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Customer asset protection

Investor concerns about the safety of their assets maintained at custodians achieved new heights during the financial downturn, when there was daily uncertainty about the health and existence of large financial institutions. Since then, the very public collapse of some large financial firms has led customers to question the safety of their assets and coalesced forces driving:

- Increased regulatory scrutiny around customer asset protection
- Questions about the role regulators, auditors, and institutions play in protecting customer assets
- The need for greater awareness by customers about how their assets are being handled

As broker-dealers and futures commission merchants (FCMs) move forward in the continued effort to protect their customers' assets, it may be helpful to understand previous rulemaking actions, where regulation may be heading, and potential governance structure adaptations.

A look back at rulemaking

The customer asset protection rules were designed to safeguard customer assets against insolvency by requiring broker-dealers and FCMs to segregate and report customer assets they hold. In essence, broker-dealers and FCMs are expected to operate with a clear understanding of the amount of customer assets to segregate and where customer assets are located. A summary of both the Securities Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) rule set provides a view into the SEC's possession or control and reserve formula requirements and the CFTC's segregation and secured amount requirements.

SEC	CFTC
• SEC Rule 15c3-3 is intended to protect customer funds with two main requirements (1) possession or control of securities and (2) reserve formula. The requirements have the objectives of establishing guidelines to calculate customer assets to be segregated, methods to segregate and practices to prevent broker-dealers from using segregated customer assets to finance their proprietary activities, satisfying deliveries and covering customer short transactions. The possession or control section of the rule requires a daily identification and segregation of fully paid and excess-margin customer securities and limits the broker-dealer's activities for specific securities not segregated. Segregated securities are held in "good control" locations that should be free of any rights or liens. • The reserve formula calculation is performed weekly to identify customer related payables and receivables. If the calculation results in a net payable to customer, the broker-dealer is required to reserve this amount in a special reserve bank account. This special reserve bank account is for the exclusive benefit of customers and funds can only be withdrawn with the support of an updated reserve formula calculation. In theory, on the date the reserve formula is calculated, combining the securities held in possession or control plus the funds included in the reserve formula should equal the amount the broker-dealer owes to the customer.	• CFTC Regulations 1.20 and 30.7 are designed to protect customer funds through requiring the continuous segregation of customer assets supported by two main reports (1) segregation statement and (2) secured amount statement (required by a FCM that carries customer accounts/holds customer funds trading on U.S. or foreign commodity exchanges respectively) • The CFTC's segregation and secured amount computations are performed to determine the required amount sufficient to cover obligations to customers • The segregated and secured amount computations are calculated daily by comparing the amount required to be segregated, as determined by the net balance in the account and any profits or losses on open futures contracts, with the amount of segregated or secured funds on hand. Any shortages identified require additional funds to be locked up • CFTC Regulation 1.25 further governs permissible investments of customer funds and provide good control locations or acceptable custodians at which customer assets can be held
For both broker-dealers and FCMs, the rules require that notification be made to the regulators when noncompliance occurs.	

Where regulation is headed

The CFTC and SEC have made some changes and proposed others to enhance reporting requirements and further promote customer asset protection. These rules focus on three broad themes: accountability, transparency, and risk management. The SEC's approach to improving customer asset protection has been primarily through proposed amendments to its reporting and audit rule, Rule 17a-5.[1] As summarized below, the proposal would require additional reports by securities firms and independent compliance audits of the broker-dealer's compliance with SEC financial responsibilities rules (FRRs).

