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Division of Swap Dealer and Intermediary Oversight

CFTC Letter No. 18-26
No-Action
October 31, 2018
Division of Swap Dealer and Intermediary Oversight

Re: Commission Regulation 30.7 – Staff No-Action Position Regarding Futures Commission Merchant's Deposit of Customer-Owned Securities as Margin with a Foreign Broker

Dear _____ :

This is in response to your letter dated August 13, 2018 to the Division of Swap Dealer and Intermediary Oversight ("Division" or "DSIO") of the Commodity Futures Trading Commission ("Commission" or "CFTC"). You submitted your letter on behalf of "X"[1] and its affiliate, "Y".[2] By your letter, you notified the Division of a material change in the laws and regulations that impact how "Y" may hold customer-owned securities deposited by "X" for its customers trading foreign futures and foreign options transactions on contract markets and cleared by clearing organizations located in the UK. The notification was provided in satisfaction of conditions contained in a 2016 DSIO no-action letter issued to "X" and "Y".[3]

Regulatory Background

Commission Regulation 30.7 sets forth requirements governing the treatment of customer funds held by an FCM to trade foreign futures or foreign options contracts.[4] Regulation 30.7(b) includes requirements that an FCM must deposit customer funds under an account name that

[1] "X" is registered with the Commission as a futures commission merchant ("FCM") and is a member of the principal Commission-registered derivatives clearing organizations ("DCOs").

[2] "Y" is incorporated under the laws of England and Wales, and maintains its principal place of business in London, United Kingdom ("UK"). "Y" is authorized as an investment firm with the UK's Financial Conduct Authority ("FCA") and is a member of the principal central counterparties ("CCPs") authorized under the European Market Infrastructure Regulation ("EMIR"). 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, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN. "X" maintains a customer omnibus account with "Y" to hold "X"'s customers' foreign futures and foreign option transactions.

[3] Letter from Eileen T. Flaherty, Director, Division of Swap Dealer and Intermediary Oversight, to _____, December 9, 2016. This letter is published in redacted form as CFTC Letter No. 16-88 ("Letter 16-88") and is available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/16-88.pdf.

[4] Commission regulations are set forth in Chapter 17 of the Code of Federal Regulations, 17 CFR Chapter I.

clearly identifies the funds as belonging to customers of the FCM and as being subject to Part 30 of the Commission's regulations. Regulation 30.7(b) further provides that permitted depositories for customer funds include a bank or trust company located in the United States; a bank or trust company located outside of the United States, provided that the bank or trust company has at least $1 billion in regulatory capital; an FCM; a DCO; a foreign clearing organization; a member of a foreign board of trade; or such member or foreign clearing organization's designated depositories. Regulation 30.7(e) generally provides that an FCM may not commingle foreign futures and foreign options customer funds with its own money, securities or property. Regulation 30.7(c) generally requires an FCM to deposit foreign futures and foreign option customer funds under the laws and regulations of the foreign jurisdiction that provide the greatest degree of protection to such funds, and further prohibits an FCM from waiving any of the protections provided to customer funds under the laws of the foreign jurisdiction.

Division No-Action Letter 16-88

DSIO issued Letter 16-88 on December 9, 2016 to "X" and "Y" providing a no-action position pursuant to which "X" customer-owned securities that may be deposited with "Y" to margin foreign futures and foreign options positions executed on a foreign board of trade located in the UK may thereafter be posted with such foreign board of trade's UK CCP.[5] "X" and "Y" jointly requested the relief because unlike the rules of Commission-registered DCOs, which permit an FCM to pledge customer-owned securities in satisfaction of its customers' initial margin requirements, European Union ("EU") CCPs generally require their respective clearing members to have obtained either: (i) sole legal and beneficial ownership of any customer-owned securities posted with the CCP as margin (i.e., "title transfer"); or (ii) the customer's consent to treat such securities as if the clearing members had such ownership (i.e., granting a "limited right to reuse" such securities). "X" and "Y" were concerned that transferring customer-owned securities to "Y" for deposit with a UK CCP under a "limited right to reuse" granted to "Y" may be a violation of Regulation 30.7(c).[6]

DSIO issued Letter 16-88 subject to the facts and representations set forth in the letter, including that "Y" would deposit customer-owned securities posted by "X" in an individual client segregated account ("ISA") established with the Authorized CCP in accordance with

[5] "X" and "Y" limited their joint request to CCPs that: (i) received recognition orders as recognized clearing houses ("RCHs") and are subject to supervision by the Bank of England under Part 18 of the Financial Services and Markets Act 2000; and (ii) are authorized as CCPs pursuant to Article 17 of EMIR (hereinafter referred to as the "Authorized CCPs"). "Y" is a member of the following RCH's that are Authorized CCPs: ICE Clear Europe Limited; LCH Limited; and LME Clear Limited.

