CFTC Letter No. 97-45

May 5, 1997

Division of Trading & Markets

Re: Request for No-Action Relief from Commission Rules 1.20(a) and 30.7(c)(5)

Dear :

This is in response to your letter dated April 2, 1997 wherein you request, on behalf of the Joint Audit Committee, relief from Commission Rules 1.20(a) and 30.7(c)(5).[1] Rule 1.20(a) requires, among other things, that an FCM depositing customer funds[2] with a clearing organization[3] obtain and retain in its files[4] an acknowledgment from such clearing organization that the clearing organization was informed that the customer funds deposited therein are those of commodity or option customers and are being held in accordance with the provisions of the Commodity Exchange Act (Act) and the rules thereunder.[5] Rule 30.7(c)(5) requires an FCM to obtain and retain a similar acknowledgment from a depository where it maintains the foreign futures or foreign options secured amount[6] (hereinafter secured amount) on behalf of foreign futures or foreign options customers.[7]

You point out in your letter that Commission Rule 1.20(b) requires clearing organizations to account for separately and to segregate as belonging to commodity or option customers all customer funds received from a clearing member.[8] Under the authority granted the Commission in Section 4(b) of the Act to adopt rules requiring, among other things, the safeguarding of funds related to foreign futures and options transactions, Commission Rule 30.7 prohibits FCMs and depositories from commingling the secured amount with proprietary funds of the FCM or with customer funds pertaining to trades on U.S. contract markets required to be segregated in accordance with Section 4d(2) of the Act and the Commission s rules thereunder.

You have requested relief for FCMs from the responsibility to obtain and retain a separate acknowledgment letter from a U.S. clearing organization with respect to deposits of customer funds as defined in Commission Rule 1.3(gg) and the secured amount if the clearing organization s rules provide for the segregation (as customer funds or the secured amount, as appropriate) of all funds held on behalf of customers.[9] You have stated that such clearing organization rules and the statutory and regulatory provisions referred to herein provide protection to customer funds and the secured amount and that no additional protections are afforded by the FCM obtaining and retaining an acknowledgment letter from the clearing organization. You further stated that the

acknowledgment letters create an administrative burden on and unnecessary paperwork for FCMs, and that such letters are subject to continuous reviews resulting in a needless expenditure of FCM and clearing organization resources.

The clearing organization acknowledgment requirement in Rule 1.20(a) was adopted in 1968, following the amendment to the Act adding the concluding paragraph of Section 4d(2).[10] Those amendments predate the Commission s creation and its adoption of Rule 1.41(a)(3), wherein the Commission has defined the term contract market to include, for the purposes of rule review and oversight of the program for rule enforcement, a clearing organization that clears trades for a contract market. Thus, if a clearing organization s rules provide for the appropriate segregation of all funds held on behalf of customers, the Commission can review the enforcement of such rules as part of its ongoing oversight of the operations of self-regulatory organizations.[11] This oversight and the direct obligations imposed on clearing organizations with respect to treatment of customer funds should permit the Division to provide relief to FCMs with respect to the acknowledgment letter requirement as it pertains to clearing organizations.[12]

In light of the foregoing, the Division will not recommend that the Commission commence enforcement action against an FCM pursuant to Section 4d(2) of the Act and Commission Rules 1.20(a) and 30.7(c)(5) based solely upon the FCM s failure to obtain and retain, in accordance with Commission Rule 1.31, an acknowledgment letter from a clearing organization concerning the treatment of customer funds and the secured amount deposited by the FCM with the clearing organization. This relief is subject to the condition that the clearing organization depository of such funds has adopted and submitted for Commission approval rules which provide for the segregation (as customer funds or the secured amount, as appropriate, in accordance with all relevant provisions of the Act and the Commission s rules and orders promulgated thereunder[13]) of all funds held on behalf of customers.[14]

