PANEL ON WHAT ALL LEGAL AND COMPLIANCE PERSON SHOULD KNOW

FIA LAW & COMPLIANCE CONFERENCE

APRIL 16, 2026

PAPER BY PROFESSOR RONALD FILLER

I have taught a course on Futures/Derivatives Law at five different U.S. law schools between 1977 and 2025, a period that covers 48 years, and have spoken at all 49 FIA Law & Compliance Conferences. I have also been honored to serve as a member of several regulatory boards and advisory committees over these years, including serving as a Public Director on the NFA's Board (2010 to Present), on several exchange and clearinghouse boards, and as a Past Chair of the CFTC's Global Markets Advisory Committee. This paper will reflect my views and observations over these past 50 years.

The applicable law, as we all know, is the Commodity Exchange Act ("CEA"), 7 USC 1 *et seq*. This law was established by Congress in 1936 during the New Deal legislation put forth by President Franklin D. Roosevelt. The 1936 legislative changes created the concept of "customer segregation," which is still the bedrock of the most important customer protection that still exists today. There were other minor legislative changes over the next 38 years but what we know now as the CEA was first created by the Commodity Futures Trading Commission Act of 1974 which not only established the Commodity Futures Trading Commission ("CFTC") but also overhauled the CEA by granting the CFTC exclusive jurisdiction over all contracts in a commodity interest for future delivery.

Prior to the 1974 Amendments to the CEA, only the so-called nine legacy contracts, i.e., the traditional agricultural futures contracts (corn, wheat, soybeans, etc.) were subject to the provisions underlying the CEA. Thus, if a customer wanted to trade any futures contract, other than these legacy contracts, such as gold, silver, the foreign currencies, coffee, sugar, cocoa, etc., the customer would have had to open a non-regulated account at his/her futures commission merchant ("FCM"). The customer segregated provisions did not apply to these non-regulated accounts nor did the CEA nor did any governmental agency have any jurisdiction over these non-regulated accounts. The only real "regulator" then were the futures exchanges on which these non-regulated futures contracts were traded. Hence, the industry then was, in essence, a cowboy model, with very little to no regulations and no law that applied to all futures contracts then traded. This all changed in 1974. Since 1974, there have been other amendments to the CEA, with the biggest legislative changes occurring with the Commodity Futures Modernization Act of 2000 and the Dodd-Frank Act in July 2010.

In teaching these courses, I have always talked about two major categories of regulations, one set protecting the markets and one set protecting the customers/end users of the U.S. futures markets. As to the concept of market fraud or abuses, we have always taken the view that the U.S. markets are open to anyone, provided that they play the game to comply with all applicable laws and regulations. And if you do not, you are subject to civil enforcement actions or even criminal actions. These market abuse themes are also enforced by the respective exchange on which the futures products are traded. However, the heart and soul of the U.S. regulatory scheme is its customer protection model, that is, we must protect all end users of the futures markets against all evil things and actions. To protect the customers, I have always told my students that there were six basic regulatory concepts, namely:

1. Registration – is the firm or person required to be registered in a particular category with the CFTC? If so, then the other five categories of regulations may come into play. They are:

2. Do the net capital rules under CFTC Rule 1.17 apply to that firm, or not?

3. What risk disclosures must be provided by the firm to its customers?

4. What records must be kept by that firm and for how long?

5. What type of reports must be provided to regulators and to the customers of that firm?

6. What customer asset protections exist to protect the customers from any potential fraud committed by that firm with respect to acting as a custodian of the assets deposited by the customer with the firm?

I. GENERAL CONCEPTS

A futures contract is a contractual obligation on the part of the purchaser (the "long") to buy a stated amount of a commodity from the seller of a commodity (the "short"). That transaction must be conducted through a commodity exchange regulated by the CFTC as a "designated contract market." (DCM) [7 U.S.C. § 6].

The long trader agrees to take delivery under a futures contract at a future date and at a location specified by the rules of the commodity exchange on which the futures contract is traded. Historically, the buyer, or long, was obligated to take delivery of the cash commodity. When delivery occurred, a negotiable instrument, such as a warehouse receipt or a vault receipt, was transferred between the parties to evidence ownership and delivery of the underlying cash commodity.

The seller in this arrangement incurs a reciprocal obligation to deliver the commodity at the specified date and agreed upon price. In fact, the seller initiates all deliveries that occur on a futures exchange.

Commodity futures contracts are available in a number of standardized delivery months set by the exchange for the commodity being traded.

