

Pushing For Stricter FCM Controls Post MF Global

Law360, New York (June 11, 2012, 1:15 PM ET) -- The futures industry's self-regulating organization has proposed new requirements intended to provide better disclosure and control regarding the amount of a futures commission merchant's residual interest in customer segregated accounts and the withdrawal of funds from customer segregated accounts.

In the continuing regulatory response to the insolvency of futures commission merchant (FCM) MF Global, the National Futures Association (NFA) on May 29 sought Commodity Futures Trading Commission approval of new financial requirements for FCMs.[1]

Under current CFTC rules, an FCM must segregate from its own funds those funds received directly from its futures customers as well as any accruals owed to customers. CFTC rules also require that an FCM maintain, at all times, sufficient funds in customer-segregated accounts to meet its obligations to its customers.

In order to ensure that it meets the requirement to maintain sufficient segregated funds, an FCM may deposit its own funds as excess funds in the segregated customer accounts. The amount of funds deposited by an FCM in excess of the required segregated amount is referred to as the FCM's "residual interest."

NFA's proposed rules are intended to provide better disclosure and control regarding the amount of the residual interest maintained and the withdrawal of the residual interest. Specifically, when approved by the CFTC, the new rules will require written policies and procedures regarding the amount of an FCM's residual interest in customer segregated accounts, impose requirements on an FCM's withdrawal of its residual interest, and require additional monthly and semimonthly financial reporting to NFA.

Written Policies and Procedures

The proposed rules would require an FCM to maintain written policies and procedures that set a target amount for the residual interest it intends to maintain in segregated customer accounts. The FCM's board of directors, CEO, or CFO would have to approve in writing the target amount and any subsequent changes in the target amount, as well as any material changes in the policies and procedures for maintaining this amount.

NFA's proposed requirements do not prescribe a specific target amount for an FCM's residual interest, but rather permit an FCM to set its own target amount (either by percentage or dollars) so long as it is designed to reasonably ensure the FCM remains in ongoing compliance with applicable segregation requirements. The target amount would not be required to be a static number, but could be a range.

In setting the target amount, an FCM would need to analyze, among other things, the nature of the FCM's business; the creditworthiness and trading activities of its customers; the volatility and liquidity of the markets and products traded by the FCM's customers; and the historical trends in customer segregated funds balances and customer debits. The FCM would be required to maintain a written record of its analysis of relevant factors reviewed in setting the target amount.

NFA's proposal indicates that falling below the target amount would not be considered a per se rule violation, but that if an FCM withdraws its own funds from the customer segregated accounts for other than the benefit of customers, it would need to either deposit sufficient funds to restore the balance to the target amount by close of business on the next business day, or revise its target amount. NFA cautions, however, that unless the FCM's business materially changes, it would not expect material and/or frequent modifications to an FCM's target amount.

Withdrawal of an FCM's Residual Interest from Customer Segregated Accounts

The proposed rules would require that any disbursement of funds from customer segregated accounts in excess of 25 percent of the FCM's residual interest in such accounts, other than for the benefit of the FCM's customers, must be pre-approved in writing by the FCM's CEO or CFO or by a principal with knowledge of the FCM's financial requirements and position (financial principal).

This must be followed by the filing of a written notice of such disbursement with NFA (signed by the FCM's CEO, CFO, or financial principal) that includes (1) a description of the reason, amount, and recipient(s); (2) confirmation that the FCM's CEO, CFO, or financial principal pre-approved, in writing, the disbursement; (3) the current estimate of the FCM's residual interest remaining in the customer segregated accounts after the disbursement; and (4) a representation that, to the best of the notice signatory's knowledge and reasonable belief, the FCM remains in compliance with applicable segregation requirements after the disbursement.

After a disbursement requiring notification to NFA and until it completes its next daily calculation of customer segregated funds,[2] an FCM may not make any further disbursement from customer segregated accounts, other than for the benefit of the FCM's customers, regardless of the amount, without obtaining the approval of the CEO, CFO, or financial principal and filing a written notice with NFA.

Financial Reporting Requirements

Under the proposed rules, all FCMs will be required to make certain financial filings to NFA on a daily, semimonthly and monthly basis:[3]

Daily Filings

By noon of each business day, an FCM must submit (1) the total amount of funds held in segregated customer accounts, (2) the total amount of segregated customer funds required under applicable rules, and (3) the amount of the FCM's residual interest in such funds.

Semimonthly Filings

Prior to noon on the business day following the 15th and the last day of each month, an FCM must file with NFA (1) the amount of segregated customer funds held in cash and each type of permitted investment under CFTC Rule 1.25 and (2) the identity of each depository holding customer segregated funds and the amount held at each depository.

Monthly Filings

Within 17 business days after the end of each month, the FCM must submit the following information: (1) its adjusted net capital, minimum net capital requirement, and the amount of excess net capital it has; (2) whether any depository holding customer segregated funds is an affiliate of the FCM; and (3) the FCM's measure of leverage.

These filings must be made by the CEO or CFO (or someone designated by the CEO or CFO to file on his/her behalf). By making such a filing, the CEO or CFO certifies that, to the best of his/her knowledge and belief, the information is true, correct and complete. NFA will impose a \$1,000 late fee for each business day that the relevant information is late; the proposed rules specifically note that the payment of a late fee does not preclude NFA from also bringing disciplinary action for failing to meet the relevant deadlines.

While not part of the proposed rules, NFA has indicated that at the August meeting of its board of directors, it will consider taking action that will make the information collected in these financial filings publicly available on NFA's website.

The proposed interpretive notice makes it clear that if an FCM purposefully manipulates the submitted information so that it does not reflect the FCM's general financial condition throughout the month, the FCM may be found to have submitted misleading information to NFA and to have violated just and equitable principles of trade. In this way, NFA appears to be warning FCMs against so-called "window dressing" where an entity attempts to make its financial condition appear best during relevant reporting periods.

CFTC Approval

As noted above, NFA has requested that the CFTC approve the proposed rules. When the CFTC approves the rules, it would be expected that NFA would then announce an effective date for complying with the rules that provides a period of time for FCMs to develop the required written policies and procedures and make any required system changes necessary to comply with the reporting requirements. But in light of the concerns raised by the demise of MF Global, firms should not expect that this period will be extremely lengthy.

--By Michael A. Piracci, Michael M. Philipp and Dana D.C. Westfall, Morgan Lewis & Bockius LLP

Michael Piracci is counsel in the firm's New York office. Michael Philipp is a partner in the firm's Chicago office. Dana Westfall is an associate in the firm's Chicago office.

The opinions expressed are those of the authors and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] NFA's submission to the CFTC may be found on NFA's website at http://www.nfa.futures.org/news/PDF/CFTC/FR_Sec_16_ProtectionCustomerFunds_IntNotc_0517.pdf.

[2] CFTC Rule 1.32 requires that each FCM, by noon on the next business day, computes as of the close of each business day the total amount of funds held in segregated customer accounts, the total amount of segregated customer funds required under applicable rules, and the amount of the FCM's interest in such funds.

[3] FCMs for which NFA is currently the designated self-regulatory organization (DSRO) already submit most of this information to NFA, but the new proposed financial reporting requirements would apply to all NFA members, irrespective of whether NFA is an FCM's DSRO.

All Content © 2003-2012, Portfolio Media, Inc.