Client Alert

November 2013

CFTC Court Case and New Rules Establish Bank Duties to Monitor Commodity Brokers

A recent court order in favor of the Commodity Futures Trading Commission (or CFTC) and new rules issued by CFTC establish a standard of liability for depository institutions that fail to fulfill their customer funds protection obligations under the Commodity Exchange Act (or CEA) and, thus, requires them in certain circumstances to monitor the activities of clients that are registered with CFTC as futures commission merchants (or FCMs), commonly known as commodity brokers. This client alert summarizes the court order and the new rules and, then, discusses the implications for depository institutions and certain related preventive measures that they should consider implementing.

I. The Court Order

The court order relates to the banking relationship of a depository institution with Peregrine Financial Group, Inc. (or Peregrine), an FCM registered with CFTC, and the millions of dollars in customer funds allegedly deposited with the institution over the course of its banking relationship with Peregrine and Russell Wasendorf, Sr. (or Wasendorf), Peregrine's owner and chief executive officer. During the course of that relationship, Wasendorf defrauded more than 24,000 of Peregrine's customers and was eventually sentenced to 50 years in prison and ordered to pay more than $215 million in restitution. According to CFTC, Peregrine deposited more than $308 million of its customers' funds with the depository institution during the eight years leading up to the discovery of the fraud. The funds of Peregrine's customers were received by the institution in a customer account that, according to CFTC, the institution knew was subject to the CEA's segregation requirement and CFTC rules intended to protect customer funds, including rules that prohibited those funds from being held, disposed of or used as belonging to Peregrine or any other person except the customers of Peregrine.

CFTC alleges in its case that the depository institution improperly held or used the funds of Peregrine's customers by permitting the customer account to be used, over the course of a series of transactions involving Wasendorf or an entity controlled by Wasendorf, in a manner that the institution knew was not for the benefit of Peregrine's customers but was for the benefit of Wasendorf or other parties. For instance, according to CFTC, the depository institution knowingly allowed and facilitated the withdrawal of funds from the customer account to pay for, among other things, Wasendorf's private airplane, his restaurant, his personal investments and his divorce settlement. In each case, according to CFTC, the transactions were carried out by the institution in violation of the CEA and CFTC's regulations. The institution moved to dismiss CFTC's case, arguing that the case is insufficient to state a claim for violation of the CEA resulting from its alleged failure to supervise withdrawals from Peregrine's customer account because the CEA does not impose a duty on banks to monitor the transactions of their FCM clients. However, the court issued an order denying the motion to dismiss, endorsing CFTC's prior interpretation that banks may be violating the CEA or be aiding and abetting a violation by acquiescing to the withdrawal or use of customer funds for an unlawful purpose where they have reason to know customer funds potentially are being misappropriated. Accordingly, the court found that CFTC made sufficient factual allegations regarding the depository institution's knowledge and conduct in holding Peregrine's customer account while facilitating the withdrawal of customer funds.

II. CFTC's New Rules

Motivated in part by the Peregrine case, CFTC issued new rules establishing the interpretation endorsed by the court as the standard of liability for depository institutions and expanding their obligations to monitor the activities of FCM clients. The new rules will become effective on January 13, 2014 and supplement the rules of the National Futures Association (or NFA), a self-regulatory organization for the U.S. derivatives industry, imposing requirements on depository institutions that hold customer funds for FCMs. They require an institution to sign a new written acknowledgement letter, in the form provided by CFTC and attached to this client alert as an appendix, within 180 days after the effective date and within 120 days of any changes in the name or address of its FCM client or the institution or in the account numbers under which customer funds are held. The form of the acknowledgement letter contains several undertakings that have not previously been required of depository institutions. Additionally, a depository institution must agree that it may presume any withdrawal from customer accounts and the balances maintained therein are in conformity with the CEA and CFTC regulations without inquiry unless, in the ordinary course of its business, it has notice or actual knowledge of a potential violation by an FCM of any provision of the CEA or CFTC regulations that relates to the segregation of customer funds.

