By Electronic Mail

January 22, 2020

Mr. Christopher J. Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 20581

Re: Petition for Rulemaking under Commodity Futures Trading Commission Rule 13.1 – Codification of No-Action Position under CFTC Letter No. 19-17

Dear Mr. Kirkpatrick:

The Futures Industry Association ("**FIA**"),[1] on behalf of its member firms that are registered with the Commodity Futures Trading Commission ("**Commission**" or "**CFTC**") as futures commission merchants ("**FCMs**"), and ICE Clear U.S.[2] ("**ICUS**" and together with FIA, the "**Petitioners**"), respectfully submit this petition for rulemaking ("**Petition**") under Commission Rule 13.1.[3] As

[1] FIA is the leading global trade organization for the futures, options, and centrally cleared derivatives markets, with offices in London, Brussels, Singapore and Washington DC. FIA's mission is to support open, transparent and competitive markets; protect and enhance the integrity of the financial system; and promote high standards of professional conduct. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries, as well as technology vendors, lawyers and other professionals serving the industry. FIA's core constituency consists of firms that operate as clearing members in global derivatives markets, including firms registered with the Commodity Futures Trading Commission as futures commission merchants.

[2] ICUS is registered with the Commission as a derivatives clearing organization ("**DCO**"). As such, it is required to comply with the provisions of Part 39 of the Commission's rules, including Rule 39.13(g)(8), discussed below, in connection with clearing futures, options on futures and cleared swaps on behalf of customers of its FCM clearing members.

[3] Commission Rule 13.1 authorizes any person to "file a petition with the Secretariat of the Commission for the issuance, amendment or repeal of a rule of general application." The petition must "set forth the text of any proposed rule or amendment" and "further state the nature of the petitioner's interest and may state arguments in support of the issuance, amendment or repeal of the rule."

explained in detail below, the Petition seeks to amend Commission Rule 1.56[4] and Rule 1.11[5] to codify, with certain exceptions, the terms and conditions of the no-action position adopted by the Division of Clearing and Risk ("**DCR**") and the Division of Swap Dealer and Intermediary Oversight ("**DSIO**" and, together with DCR, the "**Divisions**") in CFTC Letter No. 19-17 (the "**Proposed Amendment**").[6] Adoption of the Proposed Amendment would authorize FCMs and DCOs to continue to treat separate accounts of a customer as accounts of separate entities for purposes of Rule 39.13(g)(8)(iii) following expiration of the time-limited relief set out in CFTC Letter No. 19-17, *i.e.*, June 30, 2021.[7]

Background

From time-to-time, an FCM may enter into a customer agreement with certain beneficial owners, pursuant to which the FCM agrees to treat separate accounts established by or on behalf of the same beneficial owner as if they were separate legal entities. The reasons why a beneficial owner may request separate treatment for its accounts vary but may include, for example:

- A commercial enterprise, such as an agricultural producer or a petroleum refiner, may obtain financing from a lender that may, in connection with such financing, require the commercial enterprise to hedge the transaction. The lender will be given a subordinated security interest in the hedge account and the right to assert control over the positions and collateral in the account in the event that the commercial breaches its obligations to the lender. However, the lender neither wants nor has a legal right to any assets held in other accounts that the commercial enterprise may establish with the FCM.

---

[4] Rule 1.56(b) prohibits an FCM from representing in any way that it will: (i) guarantee a customer or noncustomer against loss; (ii) limit the loss of such customer or noncustomer; or (iii) not call for or attempt to collect margin. 17 CFR § 1.56(b) (2019).

[5] Rule 1.11 sets forth the Commission's risk management program for FCMs in substantial detail for the purpose of assuring that each FCM has in place appropriate policies and procedures to monitor and manage the risks associated with the activities of the FCM in its capacity as such. 17 CFR § 1.11 (2019).

[6] The text of the Proposed Amendment is set out in Appendix A to this Petition and a comparison of the proposed rules against the current rules appears as Appendix B. As noted, the purpose of the Proposed Amendment requested by this Petition is to codify, with certain exceptions, the terms and conditions set out in Letter No. 19-17. Concurrently with the filing of this Petition, the Petitioners have filed for the Commission's consideration a separate petition for rulemaking proposing further amendments to Commission Rules 1.56 and 1.11, which would modify the strict prohibitions in Rule 1.56(b), subject to enhanced risk management requirements set out in Rule 1.11, as proposed to be amended. We have separated the proposals to assure the Commission flexibility in its consideration of each.

[7] Commission Rule 39.13(g)(8)(iii) provides that each DCO must "require its clearing members to ensure that their customers do not withdraw funds from their accounts with such clearing members unless the net liquidating value plus the margin deposits remaining in a customer's account after such withdrawal are sufficient to meet the customer initial margin requirements with respect to all products and swap portfolios held in such customer's account which are cleared by the derivatives clearing organization." 17 CFR § 39.13(g)(8)(iii) (2019).