[6] "X" and "Y" did not request relief to transfer title of customer-owned securities from the customers to "Y". Accordingly, Letter 16-88 only addressed the ability of an FCM to deposit customer-owned securities with a third party under a limited right to reuse. Title transfer of customer-owned securities to a foreign broker or any other party is prohibited by Regulation 30.7.

EMIR Article 39(3) and pursuant to applicable CCP regulations.[7] Letter 16-88 recited your representations and statements to the Division that in the event of a default of "Y", EMIR Articles 48(6) and 48(7) would permit "X", in accordance with the relevant Authorized CCP rules and procedures, to instruct the Authorized CCP maintaining "X's" ISA to transfer the positions and assets to another clearing firm or to liquidate the account and return the full proceeds of the ISA to "X" thereby avoiding the default proceeding of "Y". Letter 16-88 further recited your statements that the assets held at the Authorized CCP should not be subject to the administration of "Y" and the protections afforded "X's" customer assets maintained in an ISA would not be exposed to loss in the event of "Y's" insolvency. Letter 16-88 also contained certain ongoing conditions, including requiring "X" and "Y" to "notify the Division in the event of any material change in the [relevant] law or regulations governing individual client segregated accounts."[8]

Change in European Laws and Regulations

Your letter of August 13, 2018 notifies the Division of material changes in EU law and regulations governing ISAs at Authorized CCPs that are relevant to Letter 16-88. Specifically, you represent that the Markets in Financial Instruments Regulation ("MiFIR")[9] and the Regulatory Technical Standards on Indirect Clearing ("MiFIR RTS"),[10] which took effect no later than January 3, 2018, have resulted in Authorized CCPs electing not to offer ISAs[11] to "indirect clients" in an "indirect clearing arrangement."[12]

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[7] You have previously represented that EMIR Article 39(9) provides that if a customer of a clearing member elects an ISA, that such customer's positions and assets must be recorded in an account separate from other customer accounts, may not be netted with any positions in any other house or customer account, and may not be exposed to losses attributable to any other house or customer account. See your letter dated October 4, 2016 to Eileen T. Flaherty, Director, DSIO, p. 8.

[8] Letter 16-88, pp 6-7.

[9] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0600&from=EN

[10] Commission Delegated Regulation (EU) No 2017/2154 supplementing Regulation (EU) No 600/2014 with regard to regulatory technical standards on indirect clearing arrangements. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32017R2154

[11] You state that MiFIR and MiFIR RTS do not prohibit Authorized CCPs from offering ISA accounts to indirect clients. However, you represent that you are not aware of any Authorized CCP currently offering, or proposing to offer, ISAs to indirect clients.

[12] The term "indirect clearing arrangement" refers to a set of relationships where at least two intermediaries are interposed between an end-client and the relevant Authorized CCP. The basic indirect clearing arrangement involves four entities: (i) the Authorized CCP; (ii) a clearing member of the Authorized CCP (e.g., "Y"); (iii) the clearing member's client that is itself an intermediary (a "direct client") (e.g., "X"); and (iv) the client of the direct

You also represent, however, that as an alternative to an ISA, the applicable provisions of MiFIR and the MiFIR RTS require a direct client of a clearing member of an Authorized CCP to offer its indirect clients at least the choice of a gross omnibus segregated account ("GOSA"), which is intended to provide indirect client assets protections that have the "equivalent effect" to the protections of an ISA.[13] You further represent that although the MiFIR RTS addresses in particular the protection of indirect client participants and assets in the event of the failure of a direct client, e.g., a U.S. FCM, indirect clearing arrangements will also be affected in the event of an Authorized CCP or clearing member default.

To achieve the objective of providing indirect clients with protections that are of "equivalent effect" of those provided for in Article 39 and 48 of EMIR, paragraph (b) of Article 4(2) of the MiFIR RTS effectively requires "Y" to offer and maintain, at "X's" request, a GOSA containing the assets and positions held by "X" for its customers. "Y" is further required to ensure that, under the GOSA, the positions of one "X" customer do not offset the positions of other "X" customers, and to further ensure that the assets of one "X" customer are not used to cover the positions of other "X" customers. You represent that paragraph (b) of Article 4(4) of the MiFIR RTS effectively requires "Y", at the request of "X", to maintain a segregated GOSA at the Authorized CCP for the exclusive purpose of holding the assets and positions of "X's" customers. You also represent that "Y" is required to establish a separate GOSA for each direct client (including "X") at an Authorized CCP; "Y" is not permitted to commingle any other direct client's assets or positions, or the assets or positions of any other direct client's customers, in "X"'s GOSA account.[14]

With respect to an Authorized CCP, you represent that Article 3 of the MiFIR RTS, in relevant part, requires that the Authorized CCP that holds a "X" GOSA account for "Y" as a clearing member must keep separate records of the positions for each of "X's" individual customers in the GOSA, calculate the margin for each customer individually, and collect the margin on a gross basis.[15] You further represent that the GOSA structure established pursuant to Article 4(2) and 4(4) of the MiFIR RTS is comparable, but not identical, to the account structure established under Part 22 of the Commission's regulations for cleared swap transactions. In this regard, you state that Article 4(3) of the MiFIR RTS provides, in part, that a "clearing member

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client ("indirect client") (e.g., "X's" customers). Thus, "X's" customers, "X", "Y" and Authorized CCPs are subject to the MiFIR andMiFIR RTS "indirect clearing arrangement."

