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 – Proposed Amendments to Commission Rule 1.11 and 1.56

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. ("**ICUS**" and together with FIA, the "**Petitioners**"), respectfully submit this petition for rulemaking ("**Petition**") under Commission Rule 13.1.[2] This Petition seeks to amend Commission Rule 1.56[3] and Rule 1.11[4] to expressly permit allocated asset

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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 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."

3 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).

4 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).

recourse provisions in agreements between customers and FCMs under certain circumstances, including compliance with heightened risk management procedures ("**Proposed Amendment**").[5] As explained in detail below, adoption of the Proposed Amendment would significantly enhance customer protection, clarify current industry practice and increase stability in the derivatives markets.[6]

Background

Every trading day, millions of Americans access the derivatives markets through accounts managed by fiduciaries: pension funds, mutual funds, retirement and health plans, 401k plan investment options, and other managed investments. These investors rely on fiduciaries to appropriately invest their assets for their financial security. In turn, the fiduciaries may allocate specific, dollar-limited portions of their beneficiaries' assets to investment managers pursuant to investment management agreements ("**IMAs**" and such allocated funds, "**Assets Under Management**" or **"AUM"**) and investment guidelines designed to achieve returns while prudently managing investment risk. These allocations represent a significant portion of derivatives markets activity and are, therefore, important to the efficient operation of the market.

For decades, a predominant method of handling this arrangement has been contractual agreements between FCMs and investment managers that provide that, in the event of a default, the FCM has recourse to a subset of the customer's assets represented to the FCM and updated from time to time, including all of the assets allocated to that investment manager on behalf of an institutional customer (such arrangements, "**Allocated Asset Recourse**" or "**AAR**"). These contractual arrangements implement the customers' defined trading mandates that enable millions of American pensioners, retirees, and health care beneficiaries to reap the benefits of using futures to manage risk.

Allocated Asset Recourse provisions generally provide that the FCM's recourse in the event of a customer's default shall be limited to the customer assets allocated to and under management by the investment manager in its capacity as agent with authority to invest and trade on behalf of the institutional customer.[7] AAR contractual arrangements allow FCMs to carry managed accounts

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5 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 Amendment requested by this Petition is to expressly permit allocated asset recourse provisions in agreements between customers and FCMs under certain circumstances, including compliance with heightened risk management procedures. 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, to codify, with certain exceptions, the terms and conditions set out in CFTC Letter No. 19-17. We have separated the proposals to assure the Commission flexibility in its consideration of each.

6 References to the derivatives markets throughout this Petition are intended to encompass all types of derivatives products, including cleared over-the-counter derivatives as well as standardized futures and options on futures contracts.

7 Although there is no single, standard form of Allocated Asset Recourse, contract terms between an FCM and an investment manager representative of this approach are as follows:

for institutional customers. These institutional customers are generally restricted by their fiduciary obligations to their beneficiaries from exposing the entirety of their beneficiaries' assets to investment risk. Accordingly, such institutional customers generally engage multiple managers or engage a single manager to implement different strategies. To meet their own fiduciary obligations, these institutional customers may enter into IMAs that contain provisions that restrict the managers to trade (and expose to market risk) only the assets specifically allocated to the manager or strategy described in the related IMA. This is intended to prevent losses from exceeding the amount of the allocation to the investment manager. AAR provisions in FCM customer agreements allow investment managers operating under such constraints to enter the derivatives markets on behalf of their institutional customers (and the individual beneficiaries of those institutional customers) in a way that would not be possible if the agreements with FCMs provided for unlimited recourse to their institutional customers' assets (because such agreements would violate the asset owners' fiduciary obligations to those ultimate beneficiaries).

In short, AAR provisions have been a foundational component of the arrangement that allows a large segment of the investing public to access the derivatives markets, while protecting those customers' other assets. However, recent pronouncements by the Joint Audit Committee ("**JAC**") undermine that foundation.

In May 2019, the JAC issued Regulatory Alert 19-03, CFTC Regulation 1.56(b) – Prohibition of Guarantee against Loss ("**Alert 19-03**"). Alert 19-03 states that AAR clauses "are not in compliance with industry regulations and are not permitted in any agreement between an FCM and its customers and noncustomers." "For clarity," Alert 19-03 continues, "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 Division of Clearing and Risk ("**DCR**") and the Division of Swap Dealer and Intermediary Oversight ("**DSIO**" and, together with DCR, the "**Divisions**") dated June 26, 2019, FIA requested relief from aspects of Alert 19-03 (and an accompanying Alert 19-02, addressed in a separate Petition filed concurrently herewith), explaining that the policies set out in the Alerts had a direct and adverse effect on the ability of FCMs to maintain separate accounts for the benefit

