Fundamentals of Futures Trading Compliance for Broker-Dealers*

By GuyLaine Charles

Broker-dealers live in the heavily regulated world of securities and are subject to the jurisdiction of the Securities Exchange Commission ("SEC") and examination by their designated examination authority ("DEA"). Some broker-dealers may want to offer their clients additional services, including the execution and clearing of futures contracts, in which case these broker-dealers will enter the realm of the Commodity Futures Trading Commission ("CFTC") and will be required to comply with the laws and regulations surrounding the trading of futures contracts. In this article we will outline some of the compliance obligations that are imposed on broker-dealers who choose to expand their offerings to futures dealing. However, before delving into these compliance requirements, we will provide a brief overview of the world of futures contracts – their history, what they are, where they are transacted, with whom and how.

Futures Contracts

I. History of the futures market

The trading of futures contracts, as a "contract of sale of a commodity for future delivery" is commonly known, began in the United States in the mid-nineteenth century. The increase in the production of wheat brought farmers from the Midwest to Chicago to sell their wheat in a central location. This practice evolved from a spot market to a market where participants agreed to the future delivery of wheat at a pre-arranged price. Sellers (the short position) would agree to sell a certain amount of wheat at a fixed price on a future date and buyers (the long position) would agree to buy the quantity of wheat for the agreed price on the future date. As the market matured, holders of these contracts began to sell their obligations to third parties; opening up the market to speculators and, potentially, to manipulation. As crops are, by their nature, limited in quantity and in time (as they are seasonal), it became possible for some market participants to "corner-the-market"[1] on a

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given product therefore creating significant losses for other market participants. In an attempt to address manipulation of the futures markets and protect investors, legislation to regulate the futures market was enacted beginning in the early twentieth century. The Futures Trading Act of 1921[2] taxed futures trading in grain (wheat, corn, rye etc.) that was not traded on a contract market. The law was subsequently declared unconstitutional and was replaced with the Grain Futures Act of 1922,[3] which did not tax off-market trading but simply banned it. The Grain Futures Act was replaced in 1936, by the Commodity Exchange Act of 1936 (the "CEA"),[4] which today governs the trading of futures contracts and options on futures contracts. The CEA added agricultural commodities to the products subject to trading on a contract market, including cotton, butter and eggs. The 1974 amendment to the CEA, the Commodity Futures Trading Commission Act of 1974,[5] established the CFTC as an independent agency of the United States Government to oversee the futures market.[6] At the helm of the CFTC are five bipartisan Commissioners (including one Chairperson) who are appointed by the President of the United States.[7] While the CFTC is tasked with regulating the futures market, the regulatory regime also includes an active self-regulatory organization component. In accordance with the CEA,[8] the CFTC delegates much of its registration and enforcement responsibilities to the National Futures Association ("NFA") as a self-regulatory futures association. The NFA was granted official "registered futures association" status in 1981 and began operating in 1982. Participants in the futures market must comply with both CFTC and NFA rules. Each participant is also subject to additional supervision from the exchange selected as its designated self-regulatory organization ("DSRO"). With limited exceptions,[9] the CFTC retains the right to review the NFA's decisions, including registration denials and disciplinary actions.

Any broker-dealer that intends to solicit or accept orders for the purchase or sale of a commodity for future delivery (dealing in futures) will be subject to the provisions of the CEA.

II. Present day futures markets

Present day futures markets are vastly different from the central grain markets of the mid-nineteenth century. Today, futures contracts subject to the CEA are ***standardized contracts*** for the purchase and sale of a ***physical commodity*** for future delivery on a ***regulated futures exchange***.[10]

a. Standardized Contracts

The standardization of contract terms is a key feature of a futures contract. The standardization increases liquidity as it allows parties to easily trade in and out of their positions. A customer wanting to exit a position will simply enter into a transaction that offsets its existing position. The customer will either make a gain or suffer a loss on the trade, but will have easily closed-out its position. The terms of futures contract that are standardized include, among other terms, contract size, quotation unit, minimum price fluctuation, delivery terms and contract duration.[11]

b. Physical Commodity

The list of commodities traded on futures markets has expanded since the nineteenth century. Commodity is currently defined in the CEA as follows:

> The term "commodity" means wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions (as provided by section 13–1 of this title) and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.[12]

This definition is neither exhaustive nor precise for the purposes of futures trading, as any commodity for which

there is a futures contract that is actively traded is subject to the CEA. There are futures contracts currently being traded in products ranging from agricultural commodities to energy, metal, equities and financial commodities (interest rates and foreign exchange). Options on futures contracts are similarly regulated. On August 31, 1982, the CFTC approved its first option on a futures contract.[13]

c. Regulated Futures Exchange

Section 4(a) of the CEA provides that it is unlawful to enter into a futures contract unless the contract is traded on an organized exchange or other trading facility that complies with the core principles set out in Section 5(d) of the CEA (and any further requirements established by the CFTC), or on a derivatives transaction execution facility.[14] A compliant exchange is known as a designated contract market. Some futures exchanges in the United States include the Chicago Board of Trade ("CBOT"), the Chicago Mercantile Exchange ("CME") and the Intercontinental Exchange ("ICE").[15] The exchanges set the standardized terms of their futures contracts.