[13] Following the indirect client's account election, the MiFIR RTS provide for the establishment of appropriate accounts at each level up to the Authorized CCP.

[14] You state that Article 5 of the MiFIR RTS requires "X", as a direct client of "Y", to provide "Y" with all the necessary information on a daily basis to allow "Y" to identify the positions held in the GOSA for the account of each customer of "X".

[15] The Authorized CCP is not, however, required to know the identity of individual indirect clients in discharging these obligations.

holding assets and positions for the account of several indirect clients in a [GOSA] shall provide the Authorized CCP on a daily basis with all the necessary information to allow the Authorized CCP to identify the positions held for the account of each indirect client." You further state that in the event of the default of "Y", it is understood that the "X" GOSA will be treated in a manner similar to how a "X" ISA would be treated under Letter 16-88. Specifically, in the event of default of "Y", the positions and assets of the "X" GOSA will be ported to another clearing member of the Authorized CCP or the positions will be liquidated and the assets will be returned directly to "X", bypassing the estate and insolvency proceeding of "Y", provided the Authorized CCP knows "X's" identity.[16]

You state that the change in EU law and regulations governing how clearing members and Authorized CCPs hold customer collateral has not resulted in any change in general requirements established by Authorized CCPs that require clearing members to have either title to, or a right to reuse, securities posted as margin for derivative transactions. Consistent with Letter 16-88, you request confirmation from the Division that it will not recommend that the Commission initiate an enforcement action under Part 30 if "X" deposits customer-owned securities with "Y" under a limited right to reuse such securities. The right to reuse would be limited such that "Y" could hold customer-owned securities only in a GOSA account at "Y" where such securities were subject to the UK FCA's Client Assets Source Book, or in a GOSA account at an Authorized CCP.

Discussion of No-Action Relief

Based on the foregoing, the Division confirms that it will not recommend that the Commission initiate an 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 an Authorized CCP. The relief provided in this letter is subject to compliance with the following conditions:

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. Each CCP holding "X's" customer-owned securities in a GOSA must be an Authorized CCP.

[16] You note that Article 4(3) would also provide that in the event of the default or insolvency of a direct client, the assets and positions in the direct client's customer GOSA would be liquidated and returned to the indirect clients. However, consistent with Part 190 of the Commission's regulations, in the event of "X's" insolvency, all funds held for customers trading on foreign markets would be under the control of the trustee in bankruptcy and distributed to foreign futures customers consistent with Part 190.

3. "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 reuse of customer-owned securities that are deposited in a GOSA with an Authorized CCP under EMIR.

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

5. The grant of a right of reuse of customer-owned securities to "X" and subsequently by "X" to "Y" must be for the exclusive purpose of "Y" transferring such securities to a GOSA for "X" at an Authorized CCP. Such GOSA shall 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 Authorized CCP.

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

7. "X" and "Y" may not receive or hold customer-owned securities subject to a right of reuse 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 reuse. "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 a GOSA at an Authorized CCP and may not hold or transfer such securities through proprietary accounts.

8. Any customer-owned securities withdrawn from the GOSA established at an Authorized CCP and returned to "Y" will be withdrawn only at the request of "X". Such customer-owned securities will be transferred directly from the GOSA at the Authorized CCP to the "X" GOSA at "Y", and will immediately be subject to the FCA Custody Rules until returned to "X".

9. "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 the Authorized CCPs as central counterparties, including the laws and regulations established under EMIR, MiFIR RTS, and MiFIR. The Division's no-action position

may be void if "Y" and/or the Authorized CCPs are no longer subject to EMIR or MiFIR 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.[17] 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. As with all no-action letters, the Division retains the authority to, in its discretion, further condition, modify, suspend, terminate or otherwise restrict the terms of the no-action relief provided in this letter. 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 Tom Smith at 202-418-5495, Josh Beale at 202-418-5446, or Jennifer Bauer at 202-418-5472.

Sincerely,

Matthew B. Kulkin
Director

[17] In this regard, "X" remains subject to the limitation contained in Regulation 30.7(c) on holding no more than 120 percent of the required margin on its customers' foreign futures and foreign options positions with permitted depositories located outside of the United States.