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> FCM acknowledges and agrees that with respect to each Customer listed on Schedule A to the Agreement (as may be amended from time to time) (i) the Advisor is entering into this Agreement solely as agent on behalf of such Customer and (ii) only the assets under management by the Advisor of each such Customer listed on Schedule A, and neither the assets of the Advisor nor the assets under management of any other Customer, shall be available to meet such Customer's obligations under this Agreement. No resort to or claim upon the assets of any other Customer or the Advisor shall be made with respect to the obligations of such Customer. Nothing in this Section [__] shall be construed as a representation by the FCM that, with respect to any transaction by a Customer in any Account, FCM will (A) guarantee such Customer or such Account against loss; (B) limit the loss of such Customer or Account; or (C) not call for or attempt to collect from the Customer initial and maintenance margin as established under the rules of any applicable Exchange.

of their institutional customers.[8] In response, on July 10, 2019, the Divisions issued CFTC Letter No. 19-17, in which the Divisions expressed the view 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."

While well-intentioned, the positions expressed in Alert 19-03 and CFTC Letter No. 19-17 are in tension with inescapable market realities. Participation by institutional customers in the derivatives markets has long depended on the prudent use of AAR investment arrangements, and that longstanding reliance cannot be reversed through negotiations between FCMs and their customers, or advice from professional advisors. It follows that enforcement of the JAC's interpretation of Rule 1.56 would have significant adverse effects on FCMs, their customers, and the derivatives marketplace, and result in outcomes that are inconsistent with the goals of customer protection and risk management that Rule 1.56 was designed to achieve.

By this Petition, the Petitioners respectfully request that the Commission (i) modify Rule 1.56 to expressly authorize AAR arrangements, subject to certain conditions, and (ii) modify Rule 1.11 to strengthen risk management controls around AAR arrangements.

Basis for Petition

Rule 1.56(b) prohibits an FCM from representing that it will, with respect to any commodity interest in any account carried by the FCM for or on behalf of any person: (i) guarantee such person against loss; (ii) limit the loss of such person; or (iii) not call for or attempt to collect initial and maintenance margin as established by the rules of the applicable board of trade.

Although it is our position that AAR provisions do not violate Rule 1.56(b),[9] in light of the interpretations of Rule 1.56(b) in Alert 19-03 and CFTC Letter No. 19-17, we urge the Commission to modify the language of Rule 1.56 (and Rule 1.11) to clarify that AAR provisions do not violate Rule 1.56, and to expressly authorize such arrangements, subject to certain conditions.

The Proposed Amendment is consistent with the longstanding policy objectives underlying Rule 1.56. The Commission originally proposed Rule 1.56 following the bankruptcy of an FCM (Incomco, Inc.) that had marketed guarantees against loss to its customers. The Commission noted that firms offering similar guarantees frequently engaged in patterns of fraudulent conduct (including charging "management" or "reserve" fees, often amounting to multiples of a customer's original investment) and that these firms tended to be in a "financially weakened condition."[10]

[8] *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 June 26, 2019

[9] Simply put, AAR is not a guarantee against loss or an undertaking to limit the loss of a customer. *See, e.g.*, note 6, *supra*. Rather, AAR is simply the contractual acknowledgment by the FCM of the constraints under which managed accounts of institutional asset owners operate.

[10] *See* 46 Fed. Reg. 11668, 11669-70 (Feb. 10, 1981).

While the concerns that motivated the adoption of Rule 1.56(b) may well have been valid more than thirty years ago, the enhancements to the customer funds protection regime that have subsequently been adopted—including enhanced segregated, secured amount and cleared swaps collateral reporting and residual interest transparency and risk-based amendments to the minimum capital requirements—render those concerns largely academic in the today's highly-regulated marketplace.

As the Divisions noted in CFTC Letter No. 19-17, the Commission's regulations concerning the protection of customer funds now extend far beyond Rule 1.56. For instance, Rule 1.11 requires FCMs to develop and maintain specific risk management policies and procedures involving, among other things, the segregation and handling of customer funds; 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; 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; and Part 39 of the Commission's rules establish risk management requirements for derivatives clearing organizations ("**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.

FCMs today operate within a strong regulatory framework and are subject to both internal and external oversight. Prior to entering into an AAR arrangement with an institutional customer, an FCM may, among other things: (i) perform a credit evaluation of the institutional customer that takes into account, among other factors, that institutional customer's allocation of assets to the manager; (ii) evaluate the asset manager's trading strategy for the institutional customer; (iii) determine the appropriate margin level for the institutional customer in light of the risk presented by the foregoing; and (iv) establish risk limits for the account, consistent with its obligations under CFTC Rules 1.11 and 1.73, that are informed by this diligence process. Once the account is opened, the typical FCM will monitor trading in the account, including by means of daily stress testing, to confirm that the exposure presented by the account remains within the prescribed risk limits and that the account is being appropriately managed in light of the account's margin level and its credit profile. An FCM may periodically modify its risk management policies as to each institutional customer.

