rule amendments would not impose any new reporting or recordkeeping requirements.

List of Subjects in 17 CFR Part 1

Brokers, Commodity futures, Consumer protection, Reporting and recordkeeping requirements.

For the reasons discussed in the preamble, the Commodity Futures Trading Commission amends 17 CFR part 1 as set forth below:

PART 1 – GENERAL REGULATIONS UNDER THE COMMODITY EXCHANGE ACT

1. The authority citation for part 1 continues to read as follows:

Authority: 7 U.S.C. 1a, 2, 5, 6, 6a, 6b, 6c, 6d, 6e, 6f, 6g, 6h, 6i, 6k, 6l, 6m, 6n, 6o, 6p, 6r, 6s, 7, 7a-1, 7a-2, 7b, 7b-3, 8, 9, 10a, 12, 12a, 12c, 13a, 13a-1, 16, 16a, 19, 21, 23, and 24 (2012).

2. In § 1.22, revise paragraphs (c)(5)(iii)(B) and (C) to read as follows:

§ 1.22 Use of futures customer funds restricted.

* * * * *

(c) * * *

(5) * * *

(iii) * * *

(B) Nine months after publication of the report required by paragraph

(c)(5)(iii)(A) of this section, the Commission may (but shall not be required to) do either of the following:

(1) Terminate the phase-in period through rulemaking, in which case the phase-in period shall end as of a date established by a final rule published in the Federal Register, which date shall be no less than one year after the date such rule is published; or

(2) Determine that it is necessary or appropriate in the public interest to propose through rulemaking a different Residual Interest Deadline. In that event, the Commission shall establish, if necessary, a phase-in schedule in the final rule published in the Federal Register.

(C) If the phase-in schedule has not been terminated or revised pursuant to paragraph (c)(5)(iii)(B) of this section, then the Residual Interest Deadline shall remain 6:00 p.m. Eastern Time on the date of the settlement referenced in paragraph (c)(2)(i) or, as appropriate, (c)(4) of this section until such time that the Commission takes further action through rulemaking.

Issued in Washington, DC, on March 18, 2015, by the Commission.

Christopher J. Kirkpatrick,
Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

**Appendices to Residual Interest Deadline for Futures Commission Merchants –
Commission Voting Summary, Chairman’s Statement, and Commissioners’
Statements**

Appendix 1 – Commission Voting Summary

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and Giancarlo voted in the affirmative. No Commissioner voted in the negative.

Appendix 2 – Statement of Chairman Timothy G. Massad

Today we are finalizing a change to a rule that concerns one of the most important objectives of the Commission, which is to protect customer funds. In addition, today's action reflects one of my key priorities since taking office, which is to make sure our rules do not impose undue burdens or unintended consequences for the nonfinancial commercial businesses that depend on the derivatives markets to hedge commercial risks.

Today's action concerns Regulation 1.22, regarding the posting of collateral. When a customer's account has insufficient margin, a futures commission merchant must commit its own capital – often referred to as the FCM's "residual interest" – to make up the difference. Regulation 1.22 sets the deadline for posting residual interest. That deadline, in turn, affects when customers must post collateral. The regulation provided that the deadline, which is currently 6:00 p.m. on the next day, would automatically become earlier in a couple years, without any Commission action or opportunity for public input.

Last fall, we proposed to amend the rule so that the FCM's deadline to post "residual interest" will not become earlier than 6:00 p.m. without an affirmative Commission action and an opportunity for public comment. Today, we are finalizing that change.

An earlier deadline can help make sure that FCMs always hold sufficient margin and do not use one customer's margin to support another customer, but it can also impose costs on customers who must deliver margin sooner. We will do a study of how well the

current rule and deadline are working, the practicability of changing the deadline, and the costs and benefits of any change. Today's action will make sure that the Commission considers all those issues and that customers will have an opportunity to provide us with input on any future change the Commission may consider.

Appendix 3 – Statement of Commissioner Mark P. Wetjen

In the fall of 2013, the Commission made some important changes to rule 1.22, to which registered futures commission merchants (FCMs) are subject. The revision to this rule, known as the “residual-interest requirement”, clarified that one customer's funds could not be used by an FCM to cover another customer's margin deficit, but phased in a deadline for stricter compliance with this clarified standard. The change was designed to reduce risks to those customer funds placed in the care of FCMs, and were among a host of regulatory enhancements adopted by the Commission after two failures of large, registered FCMs in 2011 and 2012 – MF Global and Peregrine Financial.

I supported those regulatory enhancements – including the revision to rule 1.22 – because of the importance of the matter addressed in each: the safekeeping of customer money, which is the most sacrosanct duty that any financial institution owes to its customers. Today, the overall framework of regulatory requirements that registered FCMs must comply with is substantially different today than in 2011. For example, FCMs are no longer permitted to use customer funds for in-house lending through repurchase agreements; they are subject to restrictions on the types of securities that customer funds can be invested in; they must pass on customer initial margin on a gross basis to the clearinghouse; through LSOC (legal segregation with operational comingling) they must legally segregate cleared swaps customer collateral on an

individual basis; and they were required to significantly enhance their supervision of and accounting for customer funds. As a result, the risks posed to customers funds stewarded by FCMs have been significantly reduced.