Another form of derivative contract is the "option." A "call" option contract gives the purchaser the contractual right, but not the obligation, to buy something at a specified price for a specified period of time. This is referred to as a "call" option because it gives you the right to "call" (buy) the commodity away from the seller of the option.

In contrast, a "put" option allows the purchaser to "put" (sell) the commodity to the seller of the option at an agreed upon price for a specified period of time. This means that, if the price of the underlying commodity declines, the seller of the put option must pay the buyer the higher price agreed to in the put option contract (the "strike price").

The purchaser of a put or call option, who is also called the "holder" or "buyer," will pay a "premium" to the seller of the option, who is also called the "grantor" or "writer" of the option.

That premium payment is paid to the seller of the option for accepting the contractual obligation to deliver the stock in the event that the purchaser calls for the stock or pays for the securities if the purchaser puts the actual "cash" commodity underlying the option.

The premium will be valued on the basis of the expected risks from the option that is based on the perceived price volatility of the option and the remaining time of the option's life, i.e., the time value. This means that the premium on a long-term option on a volatile underlying commodity will normally be greater than the premium for a shorter term option on a less volatile commodity.

In an "American" option, the long may exercise the option at any time before the expiration date of the option. In contrast, "Bermuda" and "European" options restrict the dates on which the option may be exercised, such as limiting exercise to the expiration date. European options contemplate a cash settlement.

Like futures contracts, the terms of commodity options traded on an exchange are standardized. As is also the case for futures contracts, exchange traded option contracts are generally liquidated by offset, rather than through the exercise of the option and the delivery of the underlying commodity.

And, finally, we now have swaps as a result of the Dodd Frank Act enacted into law in July 2010. Prior to that, swaps were exempt from the CEA and the federal securities laws as a result of the CFMA of 2000. Congress did give some jurisdictional authority to the SEC if the underlying swap met the definition of a security-based swap. However, it's the CFTC that has, from the beginning, taken the more aggressive approach to regulating swaps.

Futures contracts, options on futures contracts and swaps all fall within the definition of a "commodity interest." A financial product that meets the definition on of a commodity interest and is for "future" delivery becomes subject to the jurisdiction of the CFTC.

II. THE 1974 AMENDMENTS TO THE CEA

In 1974, after extensive hearings and deliberation, Congress enacted the Commodity Futures Trading Commission Act of 1974. 88 Stat. 1389. Like the 1936 and the 1968 legislation, the 1974 enactment was an amendment to the existing statute that broadened its coverage and increased the penalties for violation of its provisions. The CFTC was authorized to seek injunctive relief, to alter or supplement a contract market's rules, and to direct a contract market to take whatever action deemed necessary by the CFTC in an emergency. The 1974 legislation retained the basic statutory prohibitions against fraudulent practices and price manipulation, as well as the authority to prescribe trading limits. The 1974 amendments, however, did make substantial changes in the statutory scheme; Congress authorized a newly created CFTC to assume the powers previously exercised by the Secretary of Agriculture, as well as certain additional powers. The enactment also added two new remedial provisions for the protection of individual traders. The newly enacted § 5a(11) required every contract market to provide an arbitration procedure for the settlement of traders' claims of no more than $15,000. And the newly enacted § 14 authorized the CFTC to grant reparations to any person complaining of any violation of the CEA, or its implementing regulations, committed by any futures commission merchant or any associate thereof, floor broker, commodity trading adviser, or commodity pool operator. This section authorized the CFTC to investigate complaints and, "if in its opinion the facts warrant such action," to afford a hearing before an administrative law judge. Reparations orders entered by the CFTC are subject to judicial review.

III. CONTRACT MARKET REGULATION

The CEA requires all futures contracts to be traded on a "contract market" designated as such by the CFTC. These "Designated Contract Markets" (DCMs) are also commonly called "boards of trade" or simply "futures exchanges." These exchanges are membership organizations through which their members trade.

Part 38 of the CFTC's regulations [17 C.F.R. Part 38] sets forth the requirements for an exchange to become a registered DCM. Futures contracts cannot be traded on an exchange without such registration.

Appendix A to Part 38 of the CFTC's regulations [17 C.F.R. Part 38] includes a Form DCM, which provides instructions and a list of necessary information and documentation that a DCM must submit to the CFTC to initiate the designation process.

Among other things, as a part of its self-regulatory obligations, exchanges seeking DCM status must have their own set of regulations governing all aspects of the exchange's trading, clearing and membership obligations and must make sure that their members and member firms comply with its regulatory structure. Among the documents required for the DCM application is a set of the exchange's proposed rules that will govern trading.

