

## DIVISION OF TRADING AND MARKETS

### FINANCIAL AND SEGREGATION INTERPRETATION NO. 14

#### **Accounting For Deposits And Contractual Obligations Between An Fcm And Its Introducing Brokers And Associated Persons**

This interpretation by the Division of Trading and Markets addresses several issues relating to transactions and contractual obligations between a futures commission merchant ("FCM") and the introducing brokers ("IBs") and associated persons ("APs") it uses to service the accounts of its customers. Following are the basic principles which must be observed regarding such IBs and APs:

##### **1. IBs' and APs' Trading Accounts Must be Classified Properly for Purposes of Compliance with the Commission's Segregation of Funds Rules**

A commodity trading account of an AP employed by the FCM carrying the account is to be treated as a proprietary account, as that term is defined in Commission Regulation 1.3(y). This means that the account's commodity trades, margin funds, and open positions may not be commingled with the trades, funds, or positions of public customers. A commodity trading account of an IB, which has no relationship with the FCM carrying the account as set forth in Regulation 1.3(y), however, is to be treated as a customer's account and the FCM must segregate the IB's trades, margins, and open positions just as it would for any other "public customer." The distinction between an AP's and an IB's rights to have the funds in their own commodity trading accounts segregated, as well as the distinction between an IB's claims against segregated funds and the IB's claims as a general creditor, should be kept in mind in reviewing the remainder of this interpretation.

##### **2. IBs' and APs' Security Deposits May not be Commingled with the Funds Segregated by an FCM for its Customers**

Any funds which an FCM receives from an IB or an AP which are in the nature of a security deposit (other than to margin commodity positions on contract markets, such as a deposit against possible future uncollectible amounts from accounts serviced by the IB or AP), must be deposited in an account other than an account used to segregate funds for commodity customers. Such funds do not represent funds deposited to margin, guarantee, or secure the commodity trades of the AP or IB, and, therefore, may not be commingled with funds segregated pursuant to Section 4d(2) of the Commodity Exchange Act ("CEAct") for commodity customers who are trading on U.S. contract markets, nor may such funds be deposited in accounts representing funds set aside pursuant to Regulation 30.7 for customers trading on non-U.S. commodity exchanges. For the same reason, such security deposits should not be credited to a commodity trading account that the IB or AP may have on the FCM's books.

##### **Net Capital Treatment**

An IB who has not entered into a guarantee agreement with an FCM which satisfies the requirements of Regulation 1.10(j) is required to meet the minimum adjusted net capital requirement for an IB set forth in Regulation 1.17(a)(1)(ii). In determining compliance with such capital requirement an IB is permitted by Regulation 1.17(c)(2)(ix) to treat one-half of the security deposit it has with the FCM clearing its customers accounts as a current asset. In an attempt to give the IB 100% credit for a security deposit, some FCMs have credited the security deposit to a commodity trading account to make it appear the deposit represents margin for the IB's trading account. If the balance in an IB's trading account at an FCM is not commensurate with the amount of trading actually done by the IB and no other deposit in the nature of a security deposit has been made with the FCM, then one-half of the balance in the trading account must be presumed to be a security deposit and be treated by the IB as a non-current asset.

##### **3. Segregated Customers' Funds May not be Used to Pay Commissions and Other Fees to APs and IBs**

Section 4d(2) of the CEAct and Section 1.20(a) of the Commission's regulations require an FCM to segregate and separately account for customers' commodity funds. That section of the CEAct and Regulation 1.20(c) permit certain uses of such funds and provide, among other things, that the segregated funds,

". . . as in the normal course of business is necessary to purchase, margin, guarantee, secure, transfer, adjust, or settle the trades, contracts or commodity options . . . may be withdrawn and applied to such purposes, including the payment of premiums to option grantors, commissions, brokerage, interest, taxes, storage and other fees and charges, lawfully accruing in connection with such trades, contracts or commodity options . . . ."

Commissions earned by APs and IBs are not necessary to the execution of commodity trades and maintenance of any resulting positions. Consequently, commissions due an IB or AP constitute a general obligation of the FCM and, as such, may not be paid by the FCM directly out of funds segregated for the benefit of commodity customers, even though commissions may have been charged to customers' accounts and the funds themselves not yet transferred from a segregated depository to an operating account of the FCM, and even though the customer need not itself pay such commissions by means of a separate transfer to the FCM.