- An institutional customer, such as a pension fund or mutual fund, may allocate assets to investment managers pursuant to investment management agreements ("**IMAs**") that contractually obligate each investment manager to invest the customer's assets under management in accordance with an agreed trading strategy, independent of the trading that may be undertaken for the customer by the same or other investment managers acting on behalf of other accounts of such customer.[8]

As the Commission is aware, in May 2019, the Joint Audit Committee ("**JAC**") issued two Regulatory Alerts: (i) Regulatory Alert 19-02, Combining Accounts for Margin Purposes; and (ii) Regulatory Alert 19-03, CFTC Regulation 1.56(b) – Prohibition of Guarantee against Loss.

In Regulatory Alert 19-02, the JAC reminded FCMs that, when determining an account's margin funds available for disbursement, all accounts of the same beneficial owner within the same regulatory account classification must be combined, even if under different control.[9] Although not specifically referenced in Regulatory Alert 19-02, the Chicago Mercantile Exchange ("**CME**") elsewhere made clear its view that the regulatory alert is consistent with the provisions of Commission Rule 39.13(g)(8)(iii).[10]

In Regulatory Alert 19-03, the JAC expressed the view that so-called limited recourse and nonrecourse clauses "are not in compliance with industry regulations and are not permitted in any agreement between an FCM and its customers and noncustomers." The JAC added: "For clarity, in the case of a separate account of a beneficial owner managed by an asset manager, the FCM must have at all times the absolute right to look to funds in all accounts of the beneficial owner even accounts that are under different control, as well as the right to call the underlying beneficial owner for funds even if beyond the amount the beneficial owner has allocated to the asset manager(s)."

By letter to the Divisions dated June 26, 2019, FIA requested relief from aspects of Regulatory Alert 19-02 and Regulatory Alert 19-03, explaining that the policies set out in these regulatory alerts had a direct and adverse effect the ability of FCMs to maintain separate accounts for the

---

[8] Commission rules reflect this understanding. For example, Rule 1.33(d) requires an FCM to furnish to an account controller a copy of each monthly statement and confirmation provided to the client for that account; Part 150 provides an exemption from aggregating positions for independently controlled accounts of eligible entities.

[9] For purposes of Regulatory Alert 19-02 and 19-03 and this Petition, we understand that the term "beneficial owner" means the individual or legal entity identified on the books and records of the FCM carrying the account as the account's direct owner, *i.e.*, the FCM's customer. The term is not intended to mean the individuals or other legal entities that directly or indirectly own the legal entity that is the FCM's customer.

[10] *See* Letter from Sunil Cutinho, President, CME Clearing, to Brian A. Bussey Director, DCR, and Matthew B. Kulkin, Director, DSIO, dated June 14, 2019.

benefit of their customers.[11] On July 10, 2019, in response in part to FIA's letter, the Divisions issued CFTC Letter No. 19-17.

With respect to Regulatory Alert 19-03, the Divisions effectively confirmed the JAC's interpretation that limited recourse or non-recourse clauses would violate Commission Rule 1.56. The Divisions also noted that, in the event of a shortfall in any customer account, "the FCM must retain the ability to ultimately look to funds in other accounts of the beneficial owner, including accounts that may be under different control, as well as the right to call the beneficial owner for additional funds."

With respect to Regulatory Alert 19-02, the Divisions adopted a no-action position authorizing a DCO to allow an FCM to treat the separate accounts of a customer as accounts of separate entities for purposes of Rule 39.13(g)(8)(iii) "where the FCM clearing member's written internal controls and procedures require it to, and it in fact does, comply with the terms and conditions" set out in the letter. Significantly, as noted above, the no-action relief is time limited and extends only until June 30, 2021.

Basis for Petition

In adopting the no-action position with regard to Commission Rule 39.13(g)(8)(iii), the Divisions set a two-year limit "in order to provide Staff with time to recommend, and the Commission with time to determine whether to conduct, and if so, to in fact conduct, a rulemaking to implement appropriate relief on a permanent basis." We respectfully submit that such rulemaking is not only appropriate but essential to provide both FCMs and their customers with the legal certainty to which they are entitled.