Each futures exchange must clear its trades through a clearinghouse. These clearinghouses stand between the parties to the trade and guarantee the obligations of each party to the other so that once a trade is executed, settled and cleared the clearinghouse becomes the buyer to the seller and the seller to the buyer.

III. Who transacts in futures and why?

Futures customers can be categorized as follows: hedgers, who enter into futures contracts to manage their business risk, and speculators, who enter into futures contracts in the hopes of profiting from price movements. The extent to which hedging in futures markets is possible stems from speculation; speculators increase market liquidity which allows hedgers to efficiently enter and exit the market.[16] While the futures market is open to anyone, in order to access it, one must go through an intermediary, a futures commission merchant ("FCM")[17] and at times an introducing broker ("IB"). FCMs will oftentimes enter into an arrangement with an IB whereby the IB solicits orders for the FCM in return for a commission. Generally, an IB is an individual or organization that solicits or accepts orders to buy or sell, amongst other products, futures contracts and options on futures but does not accept money or other assets from customers to support these orders.[18] An IB has a direct relationship with the customer, but delegates the trade execution to an FCM. The FCM on the other hand, provides customers with access to the futures exchange. The FCM will open and maintain one or more accounts for a customer and assist it in buying and selling futures contracts. The FCM accepts orders (either directly or through an IB), makes margin calls, custodies collateral, and provides periodic reporting on a customer's positions. Generally, an FCM is analogous to a brokerage house in the securities market.[19]

The next part of this article will focus on how a broker-dealer becomes an FCM and will discuss some of the obligations that a broker-dealer must satisfy in order to comply with the CEA and the relevant rules and regulations governing the trading of futures.

Futures Commission Merchants

I. Becoming an FCM

Any broker-dealer that intends to solicit or accept orders for the purchase or sale of a commodity for future delivery (dealing in futures) will be subject to the provisions of the CEA. Other than in limited circumstances (such as trading solely for proprietary accounts,[20] a foreign broker acting through a registered entity,[21]or a person located outside of the United States and exempt from registration in accordance with CFTC regulations), a broker-dealer dealing in futures will be required to register as an FCM with the NFA.

FCM applicants are required to complete and file a Form 7-R and other accompanying forms with the NFA, which for registered broker-dealers may be a copy of its Financial and Operational Combined Uniform Single Report required under the Securities Exchange Act of 1934 ("FOCUS Report").[22] However, for a registered broker-dealer (i) whose registration with the SEC is in good standing, (ii) which is a member of a registered national securities association, and (iii) that limits its futures dealing to security futures,[23] the registration process is less burdensome. Broker-dealers meeting these requirements can fast track FCM status by filing a "notice registration" ("Notice Form 7-R") with the NFA.[24] Notice Form 7-R is a two-page application that allows broker-dealers to "passport" into registration with the CFTC as an FCM. With notice registration, registration as an FCM is effective upon receipt of a *properly* completed Notice Form 7-R.[25] In addition, the CEA requires the CFTC to issue rules and regulations *in consultation* with the SEC in

order to avoid duplicative or conflicting regulations applying to FCMs that are also broker-dealers, known as "dual-registrants".[26] This article will focus on the requirements for broker-dealers who will be transacting in all commodities and not solely security futures.

In addition to domestic FCMs, the CFTC also regulates foreign futures and options brokers ("FFOBs")[27] who deal foreign futures to U.S. Customers. The CFTC requires that all persons engaged in activities like those of an FCM to either register as an FCM or seek an exemption. Accordingly, a FFOB may either register as an FCM or seek an exemption from CFTC regulations, although if granted the exemption, certain anti-fraud and disclosure regulations would still apply to the FFOB.[28]

II. Compliance obligations of an FCM

The CFTC and the NFA impose a number of obligations on FCMs. FCM obligations are numerous and somewhat onerous, and include:

a. appointing a Chief Compliance Officer who will be subject to certain duties and responsibilities;
b. registering its "Associated Persons";
c. maintaining a minimum net capital;
d. recordkeeping;
e. establishing a risk management program;
f. segregating customer funds;
g. establishing a business continuity plan;
h. providing financial filings; and
i. providing ethics training for employees.