In addition, with respect to each futures contract to be traded on the DCM, proof must be provided by the applicant showing that that the respective futures contract will be traded in a manner that satisfies the twenty-three core principles added to the CEA by the Commodity Futures Modernization Act of 2000 (CFMA).

IV. FINANCIAL REGULATION

Financial regulations typically fall into one of two categories, namely, whether they are "principles-based," meaning that they take a broader, more macro approach, or are "prescriptive-based," meaning that they are quite specific and detailed in nature.

Historically, most federal regulations involving derivatives have been prescriptive-based in nature. The underlying regulations provide specific requirements or guidelines as to how a registrant must comply with the respective regulation.

More recently, financial regulators have utilized more the concept of "principles-based" regulation in adopting new rules, to take into consideration the ever-changing financial products that are traded on exchanges. In other words, as Moses did on Mount Sinai, they believe that a Ten Commandments approach, such as "thou shall not commit fraud," may be the preferred regulatory model rather than being specific as to what constitutes fraud.

The best example of this principles-based regulatory model are the twenty-three core principles, which are outlined below, that were adopted by the CFMA in 2000.

In contrast, stock exchanges, which are regulated by the SEC, do not have similar core principles regarding their rules or rule amendments. Therefore, each stock exchange may only adopt a new rule or amend an existing rule through a request for approval by the SEC. This more formal rule approval process has placed stock exchanges at a competitive disadvantage to DCMs when both stock exchanges and DCMs are offering products that compare favorably from an economic equivalent perspective.

Prescriptive-based regulations used by both the SEC and CFTC should be distinguished from the “prudential” regulatory approach of the banking regulators. The SEC and CFTC seek to regulate through high profile court or administrative cases that draw big headlines and involve large fines. In contrast, bank regulators prefer to work quietly with the banks they regulate. Bank regulators use their discretion in discouraging banks from engaging in unsafe and unsound practices that might affect the financial stability of a bank.

It is difficult to judge which regulatory model is preferable, since they both failed in the run up to the Financial Crisis in 2008. It is clear, however, that financial institutions have become milk cows for prescriptive-based regulators. Hardly a day goes by without an announcement in the news of another massive settlement in a regulatory action against a large financial institution by one regulator or another.

As noted above, the CFMA added twenty-three core principles to the regulation of DCMs and clearinghouses, also known as “designated clearing organizations” (DCOs). They are set forth in detail in Part 38 of the CFTC’s regulations [see also, 7 U.S.C. § 7]. To maintain its designation as a DCM, the exchange must comply, on both an initial and ongoing basis, with these core principles. They are:

1. To be a DCM
2. Compliance with Rules
3. Contracts Not Readily Subject to Manipulation
4. Prevention of Market Disruption
5. Position Limitations and Accountability
6. Emergency Authority
7. Availability of General Information
8. Daily Publication of Trading Information
9. Execution of Transactions
10. Trade Information
11. Financial Integrity of Transactions
12. Protection of Markets and Market Participants
13. Disciplinary Procedures
14. Dispute Resolution
15. Governance Fitness Standards

16. Conflicts of Interest
17. Composition of Governing Boards of Contract Markets
18. Recordkeeping
19. Antitrust Considerations
20. System Safeguards
21. Financial Resources
22. Diversity of Boards of Directors
23. SEC swaps reporting and inspection

These core principles provide invaluable flexibility to DCMs. The futures exchange thus merely needs to certify that any new rule or rule amendment satisfies these core principles. Each new product traded on the DCM constitutes a new exchange rule. Therefore, futures exchanges can easily add a new futures contract to be traded on the exchange through this rule certification process, without a prior economic review by the CFTC. Previously, such reviews by the CFTC were required and often led to considerable delay and expense in introducing new products.

Since this “core principles” model does not exist in the securities industry, stock exchanges, such as the Chicago Board of Options Exchange (CBOE), must submit any new rule or rule amendment, including any new product to be traded, to the SEC for review and approval. This review and approval process can take months to complete. As noted above, this puts stock exchanges at a competitive disadvantage to their futures exchanges’ counterparts.

Each futures contract traded on a DCM must be cleared through a derivatives clearing organization (DCO), commonly referred to as a clearinghouse or central counterparty (CCP). Each DCO, like a DCM, must be approved by and registered with the CFTC [7 U.S.C. § 7a–1]. A DCO must meet certain core principles, including governance standards, system safeguards, default procedures, treatment of customer funds, settlement procedures, risk management and financial resources. [7 U.S.C. § 7a–1(c)].

