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Division of Swap Dealer and Intermediary Oversight

Eileen T. Flaherty
Director

CFTC Letter No. 16-88
No-Action
December 9, 2016
Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulation 30.7 – Staff No-Action position regarding transfer of customer-owned securities by US FCM to foreign broker

Dear _____:

This is in response to your letter dated October 4, 2016 and accompanying Appendix, submitted to the Division of Swap Dealer and Intermediary Oversight ("Division" or "DSIO") of the Commodity Futures Trading Commission ("Commission") on behalf of your clients, "X" and "Y", as supplemented by e-mail messages to, and telephone conversations with, Division staff (collectively, the "Correspondence"). By your Correspondence, you request that DSIO confirm it will not recommend that the Commission take enforcement action against "X" or "Y" if, subject to certain terms and conditions noted below, (i) "X" deposits customer-owned securities with "Y" to margin such customers' foreign futures or foreign options[1] positions executed on a foreign board of trade located in the United Kingdom ("UK") and cleared through a clearing organization that (a) is a central counterparty ("CCP") that has received a recognition order as a recognized clearing house ("RCH") and is subject to supervision by the Bank of England under Part 18 of the Financial Services and Markets Act 2000, and (b) has been authorized as a CCP pursuant to Article 17 of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("EMIR") (each, an "EU CCP"); and (ii) "Y" deposits such securities in an individual client account ("ISA") established with such EU CCP.

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[1] The terms "foreign futures" and "foreign options" are defined in Commission Regulations 30.1(a) and 30.1(b), respectively, to mean generally any contract for the purchase of sale of a commodity for future delivery, or any commodity option transaction or agreement made, or to be made, on a foreign board of trade. The Commission's regulations are found at 17 CFR Part 1 et seq. (2016).

Background

As represented in your correspondence, we understand the relevant facts to be as follows.

"X" and "Y" are indirect subsidiaries of "Z", a registered bank holding company and financial holding company that is regulated and supervised by the Federal Reserve Board. "X" is registered with the Commission as a futures commission merchant ("FCM") and is a clearing member of several derivatives clearing organizations ("DCOs") registered with the Commission. "Y" is incorporated under the laws of England and Wales, maintains its principal place of business in London, UK, is authorized as an investment firm with the United Kingdom's Financial Conduct Authority ("FCA") and Prudential Regulatory Authority and is a member of a number of EU CCPs authorized in accordance with EMIR.[2] "X" maintains a customer omnibus account with "Y" to facilitate its customers' foreign futures and foreign options transactions.[3]

Unlike DCO rules which permit an FCM to pledge customer-owned securities in satisfaction of its customers' initial margin requirements, EU CCP rules generally require that a clearing member have either: (i) sole legal and beneficial ownership in any securities posted with the EU CCP as margin; or (ii) the customer's consent to treat such securities as if it had such ownership, (referred to herein as a "right of re-use"). Commission customer protection regulations effectively prohibit "X" from transferring title to "Y" or granting "Y" a right of re-use as contemplated under EU CCP rules.

In this regard, Commission Regulation 30.7 sets forth the requirements governing the treatment of customer funds held by an FCM to trade foreign futures or foreign options contracts. Pursuant to Regulation 30.7(b) an FCM must deposit 30.7 customer funds under an account name that clearly identifies the funds as belonging to 30.7 customers and shows that such customer funds are set aside as required by Commission regulations. Regulation 30.7(e) further provides generally that an FCM may not commingle 30.7 customer funds with its own money, securities or property. These regulations are inconsistent with either "X" transferring legal and beneficial ownership of the customer-owned securities to "Y" or granting "Y" a right to re-use such customer-owned securities (which transfers legal title of the securities at the time a right of re-use is exercised).

Moreover, Regulation 30.7(c) requires that an FCM deposit 30.7 customer funds under the laws and regulations of the foreign jurisdiction that provide the greatest degree of protection to such funds. You note in your correspondence that, as currently drafted, the language of the "Futures Agreement" that "Y" enters into with its clients (including "X") would be inconsistent with

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[2] "Y" is a member of the following RCHs that are EU CCPs: CME Clearing Europe Limited, ICE Clear Europe Limited, LCH.Clearnet Limited, and LME Clear Limited.