The CFTC imposes other obligations on FCMs, including, for instance, the requirement to comply with anti-money laundering legislation; however, in this article we will focus on providing a brief overview of the obligations listed above.

a. Chief Compliance Officer

Like the SEC, the CFTC requires its regulated entities to designate an individual to act as Chief Compliance Officer ("CCO").[29] The broker-dealer CCO's duties will be expanded to include:

- establishing and administering compliance policies and procedures reasonably designed to ensure compliance with the CEA and CFTC regulations;[30]
- in consultation with the board of directors or the senior officer, resolving conflicts of interests;[31]
- establishing procedures, in consultation with the board of directors or the senior officer, for the remediation of noncompliance issues identified by the CCO;[32]
- establishing procedures, in consultation with the board of directors or the senior officer, for the handling, management response, remediation, retesting, and closing of noncompliance issues;[33] and *notably*,
- preparing a signed annual written report ("Annual Report") that covers the most recently completed fiscal year.[34]

The Annual Report

The Annual Report must include a description of written compliance policies and procedures, including the code of ethics and conflict of interest policies.[35] CCOs are not required to make any claims that the FCM is in compliance with the rules – the report is meant to reassure the CFTC that adequate policies and procedures are in place.

In addition, the report must review each applicable requirement under the CEA and CFTC regulations and identify the corresponding policies and procedures designed to ensure compliance with these requirements.[36] The Annual Report must also describe any material non-compliance issues that have been identified and the action taken to rectify the situation.[37]

Unlike the National Association of Securities Dealers ("NASD") and Financial Industry Regulatory Authority ("FINRA") rules[38] which require the submission of an annual report to the broker-dealer's board of directors and audit committee, the FCM's Annual Report, after it has been distributed to the FCM's board of directors or senior officers, must be submitted electronically to the CFTC simultaneously with its Form 1-FR-FCM or FOCUS Report, as applicable (and as discussed below).[39] In addition, the FCM's Annual Report must be certified by either the CCO or Chief Executive Officer ("CEO") that "to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete."[40]

b. Associated Persons

The CEA requires (with certain exemptions)[41] that an individual associated with an FCM be registered as an associated person ("AP") if such individual is employed in any capacity

that involves (i) the solicitation or acceptance of customer orders or (ii) the supervision of any person or persons engaged in the solicitation or acceptance of customer orders.[42] The NFA is responsible for this registration process.[43] It is important to note that an individual's title is not the dispositive factor in determining his or her supervisory role; the NFA considers all relevant factors in making the determination of who is required to register.[44]

Additionally, an individual "in the line of supervisory authority" must also register as an AP.[45] To illustrate, if X supervises A who is engaged in soliciting and accepting customer orders, both X and A must be registered as APs. However, every person in X's line of supervision must also be registered as an AP, even if such person does not directly supervise A or any other person who is involved in soliciting or accepting customer orders. In effect, depending on a firm's organizational structure, the CEO of an FCM may be required to register as an AP even if only one junior employee is engaged in soliciting and accepting customer orders.

The process for AP registration consists of multiple parts. Most importantly, an AP applicant is required to pass certain proficiency requirements (generally, the National Commodity Futures Examination, otherwise known as the Series 3).[46] The AP applicant must then file the following with the NFA:

- A Form 8-R and Verification of Form 8-R;[47]
- A fingerprint card; and
- An application fee.[48]

In June of 2013, the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSIO") issued a no-action letter providing that the DSIO would not recommend that the CFTC take enforcement action against an FCM which fails to provide a fingerprint card for any AP that has not resided in the United States since the age of 18, subject to providing the CFTC with certain other specific information.[49]

c. Minimum Net Capital

Every FCM is required by the CFTC to maintain minimum net capital.[50] If the FCM is (i) a member of DSRO; (ii) maintains the financial standards established by the DSRO; and (iii) conforms with the DSRO's reporting requirements (which have been approved by the CFTC), the FCM will be deemed compliant with the CFTC requirements with respect to net capital requirements.[51] Otherwise, the FCM will be required to maintain an adjusted net capital of at least the greatest of:

i. $1,000,000;
ii. the FCM's risk-based capital requirement – which is 8% of the total risk margin requirement for positions carried by the FCM in customer and non-customer accounts;
iii. the minimum adjusted net capital required by the NFA; or
iv. for broker-dealers, the amount of net capital required by SEC Rule 15c3-1(a).[52]

A registered FCM must, at all times, be in compliance with the minimum net capital requirement and must be able to demonstrate such compliance to the CFTC or its DSRO.[53]

If an FCM becomes undercapitalized or unable to demonstrate compliance at any time, or cannot certify to the CTFC upon request that it has sufficient access to liquidity to continue operating as an FCM, it must (i) immediately notify both the CFTC and the NFA and (ii) transfer all customer accounts to another FCM and immediately cease doing business as an FCM (other than for liquidation purposes) until a time when it is able to demonstrate compliance.[54] However, if the FCM can demonstrate to the satisfaction of the CFTC or the NFA its ability to come into compliance with the minimum net equity requirements, the CFTC or the NFA may allow the FCM up to ten business days to achieve compliance before requiring that the FCM transfer its accounts and cease doing business.[55]

d. Basic Recordkeeping

Every FCM registered or required to be registered with the CFTC must maintain, and make available for inspection by the CFTC and the Department of Justice upon request, certain records that support and explain its activities.[56] All required books and records must be retained for a minimum of five years and must be readily accessible for the first two years of such five-year period.[57] Notably, the CFTC requires that FCMs, subject to certain exceptions,[58] retain all "oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that lead to the execution of a transaction in a commodity interest and *related* cash or forward transactions, whether communicated by telephone, voicemail, facsimile, instant messaging, chat

rooms, electronic mail, mobile device, or other digital or electronic media […]."[59]