V. MARGIN

"Margin" for futures contracts is such a strange and complex term. Whoever first called minimum exchange-traded futures deposits "margin" should be shot in my opinion as it has created much confusion over the past many years. The term "margin" for futures, which implies a performance bond or surety bond concept, is entirely different from the term "margin" for securities, which reflects a stock loan arrangement. I will try and explain the concept of margin, and its purpose, in this column.

The Board of Governors of the Federal Reserve System ("FED") has adopted Regulation T ("Reg. T") which states, in essence, that a broker-dealer may not lend its customers more than 50%, nor extend credit in an amount greater than 50%, of the value of the securities acquired in a securities account. Reg. T thus governs the amount of margin that a broker-dealer must collect and maintain in the customer's securities account whenever securities are bought or sold short. It also governs the amount of customer funds that may be withdrawn if that customer has opened a margin account with that broker-dealer.

These so-called margin accounts are also governed by securities SROs, such as the New York Stock Exchange ("NYSE"). NYSE Rule 431 [now superseded by FINRA Rule 4210], in particular, establishes a minimum maintenance margin requirement of 25% for long positions and 30% for short positions held in the underlying margin account.

Accordingly, margin in a securities account, in essence, reflects a loan arrangement between the broker-dealer and the customer, the amount of the loan being the difference between the respective stock purchase amount and the current equity value in the account. This is real debt that is incurred. For example, if Customer A buys 100 shares of XYZ stock @ $50.00 per share, Customer A would need to deposit a minimum of $2,500.00 with the broker-dealer and borrow the balance.

Pursuant to the standard Stock Margin Agreement, if the customer does not maintain the minimum maintenance margin requirements established by that broker-dealer for its margin account, then the broker-dealer may take certain actions against the customer, including the liquidation of some or all of the open securities positions in the margin account which, in effect, transforms the equity in the margin account to cash. The customer is nevertheless liable for any outstanding indebtedness still owed by that customer to the broker-dealer following such liquidation or close-out. So, even though the concept of "margin" is so dramatically different between a futures account and a securities margin account, this concept of permissible actions that may be taken by a broker-dealer or futures commission merchant ("FCM") is a constant, as explained below. In futures, margin takes on a different meaning.

Margin, or "initial margin" ("IM") as it is often called in the futures arena, reflects a performance bond or surety bond, whereby the customer of an FCM agrees, pursuant to the Futures Customer Agreement, to deposit and maintain, at all times, the initial margin required by the FCM for that customer's account, that is, the customer agrees to perform by maintaining the required amount of equity in his/her futures account at the FCM. Typically, for most large institutional futures customers, the IM requirement represents the minimum margin requirement set by the respective exchange for that particular futures product but the FCM may, pursuant to the Futures Customer Agreement, reserve the contractual right to require the futures customer to maintain an amount of initial margin greater (but never lower) than the minimum amount set by the exchange. As in a securities margin account, the futures customer must maintain an amount of equity, often called the net liquidating value ("NLV"), in its account that equals or exceeds the initial margin requirements. And if a futures customer does not meet this minimum amount requirement each day, the FCM may exercise its contractual right by claiming that the customer's account has resulted in an Event of Default, as defined in the Futures Customer Agreement, and may thus liquidate any and all of the open futures positions.

With respect to futures, the amount of margin required by an exchange is normally calculated based on an historical price basis, typically a one day, two standard deviation methodology. This mathematical analysis rationalizes that the minimum margin requirement for that particular futures product should cover, historically, approximately 95% of the underlying price changes that occurred over a certain period of time, typically the past 30 to 60 days, depending on the formula used by that clearinghouse. FCMs may, or even should, evaluate their large futures customers in different light, applying a higher standard, such as a three day or even a five day, two or more standard deviation test, especially if such customers are engaged in a prime brokerage arrangement with that firm, as other products involved in the prime brokerage arrangement apply a different margin payment obligation.

VI. FUTURES COMMISSION MERCHANTS

Firms or persons that solicit or sell a financial product to the public must be registered in some capacity with a U.S. financial regulatory agency and become a member of one or more self-regulatory organizations (SROs).

The U.S. regulatory scheme is primarily driven by the financial product being sold to the customer. If the financial product constitutes a "security," then the firm that sells the security must be registered as a broker-dealer (BD) with the Securities and Exchange Commission (SEC) and be a member firm of the Financial Industry Regulatory Agency

(FINRA). The employee of that BD, who sells or solicits the security to the customer, must be registered as a securities registered representative (RR) and be a member of FINRA.