Proposed SEC broker-dealer regulations

Category	Summary rule making	Considerations
Accountability	**Annual compliance report**: Carrying broker-dealers that maintain custody of customer funds or securities will be required to prepare an annual compliance report that requires the broker-dealer to assert its compliance with and effective control of the following FRRs: • The uniform net capital rule – SEC Rule 15c3-1 • Customer protection – reserves and custody of securities – SEC Rule 15c3-3 • Quarterly securities count – SEC Rule 17a-13 • Account statements (as per designated examining authorities (DEAs)) The assertion should note whether or not: • The broker-dealer was in compliance with the FRRs in all material aspects as of its fiscal year-end • The information used to assert compliance with the FRRs was derived from the books and records of the broker-dealer • The internal control over compliance with the FRRs in the most recent fiscal year exhibited no instance of material weakness • The broker-dealer has established and maintained a system of internal control to provide it with reasonable assurance that any instances of material non-compliance with the FRRs will be prevented or detected on a timely basis Non-carrying broker-dealers would be required to file an exemption report asserting that the broker-dealer is exempt from the provisions of SEC Rule 15c3-3 because it meets one or more of the conditions set forth in paragraph (k) of SEC Rule 15c3-3. A broker-dealer dually registered as an investment adviser under the Investment Advisers Act of 1940 would no longer have to obtain an internal control report under the investment advisers' custody rule but would still be subjected to annual surprise security counts. **Public Company Accounting Oversight Board (PCAOB) standards**: The PCAOB proposed new standards for broker-dealer audits and auditing of supplemental information. The PCAOB proposed new attestation standards on examinations of the compliance and exemption reports that would require independent auditors to review the assertions made by the carrying broker-dealer as of a specific business date and apply a risk-based approach in reviewing the assertions made by a broker-dealer claiming an exemption from Rule 15c3-3. **Financial responsibility**: The SEC has proposed changes to Rule 15c3-3 that are intended to improve asset protection and require the broker-dealer to perform the following: • **Treatment of accounts**: Treat accounts carried for both domestic and foreign broker-dealers, previously considered as non-customer, as customer accounts for the purposes of the SEC Rule 15c3-3 reserve formula. This may avoid inconsistencies with customer identification under the Securities Investor Protection Act (SIPA) and mitigate the risk of a customer asset shortfall in future broker-dealer failures	• Internal discussions on who would provide the assertions should be considered • Broker-dealers should consider assessing their current controls and associated FRR documentation, including but not limited to controls and supervision of systems, data, and applicable regulatory rules used to prepare reports and calculations • Consideration to methods to package data, schedules, etc., to support assertion, including development of the compliance or exemption reports • Broker-dealers and their auditors would need to coordinate their efforts to assist with complying with the proposed requirements • Broker-dealers would be required to perform a separate reserve calculation for assets held by domestic and foreign broker-dealers and need to establish new bank accounts to meet the segregation requirement. This would also include assessing the components necessary to meet the requirement and re-engineer the processes used in the current customer reserve calculations • Broker-dealers that utilize cash to satisfy their reserve requirements would need to re-distribute the funds or implement the use of qualified securities in order to satisfy the calculation's requirement. In addition, broker-dealers would have to re-evaluate the methods used to identify the qualified security parameters as new securities can be used to satisfy the reserve requirement

[1] See SEC Release 34-66910 on the reissuance of SEC Release 34-55431 (Amendments to Customer protection), and SEC release 34-64676 Amendments to SEC Rule 17a-5