Such records must be prepared under the supervision of a listed principal[60] and registered AP of the FCM resident in an office located in the U.S. The records must also be maintained in that same office in a form and manner that allows them to be easily identifiable and searchable by transaction.[61] However, FFOBs subject to a foreign jurisdiction that has been deemed to have a regulatory scheme that is comparable to the CFTC's may maintain their records in their home jurisdiction subject to CFTC approval.[62] That said, all NFA members must ensure that all documents required to be filed with the NFA are in English.[63]

e. Risk Management Program[64]

As of July 2014, each FCM that carries customer accounts will be required to establish, maintain and enforce policies and procedures designed to monitor and manage the risks associated with the FCM's activities (a "Risk Management Program"). The Risk Management Program requires that the FCM establish a risk management unit.[65] The risk management unit must be independent from the FCM's business unit (as defined in the CFTC regulations)[66] and will report to the FCM's senior management. The Risk Management Program must identify, at a minimum:

- "market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital, and any other applicable risks"[67] as well as the FCM's risk tolerance limits. The risk tolerance limits are subject to quarterly review and approval by senior management and annually by the FCM's governing body.[68] Policies and procedures to detect breaches of the risk tolerance limits should also be included in the Risk Management Program;
- in the event of a material change and otherwise quarterly, its risk exposure. The risk exposure report should be submitted to the FCM's governing body and senior management. The report should also state any changes needed to the Risk Management Program and the timeline for the implementation of these changes. The report must be filed with the CFTC within five business days of having been provided to senior management;[69] and
- policies and procedures to address segregation risk, operational risk and capital risk.

Upon registration and upon request, each FCM is required to provide to the CFTC and its DSRO a copy of its policies and procedures describing its risk management program.[70]

f. Segregated Funds

Perhaps one of the most significant FCM requirements, as highlighted by the recent failures of MF Global and Peregrine Financial Group, Inc.,[71] is the protection of customer property. Generally, an FCM has three different types of customers, depending on the products traded:

- Customers who trade futures or options on futures which are listed on *U.S. futures exchanges* ("U.S. Futures Customers");
- Customers who trade futures or options on futures which are listed on *foreign boards of trade* ("Foreign Futures Customers"); and
- Customers who trade *swaps that are cleared* on a derivatives clearing organization registered with the CFTC ("Cleared Swaps Customers").

For the purposes of this article, as we are not covering swaps, we will simply address the requirements with respect to U.S. Futures Customers and Foreign Futures Customers.

In order to carry its trades, a customer will deposit cash, securities, and other collateral (collectively "funds") with the FCM. In accordance with Sections 4d(a)(2)of the CEA, the FCM must segregate its customers' funds from its own proprietary funds. Further, CFTC regulations require that FCMs adhere to a specific fund segregation regime with respect to each type of customer.[72]

It should be noted that the CFTC recently adopted a final rule intended to strengthen the protection afforded to customers of FCMs (the "Final Rule") including with respect to the segregation of customer funds.[73] Some of the components of the Final Rule are discussed herein. The final rule becomes effective on January 13, 2014, although it contains various compliance deadlines.

U.S. Futures Customers

Funds for U.S. Futures Customers that are deposited with an FCM as margin or that are otherwise required to be held for the benefit of the customer are required to be segregated in a separate account identified as belonging to the U.S. Futures Customer (a "Segregated Account").[74] U.S.

Futures Customers funds held in a Segregated Account are strictly for the benefit of the relevant U.S. Futures Customer and may not be used to meet the obligations of the FCM or of any other person (including another customer).[75] However, an FCM is allowed to commingle U.S. Futures Customer funds (but not Foreign Futures Customers or Cleared Swaps Customers funds unless expressly permitted by regulation, rule or order) into a single or multiple accounts at (i) a bank, (ii) a trust company, (iii) a derivatives clearing organization ("DCO"), or (iv) another FCM, (each a "depository"); provided that the account is properly titled to make clear that the funds belong to, and are being held for the benefit of the FCM's U.S. Futures Customers.[76]

On a daily basis, each FCM is required to prepare a Statement of Segregation Requirements and Funds in Segregation for Customers Trading on U.S. Commodity Exchanges as of the close of business and to submit this statement to the CFTC and to its DSRO by noon the next day.[77]

Foreign Futures Customers

An FCM must at all times maintain in a separate account funds in an amount that would cover its obligation to its Foreign Futures Customers and in any event no less than the amount required under the laws or rules of the jurisdiction of the depository or the Foreign Futures Customer.[78] An FCM is allowed to commingle Foreign Futures Customers funds in a single account held at the following depositories: (i) a bank or trust company located in the U.S.; (ii) a bank or trust company located outside the U.S. that has in excess of $1 billion in regulatory capital; (iii) an FCM; (iv) a DCO; (v) a clearing organization of any foreign board of trade; (vi) a member of any foreign board of trade; or (vii) the designated depository of (v) or (vi) above.[79] The CFTC regulations provide certain limitations on the FCM's ability to deposit the funds with a non-U.S. depository.[80]

Like the SEC, the CFTC requires its regulated entities to designate an individual to act as Chief Compliance Officer ("CCO").