Similarly, if the financial product constitutes a futures contract, then the brokerage firm must register as a futures commission merchant (FCM) with the Commodity Futures Trading Commission (CFTC) and become a FCM Member Firm with the National Futures Association (NFA), the futures industry's equivalent to FINRA within the securities industry. The non-clerical employees of the FCM must be registered as Associated Persons (APs) with the CFTC and become an Associate Member of NFA. Each individual who registers in any capacity with the SEC or with the CFTC is also required to take certain fitness examinations.

Applicants seeking to become registered as a RR or as an AP must answer questions regarding his or her prior experiences, including whether the applicant has ever been sanctioned by a regulatory agency, whether the person has been convicted of any felony or certain misdemeanors and whether the person has filed for bankruptcy. If the applicant checks the "YES" box next to any of these questions, the applicant must provide background information regarding the reason for those adverse events. The NFA also requires applicants to be fingerprinted, and it conducts a background check on each applicant See, 7 U.S.C. § 12a (authorizing finger printing). Failure to answer the questions properly can lead to actions brought by FINRA or by the NFA against the applicant denying the application or subsequently withdrawing the application if it was originally granted before the NFA learned of the discrepancy.

If the applicant committed a crime that results in a statutory disqualification (e.g., a felony), then the application must be automatically denied. [7 U.S.C. § 12a]. The denied applicant may then appeal to the Membership Committee of the respective SRO. FYI – I currently serve on the Membership Committee of the NFA. Please keep in mind that both FINRA and NFA are membership organizations, and each can thus deny membership to any applicant who meets a statutory disqualification.

VII. NET CAPITAL REQUIREMEMNYS

To be registered as a BD or as an FCM, the firm must maintain a certain minimum amount of net capital. The applicable term is “adjusted net capital,” which means the amount of the Firm’s liquid current assets in excess of the Firm’s total liabilities. Unlike a company’s shareholder value accounting, the financial requirements for a BD and an FCM are much higher as all of its fixed assets and goodwill do not apply to this calculation.

Even current assets are reduced by a percentage “haircut” based on the riskiness of the current assets. For example, the market value discounts (or haircuts) range from .5 percent for government securities with maturities between three and six months to 6.0 percent for government securities with maturities over twenty-five years. See, SEC Rule 15c3–1 [17 C.F.R. § 240.15c3–1].

BDs are required to have an adjusted net capital equal to the greater of (a) $250,000 or (b) an amount based on one of two formulas. These two formulas are: (a) the Aggregate Indebtedness Standard, and (b) the Alternative Standard. Under the Aggregate Indebtedness Standard, the BD may not permit its aggregate indebtedness to all other persons to exceed 1500 percent of its net capital (800 percent during its first twelve months after commencing business as a BD). Under the Alternative Standard, the BD must maintain adjusted net capital in an amount that is the greater of (i) $250,000, or (ii) 2 percent of its aggregate debit items. See, SEC Rule 15c3–1 [240 C.F.R. § l 15c3-1]Aggregate indebtedness typically refers to the amount of stock loans that a BD provides to its customers.

FCMs are required to have an adjusted net capital equal to the greater of (a) $1,000,000 or (b) 8 percent of the risk-based margin amounts held at the FCM. See, CFTC Rule 1.17. [17 C.F.R. § 1.17]. See also “FCM Financial Data”, which can be found on the cover page of the CFTC website at: www.cftc.gov. This chart, updated monthly, provides important financial information on all FCMs, including, among other things, their adjusted net capital, the excess amount of their adjusted net capital and the amount of customer assets held by each FCM in their customer protected accounts.

Both BDs and FCM are subject to another test, commonly referred to as the “early warning” test. The early warning amount is a percentage above the minimum net capital requirements noted above. [17 C.F.R. § 1.12]. Therefore, the BD and the FCM must, as a practical matter, maintain adjusted net capital in excess of the early warning test

VIII. RISK DISLCOSURE REQUIREMENTS

Each BD and FCM has a duty to disclose material risks associated with any investment made by its respective customers. The amount and type of such disclosures vary depending upon the product being sold and the investment sophistication of the respective customer. If the customer is a high net worth individual, then less disclosure may be required. The decision to provide or not provide any such disclosures is based on a customer-by-customer analysis. This principle is best explained in FINRA Rule 2111 which requires the BD and the RR to determine that the customer is "suitable" for any recommendation or market strategy involving a security before making any such recommendation or providing any market strategy to that customer. However, there is no "suitability rule" in futures. Nevertheless, both the federal securities and NFA futures regulations require the BD and FCM to "know your customer" before opening any account with that customer.