All of these practices are subject to internal and external oversight. CFTC Rule 1.11 establishes a risk management program with which FCMs must comply and which limits the risk FCMs may undertake. And FCMs are closely monitored and audited by their designated self-regulatory organizations (as well as by Commission staff). Recognizing the critical role that AAR arrangements play in facilitating participation of institutional asset owners in the derivatives markets does not create additional risks to FCMs that they are not well equipped to manage and their regulators to oversee and monitor.

Moreover, AAR arrangements are distinguishable from the practices that the CFTC was concerned about when adopting Rule 1.56. The proposing release to Rule 1.56 describes concerns about FCMs expressly agreeing not to call for additional margin to attract business, and notes that those practices were often targeted toward less sophisticated customers. In contrast, AAR provisions are typically sought by highly sophisticated market participants and often stem from existing asset allocations and account structures associated with those firms. Moreover, AAR provisions do not typically provide that the FCM will not call for additional margin. Rather the FCM typically has the authority to call for and collect any margin that is due on any positions, and will exercise its authority to call for such margin and close out accounts that fail to satisfy margin requirements. It is ultimately the aforementioned asset allocations and account structures, rather than AAR provisions, which dictate the result that such calls will be met from assets under the authority of a particular manager. When implemented under appropriate risk management procedures that limit the FCM's exposure by taking account of those constraints, they pose no risk to the FCM that it is incapable of managing, while enabling those institutional asset owners to participate in the derivatives markets.

Failure to adopt the Proposed Amendment, which would clarify the requirements of Rule 1.56 in the wake of Alert 19-03, would have profoundly adverse consequences for both FCMs and their institutional customers. Institutional asset owners, constrained by their fiduciary duties to their ultimate beneficiaries may not be able to accede to an FCM's "ultimate right" to look to funds in the beneficial owner's other accounts. Indeed it is possible that such asset owners may exit the derivatives markets and seek alternative risk management instruments in markets not subject to the CFTC's jurisdiction. Alternatively, they may continue to participate in derivatives markets, but through thinly capitalized special purpose vehicles corresponding to limited trading mandates. In the absence of the Proposed Amendments, the risk to derivatives markets structure is clear: some of the market's best credits may become its worst or leave entirely, and in that event, market liquidity and depth will contract. This stands to increase, not decrease, FCM counterparty risk and make derivatives markets less resilient, and less able to withstand financial crisis.

Institutional asset owners (*e.g.*, pension plans, mutual funds and municipalities) trading through institutional asset managers represent, on average, 25% of the holdings in the top 10 U.S.-listed futures contracts (based on COT reports of open interest in equity index and interest rate futures); in certain contracts, that figure is 40% or higher. AAR arrangements are the foundation on which that institutional market is built, and prohibiting them potentially impacts millions of investors and beneficiaries who currently depend on access to the derivatives markets to manage risk in investment portfolios that constitute a major part of America's retirement and other savings.

Lastly, authorizing AAR arrangements between FCMs and their customers under certain circumstances would be consistent with general practices beyond the derivatives marketplace. AAR is common to financial contracts (ISDAs, option agreements and securities agreements such as GMRAs and PB agreements), and are consistent with the parallel SEC rules which, like Rule 1.56, preclude guarantees against loss. Accordingly, making clear that such arrangements are permitted in the derivatives markets would generate certainty and consistency across financial contracts.

The Proposed Amendment

Revised Rule 1.56

Revised Rule 1.56 would expressly authorize AAR provisions under certain circumstances where such arrangements are appropriate and necessary in light of applicable fiduciary and other legal constraints on an institutional customer.

There are two circumstances where institutional customers are legally or contractually constrained from entering into contractual arrangements that could result in unlimited recourse:

- The first is where institutional asset owners, such as a pension fund or mutual fund (aggregating the interests and investment of millions of retail investors), allocate a specific limited subset of their capital subject to a specific investment mandate to investment managers pursuant to IMAs. The IMAs contractually obligate each investment manager to invest the institutional customer's AUM in accordance with an agreed trading strategy limited solely to the AUM. Such trading is independent of the trading that may be undertaken for the institutional customer by the same or other investment managers acting on behalf of other accounts of such customer with respect to other AUM allocations.

- The second is where commercial enterprises such as agricultural producers or petroleum refiners obtain financing from a lender that may, in connection with such financing, require the commercial enterprise to hedge the transaction. Such a hedging position is independent of the customer's general futures trading and specific only to the financing transaction.

