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CLIENT ALERT

CFTC Permits Separate Account Treatment

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The Commodity Futures Trading Commission is charged with implementing the objectives of the Commodity Exchange Act, which include avoiding systemic risk and protecting customer assets. Initial margin that adequately covers the gap risk between the last margin call and the close out of a derivatives position stems the impact of a customer or clearing member default and serves as a cushion against systemic risk. The CFTC has long required a derivatives clearing organization (DCO) to ensure that its clearing members prevent customer withdrawals, unless the remaining account balance following such withdrawal is adequate to meet the initial margin requirements of the customer's cleared positions.[1] This regulation is known as the margin adequacy requirement. The purpose of this regulatory requirement is to ensure that a clearing member of a DCO, considered the first line of defense against the failure of the DCO, holds customer assets sufficient to cover the customer's required initial margin amount.

The margin adequacy requirement has often posed significant implementation challenges for futures commission merchants (FCMs) and their commodity pool customers with respect to certain market practices. Some commodity pools (investment vehicles or funds) allocate assets to multiple trading advisors. Under such arrangements, each advisor manages a specified portion of the fund's assets, independent of the trading undertaken by trading advisors acting on behalf of other accounts of the commodity pool. If each account were treated as a single customer, a

[1] 17 C.F.R. § 39.13(g)(8)(iii).

deficiency in an account managed by one trading advisor would constitute a deficiency for the account managed by a separate advisor, even though there might be margin excess in that separate account. As a result, the customer would not be able to continue its trading activities with respect to the fully margined separate account, or worse, would be closed out. Separate account treatment allows an FCM's customer to apportion assets among multiple advisors without concern about whether the activities of one advisor will impact another.

Recently, the CFTC amended its regulations to extend the margin adequacy requirement—currently applicable to DCOs and their FCM clearing members—to all FCMs, including non-clearing FCMs. Additionally, the CFTC is allowing FCMs to treat a single customer's separate accounts as accounts belonging to separate entities, subject to certain risk-management safeguards.[2] In adopting the final rule, the CFTC codified, with important modifications, the staff's no-action position in CFTC Letter No. 19-17 and the superseding letters regarding separate account treatment.[3]

Many in the industry hail the codification of separate account treatment as an important step in the right direction. It simplifies compliance for FCMs and their commodity pool customers and aligns with industry practice of treating the separate accounts of the same customer as separate legal entities. Below we summarize the margin adequacy and separate account treatment rule amendments codified in CFTC Regulation 1.44 and highlight key compliance considerations.[4]

Margin Adequacy Requirement

An FCM must prevent customer withdrawals unless the net liquidating value (*calculated as of the previous business day*) plus the margin deposits remaining after such withdrawal are sufficient to meet the initial margin requirements of all of the customer's positions, except where an FCM is permitted to disburse funds on a separate account basis. Under the final rule, the margin adequacy requirement has been extended to non-clearing FCMs (in addition to clearing FCMs) and foreign futures and foreign options transactions (in addition to U.S. futures and U.S. options and swaps).

Separate Account Treatment

For purposes of complying with the margin adequacy requirement, an FCM may elect to treat the separate accounts of a customer as accounts of separate entities during the "ordinary course of business." Separate account treatment permits a customer to continue its trading activities in a separate account when there is a short-term margin shortfall in another account it owns. It is important that separate account treatment does not expose the FCM or DCO to significant financial risks. Additionally, in an omnibus account structure, if separate account treatment results in the

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[2] *Regulations To Address Margin Adequacy and To Account for the Treatment of Separate Accounts by Futures Commission Merchants*, 90 Fed. Reg. 7880 (Jan. 22, 2025), available here.

[3] CFTC Letter No. 19-17, July 10, 2019, available here, as extended.

[4] The CFTC also adopted corresponding amendments to its regulations to integrate the new rule into the existing regulatory framework.

undermargining of a customer account, an FCM may misuse one customer's margin to cover another customer's liabilities. To address these concerns, the CFTC adopted several risk-mitigating guardrails summarized below.

1. *Election of Separate Account Treatment.* The CFTC established the manner in which an FCM may elect to engage in separate account treatment. An FCM must maintain an up-to-date list of its separate account customers in its books and records, identifying the customer and the customer's separate accounts. Additionally, within one business day of including its first customer on such list, an FCM must notify its designated self-regulatory organization (DSRO) and the CFTC of its election to apply separate account treatment to certain customers.