[3] You state that with limited exceptions, all such customers are "eligible contract participants" ("ECPs") as defined in section 1a(18) of the Commodity Exchange Act (the "Act" or "CEA").

Regulation 30.7(c). Under the terms of the Futures Agreement, at the time of a transfer of title to "Y" or at the time of "Y's" exercise of a right of re-use, as the case may be,[4] customer-owned securities would not receive the protections afforded by FCA rules relating to the safe custody of assets (the "Custody Rules").[5]

In order for "X" and "Y" to comply with the above Commission customer protection regulations, "X" currently holds customer-owned securities in the US and deposits only money with "Y" to meet its customers' obligations to EU CCPs. As an indirect subsidiary of a bank holding company, this arrangement subjects "X" to significant capital charges imposed under capital requirements promulgated by the Federal Reserve Board.[6]

You have requested that the Division provide no-action relief to "X" and "Y" such that "X" may deposit customer-owned securities with "Y" subject to a limited right of re-use that would permit "Y" at "X's" direction to establish an ISA[7] with an RCH that is also an EU CCP for the benefit of "X's" customers.[8] You state your belief that such an arrangement would be consistent with Commission Regulation 30.7(c) in that an individually segregated account at an EU CCP would provide "the greatest degree of protection" of such funds as envisioned by the rule.

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4 You note that the version of the Futures Agreement "Y" uses with its clients is dependent on the type of transfer that is contemplated. One version contemplates full transfer of title to securities deposited while the other contemplates providing a right of re-use of those securities.

5 You note that the Futures Agreement's provision regarding right of re-use is consistent with 3.1.7G of the FCA's Client Assets Source Book ("CASS"), which provides generally that under a right to use arrangement "the asset ceases to belong to the client" when the firm exercises its "right" "and in effect becomes the firm's asset and is no longer in need of the full range of client asset protection."

6 The Federal Reserve has adopted regulations implementing the Basel III capital framework.

7 Article 39(3) of EMIR provides that "[a] CCP shall offer an option to keep separate records and accounts enabling each clearing member to distinguish in accounts with the CCP the assets and positions held for the account of a client from those held for the account of other clients" (i.e., individual client segregation).

8 CASS 6.1.6B R requires that any right of use must be pursuant to a written agreement that sets out: (i) the terms of the arrangement relating to the transfer of the client's full ownership of the safe custody asset to the firm; [and] (ii) any terms under which the ownership of the safe custody asset is to transfer from the firm back to the client. Such terms may include, for example, "terms under which the arrangement relating to the transfer of full ownership of the safe custody asset to the firm is not in effect from time to time, or is contingent on some other condition." CASS 6.1.6C G.

Discussion

As discussed above, absent no-action relief "X" may not grant "Y" a right of re-use of customer-owned securities deposited with "X" to margin foreign futures and foreign options positions.

In requesting relief of the Division, and to evidence that "X" customer-owned securities would be protected consistent with Commission rules, you have represented that, among other things, "X" customer-owned securities deposited with "Y" would be used solely to margin foreign futures and foreign options transactions of "X's" customers that will be cleared through a clearing organization that is both an RCH and an EU CCP. Further, consistent with CASS 6.1.6B R, the Futures Agreement between "Y" and "X" will be amended to permit "Y" to re-use customer-owned securities deposited with it solely for the purpose of transferring such securities to an ISA maintained by an EU CCP. The amended Futures Agreement would further provide that "Y" could authorize transfers out of the ISA at the EU CCP only upon instruction of "X".[9]