The timing as to when to provide the disclosures varies for BDs and FCMs. For example, CFTC Rule 1.55 [17 C.F.R. § 1.55] requires the FCM to provide a Uniform Risk Disclosure Statement to the futures customer before the customer's futures account is opened. In contrast, various securities disclosures, such as prospectuses and stock option disclosures are required to be sent along with the confirmation (e.g., on a post-trade basis).

The degree of the disclosure requirement also varies depending on the background, experience and investment sophistication of the respective customer. Regulatory principles are designed to provide greater information to a "retail" customer than to a more sophisticated "institutional" customer. Unlike the retail customer, the institutional investor has sufficient assets to protect itself without government oversight. FINRA Rule 2111 now defines an "institutional account" as any firm or person who has more than $50,000,000 in asse

IX. RECORD-KEEPING REQUIREMENTS

Every firm registered either as a BD or as an FCM must maintain all records for a minimum period of five years. The first two years must be kept on premises and the prior three years may be kept at an offsite location [17 C.F.R. § 1.31]. Today, all such firms primarily maintain the required records on a computerized system. The records that must be kept include but are not limited to:

1. All customer account opening documents
2. All statements that have been sent to a customer including the Daily Confirmations and Monthly Statements
3. All correspondence between the Firm and its customers including but not limited to all written correspondence, emails, text messages and other electronic media
4. All complaints filed by any customer against the Firm or an Employee of the Firm
5. All orders and tickets that have been prepared including all electronic records
6. All reports that have been filed with any regulatory agency or exchange
7. All litigation matters filed against the Firm or any of its Employees relating to the Firm's business.

[See e.g., 17 C.F.R. § 1.35].

X. REPORTING OBLIGATIONS

Reporting obligations fall under two basic categories, that is, reports, such as Daily Confirmation Statements and Monthly Statements that must be provided to a customer and reports that must be provided to a regulator or an exchange. In today's electronic world, most customers receive their trade and account information online. Those reports that must be provided to a regulator, such as the Focus Report noted above but more importantly, reports relating to trade data, such as the Large Trader Reports for futures and swap data provided to a Swap Data Repository, provide critical information to a regulator carrying out its responsibilities to ensure that our markets are not being traded in any fraudulent manner.

XI. CUSTOMER ASSET PROTECTIONS

Customers often have excess margin funds (excess funds) in their commodity futures accounts that are not needed to margin their open commodity futures contracts. That excess arises for many reasons, such as the closing of futures trading positions, which frees up the funds that were used to margin those positions. A favorable gain from variation margin can also create excess funds.

Section 4d of the CEA [7 U.S.C. § 6d] requires all customer assets, including the excess commodity futures and commodity options customer funds, to be held in a specially segregated account until the customer authorizes the transfer of those funds to accounts that are not subject to CEA regulation (unregulated accounts).

A brokerage firm must maintain customer assets in compliance with applicable SEC and CFTC regulations. For broker-dealers, the applicable regulation is SEC Rule 15c3–3 [17 C.F.R. § 240.15c3–3]. For FCMs, the applicable CFTC regulations are CFTC Rule 1.20 et seq. [17 C.F.R. § 1.20 et seq.]; CFTC Rule 30.7 [17 C.F.R. § 30.7]; and CFTC Part 22 [17 C.F.R. Part 22].

Substantial financial safeguards and customer protections exist within the futures industry that are designed to protect customer funds in the event of an FCM bankruptcy. Assets held in a futures account at an FCM are protected and governed specifically by applicable laws and CFTC regulations that require the segregation of cash and collateral deposited by customers in conjunction with their futures trading. Pursuant to the CEA and applicable CFTC regulation, an FCM, must maintain its futures customer assets in at least two different types of customer fund accounts (e.g., segregated and secured amount accounts) and may use a third type (e.g., a non-regulated account), each of which have different priority rights in the event of the FCM's insolvency.