The funds of Foreign Futures Customers may not be held, commingled, or deposited with the funds of U.S. Futures Customers unless expressly permitted by regulation, rule or order.[81] Customers trading on foreign markets assume additional risks since applicable laws will vary depending on the foreign jurisdiction in which the transaction occurs. In particular, Foreign Futures Customers assume the risk that their funds may not be entitled to the same level of protection as the funds of U.S. Futures Customers; if an FCM liquidation were to occur, the funds in Foreign Futures Customer's accounts may be liquidated in accordance with non-U.S. laws. To prevent the delay and administrative costs associated with retrieving U.S. funds in an account subject to non-U.S. bankruptcy laws, the funds of Foreign Futures Customers must be held completely separately from the funds of U.S. Futures Customers.

On a daily basis, each FCM is required to prepare a the Statement of Secured Amounts and Funds held in Separate Accounts for foreign futures and foreign options customers as of the close of business and to submit this statement to the CFTC and to its DSRO by noon the next business day.[82]

Depositories and Residual Interest

As of July 2014, any chosen depository (other than, with respect to U.S. Futures Customer funds, a DCO in certain circumstances) must provide the FCM and its DSRO with a written acknowledgement of the segregation/separation of the funds, within three business days of any deposit.[83] The depository must also agree, via a standardized depository acknowledgement letter, to provide the CFTC's Division of Swap Dealer and Intermediary Oversight ("DSDIO") "with direct, read-only electronic access to transaction and account balance information for … customer accounts"[84] and the CFTC's Division of Clearing and Risk or the DSDIO with the ability to examine the accounts at any reasonable time.

Beginning November 14, 2014, each FCM shall be required to deposit residual interest by the "Residual Interest Deadline" (which initially is 6:00pm Eastern Time and is subject to change) if, based on its calculations, the FCM determines that it has not met its targeted residual interest,[85] or its customers' accounts are under-margined.[86] Any residual interest may only be reduced or withdrawn in accordance with the regulations.[87]

Investment of Customer Funds

In certain circumstances, an FCM is entitled to invest customer property. If it does so, the FCM is required to manage the investments with the objective view to protecting the principal and ensuring liquidity. To that end, investments must be very safe and highly liquid – which is defined as being able to be converted into cash within one business day without a material discount in value. [88]

An FCM may only invest customer funds in the following permitted instruments[89] (provided that, generally, none of these instruments, except for the money market mutual fund, have embedded derivatives):[90]

- U.S. government, state, and municipal securities; Securities of U.S. government sponsored enterprises (U.S. agency obligations);
- Bank certificates of deposit;
- Commercial paper (fully guaranteed by Federal Deposit Insurance Corporation ("FDCI"));
- Corporate notes or bonds (fully guaranteed by FDIC); and
- Certain money market mutual funds.

Concentration Limits

The CFTC also imposes limits on the amount of customer funds that can be invested in any given instrument or with any given issuer ("concentration limits"). Except for investments in U.S. government securities (which are not subject to concentration limits), the concentration limits are as follows.

Type of Instrument	Concentration Limit[91]
Municipal Securities	No more than 10%
U.S. Agency Obligations	No more than 50%
Certificates of Deposit	No more than 25%
Commercial Paper (fully guaranteed by FDIC)	No more than 25%
Corporate Notes or Bonds (fully guaranteed by FDIC)	No more than 25%
Money Markey Mutual Funds (there is no concentration limit if the money market fund is comprised of only U.S. securities)	No more than 50%
Money Markey Mutual Funds (less than $1 billion in assets or with a management company comprising less than $25 billion in assets)	No more than 10%

Type of Issuer	Concentration Limit[92]
Any single issuer of Municipal Securities	No more than 5%
Any single issuer of U.S. Agency Obligations	No more than 25%
Any single issuer of Certificates of Deposit	No more than 5%
Any single issuer of Commercial Paper (full guaranteed by FDIC)	No more than 5%
Any single issuer of Corporate Notes or Bonds (fully guaranteed by FDIC)	No more than 5%
Any single family of Money Markey Mutual Funds (which MMMF is not comprised of only U.S. securities and which does not have less than $1 billion in assets or with a management company comprising less than $25 billion in assets)	No more than 25%
Any individual Money Markey Mutual Fund (which MMMF is not comprised of only U.S. securities and which does not have less than $1 billion in assets or with a management company comprising less than $25 billion in assets)	No more than 10%

While gains on permitted investments were always for the benefit of the FCM, the Final Rule now clarifies that any losses on the permitted investments shall be borne by the FCM.[93]

g. Business Continuity

In the wake of the events of September 11, 2001, the NFA adopted a rule requiring its members to establish a business continuity and disaster recovery plan. FCMs are required to adopt and maintain a written business continuity and disaster recovery plan that outlines procedures to be followed in the event of an emergency.[94] The plan should be reasonably designed so that an FCM can continue operating, reestablish operations, or transfer its business to another FCM with minimal disruption to its customers, other NFA members, and the futures markets.[95] The NFA rule is less prescriptive than the rule adopted by FINRA;[96] therefore applying a broker-dealers' business continuity and disaster recovery plan to its futures business should ensure compliance.