#### 4. IBs And APs Are General Creditors of an FCM with Respect to Any Commissions and Fees Owing to Them

In the bankruptcy of an FCM, IBs and APs are general creditors of the FCM with respect to any commissions or other fees owing to them by the FCM for services rendered to the FCM. Consequently, they have no claim for such commissions or fees against any assets segregated by the FCM for the benefit of its commodity customers pursuant to Section 4d(2) of the CEAct and Section 1.20 of the Commission's regulations, or against any assets set aside in special accounts for the benefit of customers trading on non-U.S. commodity markets pursuant to Section 30.7 of the regulations.<sup>1</sup>

Commissions charged or to be charged a customer are subject to contractual arrangements between the FCM and its customers. As such, in bankruptcy, commissions owed the FCM or payable by the FCM to third parties that are chargeable to a customer's account pursuant to a contractual arrangement, but not yet charged to such customer's account, must, based upon the FCM's right of offset, be subtracted from the net equity claim (the liability owed to that customer by the FCM in bankruptcy) of the individual customer whose account incurred the charges. Offset is only assertible by the FCM who carries the customer account and it cannot be asserted by third parties to whom the FCM in turn owes payment. Only after customer claims have been fully satisfied can general creditors be satisfied, on a pro rata basis, from the FCM's residual financial interest, if any, in segregated funds and from other assets. An FCM's residual interest consists only of funds deposited in the segregated account to the extent they are not needed to satisfy the FCM's segregation requirements. Third party creditors have no interest in an FCM's segregated funds in bankruptcy, although when all customer liabilities are paid, any excess segregated funds revert to the FCM debtor's general estate. Thus, noncustomer creditors can have no greater interest in or claim against segregated assets than does the FCM for its residual interest therein.

The FCM's right of offset (in regard to earned, but uncharged commissions) under Section 4d(2) of the Act, therefore, does not entitle third parties to a security interest or other claim to commissions from segregated customer funds. Nor may any claim of such third parties be accorded a priority in such funds over the interests of customers of the FCM. Allowing such a priority would conflict with express Bankruptcy Code priorities and with the language of Section 4d(2) of the CEAct, which states:

It shall be unlawful for any person, including but not limited to any clearing agency of a contract market and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant.

That provision bars any person from treating such funds as held other than for the exclusive benefit of customers.

APs' and IBs' contractual claims against an FCM for commissions owed them as a result of their servicing customers' accounts for the FCM cannot be satisfied with funds segregated for customers. To do so could cause customers who have no liability for such commissions to fund commission charges deriving from transactions of other customers. This limitation on recovery does not result in a windfall to the customer who does owe the commissions, however, because the FCM's liability to that customer, and hence the money payable to that customer in bankruptcy, must be reduced by the amount of commissions earned, but not yet charged to that customer's account, thereby reducing such customer's claim against assets segregated for customers generally. However, the Division notes that individual customers may permit third party creditors, such as banks, a security interest in amounts owed them by the FCM. Therefore, similar to other third party creditors, a customer may grant its IB a security interest in any funds that may be due such customer from the FCM. In the event of a shortfall in segregated funds, parties holding a security interest in the account of an individual customer would receive no greater interest in segregated funds than that afforded the individual customer who granted the security interest.

5. Commissions Earned by an AP or IB, but Not Paid by the FCM, Must be Reflected as a Liability on the FCM's Financial Reports

Commissions earned by an FCM's AP or IB (that portion of the full commission charged a customer which will be shared by the FCM with the AP or IB), but not yet paid out to the AP or IB by the FCM, must be accrued and reported as a payable to the AP or IB in the FCM's financial reports. This requirement applies whether or not a commission has actually been charged to a customer's account. If a commission has been earned, but not yet charged to a customer's account, the FCM may reflect that accrued commission as an asset (see Page 4-18 of the Instructions to form 1-FR-FCM -- "Accrued Half-Turn Commission"). Where an FCM shares the commission with an IB, the IB will reflect that amount as a receivable from the FCM. Such an amount reflected as a receivable by the IB is classified as either a current or noncurrent asset depending on how long the receivable has been outstanding and whether the accrued commission is covered by free funds<sup>2</sup> in the customer's account. (See Commission Rule 1.17(c)(2)(ii)(B), 17 C.F.R. § 1.17(c)(2)(ii)(B) (1994)).

\* \* \* \*

The statements made in this interpretation are not rules or interpretations of the Commodity Futures Trading Commission, nor are they published as bearing the Commission's approval. Rather, they are interpretations and practices followed by the Division of Trading and Markets in administering the Commodity Exchange Act and the regulations thereunder.

FOR FURTHER INFORMATION CONTACT: Paul H. Bjarnason, Jr., Chief Accountant, or Lawrence B. Patent, Associate Chief Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, 2033 K Street, N.W., Washington, D.C. 20581.

Issued in Washington, D.C. on \_\_\_\_\_ by the Division of Trading and Markets.

Andrea M. Corcoran

Director

[TMINT-14.606]

---

<sup>1</sup> See The Oxford Organisation, Ltd. v. Ronald R. Peterson as Trustee in Bankruptcy for Stotler and Company, No. 91 C 1178 (N.D. Ill. Aug. 18, 1992) where the U.S. District Court for the Northern District of Illinois granted the motion for the trustee in bankruptcy for Stotler, an FCM, for summary judgment against Oxford, an IB of Stotler's, that sought to recover \$154,068, plus interest, in unpaid commissions. The court adopted the Commission's view that there is no fiduciary relationship between FCMs and IBs under the CEAct, and that imposing a constructive trust in an IB's favor would, as a policy matter, thwart the priority granted FCM customers under the Bankruptcy Code.

<sup>2</sup> *Free Funds* is the amount by which the net liquidating equity in an account exceeds the initial margin requirement for the positions in that account.

---