Absent Commission action, the no-action relief with regard to the treatment of separate accounts under Commission Rule 39.13(g)(8)(iii) will expire and FCM clearing members will no longer be able to treat the separate accounts of a customer as accounts of separate entities. For many FCMs and their customers, the terms and conditions of the no-action position in CFTC Letter No. 19-17 present significant operational and systems challenges.[12] While these challenges may vary across FCMs, the conditions contemplate that FCMs adopt new practices for stress testing accounts,

---

[11] *See*, *e.g.*, Letter from Walt L. Lukken, President and Chief Executive Officer, FIA, to Brian A. Bussey Director, DCR, and Matthew B. Kulkin, Director, DSIO, dated June 26, 2019

[12] In this regard, we note that FIA earlier submitted a letter requesting additional time in which to comply with the terms and conditions of CFTC Letter No. 19-17. *See* Letter from Walt L. Lukken, President and Chief Executive Officer, FIA, to Brian A. Bussey Director, DCR, and Matthew B. Kulkin, Director, DSIO, dated July 24, 2019. It is unclear whether the *Statement by the Directors of the Division of Clearing and Risk and the Division of Swap Dealer and Intermediary Oversight Concerning the Treatment of Separate Accounts of the Same Beneficial Owner*, dated September 13, 2019, was intended to be the Divisions' response to FIA's letter.

review and possibly change margin timing expectations for non-US accounts,[13] undertake legal analysis to clarify interpretive questions, and revise their segregation calculation and recordkeeping practices. The conditions may also present time-consuming documentation changes and customer outreach.[14]

The burdens placed on such FCMs and their customers would be multiplied if the Commission were to decide not to act and not make permanent the no-action provisions of Letter No. 19-17, as proposed to be modified herein. A delay in adopting a rule may lead to the same result if, after notice and an opportunity for comment and a weighing of the costs and benefits, the Commission determines that another approach is, in fact, preferred. In either situation, FCMs and their customers would be forced to undo those changes and implement new ones in less than two years' time, which may also increase confusion for beneficial owners themselves.

Failure to adopt a rule may also affect a customer's relationships with third parties. For example, an asset manager may be less likely to use exchange-traded derivatives to hedge its customers' cash market positions if the asset manager could not have confidence that it would be able to withdraw its customers' excess margin as necessary to meet its obligations in other markets. Similarly, a bank may be less likely to provide a commercial participant with margin financing if the proceeds of its loans could be applied to meet other obligations of the participant. Institutional customers that rely on asset managers may seek to impose restrictions on such managers that would interfere with such managers' trading strategies.

FIA member firms that are FCMs (and their customers), therefore, have a direct interest in assuring that they are able to take advantage of the no-action relief beyond June 30, 2021 and are pleased to submit this Petition to facilitate the Commission's consideration of a proposed rulemaking.[15] As described below, FCMs are willing to implement many of the requirements of CFTC Letter No. 19-17 in order to extend their ability to offer separate margining to customers beyond June 30, 2021. However, having legal certainty as to the basis for doing so would help eliminate unnecessary expenditure and uncertainty in the market. Furthermore, a rulemaking would allow for an appropriate consideration of the costs and benefits of any final approach and would reduce interpretive questions.

The Proposed Amendment

As noted earlier, the Proposed Amendment would authorize FCMs to treat the separate accounts of a customer as accounts of separate entities for purposes of Rule 39.13(g)(8)(iii) by codifying,

---

[13] Condition 5 requires each separate account to be on a one-day margin call. Customers located outside of the US may have negotiated longer timing to take into account time zone differences and settlement practices for non-US currencies.

[14] *See* Letter from Walt L. Lukken, President and Chief Executive Office, FIA, to Joshua B. Sterling, Director, DSIO, and Sarah E. Josephson, Acting Director, DCR, dated July 24, 2019.

[15] For the avoidance of doubt, this Petition addresses only the no-action position with respect to Commission Rule 39.13(g)(8)(iii).

with certain exceptions, the terms and conditions of CFTC Letter No. 19-17. Rather than amend Rule 39.13, however, we propose amending Rule 1.56 to add a new paragraph (f), supplemented with enhanced risk management requirements at Rule 1.11(e) where Rule 1.56(f) applies.[16]

New Rule 1.56(f) would recognize the right of an FCM, subject to the conditions of Rule 1.56(f), to enter into an agreement with its customer pursuant to which: (i) notwithstanding Rule 39.13(g)(8)(iii), the FCM may allow a customer to withdraw excess funds from a separate account while there is an outstanding margin call in another separate account; and (ii) the FCM agrees that it will not (in the absence of certain specified conditions that terminate the privileges described in the Proposed Amendment) use excess funds from one account to meet an obligation in another account without the consent of the customer, provided the FCM has in place the enhanced risk management requirements set out in the Proposed Amendment.

The Proposed Amendment would further provide that the authority of the FCM to exercise the privileges described in the Proposed Amendment will terminate in the event that, with respect to the customer:

- The customer has either instituted or has instituted against it a bankruptcy proceeding; or
- The FCM is not otherwise in compliance with Rule 1.56(b).

