

CFTC Staff Guidance Dispels Longstanding Legal Uncertainty Around an FCM's Use of Customer Securities to Secure Foreign Futures Exposures

December 1, 2025

In 2016, and again in 2018, Commodity Futures Trading Commission (CFTC) staff issued no-action letters permitting Futures Commission Merchants (FCMs) to deposit securities pledged by their foreign futures customers with a foreign broker affiliate of the FCM under a limited right of use in favor of the foreign broker. The relief afforded by those letters was narrowly tailored to regulatory requirements under UK law, and subject to highly prescriptive compliance conditions that most FCMs found difficult, or impossible, to implement. In summarizing the facts underlying the no-action positions taken in the letters, CFTC staff stated that title transfer arrangements (common under the laws governing the operations of foreign brokers, exchanges and clearinghouses) involving customer-owned securities deposited by an FCM with a foreign broker are "prohibited" by CFTC Regulation 30.7.

Regulation 30.7 requires, among other things, that an FCM (i) must deposit funds and securities deposited by customers executing and clearing futures listed on foreign futures exchanges under the laws and regulations of the relevant foreign jurisdiction that provide the "greatest degree of protection" to such funds and securities, and (ii) may not waive any of the protections afforded to such customer funds and securities under the laws of that foreign jurisdiction. The CFTC adopted these restrictions in 2013 as part of its enhanced customer protection rulemaking in the wake of the bankruptcy and liquidation of MF Global. Specifically, a dispute emerged in the MF Global bankruptcy proceeding concerning the legal status of securities deposited by customers of MF Global's FCM to secure their foreign futures exposures on foreign clearinghouses. The FCM's bankruptcy asserted that those customer securities should be returned by the foreign affiliate to the FCM estate as protected client assets. The administrator for the foreign affiliate (in a separate insolvency proceeding under UK law) claimed that the FCM had opted out of the local client asset protection regime and elected an alternative legal structure. The alternative regime, if elected, would involve an absolute title transfer of the customer securities to the foreign affiliate and would have resulted in the FCM and its

foreign futures customers effectively becoming general creditors upon the insolvency of the foreign affiliate. The Regulation 30.7 restrictions adopted in 2013 were intended to prohibit an FCM from opting out of customer asset protections available under the law and regulation applicable in foreign jurisdictions.

The no-action letters, together with the 2013 30.7 restrictions, appeared to many FCMs to create uncertainty about their ability to use customer securities to collateralize omnibus clearing accounts established with foreign brokers. In response, many FCMs felt compelled either to limit customer capacity to deposit securities to secure their foreign futures positions or to use their own cash to meet margin calls to their foreign brokers (where their customers were posting securities as margin). This strained FCM balance sheets (increasing financing costs associated with the foreign futures business) and disadvantaged FCMs relative to foreign brokers not subject to regulation by the CFTC.

On November 25, the CFTC's Division of Market Participants issued interpretive guidance that definitively dispels the uncertainty around FCMs' ability to use customer securities to collateralize their customers' foreign futures exposures. The guidance clarifies that:

1. An FCM is not in violation of Regulation 30.7 if it transfers customer securities to a foreign broker, foreign board of trade, or foreign clearing organization under a title transfer or right of re-use, provided that such title transfer or right of re-use is authorized or required under the applicable local regulatory regime or rules of the foreign board of trade or foreign clearing organization and the customer securities are being transferred solely for purposes of margining or securing the FCM's foreign futures obligations; and
2. A foreign broker would not be in violation of its obligation under the acknowledgment letter it is required to execute under Part 30 of the CFTC regulations as a condition to accepting foreign futures customer funds and securities from an FCM if the foreign broker (or a foreign board of trade, or the foreign clearing organization downstream from the foreign broker) takes title to, or invokes a right of re-use over, customer securities deposited by the FCM, provided that title transfer or right of re-use is authorized or required under the applicable local regulatory regime.

The guidance also expressly addressed any legal uncertainty arising from the staff letters issued in 2016 and 2018, confirming that the title transfer of customer securities is not subject to an outright prohibition under Regulation 30.7.

Staff emphasized that its guidance is consistent with longstanding CFTC views about how customer asset protection works for foreign futures. In October 2000, the CFTC adopted an interpretive statement revising prior guidance on Regulation 30.7. Under that earlier guidance, Regulation 30.7 was "intended to ensure that funds provided by US customers for foreign futures and options transactions ... will receive equivalent protection at all intermediaries and exchange clearing

organizations," and further, "to require each FCM ... to take appropriate action (i.e., set aside funds in a 'mirror' account) in the event that it becomes aware of facts leading it to conclude that foreign futures and foreign options customer funds are not being handled consistent with the requirements of Commission rules … ." Under that earlier guidance, an FCM was obliged to exclude customer funds not "handled consistent with" the requirements of Commission Regulation 30.7 from its calculation of its secured amount requirement, thereby triggering the obligation to supplement that requirement with a deposit of its own funds in the secured amount account. The result was a burden on FCM balance sheets that threatened effectively to cut off foreign futures intermediation and clearing for all but the largest institutional customers.

In revising that earlier guidance, the Commission stated that where an FCM (i) receives from the "initial depository" with which it establishes a foreign futures account an acknowledgment letter in the form of Appendix E to Regulation 30.7; (ii) furnishes to each foreign futures customer disclosures informing foreign futures customers that: (x) the CFTC does not regulate the activities of foreign exchanges, including the execution and clearing of transactions; (y) transactions on foreign markets may be subject to foreign regulations which offer different or diminished investor protections than CFTC regulations and thus may expose customers to additional risk; and (z) foreign futures customer funds and securities may not be provided the same protections as funds and securities deposited to margin positions on CFTC-regulated markets; and (iii) otherwise complies with the provisions of CFTC Regulation 30.7, then it may include all funds and securities maintained in the account established with the initial depository, without regard to the "manner in which any subsequent depository holds or subsequently transmits those funds."

FCMs and their non-US affiliates will want to review their collateralization arrangements on behalf of the FCM's foreign futures customers with an eye to optimizing their use of customer securities in light of the guidance.

The CFTC's interpretive guidance (CFTC Letter No. 25-38) is available here. The CFTC staff letters from 2016 and 2018 are available here and here. Appendix B to Part 30 of the CFTC Regulations is available here. The acknowledgments required by foreign brokers in favor of FCMs clearing on behalf of their foreign futures customers are Appendix E to Part 30 of the CFTC Regulations and are available here.

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