The four types of customer fund accounts used by an FCM are:

SEGREGATED FUNDS: The first such account, established pursuant to Section 4d(a) (2) of the CEA and CFTC Rule 1.20, is referred to as the "customer segregated funds account. " It holds the assets of *all customers* (U.S. and non-U.S.) deposited in conjunction with transactions on all *U.S. futures markets*. All customer assets are required to be held only in accounts maintained at custodial banks and other permitted financial institutions, including other FCMs and clearing houses that are registered with the CFTC as "derivatives clearing organizations" (DCOs). All customer segregated accounts are required to be clearly identified as segregated pursuant to CFTC Rule 1.20. These segregated funds are not permitted to be commingled with the FCM's proprietary funds or used to finance its futures or broker-dealer businesses. The amounts held in the segregated funds accounts are calculated daily as required by CFTC Rule 1.32, and the FCM must take immediate action in the unlikely event that there is ever a shortfall in its segregated funds accounts. This daily calculation must be completed by each FCM by not later than noon on the next business day. However, the customer segregated required amount needs to be in a good control location the night before. Otherwise, the FCMs deemed to be "under segregated", and, if the FCM is "under-segregated", this must be reported promptly to the CFTC and its respective DSRO. Given this same-day deposit requirement, most large FCMs will deposit a large amount of their own capital in the customer segregated account to ensure that such accounts are never "under-segregated." This capital infusion can amount to several hundred million dollars, depending on the total amount held in the segregation pool.

SECURED AMOUNT FUNDS: The second type of account, governed by CFTC Rule 30.7, is known as the "customer secured amount account" and holds the assets of *U.S. residents* deposited in conjunction with their transactions on *non-U.S. futures markets*. These funds are also required to be held in accounts at banks and other permitted financial institutions, including non-U.S. clearing houses and members of non-U.S. exchanges, provided such non-U.S. clearing houses and non-U.S. member firms are deemed to be a "good secured" location. Like segregated funds, secured amount funds are not permitted to be commingled with the FCM's proprietary assets and are calculated daily and represent 100 percent of that day's customer requirements. FCMs are permitted to secure more than the minimum requirement stated above and can elect to deposit all funds used to trade on non-U.S. markets by all of its clients, including foreign domiciled clients. Like segregated funds as noted above, the calculation for the secured amount requirements must be completed by the following morning but the secured amount requirement must be deposited in a good secured location the night before or the FCM will be deemed to be in default. As noted above with customer segregated accounts, most large FCMs will also deposit their own capital in a secured amount account to prevent any under-funding from occurring

SWAP CLEARED FUNDS: This third type of account class was added by the Dodd Frank Act and requires that all customer funds used to margin a cleared swap must be maintained in separate account pursuant to Part 22 of the CFTC regulations, 17 CFR Part 22.

NON-REGULATED FUNDS: The fourth type of account, called the "Non-Regulated Customer Credit" calculation, contains the assets (cash and open trade equity) of *non-U.S. customers* deposited in conjunction with transactions on *non-U.S. futures markets* if such amounts are not included in the secured amount account as noted above. An FCM, also registered as a broker-dealer, may use this third account type, which is governed by Securities and Exchange Commission ("SEC") Rule 15c3–3. The amounts held in this account reflect the total of the credit balances calculated for each individual account owed by the FCM to its non-U.S. customers for transactions on *non-U.S.* futures markets less any deposits of cash or securities held with a clearing organization or correspondent clearing broker. Any amounts held in a non-regulated account are not covered by the provisions of the Securities Investor Protection Act (“SIPA”).

Each of the “buckets”, noted above, contains funds used by customers to margin the relevant futures products, with the difference being whether the futures products are traded on U.S. or non-U.S. futures markets and, for non-US markets only, whether the customer is a U.S. or a non-U.S. entity.

In addition to the segregation, secured amount requirements and cleared swap amount, CFTC regulations restrict where client funds may be placed. CFTC Rule 1.20 requires the FCM to maintain customer segregated funds, whether in the form of cash or collateral, either with a clearinghouse of a U.S. futures exchange registered with the CFTC as a DCO, in a customer segregated account with a bank or with another FCM. In connection with its custodial arrangement, the FCM must obtain what is known as a “segregation acknowledgement letter,” in which the respective custodial bank or FCM acknowledges and agrees that all assets deposited in this segregated account are for the sole benefit of the FCM’s futures customers and are not subject to the claims of any of the FCM’s creditors, including that bank or FCM, respectively.

Similar letters must also be obtained for the Rule 30.7 secured amount account, the cleared swap account and the Rule 15c3–3 non-regulated account at the respective custodial bank. All customer assets are therefore held at all times in these accounts at the respective custodial bank or FCM, in accounts at the various clearing houses or with other clearing brokers that act as clearing brokers on the various exchanges around the globe on behalf of the FCM.

