

Joint Audit Committee

Regulatory Update

TO: Chief Financial Officers
Chief Compliance Officers

#08-01

DATE: January 11, 2008

SUBJECT: CFTC Staff Letter - Investments Held in Segregated Accounts

The CFTC recently issued a staff letter interpreting Regulations 1.12(h), 1.20, and 1.25 regarding the treatment of investments held in segregated accounts. The CFTC staff letter (attached) may be found at <http://www.cftc.gov/stellent/groups/public/@lrlletter07/documents/letter/07-24.pdf>.

Specifically, investments which are held in good segregated accounts (properly labeled customer segregated and covered by a satisfactory segregation acknowledgement letter) and are held separately from an FCM's own proprietary accounts should be included in segregated assets even if the investments do not comply with the requirements of CFTC Regulation 1.25 - Investments of Customer Funds.

Bear in mind, violations of CFTC Regulation 1.25 are considered serious, must be immediately corrected by the FCM and will result in disciplinary action as deemed warranted. For clarity, violations of CFTC Regulation 1.25 do not have any notification requirements even if such a violation would have put the FCM under segregation had the investment been excluded.

To reiterate, investments held in accordance with CFTC Regulation 1.20 but that do not meet the investment of customer funds requirements of CFTC Regulation 1.25 should be included in segregated assets. The violation of CFTC Regulation 1.25 will be examined separately with disciplinary action taken as appropriate.

If you have any questions, please consult your DSRO.



U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581
Telephone: (202) 418-5495
Facsimile: (202) 418-5547

Division of Clearing and
Intermediary Oversight

CFTC letter No. 07-24
December 11, 2007
Interpretation
Division of Clearing and Intermediary Oversight

[Name and address redacted]

Re: Customer Funds Segregation Requirements under Section 4d of the Commodity Exchange Act

Dear "X":

This letter responds to your recent question concerning Commission Regulation 1.12(h),¹ which requires a future commission merchant ("FCM") to provide notice to the Commission and to its designated self-regulatory organization ("DSRO") whenever the FCM knows, or should know, that "the total amount of its funds on deposit in segregated accounts on behalf of [customers] is less than the total amount of such funds required by the Act and the Commission's rules...". Your question has been prompted by the DSRO's recent examination of a member FCM, in which it was determined that the FCM had invested customer funds in certificates of deposit ("CDs") that do not meet all of the requirements of Commission Regulation 1.25. In particular, the issuing bank's commercial paper and long term debt is unrated, and therefore cannot satisfy the rating requirements in Commission Regulation 1.25(b)(2)(i)(E). The amounts invested in the CDs also exceeded the concentration limits set forth in Commission Regulation 1.25(b)(4)(i)(C).

The FCM subsequently has closed the CDs and invested the proceeds in other instruments meeting the requirements of Commission Regulation 1.25. For the period during which the CDs were still open, the DSRO is questioning whether the FCM's segregation records correctly reflected the CDs as assets held in segregation for its customers. If the CDs are excluded from the FCM's total assets in segregation, the FCM would be required to file an undersegregation notice under Commission Regulation 1.12(h). Pending further instruction, the FCM already has filed such a notice with the Commission and the DSRO.

As required by Section 4d(a) of the Commodity Exchange Act² and Commission Regulation 1.20, FCMs must segregate and separately account for the funds of their commodity

¹ Commission regulations referred to in this letter may be found at 17 C.F.R. Ch. 1 (2007).

² The Commodity Exchange Act ("Act") is codified at 7 U.S.C. §1 et seq. (2005).

and option customers. At all times, the FCM complied with its obligations under Section 4d(a) of the Act and Commission Regulation 1.20 to hold the CDs separately from the FCM's own proprietary accounts. The CDs were titled in an account name that clearly identified the deposits as segregated customer funds, and the FCM obtained a letter from the bank acknowledging that the funds in the account were those of commodity or option customers. As such, the CDs were included, at market value, in the FCM's required recordkeeping of total funds held in segregation for the benefit of its customers.

FCMs may be subject to Commission enforcement action for investments made in violation of the requirements of Commission Regulation 1.25.³ The DSRO also is expected to pursue appropriate disciplinary action for violations of Commission Regulation 1.25. However, if the funds have been segregated on behalf of customers in accordance with Section 4d(a) of the Act and Commission Regulation 1.20, an FCM is not required to exclude the market value of such Regulation 1.25 investments from the total amount of "funds on deposit in segregated accounts on behalf of customers."⁴

The views expressed in this letter are based on the facts and conditions described above, and represent the views of the Division of Clearing and Intermediary Oversight ("Division"). They do not necessarily represent the views of the Commission or any other division or office of the Commission, and the Division's opinion does not excuse the FCM from compliance with any other applicable requirements contained in the Act or the Commission's regulations thereunder. Any different, changed or omitted facts or conditions might require us to reach a different conclusion. Please contact Thelma Diaz, Special Counsel, at 202-418-5137 if you have any questions concerning this correspondence.

Very truly yours,

Thomas Smith
Deputy Director and Chief Accountant

³ See, e.g., *In the Matter of Incomco, Inc., et al.*, (Dec. 30, 1991) (fines assessed based on several counts, including two counts for misuse of customer funds by purchasing investments not permitted under Regulation 1.25).

⁴ Commission Regulation 1.12(h) was adopted in the wake of a large FCM's failure to advise the Commission of the severe depletion of its customer-segregated funds by the trading losses of a customer that was likely to default on its obligations to the FCM, which resulted in the FCM becoming undersegregated and undercapitalized. See 63 Fed. Reg. 45771 (August 27, 1998).