In establishing the foregoing standard of liability as a contractual requirement, CFTC reaffirmed its long-held interpretive position that a depository institution will be held liable for the improper transfers of customer funds by an FCM if it knew or should have known that the transfers were improper. Additionally, CFTC emphasized that, while an institution has no affirmative obligation to police or monitor an FCM client's compliance with the CEA or CFTC regulations, the institution cannot ignore signs of wrongdoing. CFTC also stated that, if an institution knows or suspects that funds held in a customer account have been improperly withdrawn or otherwise improperly used in violation of the CEA or CFTC regulations related to the segregation of customer funds, CFTC expects the institution to immediately report its concern to CFTC. Further, like the CEA and the existing CFTC regulations being replaced, the new rules provide that no person, including a depository institution, that has received FCM customer funds for deposit in a segregated account may hold, dispose of or use those funds as belonging to any person other than the customers of the FCM that deposited the funds.

III. Preventive Measures

Although the outcome of the Peregrine litigation may furnish an answer as to whether the alleged violations of the CEA and CFTC regulations are supported by the facts, the litigation itself should be viewed by depository institutions as a reason to increase internal oversight of transactions and other business activities involving clients that are registered with CFTC as FCMs or in other capacities, such as commodity pool operators or commodity trading advisors. To avoid possible violations of the CEA and CFTC regulations arising from the segregation or use of customer funds, institutions should, first, identify and review their relationships with CFTC-registered entities. The circumstances surrounding Wasendorf's fraud may be unique, but the type of banking relationship that allegedly existed with Wasendorf and Peregrine arguably is not. Maintaining a client's goodwill and protecting an institution's relationship with a client may be necessary, but given the potential liability that the depository institution in the Peregrine litigation faces as a result of CFTC's court case, the focus of the review should be to ensure that a depository institution is not accommodating CFTC-registered clients at the expense of compliance with applicable laws and regulations.

If relationships with CFTC-registered clients are identified, then a depository institution should review those relationships from time to time. The institution should obtain all information necessary to enable it to properly distinguish accounts containing customer funds from accounts containing assets of the CFTC-registered client or assets of related parties (so-called house assets). For all accounts that hold customer funds, a depository institution should obtain all information necessary to enable it to properly distinguish customer funds from house assets in those accounts. An institution also should ensure that those accounts are held as segregated trust accounts under account names that clearly identify them as customer accounts and show that they are segregated. In addition, a depository institution should collect from CFTC-registered clients, on an ongoing basis, information that allows it to credit customer funds to the proper accounts, verify the amounts of customer funds and house assets it should be holding in

customer accounts and confirm that the funds it is asked to transfer from customer accounts are being disposed of by it properly in light of its "know your customer" information and other knowledge.

Further, a depository institution should create written compliance policies and procedures (or update existing policies and procedures), and follow them, to ensure that customer funds deposited by CFTC-registered clients are held, disposed of and used properly by the institution. Its personnel should be trained on those policies and procedures, and the institution should establish controls on transactions involving funds in customer accounts and other activities regarding CFTC-registered clients and related parties. The performance of banking functions should be allocated among different personnel as appropriate for the related tasks, and the depository institution's internal auditors should be charged with ascertaining compliance with the institution's compliance policies and procedures.

In addition, a depository institution should have its counsel or compliance personnel review any written acknowledgements for customer accounts and any loan or other documents involving CFTC-registered clients or related parties to ensure that customer funds are not taken as collateral for, or relied upon or treated as being available to satisfy, the so-called "house obligations" of those clients or related parties. In addition to signing new written acknowledgement letters in the form prescribed by CFTC, the institution should have its counsel promptly clarify legal documents by letter or amendment to limit its responsibilities, to re-define secured obligations and related collateral and to make any other appropriate modifications. Any necessary changes to those documents or any other legal documents should be made expeditiously. Also, an institution should consider having its counsel supplement existing CFTC-registered client and related party relationship documents with indemnity letters and other client assurances, including covenants to furnish all necessary information and take all other actions reasonably requested to permit the institution to segregate, hold, dispose of and use customer funds in compliance with applicable laws and regulations.

