Joint Audit Committee

REGULATORY ALERT

TO: Chief Executive Officers #14-07
Chief Financial Officers
Chief Compliance Officers

DATE: November 4, 2014

SUBJECT: Restrictions on Trading While Undermargined

As part of the CFTC's recently adopted customer protection enhancements, effective November 14, 2014, the timeframe for the undermargined capital charge will be decreased to 3 days for customer, noncustomer and omnibus accounts.

Specifically effective November 14, 2014, in accordance with CFTC Regulation 1.17(c)(5)(viii)-(ix), FCMs must take a charge against capital for futures customer, noncustomer and omnibus accounts with margin calls outstanding greater than 1 business day.

For purposes of aging margin calls, days are defined as:

Day 1 = business day account becomes undermargined
Day 2 = business day margin call is issued
Day 3 = first business day margin call is outstanding
Day 4 = second business day margin call is outstanding
Day 5 = third business day margin call is outstanding
etc.

Thus, if an account became undermargined on Monday (Day 1) the FCM would have to take a capital charge for the account as of the close of business Wednesday (Day 3) if the margin call was still outstanding.[1]

<u>Risk Management Program – Collection of Margin Funds</u>

CFTC regulations require FCMs to establish, maintain and enforce a system of risk management policies and procedures designed to monitor and manage the risks of its accounts. A critical part of that system is the timely collection of margin funds from its customers and noncustomers, and the action taken when margin funds are not deposited on a timely basis.

[1] Refer to JAC Regulatory Alert #14-06, issued November 4, 2014, regarding CFTC Regulations as to Residual Interest and the Undermargined Capital Charge.

An FCM's risk management program should include policies which restrict an account's trading activity when margin funds are not forthcoming within a reasonable time. That is, the customer has not initiated payment to the FCM to timely meet its margin calls and/or the FCM has reason to believe the customer is experiencing financial distress. An FCM should ensure it has strong policies and controls over its collection and recording of margin funds.

Restrictions on Trading While Undermargined

In accordance with the JAC Margins Handbook[2], if an account is undermargined or in debit an unreasonable time, an FCM may only accept orders that serve to reduce the risk of existing positions in the account; that is, an FCM may only accept orders for risk reducing trades.[3]

Currently a reasonable time is defined as less than 5 business days for customers and less than 4 business days for noncustomers and omnibus accounts.

For clarity, an FCM should take appropriate action to restrict the trading activity of any account that has not initiated payment to the FCM to timely meet its margin calls and/or for which the FCM has a credit concern with regards to the account.

Unreasonable Time - Solely for Restrictions on Trading While Undermargined

The JAC appreciates the significant effort required of FCMs in adapting and enhancing their policies, procedures, systems and controls to meet the customer protection enhancements adopted over the last year. Most significantly, the residual interest requirement to maintain sufficient residual interest in futures customer accounts in excess of customer margin deficits will be effective November 14, 2014 and has required substantial system changes as well as changes to customer relationships, requiring in some cases prefunding of accounts as well as changes in payment methods to wires or ACH payments.

We believe the protections afforded the industry have been significantly increased through the implementation of the residual interest requirement and shortened timeframe for undermargined capital charges as well as all the customer protection enhancements implemented.

In addition, we appreciate the complexities of dealing in a global marketplace whereby customers are located throughout the world in vastly different time zones, settle in numerous different currencies, and recognize varying holidays from both a market and banking perspective.

As a result, at this time, in order to ensure FCMs and their customers have adequate time to adapt to the changing practices and requirements and to not unnecessarily disrupt trading activity, the JAC will maintain the reasonable time definition at the current less than 5 business days for customers and

[2] The JAC Margins Handbook may be found on the JAC's Website at http://www.jacfutures.com/jac/MarginHandBookAdobe.aspx.

[3] As defined in the JAC Margins Handbook "a risk reducing trade is the establishment or closure of a futures or options position which reduces the risk of existing position in the account (e.g. adding a spread position to a naked position)." Note that day trading (establishment and closure of a futures or options position on the same trading day) and risk neutral trades (establishment or closure of futures or options positions which does not impact an account's risk margin requirement) are not considered risk reducing.

less than 4 business days for noncustomers and omnibus accounts <u>solely for purposes of restrictions on trading while undermargined.</u>

Thus, a customer account which becomes undermargined on Monday (Day 1) and which remains undermargined and hasn't met the margin call by the close of business Friday (Day 5) will only be allowed to put on risk reducing trades as of the start of the following Monday's trading day.

The JAC will continue to work with the industry to evaluate the necessity and practicality of maintaining the reasonable time definition at the current less than 5 business days for customers/4 business days for noncustomers and omnibus accounts solely for trading while undermargined or if a shortened timeframe is more appropriate. Updates to this policy will be communicated through future JAC Regulatory Alerts.

If you have any questions, please contact your DSRO.