



U.S. COMMODITY FUTURES TRADING COMMISSION

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CFTC Letter No. 14-106
No-Action
August 18, 2014
Division of Swap Dealer and Intermediary Oversight
Division of Clearing and Risk

Mr. Jason Silverstein
Executive Director and Associate General Counsel
Chicago Mercantile Exchange, Inc.
20 South Wacker Street
Chicago, IL 60606

RE: Request for Permanent No-Action Relief regarding the Written Acknowledgment Requirements in Commission Regulations 1.20(d) and 22.5(a)

Dear Mr. Silverstein:

This is in response to your letter dated July 2, 2014 (“Letter”), to the Division of Clearing and Risk and the Division of Swap Dealer and Intermediary Oversight (“Divisions”) of the Commodity Futures Trading Commission (“Commission”).¹ In the Letter, you request that the Divisions confirm that they will not recommend that the Commission take enforcement action against: (1) the Clearing House of the Chicago Mercantile Exchange, Inc. (“CME Clearing”), (2) certain clearing members of CME Clearing, or (3) depositories holding customer funds² for such clearing members, in connection with the execution and submission to the Commission and the relevant designated self-regulatory organization (“DSRO”) of a modified version of the template acknowledgment letter set forth in Appendix A to Regulation 1.20.

Prior to November 2013, Regulations 1.20 and 22.5 required, among other things, that futures commission merchants (“FCMs”) obtain, from each depository with which the FCM deposits customer funds, a written acknowledgment that the depository had been informed that the funds deposited were customer funds being held in accordance with the Commodity Exchange Act.³ In November 2013, the Commission amended Regulation 1.20 to require that FCMs use the template acknowledgment letter set forth in Appendix A to Regulation 1.20

¹ Chicago Mercantile Exchange, Inc. submitted a revised version of the Letter to the Divisions on July 21, 2014, with minor technical corrections.

² The term “customer funds” means cleared swaps customer collateral, as defined in Regulations 1.3(eeee) and 22.1, and futures customer funds, as defined in Regulation 1.3(jjjj). *See* 17 C.F.R. § 1.3(gg).

³ Regulation 22.5 applies, by cross-reference, the acknowledgment letter requirements of Regulation 1.20 to FCMs in connection with the holding of cleared swaps customer collateral, as defined in Regulations 1.3(eeee) and 22.1.

(“Acknowledgment Letter”).⁴ For customer accounts⁵ existing at the time, the Commission required FCMs to obtain new Acknowledgment Letters and submit them to the Commission by July 12, 2014.⁶

By letter dated June 11, 2014 (“Extension Request”), CME Clearing informed the Divisions that: (1) it and certain of its FCM clearing members required modifications to the Acknowledgment Letter; (2) it would submit a separate request for no-action relief (*i.e.*, the Letter) to use a modified Acknowledgment Letter; and (3) it therefore required a temporary extension of the compliance deadline for Regulation 1.20 to allow the Divisions to review the proposed modifications to the Acknowledgment Letter. Based on CME Clearing’s representations and the Divisions’ understanding of the relevant facts, the Divisions granted a temporary extension of the compliance deadline to CME Clearing, certain of its FCM clearing members, and the depositories holding customer funds for such clearing members.⁷ The no-action relief was time-limited, set to expire as of the date on which the Divisions respond to the Letter.

Statement of Facts

Based upon the representations made by CME Clearing to the Divisions in the Letter, we understand the relevant facts to be as follows:

Since 2003, CME Clearing has operated a program, Interest Earning Facility 4 (“IEF4”), that permits CME Clearing’s members to pledge certain types of high quality corporate bonds as initial margin for futures and cleared swaps positions (other than credit default swaps). Under the IEF4 program, an FCM clearing member opens one or more customer accounts with a depository that participates in the IEF4 program (each an “IEF4 Depository”) and the high quality corporate bonds are pledged to such accounts as initial margin.

In accordance with Regulation 39.13(g)(14),⁸ CME Clearing requires that each of its clearing members participating in the IEF4 program (each an “Affected Clearing Member”) enter into an Account Administration and Control Agreement (“Agreement”) by and between itself

⁴ See Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68,506 (Nov. 14, 2013).