	• **Reserve cash deposits**: Exclude cash deposits at affiliated banks for the purposes of meeting customer reserve requirements and place limitations on the amount maintained within an unaffiliated account as the cash included in the account can be accessed and used as part of the commercial bank's lending activities. Cash deposits would be able to be held at unaffiliated banks as long as a series of requirements is satisfied • **Possession or control**: Currently no action is required if a segregated customer long position allocates against a customer short position. The proposal would require the broker-dealer to bring the security into possession or control after it has been aged ten business days **Disclosures**: Objective of the proposal is to limit how free credits are used by the broker-dealer and essentially requires customer authorization before the free credit is used and/or moved. The proposal allows some exceptions: (1) customer has provided previous consent; (2) applicable disclosures are provided; (3) 30-day notice is given prior to free credit balances being transferred to a different product and/or terms • **Free credits**: The SEC proposes to amend the definition of "free credit balances" in paragraph (a)(8) of SEC Rule 15c3-3 to include funds resulting from margin deposits and daily marks to market related to, and proceeds from the liquidation of, futures on stock indices and options carried in a securities account in accordance with the portfolio margining rule of a self-regulatory organization. Under the proposed amendment, a broker-dealer holding such funds would be required to treat them as "credit items" for purposes of the customer reserve computation	• Possession or control department would need to enhance their procedures to identify this additional scenario and track and resolve these items in a timely manner • Overall, broker-dealers will likely have to incorporate new functionality or reporting to current processes in order to provide the appropriate notices to customers and capture the customers' authorization and approvals of such notifications to convert, transfer or invest free credit balances • Coordination would be needed between Regulatory and operations department in order to identify the additional information required by the proposal
Transparency	**Form custody requirement**: The SEC proposal would require broker-dealers to file a new Form Custody that would be due 17 business days after quarter end and within 17 business days after the date selected for annual reports, if not a quarter end. The Form Custody covers nine items of information regarding custodial activities to help provide regulators with current information about a broker-dealer's custodial activities and promote compliance with applicable laws and regulations. Some examples of information requested on the form custody include: • Security location and reconciliation frequency • Cash and securities held for customers and noncustomers categorized by security type and market value ranges, including how and where free credits are held **Access to audit documents**: Carrying broker-dealers (that clear transactions or carry customer accounts) are required to allow the SEC and their DEAs to discuss annual audit findings with their independent auditors and review related audit documentation. **Notification requirement**: The proposal indicates that the broker-dealer's independent auditor is to notify the SEC within one business day of determining that an instance of material noncompliance exists.	• Broker-dealers should consider the data requirements of the proposed rules and ascertain whether or not current infrastructure in place is sufficient to meeting such requirements • Broker-dealers should also be prepared for the SEC and relevant DEAs to conduct more frequent and possibly targeted inquiries (on a more real-time basis)

Finalized FCM regulations

Category	Summary rule making	Considerations
Accountability	**Customer fund levels**: Effective May 1, 2012, FCMs are required to report daily customer fund levels to the Chicago Mercantile Exchange Group (CME). These reports are required to be signed by the chief executive officer (CEO), chief financial officer (CFO) or their designated representative.[2] **Residual interest**: Effective September 1, 2012:[3] • FCMs are required to adopt a pre-approval process of the disbursement of customer funds that isn't for the customer benefit and exceeds 25 percent of total segregated funds. Pre-approval by the CEO, CFO, or other designated representative is required in writing • FCMs are required to operate with written policies and procedures regarding the maintenance of the firm's residual interest in its customer segregated funds. These policies and procedures must target an amount (either by percentage or dollars) that the FCM seeks to maintain as its residual interest in those accounts in order for the FCM to remain in compliance with the applicable segregation requirements	• Filing daily customer reports with the CME allows for additional transparency into customer balances by the regulators • FCMs should expect additional inquiries from the regulators • Adopting a pre-approval process would require FCMs to have a more formal process in place with respect to residual interest, which may include a more formal process for communicating residual interest amounts to management with explanatory details or support, as well as revisiting cushion amounts and monitoring events or criteria that can adversely impact established residual targets
Transparency	**New reporting**: Effective July 2, 2012, all FCMs are required to file a Segregated Investment Detail Report (SIDR) bi-monthly,[4] which will include: • The amount of customer segregated funds and foreign futures and foreign option secured amounts held. • The identity of each depository holding customer's segregated funds or foreign futures and foreign option secured funds and the amount held at each.[5] **Access to account information**: On August 16, 2012, the National Futures Association (NFA) Board of Directors approved amendments to NFA financial requirements for FCMs that require FCMs to provide its designated self regulatory organization (DSRO) with view-only access via the Internet to account information for each of the FCM's customer-segregated and secured-funds account(s) maintained and held at a bank or trust company. If a bank or trust company is unable to allow the FCM to provide its DSRO with view-only access via the Internet, the bank or trust company will not be deemed an acceptable depository to hold customer segregated and secured accounts.[6]	• Similar to the above, the SIDR report and providing the regulators with viewing access to customer accounts may provide for more real-time monitoring by the regulators of customer funds • FCMs should expect additional inquiries from the regulators
Risk management	**Limits on investments of customer funds**: Effective February 17, 2012, restrictions have been placed on the investments of customer funds. FCMs and derivatives clearing organizations (DCO) are no longer allowed to invest in sovereign debt, corporate obligations not guaranteed by the U.S. government, or internal repo transactions.[7] **Rescinded methodology**: Effective September 1, 2012, FCMs are no longer allowed to use the margin plus, or alternative, method to calculate the secured amounts for customer funds. They must now use the net liquidating value (NLV) method to calculate the secured amounts to be segregated.[8] **Legal segregation with operational commingling (LSOC)**: Effective November 8, 2012, FCMs who also deal swaps are required to compile information about their cleared swaps customers and report daily to the DCO. On a daily basis, CFTC Regulation 22.11 requires that FCMs provide DCOs with the value of each customer's collateral associated with the clearing level initial margin requirement for the customer's cleared swaps portfolio. Records must be maintained at both the FCM and DCO of each customer's cleared swaps collateral. DCO cannot use non-defaulting customer property to cover defaulting customer losses.[9]	• FCMs to continue to closely monitor and comply with restrictions on type of investments as well as thresholds on percent of customer funds that can be invested in a product type. This may include revising existing monitoring tools and/or instituting a new monitoring tool to assist with adherence with the CFTC's requirements • The NLV method will allow for a more accurate understanding of customer account value and impact how much an FCM has to lock up • FCMs' recordkeeping requirements will likely require revision to meet the requirements of LSOC

