Funds NOT Immediately Available: Actions FCMs Should Take to Protect Customer Funds Deposited at Distressed Banks

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As US interest rates rose in 2022, the value of bank investments in long-dated and fixed-rate bonds declined. These declines were substantial enough to render many banks economically insolvent. Depositors not inclined to distinguish among degrees or kinds of "insolvency" at banks holding their funds reacted by withdrawing their deposits; several banks reacted by selling bonds, realizing book-value losses, leading inevitably to accelerated withdrawals. These market forces resulted in several regional bank failures (and near failures) all within short period of time beginning in March 2023. These events roiled the markets and led to broader banking sector fears. Indeed, many banks, even those which are considered national in scale, saw their share price plummet as doubts swirled about the health of smaller banks.

These failures have highlighted, among other things, how even seemingly solvent banks can fail in a matter of days once they signal financial distress, in part enabled by runs on deposits at unprecedented and extraordinary speeds. As a result, funds on deposit with failed banks or banks at risk of imminent failure may become temporarily (or even, at least in theory, permanently) unavailable.

What do these failures mean for futures commission merchants (FCMs) that keep their segregated customer funds at regional banks in accordance with Commodity Futures Trading Commission (CFTC) regulations? This advisory discusses how FCMs should manage risks associated with the deposit of customer funds with banks affected by interest rate risk, in the context of risk management programs under CFTC Rule 1.11, including by means of diligence reviews and proactive monitoring of their depository banks' financial condition.

Background

Under CFTC Rule 1.20, an FCM must segregate the funds belonging to its customers from its own funds and deposit such funds with "approved depositories." Approved depositories include: (1) a bank or trust company; (2) a derivatives clearing organization; or (3) another FCM.[1] Customer funds held at an approved depository, must, among other things, be "immediately available for withdrawal" upon demand of the FCM.[2]

To mitigate the risk of customer funds becoming unavailable at an approved depository, CFTC Rule 1.11 requires FCMs to establish a risk management program that includes a duty to monitor the approved depository with which it has a relationship on at least an annual basis.[3]

[1] CFTC Rule 1.20(b).

[2] CFTC Rule 1.20(h).

[3] CFTC Rule 1.11(e)(3)(i)(b).

A critical threshold question is whether (and if so, specifically in what circumstances), in the event segregated customer funds become unavailable or worse unrecoverable (e.g., due to a bank failure), an FCM would ever be charged with liability for such customer funds. In 1971, the Commodity Exchange Authority (the predecessor agency to the CFTC) addressed this question in an Administrative Determination, which stated that an FCM would not be held liable for customer funds in the event of a bank failure if "it had used due care in selecting the bank, had not otherwise breached its fiduciary responsibilities toward the customers, and had fully complied with the requirements of the Commodity Exchange Act and the regulations thereunder relating to the handling of customers' funds."[4]

The Administrative Determination may no longer reflect the CFTC's current position. In adopting enhanced customer protection rules in 2013, the CFTC appeared to call into question the wisdom of the Administrative Determination, noting that it "fails to address the question of precisely which customers are exposed to depository losses, and how much should be allocated to each such customer."[5] Since 2013 (despite a charge to staff to "inquire into these issues and to develop an appropriate proposed rulemaking"[6]), the CFTC has not further elaborated its position or issued guidance with respect to an FCM's potential liability to customers in the event of the failure of an approved depository bank.

Enhancing Ongoing Diligence and Review of Approved Depository Banks

Considering ongoing concerns around the management of interest rate risk and attendant impacts on bank balance sheets, FCMs should consider whether their existing monitoring practices of approved depositories require enhancement, both in terms of specific diligence procedures and in terms of the frequency with which such procedures are conducted.

As noted, CFTC Rule 1.11 requires an FCM to assess its approved depository's continued satisfaction with the FCM's established risk management criteria "at least annually."[7] Given the alarming speed of recent bank failures, FCMs will want to consider accelerating scheduled assessments of their depositories.[8]

Generally, FCMs will have access to their depositories' quarterly consolidated reports (which include a bank's income statement, balance sheet, deposit information and changes in the bank's capital). In some circumstances, an FCM may wish to consider more frequent reviews, including reviews of information derived from consultation with senior staff from their depositories, the bank's share price (if publicly traded), the spread on credit default swaps on the bank's debt, and other key stress indicators. This will enable the FCM to more accurately gauge a bank's risk of failure in the short to medium term. If the FCM determines that the bank's risk of failure is increasing, the FCM should promptly reassess its existing relationship with the bank and explore potential alternative approved depositories for customer funds deemed subject to risk.

Enhanced due diligence and risk management in excess of minimum requirements imposed by CFTC rules may not prevent an approved depository's failure or default. But it could further enable the FCM to timely safeguard customer funds at risk from approved depository failure, and demonstrate to CFTC staff with questions after the fact that the FCM exercised due care in selecting and monitoring its approved depository in a manner consistent with the requirements of CFTC Rule 1.11.

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[4] *See* Administrative Determination No. 230 issued by Alex Caldwell, Administrator, Commodity Exchange Authority (Nov. 23, 1971). (noting that an FCM would not be considered to have exercised due care, if an FCM had the option to use a bank which was a member of the Federal Deposit Insurance Corporation (FDIC) and the FCM without a compelling reason elected to use a non-member bank for customer funds). *See also* Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506, 68556 n. 437 (Nov. 14, 2013).

[5] 78 Fed. Reg. at 68557.

[6] *Id.*

[7] *Supra* note 7.

[8] While a failed regional bank may ultimately be fully protected by the Federal Reserve or the FDIC or be acquired by a larger national bank, a bank failure nevertheless puts deposited funds at material risk of loss. As such, an FCM should not rely on the likelihood of such events occurring when reviewing its relationship with a bank with which it has entrusted customer funds.

CONTACTS

For more information, please contact your Katten attorney or any of the following Financial Markets and Funds attorneys.

Carl E. Kennedy
+1.212.940.8544
carl.kennedy@katten.com

Stephen R. Morris
+1.212.940.6654
stephen.morris@katten.com

Alexander C. Kim
+1.212.940.6535
alexander.kim@katten.com

Eli Krasnow
+1.212.940.6438
eli.krasnow@katten.com

Katten katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

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