2. *Ordinary Course of Business.* The CFTC permits separate account treatment only in the absence of certain events that are considered to be inconsistent with the ordinary course of the business relationship between the FCM and its customers. The CFTC enumerated nine events that signal the financial or operational distress of the FCM or the separate account customer, including:

   a. the failure by the customer to deposit initial margin, maintain maintenance margin, or make payment of variation margin or option premium within the required time frames;

   b. the occurrence and declaration of an event of default with respect to the customer under the customer agreement;

   c. a good faith determination by certain specified employees of the FCM that the customer is in financial distress or there is a significant and bona fide risk that the customer will be unable to perform its financial obligations;

   d. the insolvency or bankruptcy of the customer or its parent company;

   e. a good faith determination by certain specified employees of the FCM that it is in financial or other distress; and

   f. the insolvency or bankruptcy of the FCM or its parent company.

   By the business day after it has knowledge of the occurrence of one of these events, the FCM must notify its DSRO and the CFTC, identifying the event and customer, and terminate or suspend disbursements on a separate account basis. The FCM may resume disbursements on a separate account basis if the FCM reasonably believes, based on new information, that such event has been cured, including documenting in writing the factual basis and rationale for its conclusion. CFTC Rule 1.44 also specified what constitutes a "cure" with respect to certain events not summarized herein.

3. *One Business Day Margin Call.* The CFTC imposed a short time frame for a separate account customer to meet its FCM's margin calls. Each separate account must be on a one business day margin call, with

limited exceptions applicable to certain foreign currencies and banking holidays in foreign jurisdictions. The FCM is required to issue a margin call for at least the amount necessary to meet the initial margin requirement of the relevant exchange or clearing organization, and a customer must satisfy the margin call by the close of the Fedwire Funds Service on the same business day. Helpfully, the CFTC permits a grace period for a failure to deposit, maintain, or pay margin or option premium as a result of an administrative error or operational constraint, which accords with industry practice between an FCM and its customers.

4. *Financial Metrics Calculations.* The CFTC clarified that certain computational and recordkeeping requirements with respect to a separate account customer must be performed as if each account of such customer belongs to a separate entity. Specifically, the FCM must provide for stress testing and credit limits on both an individual separate account and on a combined account basis in the FCM's internal risk-management policies and procedures. Additionally, the following calculations must be performed on a separate account basis: margin requirement for a customer, adjusted net capital for undermargined customer accounts, own funds required to cover deficits or debit ledger balances, residual interest and legally segregated operationally commingled compliance, and residual interest target. The FCM may not recognize offsets or spreads across separate accounts when computing the customer's margin requirement or offset a deficit or debit ledger balance of a customer by any credit balance of such customer when calculating its own funds requirement. Each separate account must be recorded as a distinct account of a customer in the FCM's books and records.

5. *Information and Disclosures.* The CFTC imposed certain information and disclosure requirements. An FCM must collect information, from the separate account customer or trading advisor, on the value of assets dedicated to separate accounts, the identity of the customer's parent company, if any, and contact information for any customer representatives. Additionally, an FCM must disclose to its separate account customers that, pursuant to Part 190 of the CFTC's regulations, all separate accounts of a particular customer will be combined as a single account in the event of the FCM's bankruptcy. The disclosure must be delivered directly to the customer, and the FCM must maintain a record that the disclosure was so delivered. The disclosure may be made on the FCM's website or within its disclosure document pursuant to CFTC regulation 1.55(i). That rule requires an FCM to disclose material information about the FCM to customers. An FCM's disclosure document must also inform customers that the FCM has elected to operate on a separate account basis and that, if separate account treatment for some customers were to contribute to a loss that exceeds the FCM's ability to cover, such loss may impact the segregated funds of all the FCM's customers.

An FCM electing separate account treatment must maintain written internal controls and procedures designed to ensure compliance with these risk-mitigating requirements. Implementation of these safeguards may require significant operational and documentation changes for FCMs and their funds customers, particularly for non-clearing FCMs that were not previously subject to any margin adequacy requirement. FCMs may need to rework systems and operational workflows.

All FCMs, particularly non-clearing FCMs, should review their existing policies and procedures, internal controls, customer agreements, and disclosure documents to determine which may need updating to specifically address the requirements of the final rule on separate account treatment.

Compliance Dates

An FCM that elects separate account treatment must establish a comprehensive and effective framework designed to ensure compliance with the requirements of the final rule by the applicable compliance date. The final rule becomes effective on March 24, 2025. The compliance date for an FCM that is a clearing member of a DCO as of January 22, 2025 is July 21, 2025. The compliance date for all other FCMs is January 22, 2026. FCMs have a long implementation period. It is of course best practice to begin the implementation process sooner rather than later to ensure timely compliance.

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If you have any questions regarding this client alert, please contact one of the authors, any member of our CFTC team listed below, or the Willkie attorney with whom you regularly work.

Willkie has a dedicated team of attorneys with extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

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