A depository institution also should consider designating their CFTC-registered clients as higher risk customers for purposes of the Bank Secrecy Act and anti-money laundering laws and regulations. The institution should consider whether it receives in any or all cases, either as a result of its customer identification and due diligence processes or otherwise, sufficient information for it to be required to monitor the activities of its CFTC-registered clients not only for the foregoing purposes but for purposes of the Commodity Exchange Act and CFTC rules as well. In any event, an institution should review the regulatory compliance management systems of its CFTC-registered clients, including any expectation that those clients subject themselves to third party testing and review in order to (among other things) verify for the institution that the clients are using, holding and disposing of customer funds properly.

Finally, a depository institution should consider taking the foregoing preventive measures in respect of clients that are regulated by governmental authorities other than CFTC or that may have deposited customer funds at the institution. These clients might include, for instance, trustees and other fiduciaries or broker-dealers and investment advisers regulated by the U.S. Securities and Exchange Commission.

Hunton & Williams attorneys are available to furnish more information on these matters, to assist you in complying with the CEA, CFTC regulations and other applicable laws and to review and/or revise your compliance policies and procedures. If you would like to discuss the matters addressed herein, please contact one of the following attorneys:

Joseph B. Buonanno
jbuonanno@hunton.com

Peter Weinstock
pweinstock@hunton.com

Landon S. Eustache
leustache@hunton.com

Appendix

[Date]

[Name and Address of Depository]

We refer to the [*Rule 1.20:* Segregated] [*Rule 22.5:* Cleared Swaps Customer Collateral] [*Rule 30.7:* Secured Amount] Account(s) which [Name of Futures Commission Merchant] (''we'' or ''our'') have opened or will open with [Name of Depository] (''you'' or ''your'') entitled:

> [Name of Futures Commission Merchant] [*if applicable, add* ''FCM Customer Omnibus Account''] CFTC Regulation [1.20] [22.5] [30.7] Customer [*Rule 1.20:* Segregated] [*Rule 22.5:* Cleared Swaps Collateral] [*Rule 30.7:* Secured] Account under Section[s] [*Rule 1.20:* 4d(a) and 4d(b)] [*Rule 22.5:* 4d(f)] [*Rule 30.7:* 4(b)] of the Commodity Exchange Act [*and, if applicable,* '', Abbreviated as [short title reflected in the depository's electronic system]'']
>
> Account Number(s): [_____]

(collectively, the ''Account(s)'').

You acknowledge that we have opened or will open the above-referenced Account(s) for the purpose of depositing, as applicable, money, securities and other property (collectively the ''Funds'') of customers who trade [*Rules 1.20 and 22.5:* commodities, options, swaps, and other products, as required by Commodity Futures Trading Commission (''CFTC'') Regulations, including Regulation [1.20] [22.5], as amended] [*Rule 30.7:* foreign futures and/or foreign options (as such terms are defined in U.S. Commodity Futures Trading Commission (''CFTC'') Regulation 30.1, as amended)]; that the Funds held by you, hereafter deposited in the Account(s) or accruing to the credit of the Account(s), will be [*Rule 30.7:* kept separate and apart and] separately accounted for [*Rules 1.20 and 22.5:* and segregated] on your books from our own funds and from any other funds or accounts held by us in accordance with the provisions of the Commodity Exchange Act, as amended (the ''Act''), and Part [1] [22] [30] of the CFTC's regulations, as amended; [*Rule 30.7:* that the Funds may not be commingled with our own funds in any proprietary account we maintain with you;] and that the Funds must otherwise be treated in accordance with the provisions of [*Rules 1.20 and 22.5:* Section 4d of the Act and CFTC regulations thereunder] [*Rule 30.7:* Section 4(b) of the Act and CFTC Regulation 30.7].

Furthermore, you acknowledge and agree that such Funds may not be used by you or by us to secure or guarantee any obligations that we might owe to you, and they may not be used by us to secure or obtain credit from you. You further acknowledge and agree that the Funds in the Account(s) shall not be subject to any right of offset or lien for or on account of any indebtedness, obligations or liabilities we may now or in the future have owing to you. This prohibition does not affect your right to recover funds advanced in the form of cash transfers, lines of credit, repurchase agreements or other similar liquidity arrangements you make in lieu of liquidating non-cash assets held in the Account(s) or in lieu of converting cash held in the Account(s) to cash in a different currency.