The recent customer protection rulemakings all were well intentioned, but indisputably carried some additional costs and burdens for both FCMs and their customers. The analysis was made at the time, however, that those burdens and costs were outweighed by the benefits to FCM customers, especially against the very recent backdrop of hundreds of millions of dollars of customer funds having been stolen, or tied up in a bankruptcy proceeding, for at least a period of time.

The release before us essentially re-weighs the cost or burden on one hand, and the benefit on the other, and comes up with a slightly different, but well supported, conclusion regarding the residual-interest requirement. The costs or burdens revisited in the release: (1) uncertainty to the marketplace invited by a time-of-settlement compliance deadline that was subject to future review by the Commission staff, which suggested a change could come to the requirements, but might not; and (2) the anticipated costs to FCMs of having to finance the funding to top up their customers' margin deficits, or the cost to customers of pre-funding their margin accounts with FCMs. And the benefit at issue in the release: the value to an FCM customer of ensuring that its funds will never be borrowed by an FCM to cover another customer's deficit.

The inherent risk to this common practice by FCMs is that should an FCM become insolvent after it posts required margin to the clearinghouse, but before it collects margin deficits from all of its customers, the customers whose funds were used to cover a deficit might not see those funds again, or perhaps only after a protracted bankruptcy

proceeding. This practice also is not technically compliant with how rule 1.22 is written, which prohibits FCMs from “using, or permitting the use of, the futures customer funds of one futures 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 futures customer.”

This final rule keeps the residual-interest deadline at the close of business on the day following the margin-deficit calculation and eliminates the future deadline of the time of settlement on the day following the margin-deficit calculation. The Commission staff is still required to perform a feasibility study to determine whether future, more aggressive residual-interest deadlines would be desirable.

The comment file overwhelmingly supported the change in today’s final rule – in other words, commenters took the view that the potential costs associated with the 2013 residual-interest rule appear to outweigh the risk that some of their funds could be lost in the event their FCM becomes insolvent after the time of settlement, but before an FCM collects margin deficits. Indeed, the risk that an FCM becomes insolvent during this precise timeframe without some prior notice to its customers of financial stress at the FCM is very low. Notably, many comments supporting this final rule were filed by FCM customers, the constituency rule 1.22 is designed to protect, and who appreciate the aforementioned risk. The Commission must respect the comment process and the FCM-customer viewpoint that today’s rule better balances the cost and benefits of rule 1.22.

Another relevant factor that supports the change to rule 1.22 is the risk of concentration within the FCM community as a whole, and what that means for the costs to customers of trading in derivatives and its related impacts on liquidity in those

markets. The number of registered FCMs has decreased in recent years, which may make it more difficult for customers to manage their risk by limiting their ability to access the markets, or by making it more difficult for them to allocate funds between multiple FCMs to minimize concentration risk.

The results of the public comment process, when considered in the context of the overall stronger regulatory framework for FCMs and the concentration in the FCM community described above, give me the comfort needed to support the changes to 1.22 contained in today's release.

On the other hand, without the five-year phase-in period, we might see a reluctance by the industry to move as swiftly to streamline margin-collection practices and to take advantage of any technological solutions that may be developed. Some recent technology advances hold the promise to reduce the very sorts of risks addressed by rule 1.22 by facilitating real-time margin collection and settlement. To be sure, those advances would have been more seriously and expeditiously tested and – if they demonstrate merit – embraced without the change to rule 1.22 we are releasing today. In other words, just as in 2013 when the existing rule was finalized, I continue to believe that the most costly solutions for complying with rule 1.22 that were anticipated by many commenters should not be the ones ultimately embraced by the marketplace. Moreover, given regulatory requirements imposed by other regulators, today members of the clearing ecosystem are exploring a variety of solutions to new compliance and capital burdens that also would ease and enable stricter compliance with rule 1.22, thus minimizing further the likelihood that pre-funding customer margin accounts with FCMs will become the preferred solution to compliance.

Finally, I note that a study and roundtable to review these advancements, and how they might lower risks and related costs, still are mandated by law, and I ask the Chairman to direct staff to move swiftly to comply with these regulatory requirements so that the Commission may act appropriately when and if it needs to. I look forward to continuing to collaborate with staff and market participants as we work towards enhancing the safety and efficiency of our markets.

Appendix 4 – Statement of Commissioner J. Christopher Giancarlo

I support the Commission's action to change the residual interest deadline, if necessary or appropriate, only upon a Commission rulemaking following a public comment period. This approach will allow the Commission to better understand the market impacts and operational challenges of moving the residual interest deadline. This approach is especially important given the likely negative impacts on smaller futures commission merchants who provide our farmers, ranchers and rural producers with critical risk management services.

I call on the Commission to take the same deliberative approach to the *de minimis* exception to the swap dealer definition so that the *de minimis* level does not automatically adjust from \$8 billion to \$3 billion, absent a rulemaking with proper notice and comment. Like today's proposal, the Commission should only adjust the *de minimis* threshold if necessary or appropriate after it has considered the data and weighed public comments.

[FR Doc. 2015-06548 Filed: 3/23/2015 08:45 am; Publication Date: 3/24/2015]