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A legal update from Dechert's Financial Services Group

CFTC Reduces Availability of Third-Party Custody Accounts for Futures Transactions

The Commodity Futures Trading Commission ("CFTC") recently announced several significant regulatory actions. These actions eliminate, subject to exceptions, the availability of third-party custodial accounts for futures margin deposits, add to the available non-U.S. stock index products that may be traded by U.S. persons, and permit futures commission merchants ("FCMs") and introducing brokers ("IBs") to rely upon certain commodity trading advisors ("CTAs") to fulfill their customer identification obligations under the USA PATRIOT Act.

Amendment of Staff Interpretation Facilitating Use of Third-Party Custody Accounts

On May 5, 2005, the CFTC's Division of Clearing and Intermediary Oversight ("Division") issued an amendment to a long-standing staff interpretation which previously supported the use of third-party accounts to custody funds posted to margin futures contracts. The revised interpretation effectively precludes the use of such accounts in most circumstances.

Financial and Segregation Interpretation No. 10[1] was issued in 1984 by the Division's predecessor, the Division of Trading and Markets, to give guidance concerning the circumstances under which third-party custodial accounts could be used to deposit margin funds without breach of the segregated funds requirements of the Commodity Exchange Act ("CEA") and CFTC regulations. Interpretation No. 10 permitted FCMs to enter into custody arrangements with investment companies, pension plans and other customers and third-party custodians under conditions designed to assure that margin funds would be available for immediate withdrawal by the FCM on demand, without interference by the custodian or customer.

The Division's proposed amendment of Interpretation No. 10 was published for comment in the Federal Register on February 2, 2005.[2] Comments filed by the Investment Company Institute and the AIG Series Trust opposed the proposed withdrawal of Interpretation No. 10. In contrast, the Futures Industry Association, the National Futures Association, and the Joint Audit Committee filed comment letters supporting such a withdrawal.

In determining to amend Interpretation No. 10, the Division concluded that such accounts were no longer necessary, principally due to the Securities and Exchange Commission's ("SEC") adoption of Rule 17f-6 under the Investment Company Act of 1940, as amended, permitting registered investment companies to post margin funds directly with FCMs. In addition, the Division voiced concern that the third-party custody arrangements could impair immediate, unfettered access to margin funds by FCMs.

Although the terms of Interpretation No. 10 are explicit in assuring the unfettered access of FCMs to customer funds held in triparty accounts in adopting the proposed amendment, the Division stressed that "the practical and operational features that may impair the carrying FCM's right of immediate and unfettered access to customer funds,

1 Financial and Segregation Interpretation No. 10, "Treatment of Funds Deposited in Safekeeping Accounts," Comm. Fut. L. Rep. (CCH) ¶7120 (May 23, 1984) ("Interpretation No. 10").

2 The proposed amendment was discussed in a legal update from Dechert's Financial Services Group issued in February 2005.

notwithstanding any terms and conditions stipulated in a third-party custodial agreement, have come to light."

In support of this view, the Division cited the Futures Industry Association's ("FIA") comment letter, in which the FIA noted that since customers, rather than FCMs, have the client relationship with custodian banks, customer funds in such accounts are not as readily accessible as they would be in a conventional segregated account, and "in fact, these agreements have failed to prevent the release of customer funds held in third-party accounts, without the knowledge or awareness of the carrying FCMs."

As amended, revised Interpretation No. 10 provides that FCMs will not be considered to be in compliance with the CEA if they maintain margin funds for customer accounts in third-party custodial accounts, except in the case of FCMs that are not eligible to hold the assets of their registered investment company customers due to affiliation with the investment company or its adviser. To afford affected parties adequate time to adjust their existing custodial arrangements, the amendment to Interpretation No. 10 is made effective nine months following publication thereof in the Federal Register on February 13, 2006.

Investment companies currently using third-party custodial account arrangements with FCMs will need to modify those arrangements and must determine whether modifications to their account documents are necessary to reflect the new account structure.

Enhanced U.S. Access to Taiwan Stock Exchange Index Futures Contracts

Most foreign exchange-traded futures and commodity option contracts can be offered and sold in the United States, without specific approval by the CFTC. However, special procedures apply to the offer and sale of foreign stock index and foreign government debt products. Debt obligations of a foreign government must be designated as an exempted security by the SEC under Rule 3a12-8 under the Securities Exchange Act of 1934, as amended, before a futures contract or option thereon can be offered or sold in the United States. In the case of foreign stock index products, the CFTC's staff must issue a no-action letter to allow the offer or sale of futures contracts on such indices in the United States.[3]

On May 16, 2005, the CFTC's Office of General Counsel issued a no-action letter permitting the offer and sale in the United States of the Taiwan Futures Exchange's (TAIFEX's) futures contract based on the Taiwan Stock Exchange Electronic Sector Index ("TE") and Finance Sector Index ("TF"). The TE and TF are brand-based, market capitalization-weighted security indices, maintained by the Taiwan Stock Exchange Corporation ("TSEC"). The TE includes all electronics-related stocks listed on the TSEC and the TF covers all finance-related TSEC-listed stocks. Both indices exclude preferred stocks, full-delivery stocks, and stocks listed for less than one calendar month.