Notably, the Proposed Amendment would also require the FCM to notify its designated self-regulatory organization ("**DSRO**") that it is entering into such agreements and would recognize that the Commission or a self-regulatory organization ("**SRO**") may, for cause and in accordance with the rules of the Commission or such SRO, as applicable, direct the FCM to cease exercising the privileges described in the amendment.[17]

The Proposed Amendment would further codify the bulk of the terms and conditions in CFTC Letter No. 19-17 in a revised Rule 1.11 by redesignating subparagraph (e)(4) as subparagraph (e)(5) and adding a new paragraph (e)(4), *Enhanced Risk Management for Separate Accounts*. New subparagraph (e)(4) reorganizes and incorporates most, but not all, of the terms and conditions in CFTC Letter No. 19-17. After analyzing all of the conditions, we suggest including in the codified version only those terms that provide actual benefit or enhancement relevant to any possible risk of separate account treatment, taking into account the burden each term imposes.

---

[16] Because Part 39 of the Commission's rules relate to core principles for DCOs and the relief requested here affect the obligations of FCMs, we believe it is more appropriate to place the Proposed Amendment in Rule 1.56 and Rule 1.11 rather than Part 39.

[17] The Proposed Amendment does not incorporate the definition of "ordinary course of business" set out in CFTC Letter No. 19-17. We submit that, subject to an FCM's own risk management requirements, as long as the customer timely meets its margin requirements and is not subject to a bankruptcy proceeding, an FCM should be permitted to treat the separate accounts of a customer as accounts of separate entities for purposes of Rule 39.13(g)(8)(iii).

For example, we did not include the requirement that an FCM's risk management program include stress testing and credit limits on a combined account basis as well as an individual account basis. This requirement imposes a significant systems modification burden on FCMs with limited risk management benefit. We also did not include the requirements that FCMs (i) maintain specific lists and contact information of beneficial owners of the accounts, and (ii) provide disclosure with respect to the application of the Part 190 of the Commission's rules. We believe both requirements are unnecessary.

Codification of the no-action position in CFTC Letter No. 19-17 with respect to separate accounts should not expose FCMs carrying such accounts to any additional risk. As the Divisions noted in CFTC Letter No. 19-17, the Commission's rules concerning the protection of customer funds have greatly expanded since Commission Rule 1.56(b) was promulgated. For example:

- Part 190 of the Commission's rules prescribe, among other things, the method by which the business of a commodity firm is to be conducted or liquidated following the filing of a bankruptcy petition and how customer claims are to be calculated.

- Rule 1.11 requires each FCM to develop and maintain specific risk management policies and procedures involving, among other things, the segregation and handling of customer funds. Among other requirements, each FCM must develop a process for establishing a targeted amount of residual interest that will reasonably ensure that the FCM remains in compliance with the segregated funds requirements at all times.[18]

- Rules 1.22, 22.2, and 30.7 require specific calculations regarding the requirement of residual interest in segregated, cleared swap and secured customer fund accounts to ensure that no FCM uses or permits the use of the customer funds of one customer to purchase, margin, or settle the trades, contracts, or options of another customer.[19] These rules require an FCM to compute its segregated funds balances daily and to use its own funds, *i.e.*, its residual interest, to make up any shortfalls in each customer account class.

- Part 39 of the Commission's rules establish risk management requirements for DCOs, which, in turn, require that their clearing members take certain steps to support their own risk management, thereby mitigating the risk that such members pose to the DCO and providing an extra layer of oversight.

---

[18] In establishing the total amount of the targeted residual interest in the segregated funds accounts, senior management must consider various factors, as applicable, relating to the nature of the FCM's business including, but not limited to, the composition of the FCM's customer base, the general creditworthiness of the customer base, the general trading activity of the customers, the types of markets and products traded by the customers, the proprietary trading of the FCM, the general volatility and liquidity of the markets and products traded by customers, the FCM's own liquidity and capital needs, and the historical trends in customer segregated fund balances, including undermargined amounts and net deficit balances in customers' accounts.

[19] 17 CFR §§ 1.22, 22.2 and 30.7.

Conclusion

For all of the above reasons, the Petitioners respectfully submit this Petition for the Commission's consideration and urge the Commission to act promptly to initiate the required procedures to promulgate the Proposed Amendment. We stand ready to assist the Commission and its staff in this effort. If the Commission has any questions or needs any additional information, please contact Allison Lurton, FIA's General Counsel and Chief Legal Officer at 202.466.5460 or alurton@fia.org.