An FCM is also required by CFTC regulations to properly account for and calculate on a daily basis both the amount that it is required to hold in segregation and the amount that actually is in its customer segregated accounts. Any deficiencies in the amounts required must be remedied and reported immediately to the appropriate regulators.

Most large FCMs deposit a substantial amount of their own capital in the customer segregated account to provide excess funds in the event a futures customer does not timely meet its margin requirements. This capital infusion may also be used to satisfy customer claims in the event of the FCM’s insolvency. It is referred to as the “residual interest. ”

In the event of the FCM's bankruptcy, futures customer assets are normally protected except as described below. First, assuming no material futures customer-related default exists or was the cause of the FCM's bankruptcy (e.g., the insolvency was the direct result of a non-futures customer or transaction), a bankruptcy filing should have no material impact on customers' assets held in the three aforementioned accounts. Under such circumstances, each account should contain 100% of the required amounts and should be transferred back to customers in an orderly fashion.

An FCM bankruptcy would be administered under Chapter 7 of the U.S. Bankruptcy Code, which contains specific provisions for the protection of customers in the event of an FCM's insolvency. Under Part 190 of the CFTC's rules, the bankruptcy trustee would have the responsibility of returning the custodies assets back to each futures customer. Creditors of the FCM's bankrupt estate would have no claim to any of the assets held in these three accounts. The assets would be held solely for the benefit of the FCM's futures customers.

If, on the other hand, the FCM's bankruptcy resulted from a futures customer's failure to deliver the required margin for its futures trading positions, and the default was greater than all of the shareholder equity of the FCM, then each of the three accounts held at the custodian bank (or an FCM) would be treated independently of each other. Customers' assets held in one of these three accounts may not be used to satisfy any shortfalls in another account (e.g., the amounts held in the segregated account at the respective custodial bank or at a DCO may not be used to cover a shortfall held in the non-regulated account). However, as noted in greater detail below, a clearing house, including a DCO, may apply a clearing member firm's customer assets that are on deposit with that respective clearing house to satisfy margin amounts owed to the clearing house by that clearing member firm (and that clearing member firm only) for its customer accounts. In other words, customer assets held by a clearing house may not be used to cover a shortfall in the FCM's "house" account nor may assets held at one clearing house be applied to cover a shortfall at another clearing house unless a cross-margining arrangement exists with respect to the two clearing houses.

The assets of an FCM's futures customers, which trade on the U.S. futures markets, are normally wired directly by those customers into the customer segregated account at the respective custodial bank. The custodian bank would typically maintain different segregated accounts to hold cash and any non-cash collateral, such as U.S. Treasury bills, respectively. This firewall between the bank and the FCM provides important protections to the FCM's futures customers. As noted above, the assets held in these accounts at the bank do not fall within the bankrupt estate and are reserved for payment to customers if the FCM files for bankruptcy. If the bank mishandles futures customers' assets held with the FCM, its full shareholder capital should stand behind the accounts.

If the FCM is required by an exchange to send cash or collateral to a DCO to meet its customers' initial or variation margin requirements, the required amounts are typically sent via wire transfer from the customer segregated account at the respective custodial bank or FCM to another customer segregated account held in the name of the DCO for the benefit of the FCM's futures customers.

Therefore, at all times, assets of the FCM's futures customers, who trade on U.S. futures markets, are held in a customer segregated account at the FCM's or the DCO's custodial bank. Similarly, assets that need to be transferred to clearing brokers or clearing houses outside the U.S. are also sent directly from the 30.7 Secured Amount Account at the bank to the required good secured location.

There are also customer protections relating to the types of permissible investments that an FCM may make with customer assets held by the FCM. Pursuant to CFTC Rule 1.25, the FCM is permitted to invest its futures customers' assets in a limited number of permissible investments. In today's marketplace, the most commonly used investment product are money market mutual funds that meet the requirements of CFTC Rule 1.25 and SEC Rule 2a–7 under the Investment Company Act of 1940 (the "1940 Act"). However, any investment loss that may be incurred as a result of such investment must be borne solely by the FCM; its futures customers assume no such investment risk. This concern was highlighted in 2008 by The Reserve Fund which lost a substantial amount of its investment assets through its purchase of commercial paper held in the name of Lehman Brothers and AIG, causing the fund to "break the buck." Also, the FCM must receive an acknowledgement from each money market fund that the amounts invested by the FCM on behalf of its customers with the respective money market fund may not be applied to any creditor of the FCM. This is similar to the segregation acknowledgement letter received by FCMs from their custodial banks, as noted above.