Moreover, although "Y's" exercise of its right of re-use under its Futures Agreement with "X" (i.e., the transfer of customer-owned securities to an ISA at an EU CCP) would authorize "Y" to treat such securities as its own by the terms of the Futures Agreement, the securities would at no time be held in a "Y" house account. Rather, "Y" would transfer the securities directly from the client (i.e., "X") custody account to the ISA at the EU CCP promptly upon receipt, while reflecting in its books and records that a right of use has been exercised. Similarly, upon a transfer of the customer-owned securities from the ISA at the EU CCP to "Y", such securities would be transferred directly from the EU CCP to the client custody account at "Y". Further, you represent that "Y" will amend its Futures Agreement with "X" to restrict further its right of re-use to assure that "X" customer-owned securities are held in accordance with the FCA Custody Rules until they are transferred to an ISA. Accordingly, you represent that such securities will always be held in a properly designated custody account either with "Y" or with an EU CCP, and that such securities would never be held in a "Y" or a "X" proprietary account. Therefore, you state that there is little risk that "X" customer-owned securities would be exposed to any greater potential risk of loss as a result of this arrangement than if the customer-owned securities were held pursuant to the FCA Custody Rules.

You further state that, under EMIR, in the event of "Y's" insolvency, "X's" ISA account at the EU CCP would not be subject to netting with other customer accounts maintained by "Y", including other ISA accounts maintained for other customers of "Y".[10] Rather, "X" would be permitted, in accordance with the relevant EU CCP's rules and procedures, to instruct the EU

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[9] You note that "X" might be required to withdraw assets from the account periodically, for example, in order to ensure compliance with the restriction under Commission Regulation 30.7(c) that prohibits "X" from holding in accounts maintained outside the US an amount in excess of 120 percent of the total amount of funds necessary to meet the margin and prefunding margin requirements of its foreign futures and foreign options customers.

[10] EMIR Article 39(9).

CCP maintaining the ISA to transfer the positions and assets held in the account to another clearing firm.[11] Alternatively, where a transfer of positions is not possible, the CCP may liquidate the positions and, in accordance with EMIR Article 48(7), return any balance held by the EU CCP directly to "X". You state that the assets held at the EU CCP should not be subject to the administration of the insolvent clearing member and the protections afforded customer assets that are maintained in an individual segregated account, therefore, would not be exposed to loss in the event of "Y's" default. You further state that, to the contrary, the protections afforded under EMIR are greater than the protections that would otherwise be available if "X's" customer segregated account were held in "Y's" customer omnibus account and also greater than the protections afforded a customer omnibus account maintained at a Commission registered DCO.

In the event of "X's" insolvency, you state that the treatment of assets held in an ISA account under EMIR would be no different from the treatment of assets held in an omnibus client segregated account. You state that the treatment of these assets on the books of "X" is no different from the treatment of any other foreign futures and foreign options customer assets. Assuming no shortfall in Regulation 30.7 customer funds, "X's" trustee would seek to transfer the positions and assets held in the account to another clearing firm. If there were a shortfall in Regulation 30.7 customer funds, or if the trustee were unable to transfer the account to another clearing firm, the trustee would instruct "Y" to liquidate the positions and return the assets to the trustee. You contend that all such assets would be subject to *pro rata* distribution with all other Regulation 30.7 customer funds, as required under section 766(h) of the US Bankruptcy Code ("Code").[12]

Based on the foregoing, the Division agrees that customer-owned securities transferred to an ISA under the arrangement described above is consistent with the intent of the Commission's rules and believes it is appropriate to provide the no-action relief requested, subject to certain conditions. Accordingly, the Division confirms that it will not recommend that the Commission take enforcement action against "X" or "Y" if, subject to the conditions enumerated below, "X" deposits customer-owned securities with "Y" to margin such customers' foreign futures or foreign options positions executed on a foreign board of trade located in the UK and cleared through a clearing organization that is an RCH and authorized as a EU CCP in accordance with EMIR. The relief provided in this letter is subject to compliance with the following conditions:

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[11] EMIR Article 48(6) requires that for ISAs, a CCP must "contractually commit itself to trigger the procedures for the transfer of the assets and positions held by the defaulting clearing member … to another clearing member designated by the client."

