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A legal update from Dechert's Financial Services Group

CFTC Proposes Withdrawal of Staff Interpretation Facilitating Use of Third-Party Custody Accounts for Futures Transactions

On January 27, 2005, the Division of Clearing and Intermediary Oversight ("Division") of the Commodity Futures Trading Commission ("CFTC") issued a request for comment concerning withdrawal of a 1984 CFTC staff interpretation critical to the use of third-party accounts to custody margin for futures transactions.¹

As a practical matter, if the Division were to withdraw the relevant staff interpretation, futures commission merchants ("FCMs") are likely to refuse to enter into third-party custody accounts or to impose new fees for the use of such accounts. Comments concerning the proposal must be received by the CFTC no later than April 4, 2005.

Background

In 1984, the Division's predecessor, the Division of Trading and Markets, issued "Financial and Segregation Interpretation No. 10" ("Interpretation No. 10") to give guidance concerning the circumstances under which third-party custodial accounts to maintain futures customer funds may be used without violation of the Commodity Exchange Act ("CEA").

Section 4d(a)(2) of the CEA and CFTC rules thereunder require that all funds deposited with an FCM to margin futures contracts, and all accruals thereon, be held in segregated accounts, separate from the FCM's own funds,

but to which the FCM has immediate and unfettered access. CFTC staff generally have required that segregated funds be held in accounts subject to withdrawal on demand by the FCM.

When Interpretation No. 10 was issued, registered investment companies were generally precluded from posting assets with FCMs or futures clearing organizations and, thus, third-party custodial accounts were necessary to hold margin assets posted for investment company futures transactions. The CFTC's staff guidance in Interpretation No. 10 reconciled the CEA segregation requirement for immediate FCM access to margin deposits with the custody restrictions applicable to investment companies registered under the Investment Company Act of 1940.

Under Interpretation No. 10, the CFTC would recognize assets maintained in third-party custodial accounts as properly "segregated" in accordance with the CEA if maintained in compliance with the following conditions:

- the account is held in the name of the FCM for the benefit of the customer;
- the FCM has the ability to liquidate open positions in the account if the account becomes undermargined or goes into deficit, without obtaining authorization;
- the FCM has the authority to withdraw funds from the account on demand without interference by the custodian or the customer;

¹ 70 FR 5417 (February 2, 2005).

- the account may not be maintained at an affiliate of the customer; and
- no funds may be released to the customer without advance consent by the FCM.

Proposed Action

The Division's proposed withdrawal of Interpretation No. 10 is based on the fact that registered investment companies are no longer prohibited from posting customer margin directly with FCMs² and on longstanding concerns about potential impairment of margin flows due to the use of such accounts. The CFTC release highlights the "potential systemic liquidity risks which could result from any potential diversion of FCM capital to cover undermargined customer accounts," particularly in periods of market volatility when liquidity may be most critical.

The Division solicits comment on a partial withdrawal of Interpretation No. 10, that is, a withdrawal subject to an exception permitting continued reliance on Interpretation No. 10 by FCMs not eligible to hold investment company assets under SEC Rule 17f-6 due to an affiliation with the investment company or its adviser. The Division notes that withdrawal of Interpretation No. 10 would not prohibit the use of such accounts but would mean that funds in such accounts would not be deemed to be properly segregated under Section 4d(a)(2).

As a result, funds in such accounts could not be included in an FCM's required daily computation of total customer funds on deposit in segregated accounts. The practical consequence would be that the FCM would need to deposit its own funds into the segregated account to make up the shortfall created by the third-party arrangement. The resulting cost to the FCM is likely to lead most FCMs to decline to enter into third-party arrangements altogether or to institute new fees to compensate them for their costs.

Request for Comment

The Division seeks comments concerning whether the proposed withdrawal of Interpretation No. 10 would have any adverse impacts upon investment companies or other institutional customers and "whether there are any legal or prudential considerations that support the use by institutional customers of third-party custodial accounts in effecting futures transactions" as well as concerning the costs incurred by FCMs in maintaining such accounts. It also seeks comment regarding whether a six-month implementation period following withdrawal of Interpretation No. 10 would be sufficient for FCMs and banks to make the necessary adjustments of custodial arrangements.

Our investment management and derivatives attorneys would be happy to discuss with you the issues raised by, and potential impacts of, the CFTC's proposal.



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² SEC Rule 17f-6, adopted in 1996, permits investment companies to maintain assets with FCMs in connection with futures transactions, provided that the FCM is not an affiliate of the investment company, that the funds are maintained pursuant to a written contract with specified provisions, and that any gains on futures transactions are maintained at the FCM only in *de minimis* amounts.

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