

provisions of the Commission's rules that prohibit a foreign depository from offsetting obligations of an FCM against customer funds. There is also a risk that, in the event of an FCM becoming insolvent, deposits at a foreign depository might be subject to an insolvency regime that is different from U.S. bankruptcy law. Additionally, a foreign government might limit the availability of funds by freezing or confiscating assets held within its jurisdiction or taking actions that affect its currency, even if the assets are located in the U.S.²⁷

Pursuant to Interp. 12, before placing a customer's funds offshore, an FCM had to obtain from the customer a subordination agreement. In the agreement, the customer consented to the subordination of claims concerning funds held offshore or in a foreign currency to the claims of customers whose funds are held in U.S. dollars or in other currencies in the event the FCM was placed in bankruptcy or receivership and there were insufficient funds available for distribution from the funds held in that particular currency to satisfy customer claims against those funds. The subordination agreement was meant to protect customers whose funds were held in the U.S. and denominated in U.S. dollars from both currency and location risk that might result in customers receiving less than their pro-rata share of funds.

In Interp. 12, the Commission stated that "currency risk is similar to the price risk which can occur in cases where an FCM becomes insolvent while holding customer deposits in forms which fluctuate in value," using the example of Treasury securities.²⁸ The Commission noted, however, that there were distinctions between price risk and currency risk, such that it was more equitable to spread the price risk among all customers in the event of a bankruptcy than it was the currency risk. First, the Commission indicated that all customers had the opportunity to post Treasury securities as margin, but under Interp. 12 only customers trading certain contracts could post foreign currency. Second, shortfalls in foreign currency accounts were more likely because of sovereign or location risk. Third, it would be easier and quicker for a trustee or receiver to convert Treasury securities held in the

U.S. to cash than to convert foreign currency held offshore into U.S. dollars.

Under Rule 1.49, subject to exchange margin rules, any customer may deposit foreign currency with an FCM, not just those trading certain contracts, provided the FCM is willing to accept foreign currency. In effect, such deposits would be similar to a customer depositing U.S. Treasury securities, which is currently permitted. In the case of a customer who deposits U.S. Treasury securities with an FCM to satisfy margin, there exists a price and liquidity risk related to the time it would take to convert those securities into U.S. dollars. Similarly, customer funds held in a foreign currency create an exposure during the time in which it takes to convert those currencies into U.S. dollars. As with converting U.S. Treasury securities, converting foreign currency into U.S. dollars, particularly those involving money center countries, is not extremely difficult. As a result, the Commission believes spreading currency risk among all customers is no less equitable than spreading price risk among all customers. Additionally, as discussed below, the rule and the amendment to Appendix B of the Commission's bankruptcy rules limit sovereign risk and protect customers who deposit U.S. dollars from being adversely affected due to the sovereign action of a foreign government or court, including the effect of a non-U.S. insolvency regime. As a result, the Commission believes spreading currency risk among all customers is no less equitable than spreading price risk among all customers.

In adopting the new rule, the Commission has sought to address many aspects of currency and location risks through the safeguards discussed above. One aspect of location risk that remains, however, is sovereign risk. This is the risk that the actions of a foreign government or court might result in a shortfall in segregated funds.

To address sovereign risk, the Commission is amending Framework 2 of Appendix B of its bankruptcy rules to govern the distribution of customer funds segregated pursuant to the Act and Commission rules thereunder, held by an FCM or DCO in a depository outside the U.S. or in a foreign currency.²⁹ The maintenance of

customer funds in a depository outside the U.S. or denominated in a foreign currency would result, in certain circumstances, in the reduction of customer claims for such funds. For purposes of the bankruptcy convention, sovereign action of a foreign government or court would include, but not be limited to, the application or enforcement of statutes, rules, regulations, interpretations, advisories, decisions, or orders, formal or informal, by a federal, state, or provincial executive, legislature, judiciary, or government agency. Commission staff was asked whether the devaluation of a currency by government decree would be considered a sovereign action. The Commission believes such a decree would be a sovereign action for purposes of this bankruptcy convention. The Commission recognizes that it is impossible to envision every possible sovereign action. The Commission has purposely defined sovereign risk broadly so as to afford the bankruptcy trustee the ability to exercise its discretion and judgment to fully effectuate the purpose of this bankruptcy convention.

If an FCM filed, or had filed against it, a petition in bankruptcy and maintained customer funds in a depository located in the U.S. in a currency other than U.S. dollars, or in a depository outside the U.S., the following allocation procedure will be used to calculate the claim of each customer. After reducing each customer's claim by the percentage of the shortfall that is not attributable to sovereign action, certain customer claims will be further reduced based upon their exposure to loss attributable to sovereign action. This framework is designed to prevent a shortfall in funds held outside the U.S. or in a currency other than U.S. dollars resulting from the sovereign action of a foreign government or court from adversely affecting customers whose funds are held in U.S. dollars or in the U.S. or in a currency or a country other than the one undertaking the sovereign action resulting in the shortfall.

NFA, in its comment letter, asked what would happen if a bankruptcy proceeding is commenced while a firm is in the process of converting customer funds between currencies. As noted in the framework, the first step to be taken in the event of a bankruptcy is to convert each customer's claim in each currency to U.S. Dollars at the exchange rate in effect on the Final Net Equity Determination Date as defined in

segregated funds and non-U.S. held segregated funds.

²⁷ Presumably, certain sovereign action of a foreign government could affect foreign currency even if held in the U.S. Any discussion of sovereign risk herein pertains to non-U.S. currency, wherever held.

²⁸ 53 FR at 46915, note 22.

²⁹ The current Framework 2 sets forth a plan for distribution in the case of trades made on the Chicago Board of Trade-London International Financial Futures and Options Exchange Link ("Link"). Since the Link ceased operations in 1997, there is no need to maintain the existing Framework 2. Accordingly, the Commission is replacing the existing Framework 2 related to the Link with a new Framework 2 that addresses U.S. held