Sincerely,

Walt L. Lukken
President and Chief Executive Officer of FIA

Eamonn Hahessy
General Counsel and CCO of ICE Clear U.S.

cc: Honorable Heath P. Tarbert, Chairman
Honorable Brian Quintenz, Commissioner
Honorable Rostin Benham, Commissioner
Honorable Dan Berkovitz, Commissioner

APPENDIX A

§1.11 Risk Management Program for futures commission merchants.

a. Redesignate paragraph (e)(4) as paragraph (e)(5).

b. Add a new paragraph (e)(4) to read as follows:

(4) *Enhanced Risk Management for Separate Accounts.* A futures commission merchant that maintains separate accounts as described in §1.56(f) for one or more customers must enhance its Risk Management Program to assure that each separate account is deemed a separate customer for purposes of developing and implementing its Risk Management Program to account for the additional risks of maintaining such separate accounts. Specifically, the futures commission merchant's written policies and procedures must be supplemented to:

(i) Evaluate information provided by a customer, or, as applicable, the manager of a separate account, sufficient to permit the futures commission merchant to assess the value of the assets allocated to such separate account; and

(ii) Perform stress testing and establish credit limits based on assets dedicated to such separate account, as the levels of such assets may be updated from time to time by a customer or a manager of a separate account;

(iii) Calculate the margin requirement for each separate account independently from all other separate accounts of the same customer with no offsets or spreads recognized across the separate accounts;

(iv) Assure that all calls for margin or other required deposits for any separate account of the same customer are outstanding no more than one business day, except as may result from administrative error or operational constraints;

(v) Consider a receivable from a separate account secured (a current asset) based only on the assets of that separate account;

(vi)(A) Include the margin deficiency of each separate account for purposes of its residual interest compliance calculations; and (B) cover any such margin deficiency with its own funds as applicable;

(vii)(A) Maintain a list of all separate accounts receiving such treatment indicating the customer and account numbers; and (B) record each separate account independently in the futures commission merchant's books and records; and

(ix) Provide disclosure on its website or within its disclosure document required by Regulation 1.55(i) that under Part 190 of this Chapter all separate accounts of the customer will be combined in the event of the futures commission merchant's bankruptcy.

(5) *Supervision of the Risk Management Program.* The Risk Management Program shall include a supervisory system that is reasonably designed to ensure that the policies and procedures required by this section are diligently followed.

§1.56 Prohibition of guarantees against loss.

a. Add a new paragraph (f) to read as follows:

(f)(1) Nothing in this section shall prevent a futures commission merchant that maintains two or more accounts within the same regulatory account classification (customer segregated, customer secured, cleared swaps customer, or noncustomer) for the same customer (each account hereinafter a separate account) from entering into a written agreement with the customer, pursuant to which the futures commission merchant agrees that, except as provided in paragraph (f)(2) of this section:

(i) The provisions of § 39.13(g)(8)(iii) of this Chapter to the contrary notwithstanding, the futures commission merchant may permit the customer to withdraw funds from a separate account even if the net liquidating value plus the margin deposits remaining in a customer's other accounts after such withdrawal are not sufficient to meet the customer's initial margin requirements with respect to all products and swap portfolios held in such customer's accounts that are cleared by the derivatives clearing organization; and

(ii) The futures commission merchant will not, without the prior consent of the customer, use excess customer funds from one separate account to meet any obligations in another separate account.

(2) The authority of a futures commission merchant to exercise the privileges described in paragraph (f)(1) of this section with respect to any customer will be deemed to terminate immediately in the event that:

(i) The customer has instituted, or has had instituted against it, a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights; or

(ii) The futures commission merchant is not otherwise in compliance with paragraph (b) of this section.

(3) A futures commission that intends to enter into agreements of the type authorized by paragraph (f)(1) of this section with one or more of its customers must notify its designated self-regulatory organization promptly after entering into the first such agreement.

(4) The Commission or any self-regulatory organization with authority over the futures commission merchant may, for cause and in accordance with the rules of the Commission or such self-regulatory organization, as applicable, direct the futures commission merchant to cease exercising the privileges described in paragraph (f)(1) of this section.

APPENDIX B

§1.11 Risk Management Program for futures commission merchants.

(a) *Applicability.* Nothing in this section shall apply to a futures commission merchant that does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result from soliciting or accepting orders for the purchase or sale of any commodity interest.

(b) *Definitions.* For purposes of this section:

(1) *Business unit* means any department, division, group, or personnel of a futures commission merchant or any of its affiliates, whether or not identified as such that:

(i) Engages in soliciting or in accepting orders for the purchase or sale of any commodity interest and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom; or

(ii) Otherwise handles segregated funds, including managing, investing, and overseeing the custody of segregated funds, or any documentation in connection therewith, other than for risk management purposes; and

(iii) Any personnel exercising direct supervisory authority of the performance of the activities described in paragraph (b)(1)(i) or (ii) of this section.

(2) *Customer* means a futures customer as defined in §1.3, Cleared Swaps Customer as defined in §22.1 of this chapter, and 30.7 customer as defined in §30.1 of this chapter.

(3) *Governing body* means the proprietor, if the futures commission merchant is a sole proprietorship; a general partner, if the futures commission merchant is a partnership; the board of directors if the futures commission merchant is a corporation; the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority if the futures commission merchant is a limited liability company or limited liability partnership.