[12] You state generally that in the event of "X's" insolvency, customer–owned securities subject to a right of re-use remain "customer property" under the Code and Part 190 of the Commission's regulations as any customer of "X" that trades foreign futures and foreign options is a "customer" under section 761(9) of the Code and any securities posted by a customer will be deemed "customer property" as broadly defined under section 761(10) of the Code and Commission Regulation 190.08.

1. "Y" remains incorporated under the laws of England and Wales, retains its principal place of business in London, UK and remains authorized as an investment firm with the FCA and Prudential Regulatory Authority.

2. "X" must provide each customer that deposits margin collateral that may be transferred to "Y" with full and clear disclosure setting out the risks associated with the grant of a right of re-use of customer-owned securities that are deposited in an individual client segregated account with an EU CCP under EMIR.

3. Each customer must provide written, unconditional consent to the grant of a right of re-use of customer-owned securities to "X" and "Y" prior to depositing such securities with "X".

4. The grant of a right of re-use of customer-owned securities to "X" and subsequently by "X" to "Y" must be for the exclusive purpose of "Y" transferring such securities to an individual client segregated account maintained for "X" at an EU CCP. Such individual client segregated account may be used solely to margin the foreign futures and foreign options transactions of "X's" customers executed on a foreign board of trade and cleared through an EU CCP that is also an RCH subject to supervision by the Bank of England.

5. Except as permitted herein, when the right of re-use is exercised, "X" and "Y" may not lend, appropriate, dispose of or otherwise use for their own purposes customer-owned securities.

6. "X" and "Y" may not receive or hold customer-owned securities subject to a right of re-use in proprietary accounts. "X" must hold customer-owned securities in a Regulation 30.7 compliant secured account pending its transfer of the securities to "Y" subject to a limited right of re-use. "Y" must hold customer-owned securities in an FCA Custody Account pending its exercise of its right to reuse the securities. Upon "Y's" exercise of its right to reuse the customer-owned securities, "X" and "Y" must promptly transfer the customer-owned securities to an individual client segregated account at an EU CCP and may not hold or transfer such securities through proprietary accounts.

7. Any customer-owned securities withdrawn from the individual client segregated account established at an EU CCP and returned to "Y" will be withdrawn only at the request of "X". Such customer-owned securities will be transferred directly from the individual client segregated account at the EU CCP to the "X" customer omnibus account at "Y", and will immediately be subject to the FCA Custody Rules until returned to "X".

8. "X" and "Y" will notify the Division in the event of any material change in the law or regulations governing individual client segregated accounts.

This letter, and the position taken herein, are based upon the representations made to us and are subject to compliance with the conditions stated above. Any different, changed or omitted material facts or circumstances might require DSIO to reach a different conclusion and render this letter void. You must notify DSIO immediately in the event there is any change to the facts

presented to the Division. Additionally, the Division's no-action position is based upon your representations regarding current laws and regulations in effect in the UK that govern "Y" as a broker and UK CCPs, including the laws and regulations established under EMIR. The Division's no-action position may be void if "Y" and UK CCPs are no longer subject to EMIR laws and regulations as a result of the United Kingdom's June 23, 2016 referendum to withdraw from the European Union. It is "X's" responsibility to assess any future developments regarding the laws and regulations in the UK and to determine if such developments materially affect the representations made, thereby rendering this letter void.

This letter does not provide no-action relief to "X" or "Y" from any provision of Regulation 30.7 except as specifically noted above, or from any other applicable requirements in the Commodity Exchange Act or in the Regulations issued thereunder. Further, this letter represents the position of DSIO only and does not necessarily represent the views of the Commission or of any other division or office of the Commission. Finally, this letter does not create or confer any rights for or obligations on any person or persons subject to compliance with the Commodity Exchange Act that bind the Commission or any of its other offices or divisions.

If you have any questions concerning this correspondence, please feel free to contact Thomas Smith, Deputy Director at 202-418-5495, Josh Beale, Special Counsel at 202-418-5446 or Lawrence Eckert, Special Counsel, at 646-746-9704.

Sincerely,

Eileen T. Flaherty
Director