An FCM must provide the NFA with the name and contact information of two individuals who have

decision-making authority and who will be the points of contact for NFA in the event of an emergency. Hurricane Sandy, which wreaked havoc along the eastern seaboard of the United States, and hit the states of New Jersey and New York quite severely, served as a further impetus for the NFA to bolster its business continuity and disaster recovery requirements. Each FCM is required, by November 30, 2013, to do a one-time filing of management personnel information as well as the location/address and telephone number of its disaster recovery site(s).[97]

h. Financial Reporting

On a monthly basis, and no later than 17 business days after the close of business each month, an FCM must complete and submit Form 1-FR-FCM[98] to the FCM's DSRO and the CFTC.[99] An FCM that is also a registered broker dealer may file its FOCUS Report in lieu of Form 1-FR-FCM, provided that the FOCUS Report provides all the information required under the Form 1-FR-FCM.[100]

As of July 2014, each FCM that carries customer accounts will be required to establish, maintain and enforce policies and procedures designed to monitor and manage the risks associated with the FCM's activities (a "Risk Management Program").

On a fiscal year basis, an FCM must complete and submit an ***audited*** Form 1-FR-FCM or FOCUS Report to the NFA and the CFTC.[101] For a registered broker-dealer, the Form 1-FR-FCM must be filed no later than 60 calendar days after the date of its financial statements.[102] In the event the FCM cannot submit its reports within the required time frame it may file with its DSRO a copy of its application for an extension which it has requested from its DEA. Notice of rejection or approval of the request from the DEA must be immediately filed with the DSRO. The requested extension will be considered approved by the DSRO upon receipt of an approval by the DEA.[103]

The Final Rule also requires FCMs to file with the CFTC, within 17 business days of month end, the measure of their leverage as of the close of business for each month.[104] The definition of leverage will be provided by the NFA.

Other than the following information, the information contained in the Form 1-FR-FCM or the FOCUS Report, as applicable, is not subject to disclosure under the Freedom of Information Act, the Government in the Sunshine Act and CFTC regulation:

- the amount of the FCM's adjusted net capital; the amount of its minimum net capital requirement; and the amount of its adjusted net capital in excess of its minimum net capital requirement;
- the Statement of Financial Condition in the FCM's certified annual financial reports; and
- the Statements of Segregation Requirements and Funds in Segregation for customers trading on U.S. commodity exchanges and for customers' dealer options accounts, the Statement of Secured Amounts and Funds held in Separate Accounts for foreign futures and foreign options customers in accordance with § 30.7 and the Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts under section 4d(f) of the CEA.[105]

i. Other Reporting

An FCM is required to notify the CFTC, its DSRO, and the SEC (for broker-dealer FCMs) of, among other events, the following:

a. failure to maintain adequate capital requirements;[106]
b. failure to maintain proper books and records;[107]
c. failure to properly segregate customer funds;[108]
d. failure to invest funds in accordance with regulation 1.25; and[109]
e. failure to maintain the residual amount at the residual amount target and/or above the under-margined amount.[110]

The information provided by the FCM in these notices will not be publicly disclosed.

j. Ethics Training

The CEA requires newly registered FCMs, within six months of registration, to receive ethics training regarding their responsibilities to the public.[111] Personnel of currently registered FCMs must receive periodic ethics training as needed. The

CEA also authorizes the CFTC to develop standards for such training.[112] Accordingly, the CFTC released a "Statement of Acceptable Practices" ("SAP") outlining acceptable ethics training practices.[113] The SAP allows an FCM to either provide continuing education ethics training in-house or to have training be provided by an outside party.

In light of the SAP, ethics training at FCMs should include at a minimum, the following:

- an explanation of the applicable laws and regulations, and the rules of the SRO or exchanges;
- the FCM's obligation to the public to observe just and equitable principles of trading;
- how to act honestly and fairly and with due skill, care and diligence in the best interests of customers and the integrity of the market;
- how to establish effective supervisory systems and internal controls;
- how to obtain and assess the financial situation and investment experience of customers;
- disclosure of material information to customers; and
- avoidance, proper disclosure and handling of conflicts of interest.[114]

Conclusion

The world of futures trading, similar to the world of securities trading, is heavily regulated and subject to rigorous oversight. Fiscal year 2013 was a record year for the CFTC in terms of enforcement fines; the CFTC filed 82 enforcement actions resulting in $1.7 billion in fines.[115] David Meister, head of the CFTC's Enforcement Division, said "[a]s we have begun to enforce our new Dodd-Frank authority on top of the laws that have been on the books for decades, the cases we bring and the sanctions we have obtained reflect the Division's unwavering commitment to protect market participants and promote market integrity."[116] While the requirements imposed on FCMs are structured to address the complexities of the futures markets, they should not be completely foreign to a broker-dealer. A broker-dealer, however, must have new systems and processes to properly address the specific compliance obligations that arise with futures trading. While compliance can be an onerous task, in light of the wave of new regulations, a robust and thorough compliance department will go a long way to ensure that FCMs avoid regulatory crosshairs.

