Joint Audit Committee

REGULATORY ALERT

TO: Chief Executive Officers #18-04
Chief Financial Officers
Chief Compliance Officers

DATE: August 14, 2018

SUBJECT: Residual Interest Withdrawals After 12:00 Noon

CFTC Regulations 1.23(b), 22.17(b) and 30.7(g)(2) govern the withdrawal of residual interest from the respective account classes of customer segregation, customer cleared swap and customer secured 30.7. Recently the industry has sought further guidance with regards to permitted withdraws of residual interest after 12:00 noon through the close of business specifically as it relates to intra-day withdrawals. To assist FCMs in complying with the respective CFTC regulations, the following guidance, furnished to staff of the Division of Swap Dealer and Intermediary Oversight ("DSIO") of the CFTC, is being provided.

<u>Background</u>

FCMs must maintain, by origin, sufficient funds in segregated, secured 30.7 and cleared swap customer accounts at all times. Further, FCMs must establish a target residual interest amount to reasonably ensure that the FCM maintains excess funds at all times. If an FCM fails to maintain residual interest over the target level, immediate notification must be provided to the CFTC and the FCM's DSRO. The FCM must, by the close of business the next business day, either take action to bring their level of residual interest up to their target level or the target level may be revised with the new level approved in writing by the FCM's Board of Directors or similar governing body.

CFTC regulations also provide that FCMs may not use, or permit the use of, the funds of one segregated, secured 30.7 or cleared swap customer to purchase, margin or secure the trades, contracts, commodity options or cleared swaps, as applicable, of or to secure or extend credit to any person other than the respective segregated, secured 30.7 or cleared swap customer. Compliance is demonstrated through the Residual Interest Compliance Calculation (for segregated and secured 30.7) and the Legally Segregated Operationally Commingled ("LSOC") Compliance Calculation (for cleared swap customer).

At a high level, an FCM must maintain enough residual interest in segregated and secured 30.7 accounts, respectively, by 6:00 p.m. EST each business day to cover the aggregated gross margin deficiencies of its customers remaining (unmet) margin calls from the prior business day. For cleared swap customers, the FCM must have sufficient residual interest to cover the aggregated gross margin deficiencies of all cleared swap customers prior to any end-of-day and intra-day payment cycle of initial and/or variation margin.

Residual Interest Withdrawals

FCMs may only make withdrawals of residual interest, not for the benefit of customers, after the completion and submission to the CFTC and firm's DSRO of their prior business day's segregated, secured 30.7 and cleared swap customer statements.[1],[2] After the withdrawal, the FCM must continue to be in compliance with segregation requirements; that is the FCM must maintain funds in excess of required amounts in the respective segregated, secured 30.7 and cleared swap customer origins.

Requirements for a Withdrawal – Segregated, Secured 30.7 and Cleared Swap Customer

1. The prior business day's segregation, secured 30.7 and cleared swap customer statements must be prepared, completed and submitted to the CFTC and the FCM's DSRO by 12:00 noon. Note the calculations should demonstrate compliance with the requirements; that is maintenance of excess funds.

2. Starting with the prior business day's segregation, secured 30.7 and cleared swap customer statement, as applicable for the origin of the withdrawal, a pro-forma calculation must be prepared and maintained which includes and accounts for:
   - Firm withdrawals from segregated/secured/cleared swap customer accounts, both cash and securities.
   - Firm deposits into segregated/secured/cleared swap customer accounts, both cash and securities.
   - Estimated material increases to debit/deficits from top day market movements and trading activity.
   - Any significant effects of market events or other material impacts to the calculations. Such items which may materially impact residual interest include, but are not limited to, investment losses, operational errors or customer origin transfers.

   The pro-forma segregation, secured 30.7 and cleared swap customer calculations, as applicable, must be prepared before the withdrawal and reflect the amount of pro-forma residual interest as well as the amount of pro-forma residual interest in excess of the target amount. While an FCM is not required to prepare a full segregation, secured 30.7 and cleared swap customer statement, FCMs are required to take care and be diligent in their pro-forma calculations to ensure they are as accurate, complete and up-to-date as possible.

3. A withdrawal of residual interest is limited to the amount of residual interest per the respective segregation, secured 30.7 or cleared swap customer pro-forma calculation. In determining the amount to be withdrawn, an FCM must consider:

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[1] For clarity, the segregated, secured 30.7 and cleared swap customer statements refer to the Statement of Segregation Requirements and Funds in Segregation, Statement of Secured Amounts and Funds Held in Separate Accounts and Statement of Cleared Swaps Customer Segregated Requirements and Funds in Cleared Swaps Customer Segregated Accounts respectively.

[2] Notwithstanding the forgoing, DSIO staff of the CFTC issued a no-action position to allow for the withdrawal of residual interest from cleared swap customer accounts related to undermargined amount payments received from customers before the completion of the prior business day's cleared swap customer statement under certain conditions. Refer to Commission Letter No. 17-03, dated January 26, 2017, at https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/17-03.pdf.

- CFTC Regulation 1.23(c) requires, in part, that an FCM establish policies and procedures designed to reasonably ensure that the FCM maintains the targeted residual interest amounts at all times. Further the regulation requires that the FCM maintain sufficient capital and liquidity, and take other appropriate steps as necessary, to reasonably ensure the FCM maintains such amount of targeted residual interest in customer segregated, secured 30.7 and cleared swap customer accounts at all times. If a withdrawal results in the FCM being below its respective residual interest target, the FCM must provide immediate notification and, by the close of business the next business day, either take action to bring its level of residual interest up to its target level or the target level may be revised with the new level approved in writing by the FCM's Board of Directors or similar governing body. Thus, as a best practice and for all practical purposes, the withdrawal of residual interest should be limited to the residual interest in excess of the target per the pro-forma calculation.
- While the Residual Interest and LSOC Compliance Calculations are "point in time" requirements, FCMs must be cognizant of the impact any withdrawal would have on future calculations whereby the FCM may need to deposit additional funds to meet the requirement by the respective deadline. Note: The most recently required Residual Interest and LSOC Compliance Calculations should have demonstrated compliance with the requirements at the time of the respective deadline.
- Current market events such as significant volatility or stress events (e.g. Brexit and U.S. Elections) and any known customer(s) distress must be considered as part of the FCM's risk management policies and procedures in determining any withdrawal of residual interest.

4. If the withdrawal, not for the benefit of customers, exceeds 25% of the prior business day's residual interest, it must be pre-approved in writing by the Chief Executive Officer, Chief Financial Officer or other senior officer registered with NFA as a principal of the firm with knowledge of the FCM's financial requirements and position. Further, the CFTC and FCM's DSRO must be immediately notified upon pre-approval and the notification must include confirmation of the written pre-approval, date of the disbursement, the amount and recipient(s), a description of the reasons for the disbursement, an estimate of residual interest after the withdrawal and confirmation that the firm continues to maintain excess funds.

Under the requirements for withdrawals as outlined above, based on the pro-forma calculations, an FCM may make intra-day withdrawals of residual interest. Further, the amount available for withdrawal may be greater than the prior day's excess. For example, this may happen in the case whereby an FCM adopts conservative procedures and pays all customer settlements with house funds.

Strong internal controls and procedures pertaining to the withdraw of residual interest including those pertaining to the pro-forma computations of segregation, secured 30.7 and cleared swap customer statements is critical to ensure the protection of customers and the maintenance of sufficient customer funds at all times.

If you have any questions, please contact your DSRO.