(4) *Segregated funds* means money, securities, or other property held by a futures commission merchant in separate accounts pursuant to §1.20 for futures customers, pursuant to §22.2 of this chapter for Cleared Swaps Customers, and pursuant to §30.7 of this chapter for 30.7 customers.

(5) *Senior management* means, any officer or officers specifically granted the authority and responsibility to fulfill the requirements of senior management by the governing body.

(c) *Risk Management Program.* (1) Each futures commission merchant shall establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the futures commission merchant as such. For purposes

of this section, such policies and procedures shall be referred to collectively as a "Risk Management Program."

(2) Each futures commission merchant shall maintain written policies and procedures that describe the Risk Management Program of the futures commission merchant.

(3) The Risk Management Program and the written risk management policies and procedures, and any material changes thereto, shall be approved in writing by the governing body of the futures commission merchant.

(4) Each futures commission merchant shall furnish a copy of its written risk management policies and procedures to the Commission and its designated self-regulatory organization upon application for registration and thereafter upon request.

(d) *Risk management unit.* As part of the Risk Management Program, each futures commission merchant shall establish and maintain a risk management unit with sufficient authority; qualified personnel; and financial, operational, and other resources to carry out the risk management program established pursuant to this section. The risk management unit shall report directly to senior management and shall be independent from the business unit.

(e) *Elements of the Risk Management Program.* The Risk Management Program of each futures commission merchant shall include, at a minimum, the following elements:

(1) *Identification of risks and risk tolerance limits.* (i) The Risk Management Program shall take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital, and any other applicable risks together with a description of the risk tolerance limits set by the futures commission merchant and the underlying methodology in the written policies and procedures. The risk tolerance limits shall be reviewed and approved quarterly by senior management and annually by the governing body. Exceptions to risk tolerance limits shall be subject to written policies and procedures.

(ii) The Risk Management Program shall take into account risks posed by affiliates, all lines of business of the futures commission merchant, and all other trading activity engaged in by the futures commission merchant. The Risk Management Program shall be integrated into risk management at the consolidated entity level.

(iii) The Risk Management Program shall include policies and procedures for detecting breaches of risk tolerance limits set by the futures commission merchant, and alerting supervisors within the risk management unit and senior management, as appropriate.

(2) *Periodic Risk Exposure Reports.* (i) The risk management unit of each futures commission merchant shall provide to senior management and to its governing body quarterly written reports setting forth all applicable risk exposures of the futures commission merchant; any recommended or completed changes to the Risk Management Program; the recommended time frame for implementing recommended changes; and the status of any incomplete implementation of previously recommended changes to the Risk Management Program. For purposes of this section, such reports shall be referred to as "Risk Exposure Reports." The Risk Exposure Reports also shall

be provided to the senior management and the governing body immediately upon detection of any material change in the risk exposure of the futures commission merchant.

(ii) *Furnishing to the Commission.* Each futures commission merchant shall furnish copies of its Risk Exposure Reports to the Commission within five (5) business days of providing such reports to its senior management.

(3) *Specific risk management considerations.* The Risk Management Program of each futures commission merchant shall include, but not be limited to, policies and procedures necessary to monitor and manage the following risks:

(i) *Segregation risk.* The written policies and procedures shall be reasonably designed to ensure that segregated funds are separately accounted for and segregated or secured as belonging to customers as required by the Act and Commission regulations and must, at a minimum, include or address the following:

(A) A process for the evaluation of depositories of segregated funds, including, at a minimum, documented criteria that any depository that will hold segregated funds, including an entity affiliated with the futures commission merchant, must meet, including criteria addressing the depository's capitalization, creditworthiness, operational reliability, and access to liquidity. The criteria should further consider the extent to which segregated funds are concentrated with any depository or group of depositories. The criteria also should include the availability of deposit insurance and the extent of the regulation and supervision of the depository;

(B) A program to monitor an approved depository on an ongoing basis to assess its continued satisfaction of the futures commission merchant's established criteria, including a thorough due diligence review of each depository at least annually;

(C) An account opening process for depositories, including documented authorization requirements, procedures that ensure that segregated funds are not deposited with a depository prior to the futures commission merchant receiving the acknowledgment letter required from such depository pursuant to §§1.20, and 22.2 and 30.7 of this chapter, and procedures that ensure that such account is properly titled to reflect that it is holding segregated funds pursuant to the Act and Commission regulations;

