

#### 4. Qualifications of Depositories

The Commission proposed that, if the depository is located in the U.S., it must be: (1) A bank or trust company; (2) an FCM registered with the Commission; or (3) a DCO. The Commission also proposed that, if the depository is located outside the U.S., it must be: (1) A bank or trust company that has (a) in excess of \$1 billion in regulatory capital, or (b) commercial paper or long-term debt rated in the highest rating category by at least one nationally recognized statistical rating organization (where the bank or trust company is part of a holding company system, the holding company may satisfy the rating criterion); (2) an FCM registered with the Commission; or (3) a DCO.

Both NFA and FIA noted that, under Commission Rule 30.7, a bank located outside the U.S. is recognized as a permitted depository if its commercial paper or long-term debt is rated in one of the two highest rating categories.<sup>19</sup> NFA and FIA urged the Commission to make Rule 1.49 consistent with Rule 30.7. The Commission has determined that this is appropriate. Accordingly, the final rule will permit the use of a bank outside the U.S. whose commercial paper or long-term debt is rated in one of the two highest rating categories of a nationally recognized statistical rating organization. The term "nationally recognized statistical rating organization" as used in this release refers to those rating organizations designated as such by the Securities and Exchange Commission ("SEC").<sup>20</sup> Although the Commission did not receive any comments on this point, in order to avoid any possible confusion, the Commission wishes to make clear that when using the term "nationally recognized statistical rating organization" in Rules 1.49 and 30.7, it refers to a rating organization designated as a "nationally recognized statistical rating organization" by the SEC.

NFA asked the Commission to confirm that, under Rule 1.49, funds for the trading of security futures could be deposited with an FCM registered pursuant to Section 4f(a)(2) of the Act.<sup>21</sup> The Commission confirms that an FCM registered pursuant to Section 4f(a)(2) would be a qualified depository for

security futures funds under Rule 1.49.<sup>22</sup>

Only depositories that provide the FCM or DCO with the written acknowledgment required under Commission Rules 1.20 or 1.26 may hold customer funds required to be segregated.<sup>23</sup> However, a DCO acting as a depository does not need to provide an acknowledgment letter to an FCM where the DCO's rules provide for the segregation of funds held on behalf of customers.<sup>24</sup>

#### 5. Segregation Requirements

As noted above, protection of customer funds is one of the most important purposes of the Act and the Commission's regulations. Customer funds must be segregated so as to assure that the obligations owed to customers will be met. Through segregation, customer funds are readily identifiable in the event that a registrant becomes insolvent. Accordingly, Rule 1.49 requires that the FCM or DCO, at the close of each business day, have in segregated accounts on behalf of its customers sufficient U.S. dollars held in the U.S. to meet all U.S. dollar obligations and sufficient funds in each other currency to meet obligations in such currency with certain permitted substitutions. The segregation requirements of the rule are meant to ensure that FCMs and DCOs maintain enough funds, and in the appropriate currency, to meet the obligations owed to customers.

As noted, the rule permits limited substitutions among currencies. U.S. dollars held in the U.S. may be used to meet obligations denominated in any other currency. Money center currencies and U.S. dollars held in money center countries may be held to meet obligations denominated in currencies other than the U.S. dollar. In essence, three tiers of currencies have been

established, U.S. dollars held in the U.S. ("Tier I"), U.S. dollars and money center currencies held in money center countries or money center currencies held in the U.S. ("Tier II"), and currencies other than U.S. dollars and money-center currencies ("Tier III"). Tier I currency could be used for any obligation. For U.S. dollar obligations to customers, only Tier I currency could be used. Tier II currencies could be used for any obligation except U.S. dollars. Tier III currencies could only be used for obligations denominated in that particular currency.

#### B. Recordkeeping

The Commission is also amending Rule 1.32 to require FCMs to compute segregated funds on a currency-by-currency basis if they are held in other than U.S. dollars, in accordance with new Rule 1.49. Under Rule 1.49, customer funds may be held in the U.S., a money center country, or the country of origin of the currency. Rule 1.49 also would require FCMs and DCOs that hold funds in foreign currency or offshore to maintain records sufficient to demonstrate compliance with the additional segregation requirements set forth in Rule 1.49(e).

#### C. Bankruptcy

In Interp. 12, the Commission noted two types of risk associated with holding funds offshore that might result in customers failing to fully recover segregated funds, either upon demand or in a bankruptcy or receivership, (1) currency risk and (2) location risk.<sup>25</sup>

Currency risk is the risk of currency exchange rate fluctuations. This can be a concern where an FCM is in bankruptcy or receivership and it holds deposits denominated in currencies other than U.S. dollars. Due to changes in currency exchange rates, the size of the pool of funds available for distribution to customers and the size of claims against the funds may vary from day to day while the bankruptcy is pending, thereby exposing customers with U.S. dollar-denominated claims to currency risk.<sup>26</sup>

Location risk is the risk that funds held in a foreign depository might not be fully recoverable by a customer upon demand or in the event of bankruptcy or receivership. It includes the risk that foreign depositories may not be cooperative with the Commission concerning questions of compliance with segregation requirements, or that a foreign court might refuse to enforce

<sup>19</sup> See CFTC Advisory 87-5, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,997 (Dec. 3, 1987).

<sup>20</sup> See, e.g., 17 CFR 240.15c3-1; see also 17 CFR § 270.2a-7(a)(17).

<sup>21</sup> Section 4f(a)(2) of the Act provides for notice-registration of securities broker-dealers whose only futures-related activity involves security futures products. See also, 66 FR 43080 (Aug. 17, 2001).

<sup>22</sup> The Commission notes that FCMs registered pursuant to Section 4f(a)(2) may only accept such funds in accordance with any applicable rules promulgated by the SEC.

<sup>23</sup> Commission Rule 1.20 provides that, when an FCM or DCO deposits customer funds with a depository, the FCM or DCO must obtain and retain a written acknowledgement from the depository that it was informed that the funds are subject to the provisions of the Act and Commission regulations. Rule 1.26 requires an FCM or DCO to obtain such an acknowledgment in regard to the deposit of instruments purchased with customer funds as described under Rule 1.25.

<sup>24</sup> See 65 FR 77993, 78009-13 (Dec. 13, 2000) (amending, among other things, Rules 1.20 and 1.26 to provide that a DCO acting as a depository does not need to provide an acknowledgment letter where the DCO's rules provide for the segregation of funds held on behalf of customers); 65 FR 82270 (Dec. 28, 2000) (moving forward the effective date of the amendments to Rule 1.20 and 1.26 to December 28, 2000).

<sup>25</sup> 53 FR at 46912.

<sup>26</sup> See 53 FR at 46915 (providing an example of currency risk).