K&LNG Alert

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Investment Management

CFTC Amendment Effectively Requires Fund Assets to be Held With Futures Commission Merchants

In 1984, the Division of Trading and Markets (predecessor to the Commodity Futures Trading Commission's Division of Clearing and Intermediary Oversight) issued Financial and Segregation Interpretation No. 10 ("Interpretation No. 10").[1] This Interpretation provided that the use of bank custodial accounts (also known as "third-party custodial accounts") to maintain customer funds would be consistent with the segregation requirements of the Commodity Exchange Act ("CEA").[2] As a result of Interpretation No. 10, customers of futures commission merchants ("FCMs"), including registered investment companies, have been permitted to maintain margin in connection with futures contracts using third-party custodial accounts.

On May 11, 2005, the Commodity Futures Trading Commission ("CFTC") amended Interpretation No. 10[3] to provide that registered investment company assets held in third-party custodial accounts will no longer be deemed "properly segregated" under the segregation requirements of the CEA, except where the FCM is not eligible to hold assets because it is an affiliate of the registered investment company or its adviser.[4] In effect, unless the exception applies, the amendment to Interpretation No. 10 ("Amendment") will require registered investment companies to rely exclusively on Rule 17f-6 under the Investment Company Act of 1940 ("1940 Act") and maintain margin with an FCM as opposed to the fund's custodian. The Amendment's compliance date is February 11, 2006.

In the limited instance where an FCM is affiliated with the fund or the fund's adviser, the FCM will still be deemed to comply with the segregation requirements under the CEA if the following conditions are met:

- The account must be maintained in the name of the FCM, for the benefit of the customer.
- The FCM must have the ability to liquidate open positions in an account that is undermargined without getting clearance from any third-party custodian or the customer.

[1] CFTC Division of Trading and Markets, Financial and Segregation Interpretation No. 10, *Treatment of Funds Deposited in Safekeeping Accounts*, Comm. Fut. L. Rep. (CCH), paragraph 7120 (May 23, 1984).

[2] Section 4d(a)(2) of the CEA and related regulations require that all funds received by a futures commission merchant from a customer to margin, guarantee, or secure futures or commodity options transactions and all accruals thereon must be accounted for separately, and that they not be commingled with the futures commission merchant's own funds or used to margin the trades of, or to extend credit to, any other person.

[3] CFTC Division of Clearing and Intermediary Oversight, Amendment of Interpretation, 70 Fed. Reg. 24768 (May 11, 2005).

[4] Section 17(f) of the 1940 Act generally requires that fund assets be held with a bank, a member firm of a national securities exchange or the fund itself. Rule 17f-6 provides an exemption from Section 17(f) to permit funds to maintain margin in connection with futures contracts with an FCM, provided certain conditions are met, including that the FCM is not an affiliated person of the fund or an affiliated person of such a person.

- The FCM must have the right to withdraw funds from the third-party custodial account with no right of the customer to in any way interfere with such withdrawal.
- A third-party custodial account may not be located at an affiliate of the customer or a fiduciary thereof.

These conditions are generally consistent with the original conditions placed on FCMs to maintain third-party custodial accounts under Interpretation No. 10.

Interpretation No. 10 was issued originally because, at the time, Section 17(f) of the 1940 Act prohibited registered investment companies from using FCMs and futures clearinghouses as custodians of their assets. The CFTC issued Interpretation No. 10 specifically to allow third-party custodial accounts to be deemed "properly segregated" within the meaning of the CEA under the conditions described above, which were designed to ensure that the FCM would have "immediate and unfettered access" to customer funds maintained in such accounts. The "immediate and unfettered access" requirement was intended to prevent potential delay or interruption in securing required margin payments that in times of significant market disruption could increase the effect of such disruption and impair the liquidity of other FCMs and clearinghouses.

Due to developments since the CFTC first issued Interpretation No. 10, the CFTC has concluded that the Interpretation is no longer necessary or justified, except in the limited circumstance where the FCM is an affiliate of the fund or its adviser. First, with the adoption of Rule 17f-6 under the 1940 Act in 1996, registered investment companies have been permitted (although not required) to maintain their assets with FCMs and futures clearinghouses in connection with futures transactions effected on U.S. and foreign exchanges. Second, certain operational factors have come to light which indicate that customer funds held in third-party custodial accounts are not as readily accessible to an FCM as they would be in a segregated customer account with the FCM. Moreover, the CFTC audit staff has discovered instances of funds being released from third-party custodial accounts without the knowledge or permission of the FCMs. The CFTC has found that these risks are contrary to the "immediate and unfettered access" standards of the CEA.

In adopting the Amendment, the CFTC also cited concerns about potential systemic liquidity risks that could result from diversions of FCM capital to cover customer margin obligations, particularly in times of market volatility, when liquidity is vital. In addition, the CFTC noted that third-party custodial accounts present uncertainty as to the treatment of funds in the context of an FCM bankruptcy proceeding. These arrangements may create confusion on the part of the customer and create the potential risk that third-party custodial accounts might receive priority over other customers in an FCM's bankruptcy proceeding.

As noted above, the compliance date for the Amendment is February 11, 2006. Funds using tri-party arrangements will be required to restructure those arrangements so that margin will be held with the FCM as opposed to the fund's custodian.

This Investment Management Alert is focused solely on the Amendment. This article does not address all of the issues raised by the Amendment. If you wish to obtain more information, please contact your relationship attorney at Kirkpatrick & Lockhart Nicholson Graham LLP or the authors of this article, Cary J. Meer at (202) 778-9107 or Lori L. Schneider at (202) 778-9305.

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