(D) A process for establishing a targeted amount of residual interest that the futures commission merchant seeks to maintain as its residual interest in the segregated funds accounts and such process must be designed to reasonably ensure that the futures commission merchant maintains the targeted residual amounts and remains in compliance with the segregated funds requirements at all times. The policies and procedures must require that senior management, in establishing the total amount of the targeted residual interest in the segregated funds accounts, perform appropriate due diligence and consider various factors, as applicable, relating to the nature of the futures commission merchant's business including, but not limited to, the composition of the futures commission merchant's customer base, the general creditworthiness of the customer base, the general trading activity of the customers, the types of markets and products traded by the customers, the proprietary trading of the futures commission merchant, the general volatility and liquidity of the markets and products traded by customers, the futures commission merchant's own liquidity and capital needs, and the historical trends in customer segregated fund balances,

including undermargined amounts and net deficit balances in customers' accounts. The analysis and calculation of the targeted amount of the future commission merchant's residual interest must be described in writing with the specificity necessary to allow the Commission and the futures commission merchant's designated self-regulatory organization to duplicate the analysis and calculation and test the assumptions made by the futures commission merchant. The adequacy of the targeted residual interest and the process for establishing the targeted residual interest must be reassessed periodically by Senior Management and revised as necessary;

(E) A process for the withdrawal of cash, securities, or other property from accounts holding segregated funds, where the withdrawal is not for the purpose of payments to or on behalf of the futures commission merchant's customers. Such policies and procedures must satisfy the requirements of §1.23, §22.17 of this chapter, or §30.7 of this chapter, as applicable;

(F) A process for assessing the appropriateness of specific investments of segregated funds in permitted investments in accordance with §1.25. Such policies and procedures must take into consideration the market, credit, counterparty, operational, and liquidity risks associated with such investments, and assess whether such investments comply with the requirements in §1.25 including that the futures commission merchant manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity;

(G) Procedures requiring the appropriate separation of duties among individuals responsible for compliance with the Act and Commission regulations relating to the protection and financial reporting of segregated funds, including the separation of duties among personnel that are responsible for advising customers on trading activities, approving or overseeing cash receipts and disbursements (including investment operations), and recording and reporting financial transactions. The policies and procedures must require that any movement of funds to affiliated companies and parties are properly approved and documented;

(H) A process for the timely recording of all transactions, including transactions impacting customers' accounts, in the firm's books of record;

(I) A program for conducting annual training of all finance, treasury, operations, regulatory, compliance, settlement, and other relevant officers and employees regarding the segregation requirements for segregated funds required by the Act and regulations, the requirements for notices under §1.12, procedures for reporting suspected breaches of the policies and procedures required by this section to the chief compliance officer, without fear of retaliation, and the consequences of failing to comply with the segregation requirements of the Act and regulations; and

(J) Policies and procedures for assessing the liquidity, marketability and mark-to-market valuation of all securities or other non-cash assets held as segregated funds, including permitted investments under §1.25, to ensure that all non-cash assets held in the customer segregated accounts, both customer-owned securities and investments in accordance with §1.25, are readily marketable and highly liquid. Such policies and procedures must require daily measurement of liquidity needs with respect to customers; assessment of procedures to liquidate all non-cash collateral in a timely manner and without significant effect on price; and application of appropriate collateral haircuts that accurately reflect market and credit risk.

(ii) *Operational risk.* The Risk Management Program shall include automated financial risk management controls reasonably designed to prevent the placing of erroneous orders, including those that exceed pre-set capital, credit, or volume thresholds. The Risk Management Program shall ensure that the use of automated trading programs is subject to policies and procedures governing the use, supervision, maintenance, testing, and inspection of such programs.

(iii) *Capital risk.* The written policies and procedures shall be reasonably designed to ensure that the futures commission merchant has sufficient capital to be in compliance with the Act and the regulations, and sufficient capital and liquidity to meet the reasonably foreseeable needs of the futures commission merchant.

(4) *Enhanced Risk Management for Separate Accounts.* A futures commission merchant that maintains separate accounts as described in §1.56(f) for one or more customers must enhance its Risk Management Program to assure that each separate account is deemed a separate customer for purposes of developing and implementing its Risk Management Program to account for the additional risks of maintaining such separate accounts. Specifically, the futures commission merchant's written policies and procedures must be supplemented to:

(i) Evaluate information provided by a customer or, as applicable, the manager of a separate account, sufficient to permit the futures commission merchant to assess the value of the assets allocated to such separate account; and

(ii) Perform stress testing and establish credit limits based on assets dedicated to such separate account, as the levels of such assets may be updated from time to time by a customer or a manager of a separate account;

(iii) Calculate the margin requirement for each separate account independently from all other separate accounts of the same customer with no offsets or spreads recognized across the separate accounts;

(iv) Assure that all calls for margin or other required deposits for any separate account of the same customer are outstanding no more than one business day, except as may result from administrative error or operational constraints;

(v) Consider a receivable from a separate account secured (a current asset) based only on the assets of that separate account;

(vi)(A) Include the margin deficiency of each separate account for purposes of its residual interest compliance calculations; and (B) cover any such margin deficiency with its own funds as applicable;

(vii)(A) Maintain a list of all separate accounts receiving such treatment indicating the customer and account numbers; and (B) record each separate account independently in the futures commission merchant's books and records; and

(ix) Provide disclosure on its website or within its disclosure document required by Regulation 1.55(i) that under Part 190 of this Chapter all separate accounts of the customer will be combined in the event of the futures commission merchant's bankruptcy.