We note that the relief provided by this letter does not excuse any FCM, contract market, clearing organization or any depository of customer funds or of the secured amount from compliance with any other applicable requirements contained in the Act or the Commission s rules and orders promulgated thereunder. For example, FCMs remain responsible for the treatment of customer funds in accordance with Section 4d(2) of the Act and obtaining and retaining of an acknowledgment letter in accordance with Rule 1.20(a) from a bank, trust company or other FCM with which it deposits customer funds. FCMs also remain responsible for the treatment of the secured amount in accordance with Rule 30.7, including the acknowledgment requirements of Rule 30.7(c)(5), and Commission orders related thereto. Similarly, clearing organizations remain responsible for the treatment of customer funds in accordance with Section 4d(2) of the Act and obtaining and retaining of an acknowledgment letter in accordance with Rule 1.20(b) from a bank or trust company with which it deposits customer funds.

This letter is based upon the representations made to us and is subject to compliance with

the condition set forth above. Any different, changed or omitted facts or circumstances might require us to reach a different conclusion. In this connection, we request that you notify us immediately in that event that the facts and circumstances pertaining to this issue differ in any respect from those as represented to us. This letter represents the views of this Division only and does not necessarily represent the views of the Commission or any other office or division of the Commission. If you have any questions concerning this correspondence, please contact me, Deputy Director Paul H. Bjarnason, Jr., or Associate Chief Counsel Lawrence B. Patent at (202) 418-5430.

Very truly yours,

Andrea M. Corcoran

Director

[1] Commission rules referred to herein are found at 17 C.F.R. Ch. I (1996). You referred to Rule 30.7(c)(v) in your letter, but Rule 30.7(c)(5) is the proper reference in the Code of Federal Regulations.

[2] Customer funds are defined under Commission Rule 1.3(gg) as funds received by an FCM from, for, or on behalf of, customers or option customers in connection with transactions on or subject to the rules of a contract market (i.e., a designated exchange in the U.S.), including accruals on such transactions.

[3] The term clearing organization means the person or organization which acts as a medium for clearing or for effecting settlements of futures or option transactions for and between contract market members.

[4] Retention is governed by the Commission s general recordkeeping rule, Rule 1.31.

[5] Treatment of customer funds is governed generally by Section 4d(2) of the Act, 7 U.S.C. §6d(2)(1994), and Commission Rules 1.20-1.30, 1.32 and 1.36.

[6] Commission Rule 1.3(rr).

[7] Commission Rule 30.1(c).

[8] See also the concluding paragraph of Section 4d(2) of the Act.

[9]Generally, the secured amount would not be in issue here since a U.S. clearing organization is not listed as an appropriate depository for the secured amount under Rule

30.7(c). However, the Board of Trade Clearing Corporation will act at certain times as the equivalent of the clearing organization of a foreign board of trade in connection with the linkage agreement between the Chicago Board of Trade and the London International Financial Futures and Options Exchange, and therefore FCMs participating in that program or any similar program would be subject to the acknowledgment requirement of Rule 30.7(c)(5), absent relief. See Rule 30.7(c)(3).

[10] 33 Fed. Reg. 14454, 14455 (Sept. 26, 1968).

[11] The Commission also notes that it is incumbent upon the contract market whose trades are cleared by the clearing organization to assure that clearing rules are enforced in order to receive and retain designation as a contract market. See 41 Fed. Reg. 40091, 40093 (Sept. 17, 1976); CFTC Interpretative Letter No. 82-5, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,964 (June 15, 1982).

[12] Of course, the Division would not object to FCMs continuing to obtain and to retain an acknowledgment letter from a clearing organization with respect to the deposit of customer funds.

[13] Certain Commission orders contain specific provisions regarding the handling of customer funds, such as with respect to non-proprietary cross-margining programs. See, e.g., Commission Order In the Matter of Chicago Mercantile Exchange Proposal to Expand its Cross-Margining Program with the Options Clearing Corporation to Include the Cross-Exchange Net Margining of the Positions of Markets Professionals, dated November 26, 1991, 56 Fed. Reg. 61404 (Dec. 3, 1991).

[14] The Act and the rules and orders promulgated thereunder prohibit, among other things, setoffs by clearing organizations of obligations owed by clearing members using customer funds.