

COMMODITY FUTURES TRADING COMMISSION

INTERPRETATION OF CFTC RULE 190

Funds Determined to Be Held in the Futures Account Type of Customer Account Class

This interpretation by the Commodity Futures Trading Commission is issued to clarify the appropriate means by which to allocate customer funds held by an insolvent Futures Commission Merchant (FCM) to account classes (as such term is defined in Section 190.01(a) of the Commission's Regulations) in cases where money, securities or other property margining, guaranteeing or securing futures contracts traded on non-domestic boards of trade has been deposited, pursuant to a Commission Order, in a segregated account established pursuant to Regulation 1.20.

Section 20 of the Commodity Exchange Act¹ empowers the Commission to provide by rule or regulation how the net equity of a customer is to be determined:

“. . . the Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation - (1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property; and (5) how the net equity of a customer is to be determined.

Subchapter IV of the Bankruptcy Code (concerning Commodity Brokers) has the same effect, explicitly subjecting its definition of “net equity” to “such rules and regulations as the Commission promulgates under the [Commodity Exchange] Act.”²

The Commission has exercised this power in promulgating Part 190. In particular, Net Equity is defined in Regulation 190.07. This definition includes the concept of “account classes.” For example, §190.07(b)(2) directs that one of the steps in calculating a customer's net equity is to “[a]ggregate the credit and debit equity balances of all accounts of the same class held by a customer in the same capacity.” Similarly, §190.07(c) defines the “funded balance” as “a customer's pro rata share of the customer estate account class available as of the primary liquidation date for distribution to customers of the same class.” Commission Regulation 190.01(a) defines account class as follows:

each of the following types of customer accounts which must be recognized as a separate class of account by the trustee: futures accounts, foreign futures accounts, leverage accounts, commodity option accounts, and delivery accounts as defined in §190.05(a)(2): Provided, however, That to the extent that the equity balance, as defined in §190.07, of a customer in a commodity option, as defined in §1.3(hh) of this chapter, may be commingled with the equity balance of such customer in any domestic commodity futures contract pursuant to regulations under the Act, the aggregate shall be treated for purposes of this part as being held in a futures account.

¹ 7 U.S.C. §24

² 11 U.S.C. §761(17)

There is a potential ambiguity in how this provision should be applied in two related contexts. First, where a customer account holds foreign futures contracts, and/or property margining, guaranteeing, or securing such contracts, but where the collateral has, pursuant to a Commission order, been segregated in accordance with Commission Regulation 1.20 in the manner of a domestic futures account, the appropriate “type of account” is ambiguous. One can distinguish between a “foreign future” which is characterized by the place in which it is executed, and a “foreign futures account” which may be characterized by the calculation of the applicable segregation requirements. A “futures account” is also characterized by the calculation of the applicable segregation requirement. If the Commission grants Section 4d relief to permit funds supporting foreign futures to be deposited in a “futures account” calculated pursuant to Section 4d and Commission Regulation 1.20, then it would appear apposite to treat claims on those funds as belonging to the futures account class of accounts.

Second, where a customer account contains both foreign futures contracts and domestic futures contracts, with those positions margined on a portfolio basis, such that the same property margins, guarantees, or secures both types of contracts in one account, the appropriate allocation of claims on the collateral between “futures contracts” and “foreign futures contracts” is, again, ambiguous.

As the Commission noted in the proposing release for Commission Regulation 190.01,

“The allocation provisions are intended to prefer customers for which segregation is undertaken over . . . customers holding accounts of a class for which segregation is not required. . . . The reason for identifying classes of customer accounts is to permit the implementation of the principle of pro rata distribution so that the differing segregation requirements with respect to different classes of accounts benefit customer claimants based on the class of account for which they were imposed.” 46 Fed. Reg. 57535, 57536 (November 24, 1981).

Thus, the Commission intended the customers who contribute to a segregated pool to benefit from that pool. Later in that release the Commission explained that the distinction in treatment between account classes sprang from the contrast in segregation requirements:

all property segregated on behalf of a particular class would be allocated to the class on behalf of which it is segregated. This approach is consistent with the fact that differing segregation requirements exist for different classes of accounts. Obviously, much of the benefit of segregation would be lost if property segregated on behalf of a particular account class could be allocated to pay the claims of customers of a different account for which less stringent segregation provisions were in effect. 46 Fed. Reg. at 57554.

Again, the Commission contemplated that customers would benefit from the stringency of the segregation regime to which their funds were subject. To the extent that, subject to a Commission order, customer margin supporting non-domestic trades is subject to the full stringency of segregation under Commission Regulation 1.20 rather than the less stringent Commission Regulation 30.7 secured amount calculation, it is consistent with the Commission’s

intentions in adopting the Part 190 scheme that the property in the accounts of these customers be treated as futures accounts. Conversely, it would be inconsistent with the Commission's intentions to deny customers who had contributed property that was, in accordance with Commission Orders, deposited into accounts segregated pursuant to Commission Regulation 1.20, any participation in those accounts based on those contributions.

Thus, the Commission intended that the customers who contribute to a segregated pool benefit from that pool. If customers do not contribute to a pool, they should not benefit from that pool. The Commission's intent to tie distribution of funds to the contribution of those funds, and the ambiguity of how to allocate claims on collateral that supports both futures and foreign futures positions placed in domestic segregation, both support the interpretation that, in the event of an insolvency, collateral supporting foreign futures placed in domestic segregation pursuant to Commission Order should be treated as in a futures account, not a foreign futures account, for purposes of Part 190. Thus, in a situation where by Commission order or direction, customers are required or allowed to contribute to a Commission Regulation 1.20 segregated account, those customers also should benefit from the distribution of that account proportionately to their contributions in the event of an insolvency. Such claims should be treated as encompassed within the futures account class as opposed to the foreign futures account class or any other account class.

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Issued in Washington, D.C. on October 21, 2004 by the Commodity Futures Trading Commission

/s/

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