(5) *Supervision of the Risk Management Program.* The Risk Management Program shall include a supervisory system that is reasonably designed to ensure that the policies and procedures required by this section are diligently followed.

(f) *Review and testing.* (1) The Risk Management Program of each futures commission merchant shall be reviewed and tested on at least an annual basis, or upon any material change in the business of the futures commission merchant that is reasonably likely to alter the risk profile of the futures commission merchant.

(2) The annual reviews of the Risk Management Program shall include an analysis of adherence to, and the effectiveness of, the risk management policies and procedures, and any recommendations for modifications to the Risk Management Program. The annual testing shall be performed by qualified internal audit staff that are independent of the business unit, or by a qualified third party audit service reporting to staff that are independent of the business unit. The results of the annual review of the Risk Management Program shall be promptly reported to and reviewed by the chief compliance officer, senior management, and governing body of the futures commission merchant.

(3) Each futures commission merchant shall document all internal and external reviews and testing of its Risk Management Program and written risk management policies and procedures including the date of the review or test; the results; any deficiencies identified; the corrective action taken; and the date that corrective action was taken. Such documentation shall be provided to Commission staff, upon request.

(g) *Distribution of risk management policies and procedures.* The Risk Management Program shall include procedures for the timely distribution of its written risk management policies and procedures to relevant supervisory personnel. Each futures commission merchant shall maintain records of the persons to whom the risk management policies and procedures were distributed and when they were distributed.

(h) *Recordkeeping.* (1) Each futures commission merchant shall maintain copies of all written approvals required by this section.

(2) All records or reports, including, but not limited to, the written policies and procedures and any changes thereto that a futures commission merchant is required to maintain pursuant to this regulation shall be maintained in accordance with §1.31 and shall be made available promptly upon request to representatives of the Commission.

§1.56 Prohibition of guarantees against loss.

(a) [Reserved]

(b) No futures commission merchant or introducing broker may in any way represent that it will, with respect to any commodity interest in any account carried by the futures commission merchant for or on behalf of any person:

(1) Guarantee such person against loss;

(2) Limit the loss of such person; or

(3) Not call for or attempt to collect initial and maintenance margin as established by the rules of the applicable board of trade.

(c) No person may in any way represent that a futures commission merchant or introducing broker will engage in any of the acts or practices described in paragraph (b) of this section.

(d) This section shall not be construed to prevent a futures commission merchant or introducing broker from:

(1) Assuming or sharing in the losses resulting from an error or mishandling of an order; or

(2) Participating as a general partner in a commodity pool which is a limited partnership.

(e) This section shall not affect any guarantee entered into prior to January 28, 1982, but this section shall apply to any extension, modification or renewal thereof entered into after such date.

(f)(1) Nothing in this section shall prevent a futures commission merchant that maintains two or more accounts within the same regulatory account classification (customer segregated, customer secured, cleared swaps customer, or noncustomer) for the same customer (each account hereinafter a separate account) from entering into a written agreement with the customer, pursuant to which the futures commission merchant agrees that, except as provided in paragraph (f)(2) of this section:

(i) The provisions of § 39.13(g)(8)(iii) of this Chapter to the contrary notwithstanding, the futures commission merchant may permit the customer to withdraw funds from a separate account even if the net liquidating value plus the margin deposits remaining in a customer's other accounts after such withdrawal are not sufficient to meet the customer's initial margin requirements with respect to all products and swap portfolios held in such customer's accounts that are cleared by the derivatives clearing organization; and

(ii) The futures commission merchant will not, without the prior consent of the customer, use excess customer funds from one separate account to meet any obligations in another separate account.

(2) The authority of a futures commission merchant to exercise the privileges described in paragraph (f)(1) of this section with respect to any customer will be deemed to terminate immediately in the event that:

(i) The customer has instituted, or has had instituted against it, a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors' rights; or

(ii) The futures commission merchant is not otherwise in compliance with paragraph (b) of this section.

(3) A futures commission that intends to enter into agreements of the type authorized by paragraph (f)(1) of this section with one or more of its customers must notify its designated self-regulatory organization promptly after entering into the first such agreement.

(4) The Commission or any self-regulatory organization with authority over the futures commission merchant may, for cause and in accordance with the rules of the Commission or such self-regulatory organization, as applicable, direct the futures commission merchant to cease exercising the privileges described in paragraph (f)(1) of this section.