⁵ In the Letter, CME Clearing refers to “customer segregated accounts and cleared swaps customer accounts.” For purposes of this letter, the Divisions use the term “customer account,” which is defined as both a cleared swaps customer account, as defined in Regulations 1.3(dddd) and 22.1, and a futures account, as defined in Regulation 1.3(vv). See 17 C.F.R. § 1.3(gggg).

⁶ Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. at 68,578 (setting forth the compliance date for Regulation 1.20).

⁷ See CFTC Letter No. 14-92 (July 9, 2014).

⁸ Regulation 39.13(g)(14) requires that “[i]f a [DCO] permits its clearing members to pledge assets for initial margin while retaining such assets in accounts in the names of such clearing members, the [DCO] shall ensure that such assets are unencumbered and that such a pledge has been validly created and validly perfected in the relevant jurisdiction.” 17 C.F.R. § 39.13(g)(14).

(i.e., the Affected Clearing Member), the relevant IEF4 Depository, and CME Clearing. The purpose of the Agreement is to establish that all funds deposited into the account shall be subject to CME Clearing's first priority, perfected security interest and shall be under the control of CME Clearing, to the fullest extent permitted by applicable law. The result of this control and first priority, perfected security interest is that CME Clearing would be able to exercise remedies against the funds deposited into the account in the event of a default by the Affected Clearing Member of its obligations owing to CME Clearing, including the Affected Clearing Member's insolvency.

Discussion of Request for No-Action Relief and Applicable Legal Requirements

CME Clearing's request for relief is premised upon a potential conflict between the terms of the Acknowledgment Letter and the requirements of Regulation 39.13(g)(14). Specifically, Regulation 39.13(g)(14) provides for an arrangement in which the customer funds deposited by a derivatives clearing organization's ("DCO's") FCM clearing member with a depository are subject to a security interest held by the DCO. The terms of the Acknowledgment Letter do not address this particular arrangement and, thus, an Acknowledgment Letter executed by an IEF4 Depository and an Affected Clearing Member would not recognize CME Clearing's security interest in the customer funds held under the IEF4 program.

In the Letter, CME Clearing proposed certain modifications to the Acknowledgment Letter that would recognize CME Clearing's control over and first priority, perfected security interest in the funds. The relief sought in the Letter would permit IEF4 Depositories and Affected Clearing Members to execute a modified version of the Acknowledgment Letter, as proposed in the Letter and set forth in an attachment to this no-action letter ("Revised Acknowledgment").

The Acknowledgment Letter requirements were recently finalized and are currently being implemented, and the Divisions have not been presented with a request for relief encompassing the issues presented in the Letter.⁹ The Divisions believe granting the relief requested by CME Clearing is appropriate in order to avoid the potential conflict described in the Letter.

Grant of No-Action Relief

Based on the facts presented and the representations CME Clearing has made, the Divisions will not recommend that the Commission take enforcement action against: (1) CME Clearing, (2) Affected Clearing Members, or (3) IEF4 Depositories, for Affected Clearing

⁹ The Division of Clearing and Risk issued time-limited no-action relief to ICE Clear Europe Limited and LCH.Clearnet Limited concerning the Acknowledgment Letter that those DCOs would execute with the Bank of England. See CFTC Letter No. 14-93 (July 10, 2014) (granting no-action relief to ICE Clear Europe); and CFTC Letter No. 14-94 (July 10, 2014) (granting no-action relief to LCH.Clearnet Limited). The Division of Swap Dealer and Intermediary Oversight granted no-action relief to FCMs concerning a depository's provision of read-only access to account information, as provided for in the Acknowledgment Letter, and the need to execute online access agreements. See CFTC Letter No. 14-91 (July 10, 2014). The relief granted in these no-action letters extended the relevant compliance deadline, but did not address modifications to the Acknowledgment Letter.

Mr. Jason Silverstein
August 18, 2014
Page 4

Members and IEF4 Depositories executing and submitting to the Commission and the Affected Clearing Member's DSRO, the Revised Acknowledgment attached to this no-action letter. For any customer account opened under the IEF4 program prior to or as of the date of this letter, Affected Clearing Members and the corresponding IEF4 Depositories are required to execute and submit to the Commission and the Affected Clearing Member's DSRO (within three days of execution), the Revised Acknowledgment; this process shall be completed no later than October 17, 2014. The issuance of this no-action letter hereby terminates the relief provided in response to the Extension Request.¹⁰

The position taken herein concerns enforcement action only and does not represent a legal conclusion with respect to the applicability of any provision of the Commodity Exchange Act or the Commission's regulations. In addition, the Divisions' position does not necessarily reflect the views of the Commission or any other division or office of the Commission. Because this position is based upon the representations contained in the Letter, it should be noted that any different, changed, or omitted material facts or circumstances may require a different conclusion or render this letter void. Finally, as with all no-action letters, the Divisions retain the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in their discretion.

