



COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 1

RIN 3038-AE48

Written Acknowledgment of Customer Funds from Federal Reserve Banks

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (“CFTC” or “Commission”) is amending its regulations to revise or repeal certain provisions related to the requirement that a derivatives clearing organization (“DCO”) obtain from a Federal Reserve Bank acting as a depository for customer funds a written acknowledgment that the Federal Reserve Bank was informed that the customer funds deposited therein are those of customers and are being held in accordance with Section 4d of the Commodity Exchange Act (“CEA”).

DATES: Effective [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: Eileen A. Donovan, Deputy Director, 202-418-5096, edonovan@cftc.gov; M. Laura Astrada, Associate Director, 202-418-7622, lastrada@cftc.gov; or Parisa Abadi, Attorney-Advisor, 202-418-6620, pabadi@cftc.gov, in each case, at the Division of Clearing and Risk, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION: On June 2, 2016, the Commission published for public comment in the Federal Register a proposed order that would exempt Federal Reserve Banks that provide customer accounts and other services to certain designated financial market utilities registered with the Commission from Sections 4d and 22 of the CEA.¹ The proposed order would permit Federal Reserve Banks to hold money, securities, and property deposited into a customer account by certain designated financial market utilities in accordance with the standards to which Federal Reserve Banks are held.

In response to the request for public comment, CME Group Inc. noted that the proposed order would be inconsistent with Regulation 1.20(g)(4)(ii).² Commission Regulation 1.20(g)(4)(ii) requires that a DCO obtain from a Federal Reserve Bank acting as a depository for customer funds a written acknowledgment that the customer funds deposited therein are being held in accordance with Section 4d of the CEA; however, pursuant to the terms of the proposed order, the Federal Reserve Banks would be exempt from Section 4d. The Commission subsequently issued a final exemptive order that is substantively similar to the proposed order. In the Federal Register notice issuing the final exemptive order, the Commission noted that, in light of the comment, it had determined to repeal the written acknowledgment requirement with respect to customer

¹ Notice of Proposed Order and Request for Comment on Proposal to Exempt, Pursuant to the Authority in Section 4(c) of the Commodity Exchange Act, the Federal Reserve Banks from Sections 4d and 22 of the Commodity Exchange Act, 81 FR 35337 (June 2, 2016).

² 17 CFR 1.20(g)(4)(ii). Regulation 1.20(g)(4)(ii) provides that a DCO shall obtain from a Federal Reserve Bank only a written acknowledgment that: (A) The Federal Reserve Bank was informed that the customer funds deposited therein are those of customers and are being held in accordance with the provisions of section 4d of the Act and Commission regulations thereunder; and (B) The Federal Reserve Bank agrees to reply promptly and directly to any request from Commission staff for confirmation of account balances or provision of any other information regarding or related to an account. Id.

accounts held with a Federal Reserve Bank³ in a separate Federal Register notice. The final exemptive order will render these provisions inapplicable, as the Federal Reserve Banks will not be held to the requirements of Section 4d of the CEA. Therefore, the Commission is amending Regulation 1.20 to remove the acknowledgment letter requirement for customer funds deposited by a DCO with a Federal Reserve Bank. The Commission welcomes any comments and/or questions regarding this amendment.

List of Subjects in 17 CFR Part 1

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

For the reasons stated in the preamble, the Commodity Futures Trading Commission amends 17 CFR part 1 as follows:

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. Amend § 1.20 by revising paragraphs (g)(4)(i) and (ii) to read as follows:

§ 1.20 Futures customer funds to be segregated and separately accounted for.

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(g) * * *

(4) * * *

³ Specifically, the Commission is revising paragraphs (g)(4)(i) and (g)(4)(ii) of Regulation 1.20, and repealing paragraphs (g)(4)(ii)(A) and (g)(4)(ii)(B) of Regulation 1.20.

(i) A derivatives clearing organization must obtain a written acknowledgment from each depository prior to or contemporaneously with the opening of a futures customer funds account; provided, however, that a derivatives clearing organization is not required to obtain a written acknowledgment from a Federal Reserve Bank with which it has opened a futures customer funds account.

(ii) The written acknowledgment must be in the form as set out in appendix B to this part.

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Issued in Washington, DC, on August 8, 2016, 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 Written Acknowledgment of Customer Funds from Federal Reserve Banks – Commission Voting Summary, Chairman’s Statement, and Commissioner’s Statement

Appendix 1 – Commission Voting Summary

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

Appendix 2 – Statement of Chairman Timothy G. Massad

Today, the Commission continues its work to ensure the resiliency of clearinghouses and protect customers in our markets. To provide the necessary context for these efforts, it is useful to look back at recent history.

Most participants in our markets will recall what happened at the beginning of the financial crisis in September 2008, when the Reserve Fund – a money market fund – “broke the buck” following the bankruptcy of Lehman Brothers. Redemptions were suspended and investors were not able to make withdrawals. As a result, many futures commission merchants (FCMs) were not able to access customer funds invested in the Reserve Fund. Absent relief by the CFTC, many would have been undercapitalized, potentially ending up in bankruptcy. In addition, clearinghouses could not liquidate investments in the Reserve Fund. And there could have easily been a widespread run on money market funds, but for the emergency actions taken by the U.S. government.

As a result of the crisis, as well as the collapse of MF Global, the CFTC and our self-regulatory organizations took a number of actions to better protect customer funds. We required customer funds to be strictly segregated and limited the ways they can be invested. We enhanced accounting and auditing procedures at FCMs, including by requiring daily verification from depositories of the amounts deposited by FCMs.

Today, CFTC rules require that customer funds be invested in highly liquid assets and be convertible into cash within one business day without a material discount in value. Our rules also require that clearinghouses invest initial margin deposits in a manner that allows them to promptly liquidate any such investment.