[2] See CME Advisory #12-04, notice date: April 2, 2012. Additional reporting requirements adopted under CME, CBOT and NYMEX Rule 970.D

[3] See NFA Notice I-12-14 dated July 18, 2012

[4] See NFA Notice to Members I-12-11 dated June 27, 2012

[5] It should be noted that subsequent to the effective date of this requirement, the CME Group requested that the cash balances reported by FCMs on the SIDR no longer include cash on deposit at clearing organizations or carrying brokers.

[6] See NFA News Release dated August 16, 2012, NFA's Board of Directors approves rule to enhance the customer segregated funds protection regime and Federal Register, Volume 77 Issue 220 dated November 14, 2012

[7] See final rule Federal Register December 19, 2011, Vol. 76, No. 243, at page 78776

[8] See Interpretive Notice 9066 - NFA Financial Requirements Section 16: FCM Financial Practices and Excess Segregated Funds/Secured Amount Disbursements, dated May 17, 2012

[9] See CFTC Part 22 Regulations

Additional proposed customer protection regulations

The CFTC has also drafted proposed rules on customer protection[10] and held a public roundtable in August 2012 to further discuss the subject. The next round in rule-making proposes changes in examinations, risk management, notifications, and submissions, which would:

- **Residual interest**: Require FCMs to maintain at all times a residual interest sufficient to exceed the sum of all customer margin deficits in each account class (domestic segregated accounts and foreign secured accounts)
- **Under margin charge**: Require FCM to take a capital charge for undermargined customer, noncustomer and omnibus accounts that are undermargined for more than one business day after a margin call is issued. Currently, a capital charge may apply to all accounts which are subject to margin calls for five business days or more for customers and four business days or more for noncustomers and omnibus accounts
- Treatment of foreign futures or foreign options secured amount:
  - Require funds to be set aside equally for US-domiciled and foreign-domiciled customers trading on foreign boards of trade by establishing a new definition of 30.7 Customers to include existing foreign futures or foreign option customers which are US-domiciled as well as those which are foreign-domiciled
  - Require that FCMs limit the amount of funds held in non-US jurisdictions. Under the proposed rule, an FCM must hold 30.7 funds in the US, except to the extent that the funds held outside of the US are necessary to margin, guarantee, or secure foreign futures or foreign option positions of 30.7 Customers
- **FCM examinations**: Broaden the scope of examinations by regulators and auditors to include re-assessing and/or enhancing the following:
  - Risk-based approaches used in testing areas and/or methodologies
  - Understanding the impact of potential risks associated with FCMs' affiliates
  - Assessing FCMs' internal control systems and processes
  - Enhancing and/or adopting new procedures for fraud detection
  - Regulatory coordination aimed at gaining a more holistic awareness of legal-entity matters impacting FCMs and potentially avoiding duplication in regulator exam procedures
- **Risk management program**: Require FCMs to adopt risk management programs that include:
  - Policies and procedures, method for identifying risks, risk limits, etc.
  - Annual reviews by internal audit or an external third party
- **Reportable events**: Require FCMs to file a notification for when they violate the CFTC's regulation on permissible investment of customer funds or when a material adverse event occurs (e.g., credit rating downgrade, termination of a material line of business)
- **Regulator coordination**: Require an FCM that receives a notice, examination report or any other correspondence from the SEC or a SRO to file a copy of such notice, examination report, or correspondence with the CFTC
- **Report submissions**: Require all submissions to the NFA be done electronically (potentially limiting and/or eliminating paper filings), providing for more real-time access to information about FCMs