Should you have any questions, please do not hesitate to contact Parisa Abadi, Attorney-Advisor, at (202) 418-6620.

Sincerely,

Ananda Radhakrishnan
Director, Division of Clearing and Risk

Gary Barnett
Director, Division of Swap Dealer and Intermediary
Oversight

Attachment

¹⁰ See CFTC Letter No. 14-92 (July 9, 2014) (granting a temporary extension of the compliance deadline for Regulation 1.20 to allow the Divisions to consider the proposed modifications set forth in the Letter).

[Date]

[Name and Address of Bank or Trust Company]

We refer to the Segregated Account(s) which [Name of Futures Commission Merchant] (“we” or “our”) have opened or will open with [Name of Bank or Trust Company] (“you” or “your”) entitled:

[Chicago Mercantile Exchange Inc.] as secured party of [Name of Futures Commission Merchant] [if applicable, add “FCM Customer Omnibus Account”] CFTC Regulation 1.20 Customer Segregated Account under Sections 4d(a) and 4d(b) of the Commodity Exchange Act [and, if applicable, “, Abbreviated as [short title reflected in the depository's electronic system]”]

Account Number(s): []

(collectively, the “Account(s)”).

You acknowledge that we have opened or will open the above-referenced Account(s) for the purpose of depositing, as applicable, money, securities and other property (collectively the “Funds”) of customers who trade commodities, options, swaps, and other products, as required by Commodity Futures Trading Commission (“CFTC”) Regulations, including Regulation 1.20, as amended; that the Funds held by you, hereafter deposited in the Account(s) or accruing to the credit of the Account(s), will be separately accounted for and segregated on your books from our own funds and from any other funds or accounts held by us in accordance with the provisions of the Commodity Exchange Act, as amended (the “Act”), and Part 1 of the CFTC's regulations, as amended; and that the Funds must otherwise be treated in accordance with the provisions of Section 4d of the Act and CFTC regulations thereunder. You also acknowledge that the Account is subject to an [NAME OF ACCOUNT CONTROL AGREEMENT] among Chicago Mercantile Exchange Inc. (“CME”), [Name of Futures Commission Merchant] and you. We agree to provide an executed copy of this letter to CME.

Furthermore, you acknowledge and agree that such Funds may not be used by you or by us to secure or guarantee any obligations that we might owe to you, and they may not be used by us to secure or obtain credit from you. You further acknowledge and agree that the Funds in the Account(s) shall not be subject to any right of offset or lien for or on account of any indebtedness, obligations or liabilities we may now or in the future have owing to you. This prohibition does not affect your right to recover funds advanced in the form of cash transfers, lines of credit, repurchase agreements or other similar liquidity arrangements you make in lieu of liquidating non-cash assets held in the Account(s) or in lieu of converting cash held in the Account(s) to cash in a different currency.

In addition, you agree that the Account(s) may be examined at any reasonable time by the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent or employee of our designated self-regulatory

organization (“DSRO”), [Name of DSRO], and this letter constitutes the authorization and direction of the undersigned on our behalf to permit any such examination to take place without further notice to or consent from us.

You agree to reply promptly and directly to any request for confirmation of account balances or provision of any other information regarding or related to the Account(s) from the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent, or employee of [Name of DSRO], acting in its capacity as our DSRO, and this letter constitutes the authorization and direction of the undersigned on our behalf to release the requested information without further notice to or consent from us.

You further acknowledge and agree that, pursuant to authorization granted by us to you previously or herein, you have provided, or will promptly provide following the opening of the Account(s), the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC, or any successor division, or such director's designees, with technological connectivity, which may include provision of hardware, software, and related technology and protocol support, to facilitate direct, read-only electronic access to transaction and account balance information for the Account(s). This letter constitutes the authorization and direction of the undersigned on our behalf for you to establish this connectivity and access if not previously established, without further notice to or consent from us.