CFTC No-Action Letter Permits FCMs and IBs to Rely on Certain CTAs to Discharge Customer Identification Program Obligations

On March 14, 2005, the Division issued a no-action letter[4] to the FIA, effectively permitting FCMs and IBs to rely upon CFTC-registered CTAs and CTAs registered as investment advisers with the SEC and exempt from CFTC registration pursuant to Rule 4.14(a)(8) to discharge their customer identification requirements under CFTC rules implementing the Bank Secrecy Act ("BSA"). CFTC Rule 42.2 requires FCMs and IBs to comply with, among other regulations under the BSA, the customer identification program rule ("CIP Rule") jointly adopted in May 2003 by the CFTC and the Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN").

The CIP Rule requires FCMs and IBs to maintain CIPs that include procedures for the following:

- Verifying the identities of customers
- Maintaining records of the verification process
- Comparing customer names against lists of known or suspected terrorists or terrorist organizations
- Providing customers with notice that information is being collected to verify their identities

3 See, generally, "Foreign Instrument Approval & Exemptions," CFTC Backgrounder 1-91, June 3, 2005.

4 CFTC Letter No. 05-05 (March 14, 2005) (the "FIA No-Action Letter"). A similar no-action letter was issued to the Securities Industries Association by the SEC's Division of Market Regulation. In that letter, the SEC's Division of Market Regulation agreed that it would not recommend that the SEC commence enforcement action against broker-dealers that rely on registered investment advisers that have adopted an anti-money laundering program pursuant to Section 352 of the USA PATRIOT Act to perform some or all of the broker-dealer's CIP obligations pursuant to a written contractual agreement. Securities Industry Association, SEC No-Action Letter (Feb. 12, 2004).

The CIP Rule permits FCMs and IBs to rely upon other financial institutions to implement the FCM's or IB's CIP with respect to shared customers in specified circumstances, including that:

- Such reliance is reasonable under the circumstances
- The financial institution is subject to a rule implementing the anti-money laundering compliance program requirements ("AMLP") under the BSA and is regulated by a federal functional regulator
- The financial institution enters into a contract requiring it to certify annually to the FCM or IB that it has implemented an AMLP and will perform specified requirements of the FCM's or IB's CIP[5]

CTAs are not currently subject to an AMPL rule under the BSA and thus do not satisfy the requirement of 31 C.F.R. Section 103.123(b)(6). However, FinCEN has proposed AMLP rules for certain registered CTAs and investment advisers, and the relief requested was limited to CTAs either registered with the CFTC or exempt from CTA registration but registered as investment advisers with the SEC.[6]

In the FIA No-Action Letter, the Division stated that it would not recommend enforcement action against FCMs and IBs for failure to comply with Rule 42.2 if they rely on qualifying CTAs to perform elements of their CIP, on the condition that the following requirements in 31 C.F.R. Section 103.123(b)(6) are met:

- Reliance is reasonable under the circumstances
- The CTA is subject to a federal functional regulator
- The CTA enters into a contract requiring it to certify annually to the FCM or IB that the CTA has implemented an anti-money laundering program, and that it (or its agent) will perform specific requirements of the FCM's or IB's CIP[7]

Notwithstanding the fact that CTAs are not presently subject to an AMLP rule, the Division agreed to grant relief that would allow FCMs and IBs to treat qualifying CTAs as if they are subject to an AMLP rule for the purposes of complying with Section 103.123(b)(6).

CTAs that fall within the scope of the FIA No-Action Letter should note that neither the FIA No-Action Letter nor the CIP Rule pursuant to Section 326 of the USA PATRIOT Act imposes an affirmative obligation on CTAs to perform customer identification functions for FCMs or IBs.[8] A CTA that receives a request from an FCM or IB to perform some or all of the FCM's or IB's CIP obligations should consider the requirements of a CIP pursuant to Section 326 and the costs of implementing an AMLP pursuant to Section 352 when deciding whether to enter into a contractual agreement with an FCM or an IB.

With respect to CTAs registered with the CFTC, the FIA No-Action Letter is effective until the date upon which the AMPL rule under the BSA becomes effective for registered CTAs, or 30 days after FinCEN publicly announces that it will not issue anti-money laundering program rules for registered CTAs. With respect to CTAs exempt from registration with the CFTC but registered with the SEC as investment advisers, the FIA No-Action Letter is effective until the date upon the AMPL rule under the BSA becomes effective for federally registered investment advisers or 30 days after FinCEN publicly announces that it will not issue anti-money laundering program rules for federally registered investment advisers.[9]

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5 See 31 C.F.R. Section 103.123(b)(6).

6 In May 2003, FinCEN proposed that registered CTAs that manage discretionary commodity futures or options accounts adopt an AMLP. See Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Commodity Trading Advisors; proposed rules; 68 Fed. Reg. 23640-23646 (May 5, 2003).

7 FIA No-Action Letter, at 3.

8 FIA No-Action Letter, at 3.

9 FIA No-Action Letter, at 3.

Additional practice group contacts

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