ENDNOTES

* The author is grateful to Kevin Lee who provided excellent research assistance.

1 Cornering the market is a practice consisting of "(1) securing such relative control of a commodity that its price can be manipulated, that is, can be controlled by the creator of the corner; or (2) in the extreme situation, obtaining contracts requiring the delivery of more commodities than are available for delivery." This definition of "corner" is available on the CFTC's online glossary at http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_co.

2 Futures Trading Act of 1921, Pub. L. No. 67-66, 42 Stat. 187.

3 Grain Futures Act of 1922, Pub L. No. 67-331, 42 Stat. 998.

4 Commodities Exchange Act of 1936, Pub L. No. 74-675, 49 Stat. 1491.

5 October 23, 1974, Pub.L. 93-463, 88 Stat. 1389.

6 7 U.S.C. § 2.

7 *Id.* at § 2(a)(2).

8 *Id.* at § 21.

9 17 C.F.R §171.1.

10 *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971).

11 Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1, 11 (1996).

12 7 U.S.C. § 1a(9).

13 See "History of the CFTC" at http://www.cftc.gov/About/HistoryoftheCFTC/history_1980s.

14 7 U.S.C. § 6(a).

15 The CFTC maintains a list of exchanges registered as Designated Contract Market at: http://sirt.cftc.gov/SIRT/SIRT.aspx?Topic=TradingOrganizations&implicit=true&type=DCM&CustomColumnDisplay=TTTTTTTT.

16 See David Mengle, *The Economic Role of Speculation*, ISDA Research Notes, November 2, 2010, http://www2.isda.org/functional-areas/research/research-notes/.

17 A futures commission merchant is defined in section 1a of the CEA as an "individual, association, partnership, corporation, or trust that is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery […]" and (i) "in or in connection with such [solicitation or acceptance of orders], accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom"; or (ii) "that is registered with the Commission as a futures commission merchant." For the full definition, see 7 U.S.C. § 1a(28).

18 *Id*. at § 1a(31).

19 See, e.g. *First Am. Discount Corp. v. CFTC,* 222 F.3d 1008, 1010 (D.C. Cir. 2000) (noting that a FCM is similar to a securities brokerage house in that it solicits and accepts order for futures contracts and accepts funds or extends credit in connection therewith).

20 A proprietary account, as defined in 17 C.F.R. § 1.3(y), includes accounts for the firm itself, affiliates, top officers, or directors. See also 17 C.F.R. § 3.10(c)(1).

21 *Id.* at (c)(2).

22 *Id.* at (a)(1).

23 Generally, a "security future" is a contract of sale for future delivery of a single security or of a narrow-based (generally comprised of 9 or fewer components) security index. For the full definition, see 7 U.S.C § 1a(44).

24 17 C.F.R. § 3.10(a)(3)(i).

25 Notice Form 7-R is available at: http://www.nfa.futures.org/nfa-registration/templates-and-forms/Notice7R.pdf

26 7 U.S.C. §6d(e).

27 A "foreign futures and options broker" is defined as a non-U.S. person that is a member of a for-

eign board of trade [...] licensed, authorized or otherwise subject to regulation in the jurisdiction in which the foreign board of trade is located; or a foreign affiliate of a U.S. futures commission merchant, licensed, authorized or otherwise subject to regulation in the jurisdiction in which the affiliate is located." 17 C.F.R. § 30.1(e).