Over the last few years, the Securities and Exchange Commission (SEC) has also taken action in response to the lessons of the financial crisis, by adopting a number of measures to address the potential vulnerabilities of money market funds. One such recent reform, which takes effect in October of this year, sets forth the circumstances where

prime money market funds are permitted, or in some circumstances required, to suspend redemptions in order to prevent the risk of investor runs.

While we recognize the benefit of the SEC's new rule in preventing investor runs, a suspension of redemptions by a money market fund would mean investments in such funds are not accessible and cannot be promptly liquidated. Such an event could result in customers, FCMs, and clearinghouses being unable to access the funds necessary to satisfy margin obligations.

Therefore, CFTC staff is today providing guidance making clear that Commission rules prohibit a clearing member from investing customer funds, or a clearinghouse from investing amounts deposited as initial margin, in such money market funds.

Some industry participants have suggested we should interpret or revise our rules to permit investments of at least some customer monies in such money market funds unless and until redemptions are suspended. We have declined to do so, as it would be too late to protect customers at that point. Moreover, there are alternatives to prime funds, including certain government money markets funds or Treasury securities. In fact, investments in prime money market funds represent a relatively small portion of the total customer funds on deposit and the total initial margin deposits at clearinghouses. Some of our clearinghouses and FCMs do not have any investments in prime funds.

Staff has been careful not to be overly restrictive, and therefore has issued no-action relief to allow FCMs to invest certain "excess" proprietary funds held in customer accounts in these money market funds. That is, our existing rules require FCMs to deposit their own funds (i.e., targeted residual interest) into customer accounts to make sure that there are sufficient funds in the segregated customer accounts to cover all

obligations due to customers. FCMs frequently deposit an amount of their own funds that is in excess of the targeted residual interest amount required under our rules, and that excess amount can be withdrawn at any time. Indeed, if an FCM should default, customers—and the system as a whole—are better off if excess funds are on deposit, and we do not wish to incentivize FCMs to withdraw such excess funds from the segregated account. Therefore, the no action relief makes clear that FCMs can continue to invest their own funds in excess of their targeted residual interest in such money market funds, even though they cannot invest the customer funds – or any proprietary funds they are required to deposit – in this manner.

Finally, the Commission is taking action today that will further ensure the safety of customer funds. We are issuing an order that will help make it possible for systemically important clearinghouses to deposit customer funds at Federal Reserve Banks. Our order makes clear that a Federal Reserve Bank that opens such an account would be subject to the same standards of liability that generally apply to it as a depository, rather than any potentially conflicting standard under the commodity laws.

Although Federal Reserve accounts for customer funds held by systemically important clearinghouses do not exist today, they are allowed under the Dodd-Frank Act, and we have been working with the Board of Governors to facilitate them. The two clearinghouses designated as systemically important in our markets have been approved to open Federal Reserve Bank accounts for their proprietary funds. We hope that with today's action, accounts for customer funds can be opened soon. Doing so will help protect customer funds and enhance the resiliency of clearinghouses.

I thank the dedicated CFTC staff and my fellow Commissioners for their work on these matters.

Appendix 3 – Concurring Statement of Commissioner Sharon Y. Bowen

I am pleased to concur with the two Commission actions: the “Order Exempting the Federal Reserve Banks from Sections 4d and 22 of the Commodity Exchange Act” and “Written Acknowledgment of Customer Funds from Federal Reserve Banks.” I have long believed that, in order to protect customer funds, we need to keep that money at our central bank. In the event of a major market event, I, and I believe the rest of the American people, would feel much better knowing that investors’ money is at the Federal Reserve instead of at multiple central counterparties. I am glad that our agency and the Federal Reserve have come to an agreement on an effective way to accomplish this.

I am similarly pleased with the Division of Clearing and Risk’s (DCR) “Staff Interpretation Regarding CFTC Part 39 In Light Of Revised SEC Rule 2a-7,” which clearly outlines the staff’s understanding that, given the limitations that the Securities and Exchange Commission (SEC) has imposed on redemptions for prime money market funds, that they are no longer considered Rule 1.25 assets. This is the correct interpretation. The key feature in a Rule 1.25 asset is that it must be available quickly in times of crisis or illiquidity. And we know that funds are more likely to close the gates on redemptions when market dislocation happens. That is just the time when futures commission merchants (FCMs) and customers would need access to their money, and a multi-day delay can mean catastrophe for some businesses.

For that very reason, I have concerns about the Division of Swap Dealer and Intermediary Oversight’s (DSIO) “No-Action Relief With Respect to CFTC Regulation

1.25 Regarding Money Market Funds.” While the 4(c) exemption and the DCR interpretation are clearly customer protection initiatives, the DSIO no action letter is not. This no action letter would allow FCMs to keep money in segregated customer accounts that actually would not be readily available in a crisis. Thus, while it may appear that an FCM had considerable funds available to settle customer accounts during a market dislocation, in fact that would be only be an illusion; a portion of those funds could be locked down behind the prime money market funds’ gates and therefore not actually be available when needed.

I do not think that the staff of the Commission should be supporting this kind of “window dressing” – giving the impression of greater security than there actually is. If the funds are not suitable investments for customer funds, then they are not suitable for the additional capital that the FCMs put in those accounts to protect against potential shortfalls. Having lived through bankruptcies, such as MF Global and Peregrine, I have a healthy respect for the importance of having strong clearing members with a large cushion of funds that can be accessed when needed. This no action letter undermines that effort. Given the importance of this topic to the general public, we should at least have asked for comments or even held a roundtable before making this change. I therefore hope to reexamine this subject in the near future.

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