The parties agree that all actions on your part to respond to the above information and access requests will be made in accordance with, and subject to, such usual and customary authorization verification and authentication policies and procedures as may be employed by you to verify the authority of, and authenticate the identity of, the individual making any such information or access request, in order to provide for the secure transmission and delivery of the requested information or access to the appropriate recipient(s). We will not hold you responsible for acting pursuant to any information or access request from the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent, or employee of [Name of DSRO], acting in its capacity as our DSRO, upon which you have relied after having taken measures in accordance with your applicable policies and procedures to assure that such request was provided to you by an individual authorized to make such a request.

In the event that we become subject to either a voluntary or involuntary petition for relief under the U.S. Bankruptcy Code, we acknowledge that you will have no obligation to release the Funds held in the Account(s), except upon instruction of the CME pursuant to the [NAME OF ACCOUNT CONTROL AGREEMENT], upon instruction of the Trustee in Bankruptcy or pursuant to the Order of the respective U.S. Bankruptcy Court.

Notwithstanding anything in the foregoing to the contrary, nothing contained herein shall be construed as limiting your right to assert any right of offset or lien on assets that are not Funds maintained in the Account(s), or to impose such charges against us or any proprietary account maintained by us with you. Further, it is understood that amounts represented by checks, drafts or other items shall not be considered to be part of the Account(s) until finally collected.

Accordingly, checks, drafts and other items credited to the Account(s) and subsequently dishonored or otherwise returned to you or reversed, for any reason, and any claims relating thereto, including but not limited to claims of alteration or forgery, may be charged back to the Account(s), and we shall be responsible to you as a general endorser of all such items whether or not actually so endorsed.

You may conclusively presume that any withdrawal from the Account(s) and the balances maintained therein are in conformity with the Act and CFTC regulations without any further inquiry, provided that, in the ordinary course of your business as a depository, you have no notice of or actual knowledge of a potential violation by us of any provision of the Act or the CFTC regulations that relates to the segregation of customer funds; and you shall not in any manner not expressly agreed to herein be responsible to us for ensuring compliance by us with such provisions of the Act and CFTC regulations; however, the aforementioned presumption does not affect any obligation you may otherwise have under the Act or CFTC regulations.

You may, and are hereby authorized to, obey the order, judgment, decree or levy of any court of competent jurisdiction or any governmental agency with jurisdiction, which order, judgment, decree or levy relates in whole or in part to the Account(s). In any event, you shall not be liable by reason of any action or omission to act pursuant to any such order, judgment, decree or levy, to us or to any other person, firm, association or corporation even if thereafter any such order, decree, judgment or levy shall be reversed, modified, set aside or vacated.

The terms of this letter agreement shall remain binding upon the parties, their successors and assigns and, for the avoidance of doubt, regardless of a change in the name of either party. This letter agreement supersedes and replaces any prior agreement between the parties in connection with the Account(s), including but not limited to any prior acknowledgment letter agreement, to the extent that such prior agreement is inconsistent with the terms hereof. In the event of any conflict between this letter agreement and any other agreement between the parties in connection with the Account(s), this letter agreement shall govern with respect to matters specific to Section 4d of the Act and the CFTC's regulations thereunder, as amended.

This letter agreement shall be governed by and construed in accordance with the laws of [Insert governing law] without regard to the principles of choice of law.

Please acknowledge that you agree to abide by the requirements and conditions set forth above by signing and returning to us the enclosed copy of this letter agreement, and that you further agree to provide a copy of this fully executed letter agreement directly to the CFTC (via electronic means in a format and manner determined by the CFTC) and to [Name of DSRO], acting in its capacity as our DSRO. We hereby authorize and direct you to provide such copies without further notice to or consent from us, no later than three business days after opening the Account(s) or revising this letter agreement, as applicable.

EXHIBIT 1

[Name of Futures Commission Merchant]

By:

Print Name:

Title:

ACKNOWLEDGED AND AGREED:

[Name of Bank, Trust Company, Derivatives Clearing Organization or Futures Commission Merchant]

By:

Print Name:

Title:

Contact Information: [Insert phone number and email address]

DATE:

CC: [Name and Address of Derivatives Clearing Organization]