CFTC Letter No. 99-68

December 16, 1999

Other Written Communication

Division of Trading & Markets

Dear :

This is in response to your inquiry that we received September 8, 1999, regarding the impact on customers when a commodity futures brokerage firm or clearing firm becomes insolvent. Recognizing that the laws and regulations governing the insolvency of such companies are quite complex, the following discussion is intended to be a practical explanation of the basic principles relevant to your questions rather than an exhaustive, technical legal analysis.

In your letter you stated that you have opened a commodity account with a "Chicago Company" and a "California Company." You did not indicate the precise nature of these companies, but we assume that each is a futures commission merchant ("FCM") registered with the Commodity Futures Trading Commission (the "CFTC").

As a general matter, the laws and regulations governing the insolvency of FCMs and clearing firms are designed to minimize losses to customers by providing certain protections to customer accounts. These protections include requiring the segregation of customer funds from those belonging to the FCM or clearing firm, giving priority to the claims of customers, and expansively defining the category of property that may be considered "customer property" subject to a customer's claim. (Please note that such protections *do not* include account insurance of the type provided by the Securities Investor Protection Corporation for securities accounts.) Despite the various legal protections afforded to customer accounts, there may be circumstances when the insolvency of an FCM or clearing firm could cause an FCM customer to lose some or all of the funds or other assets the FCM has received from or holds on behalf of that customer. However, there have been very few FCM insolvencies over the years and, even in those few cases, resulting customer losses have been very limited.

Our responses to your specific questions follow:

1. *What happens to the cash in my account?*

The Commodity Exchange Act requires that funds deposited by a customer with an FCM be maintained in a "segregated" account for the exclusive benefit of the depositing customer. The term "segregated" refers to separating the funds of all the customers (treated as a class) from

the FCM's own funds (sometimes referred to as "proprietary" funds) which the FCM uses in its own

operations.

If an FCM became insolvent, the FCM would be prohibited from using "customer property" to pay obligations it owes to persons other than its commodity customers. (The term "customer property" includes cash, securities or other property received, acquired or held by the FCM to margin, guarantee, secure, purchase or sell a commodity contract for a customer, as well as an open commodity contract itself.) The "segregated" funds held for customer accounts should remain intact and the customers would be protected from the FCM's insolvency. Generally, in such circumstances, cash in customer accounts is promptly transferred, along with the customers' open positions, to a solvent FCM even before a trustee is appointed to administer the bankruptcy. After such a transfer takes place, the customer is free to transfer his funds and open positions to the FCM of his choice.

If an FCM became insolvent, and there also happened to be a shortfall in the amount of funds segregated for customers (for example, because of a customer default), customers would not be protected from the FCM's insolvency. Customers would have a claim against those assets of the FCM which are deemed to be customer property. The claims of FCM customers would take priority over all claims other than those attributable to the administration of customer property. Distributions of customer property would be made on a pro rata basis to each customer.

2. *What happens to open positions in my account?*

If there were no shortfall in the amount of funds segregated for customers, generally the customers' open positions would be transferred to another FCM as quickly as possible. If, however, there were a shortfall, then the open positions could be liquidated (if there were not enough margin to support a position) or could remain open (if there were enough margin, including additional margin provided by a customer). If a position were liquidated, any proceeds from the liquidation would become part of the overall customer property distributed to all customers on a pro rata basis.

3. *What happens to Treasury Bills purchased for my account but in the name of the commodity company?*

If there were no shortfall in the amount of funds segregated for customers, then the Treasury bills held for a particular customer would be transferred to another FCM along with the customer's cash margin and open positions. If there were a shortfall in the amount of funds segregated for customers, Treasury bills purchased for a particular customer's account would be deemed to be "customer property" and would be sold. The proceeds from the sale would be combined with other segregated cash and would be distributed to all customers on a pro rata basis.

4. *What happens if the Clearing Firm goes bankrupt?*

An FCM can be either a *clearing* member of an exchange (a "clearing FCM") or a *non-clearing* member of an exchange (a "non-clearing FCM"). A non-clearing FCM clears trades through another FCM that is

a clearing FCM (another way of looking at this is that the non-clearing FCM is the direct "customer" of the clearing FCM). We assume that your reference to a "clearing firm" refers to a clearing FCM that is clearing trades for a non-clearing FCM.

The principles discussed above in response to questions 1, 2 and 3 are also applicable to the insolvency of a clearing FCM. Thus, if a clearing FCM became insolvent and there were no shortfall in the amount of funds segregated for its customers (which could include individuals and non-clearing FCMs), the funds of its customers would be protected from the clearing FCM's insolvency. If, however, a clearing FCM became insolvent and there *were* a shortfall in the amount of funds segregated for its customers, the funds of its customers would *not* be protected from the clearing FCM's insolvency. In that case, each customer (including non-clearing FCMs) would receive a distribution of customer property on a pro rata basis.

As an example, let us assume that you are a customer of the California Company (a non-clearing FCM), and that the California Company has deposited some of your customer funds with a clearing FCM. (The California Company would be the direct customer of the clearing FCM.) If the clearing FCM becomes insolvent because it is unable to cover its obligations to one or more of its direct customers, the California Company should be responsible for covering its obligations to its customers (including yourself). If the California Company has financial resources that can absorb whatever losses it might incur as a result of the clearing FCM's insolvency, the clearing FCM's insolvency should not result in a loss to the California Company's customers. However, if the California Company does not have sufficient financial resources to absorb the losses that it incurs as a result of the clearing FCM's insolvency, there might be a "domino effect" whereby the insolvency of the clearing FCM will cause the insolvency of the California Company which may, in turn, result in a loss to the California Company's customers, including yourself. The federal Bankruptcy Code, the Commodity Exchange Act and the CFTC rules are intended to minimize the likelihood of such a domino effect, and past experience has shown that they are highly effective in doing this.

The CFTC considers the protection of customer funds to be one of its highest priorities, and we encourage investors to become knowledgeable about the potential risks and rewards of trading on commodity futures and options markets. For your further information, we have enclosed a brochure, "Futures And Options-What You Should Know Before You Trade," which you may find of interest. Should you have additional questions regarding the general principles discussed in this letter, please contact me at (202) 418-5430. Should you have specific questions relating to your particular circumstances, you may wish to contact a private attorney. We hope you find this letter responsive to your inquiry.

Sincerely,

Phyllis Dietz

Staff Attorney