[10] See: Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, Commodity Futures Trading Commission, 77 FR 67866, RIN 3038-AD88, November 14, 2012.

Think about it…

The new and proposed rules, along with experiences from current and past liquidations, point to the importance of an effective governance structure that can adapt during the normal course of business and in stress scenarios. While differing events can create the need for quick decisions and limited reaction time often comes into play, having a formal governance framework can assist with monitoring risks associated with protecting customer funds. When reviewing a governance framework, these questions—and their answers—can help identify areas where enhancements may benefit how a broker-dealer or FCM protects its customers' assets.

Questions to ask…	…why important
Are there clear authorizations and a chain of command in place for establishing and modifying residual interest/cushions?	Establishing and communicating the chain of command and applying this process on a consistent basis can assist with unnecessary derailment when decisions need to be made.
Have key operational events, risk areas, and scenarios that can impact residual target amounts or potentially impair customer assets been identified and has management been made aware?	Understanding the factors/criteria that drive variances in residual interest are important for being able to react in a timely fashion as events occur. Periodically revisiting these criteria is also important.
What if a stressed situation occurs and there is demand for prompt release of cash but regulatory personnel do not have the information or resources to re-calculate the customer reserve, segregation or secured amount calculations?	Pressures of a stressed financial condition typically include multiple requests to release excess amounts and require: • Identifying clearly whether the excess amount are customer or broker-dealer/FCM funds • Aligning personnel at the appropriate levels and chain of command to approve/authorize any withdrawals of residual amounts, so that undue pressure is less likely to be placed on a subordinate and decisions are made by those who have the authority and responsibility to do so • Documenting conservative approaches (that may be informally adopted or undocumented) to make certain policy is followed and a clear authorization and documentation process is in place if an override is needed
Does the governance process address various support, technology, and controls? Does it consider: • Support needed to request and approve movement of customer assets • Appropriate technology/tools in place to monitor intraday customer asset movements • Existing controls concerning identification of customer assets to be protected and segregated	Having a formal policy in place with clearly delineated processes that can be consistently applied may assist with managing risks associated with protection of customer assets.

How Deloitte can help

Deloitte's experience with bankruptcy liquidations has placed us at the forefront of this changing regulatory landscape. We continue to be a trusted advisor in helping institutions consider industry challenges and risk practice enhancements that assist with addressing potential needs in normal times and during times of crisis. Some examples include:

- Interpreting and implementing rules
- Responding to regulator inquiries
- Assessing processes, technology, procedures, and controls used to comply with applicable regulations
- Assisting with the establishment of regulatory reporting governance and structure
- Assessing business and operational impacts on regulatory reports/calculations
- Providing insight on leading industry practices

While the rules and standards addressed in this briefing continue to be refined by regulators, there are many things broker-dealers and FCMs can consider doing to prepare. Deloitte's Governance Risk & Regulatory Strategies professionals can help broker-dealers and FCMs determine how to effectively manage and implement finalized rulings—and rulings to come.

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