[28] 17 C.F.R. § 30.3(a).
[29] 17 C.F.R. § 3.3(a).
[30] 17 C.F.R. § 3.3(d)(1); 17 C.F.R. § 3.3(d)(4).
[31] 17 C.F.R. § 3.3(d)(2); Additionally, FCMs are required to "establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to research or analysis of the price or market for any commodity are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in trading or clearing activities might potentially bias their judgment or supervision of the person; and address such other issues as the Commission determines to be appropriate." 7 U.S.C.A. § 6d(c).
[32] 17 C.F.R. § 3.3(d)(4).
[33] *Id.* at (d)(5).
[34] *Id.* at (d)(6) and (e).
[35] *Id.* at (e)(1).
[36] *Id.* at (e)(2).
[37] *Id.* at (e)(5).
[38] NASD Rule 3012; FINRA Rule 3130.
[39] 17 C.F.R. § 3.3(f)(2).
[40] *Id.* at (f)(3).
[41] 17 C.F.R. 3.12(h).
[42] 7 U.S.C. § 6k(1).
[43] 49 Fed. Reg. 39593.
[44] See NFA Notice I-07-38.
[45] See 7 U.S.C. 6k(1); See also NFA Notice I-07-38.
[46] NFA Rule 401.
[47] Form 8-R is available here: http://www.nfa.futures.org/nfa-registration/templates-and-forms/8rFormentire.pdf.
[48] NFA Rule 206(a) and NFA Rule 203(a).
[49] CFTC Letter No. 13-29.
[50] Net Capital is defined as the amount by which current assets exceed liabilities. See 17 C.F.R. § 1.17(c).
[51] *Id.* at (a)(2)(i).
[52] *Id.* at (a)(1)(A)-(D).
[53] *Id.* at (a)(3).
[54] *Id.* at (a)(4).
[55] Id.
[56] 17 C.F.R. § 1.31.
[57] *Id.* at (a)(1).
[58] 17 C.F.R. § 1.35(a)(1)(i)-(viii).
[59] *Id.* at (a)(1) (emphasis added).
[60] A principal is defined at http://www.nfa.futures.org/NFA-registration/principal/index.HTML
[61] See NFA Compliance Rule 2-10(b)(1) .
[62] Pursuant to 17 C.F.R § 30.10, persons located outside the U.S., who are subject to a comparable regulatory framework in the country in which they are located, may seek an exemption from the application of certain CFTC regulations.
[63] NFA Compliance Rule 2-10(d)(1) and 17 C.F.R. § 1.35(a)(1).
[64] 17 C.F.R § 1.11.
[65] *Id.* at (d).
[66] *Id.* at (b)(1).
[67] 17 C.F.R. § 1.11(e).
[68] Governing body means the proprietor, if the futures commission merchant is a sole proprietorship; a general partner, if the futures commission merchant is a partnership; the board of directors if the futures commission merchant is a corporation; the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority if the futures commission merchant is a limited liability company or limited liability partnership. 17 CFR 1.11(b)(3).
[69] 17 C.F.R. § 1.11(e(2).
[70] 17 C.F.R. § 1.11(c)(4).
[71] Laura Goldsmith, The Collapse of MF Global and Peregrine Financial Group: The Response from the Futures Industry, Regulators, and Customers, Review of Banking and Financial Law (2012-2013).
[72] See, 17 C.F.R. § 1.20(a); NFA Financial Requirements § 16(a); 17 C.F.R. § 30.7(a); 17 C.F.R. § 22(b).
[73] Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations (Final Rule), 78 Fed. Reg. 68506 (Nov. 14, 2013).
[74] 17 C.F.R. § 1.20(a).
[75] *Id.* at (f).
[76] *Id.* at (e).
[77] 17 C.F.R. §1.32
[78] 17 C.F.R. § 30.7(a).
[79] *Id.* at (b).
[80] *Id.* at (c).
[81] *Id.* at (e)(3).
[82] 17 C.F.R. §30.7(l)
[83] 17 C.F.R. §30.7(l)
[84] 17 C.F.R. § 1.20(d)(3)(i) and § 30.7(d)(3)(i)
[85] Amount of proprietary funds that the FCM has determined is necessary to be deposited in a customer account to ensure compliance with the segregated funds requirements.
[86] 17 C.F.R. § 1.22
[87] 17 C.F.R § 1.20(e) and 17 C.F.R §1.23 for U.S. Futures Customers, 17 CFR § 30.7(e) and (g) for Foreign Futures Customers.
[88] 17 C.F.R. § 1.25(b).
[89] *Id.* at (a).
[90] *Id.* at (b)(2)(i).
[91] *Id.* at (b)(3)(i).
[92] *Id.* at (b)(3)(ii).
[93] 17 C.F.R. § 1.29.
[94] NFA Compliance Rule 2-38.
[95] *Id.*
[96] FINRA rule 4370.
[97] NFA Notice to Members I-13-31
[98] Form 1-FR-FCM is available here: http://www.nfa.futures.org/NFA-registration/templates-and-forms/form1FR-fcm.HTML .
[99] 17 C.F.R. § 1.10(c)(1).
[100] *Id.* at (h)
[101] *Id.* at (b)(1)(ii).
[102] *Id.*
[103] *Id.* at (f)(i).
[104] *Id.* at (b)(5).
[105] *Id.* at (g)(2)(ii).
[106] 17 C.F.R. §1.12(a).
[107] *Id.* at §1.12(c).
[108] *Id.* at §1.12(h).
[109] *Id.* at §1.12(i).
[110] *Id.* at §1.12(j).
[111] 7 U.S.C. § 6p(b).
[112] *Id.* at § 6p(a).
[113] 17 C.F.R 3, App. B.
[114] *Id.* at 3, App. B(c)(1)-(7).
[115] See CFTC Release PR6749-13 available at http://www.cftc.gov/PressRoom/PressReleases/pr6749-13.
[116] *Id.*