In both circumstances, the AAR arrangement is integral to the contractual arrangements between the parties. As noted, institutional customers are operated by fiduciaries with investment mandates that constrain them from exposing the assets they manage to unlimited risk. Accordingly, institutional customers typically enter into IMAs with asset managers that restrict the asset managers' authority to the AUM. Recognizing the reality of asset managers' legal and contractual constraints, FCM customer agreements with institutional customers often mirror the restrictions set forth in IMAs and, to that end, may contain terms that limit the FCM's recourse to the assets under management by an asset manager for such customers.[11]

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[11] In the case of a margin financing arrangement, for example, 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 entity 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. Similarly, the lender does not expect that the FCM would have a legal right use the assets held in the hedge account to meet the customer's obligations in other accounts. The agreements among the lender, the customer and the customer's FCM would confirm these expectations and limitations.

The commercial entities and institutional customers described above generally use the exchange-traded markets to hedge or otherwise manage the risks of their cash market activities (a fundamental purpose of the markets). Further, they are a source of significant liquidity from which all market participants benefit. Therefore, it is imperative to ensure they are not excluded entirely from the derivatives markets. Revised Rule 1.56 provides appropriate relief from any perceived restrictions of Rule 1.56, subject to appropriate terms and conditions.

Revised Rule 1.11

To further ensure that FCMs adopt appropriate risk management policies and procedures to protect FCMs and their customers from the potential risks of maintaining separate accounts, the Proposed Amendment includes revisions to Rule 1.11 in addition to Rule 1.56. Under the terms of the Proposed Amendment, an FCM that wishes to enter into Allocated Asset Recourse agreements with commercial participants and/or institutional customers must supplement their risk management policies and procedures to:

- evaluate the credit risk of each such customer, taking into account asset allocation levels provided by a commercial participant and/or institutional customer, which may be referenced in any relevant documentation with or relating to such customer (including without limitation any investment management agreement entered into by such customer with a person authorized to control trading in such customer's accounts);

- establish risk limits and margin requirements with respect to such customer that take into account the effect of such asset allocation levels, as such levels may be updated from time to time by an investment manager or institutional customer; and

- periodically monitor allocation levels applicable to such institutional customers by reviewing asset allocation levels provided by investment managers and/or institutional customers and appropriately confirming and updating risk limits and required margin amounts based on any fluctuation in such asset allocation levels.

By amending Rule 1.56 as proposed and supplementing the risk management policies of FCMs that participate in AAR arrangements with the proposed revisions to Rule 1.11, the Proposed Amendment enhances FCM risk management practices. Unlike a blanket ban on Allocated Asset Recourse provisions, the approach reflected in the Proposed Amendment recognizes the existing practical realities faced by market participants, and advances the objectives underlying Rules 1.56 and 1.11 by ultimately maximizing customer protection and limiting systemic risk.

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 Hehessy
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) A futures commission merchant that has contracted on a limited recourse basis as described in §1.56(f) of this chapter, must enhance its Risk Management Program to account for the additional risks of such contractual provisions. Specifically, the futures commission merchant must have written policies and procedures that require, at a minimum:

(i) evaluating the credit risk of such customer, taking into account asset allocation levels referenced in any relevant documentation with or relating to such customer (including without limitation any investment management agreement entered into by such customer with a person authorized to control trading in such customer's accounts);

(ii) establishing risk limits with respect to such customer that take into account the effect of such asset allocation levels, as such levels may be updated from time to time by an investment manager or customer; and

(iii) periodically monitoring allocation levels applicable to such customer and appropriately confirming and updating risk limits and required margin amounts based on any fluctuation in such asset allocation levels.

§1.56 Prohibition of guarantees against loss.

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

(f) Subject to §1.11 of this Chapter, nothing in this section shall prevent a futures commission merchant from entering in to an agreement with a customer that limits recourse to the assets under management by a person whom such customer has authorized to control trading in its account, where such limitations derive from and correspond to the legal or contractual constraints on such person's scope of authority for such customer.

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) A futures commission merchant that has contracted on a limited recourse basis as described in §1.56(f) of this chapter, must enhance its Risk Management Program to account for the additional risks of such contractual provisions. Specifically, the futures commission merchant must have written policies and procedures that require, at a minimum:

(i) evaluating the credit risk of such customer, taking into account asset allocation levels referenced in any relevant documentation with or relating to such customer (including without limitation any investment management agreement entered into by such customer with a person authorized to control trading in such customer's accounts);

(ii) establishing risk limits with respect to such customer that take into account the effect of such asset allocation levels, as such levels may be updated from time to time by an investment manager or the customer; and

(iii) periodically monitoring allocation levels applicable to such customer and appropriately confirming and updating risk limits and required margin amounts based on any fluctuation in such asset allocation levels.

(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) Subject to §1.11 of this Chapter, nothing in this section shall prevent a futures commission merchant from entering in to an agreement with a customer that limits recourse to the assets under management by a person whom such customer has authorized to control trading in its account, where such limitations derive from and correspond to the legal or contractual constraints on such person's scope of authority for such customer.