In addition, you agree that the Account(s) may be examined at any reasonable time by the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent or employee of our designated self-regulatory organization (''DSRO''), [Name of DSRO], and this letter constitutes the authorization and direction of the undersigned on our behalf to permit any such examination to take place without further notice to or consent from us.

You agree to reply promptly and directly to any request for confirmation of account balances or provision of any other information regarding or related to the Account(s) from the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent, or employee of [Name of DSRO], acting in its capacity as our DSRO, and this letter constitutes the authorization and direction of the undersigned on our behalf to release the requested information without further notice to or consent from us.

You further acknowledge and agree that, pursuant to authorization granted by us to you previously or herein, you have provided, or will promptly provide following the opening of the Account(s), the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC, or any successor division, or such director's designees, with technological connectivity, which may include provision of hardware, software, and related technology and protocol support, to facilitate direct, read-only electronic access to transaction and account balance information for the Account(s). This letter constitutes the authorization and direction of the undersigned on our behalf for you to establish this connectivity and access if not previously established, without further notice to or consent from us.

The parties agree that all actions on your part to respond to the above information and access requests will be made in accordance with, and subject to, such usual and customary authorization verification and authentication policies and procedures as may be employed by you to verify the authority of, and authenticate the identity of, the individual making any such information or access request, in order to provide for the secure transmission and delivery of the requested information or access to the appropriate recipient(s). We will not hold you responsible for acting pursuant to any information or access request from the director of the Division of Swap Dealer and Intermediary Oversight of the CFTC or the director of the Division of Clearing and Risk of the CFTC, or any successor divisions, or such directors' designees, or an appropriate officer, agent, or employee of [Name of DSRO], acting in its capacity as our DSRO, upon which you have relied after having taken measures in accordance with your applicable policies and procedures to assure that such request was provided to you by an individual authorized to make such a request.

In the event that we become subject to either a voluntary or involuntary petition for relief under the U.S. Bankruptcy Code, we acknowledge that you will have no obligation to release the Funds held in the Account(s), except upon instruction of the Trustee in Bankruptcy or pursuant to the Order of the respective U.S. Bankruptcy Court.

Notwithstanding anything in the foregoing to the contrary, nothing contained herein shall be construed as limiting your right to assert any right of offset or lien on assets that are not [*Rules 1.20 and 22.5:* Funds] [*Rule 30.7:* 30.7 customer funds] maintained in the Account(s), or to impose such charges against us or any proprietary account maintained by us with you. Further, it is understood that amounts represented by checks, drafts or other items shall not be considered to be part of the Account(s) until finally collected. Accordingly, checks, drafts and other items credited to the Account(s) and subsequently dishonored or otherwise returned to you or reversed, for any reason, and any claims relating thereto, including but not limited to claims of alteration or forgery, may be charged back to the Account(s), and we shall be responsible to you as a general endorser of all such items whether or not actually so endorsed.

You may conclusively presume that any withdrawal from the Account(s) and the balances maintained therein are in conformity with the Act and CFTC regulations without any further inquiry, provided that, in the ordinary course of your business as a depository, you have no notice of or actual knowledge of a potential violation by us of any provision of the Act or [*Rule 30.7:* Part 30 of] the CFTC regulations that relates to the [*Rules 1.20 and 22.5:* segregation] [*Rule 30.7:* holding] of customer funds; and you shall not in any manner not expressly agreed to herein be responsible to us for ensuring compliance by us with such provisions of the Act and CFTC regulations; however, the aforementioned presumption does not affect any obligation you may otherwise have under the Act or CFTC regulations.

You may, and are hereby authorized to, obey the order, judgment, decree or levy of any court of competent jurisdiction or any governmental agency with jurisdiction, which order, judgment, decree or

levy relates in whole or in part to the Account(s). In any event, you shall not be liable by reason of any action or omission to act pursuant to any such order, judgment, decree or levy, to us or to any other person, firm, association or corporation even if thereafter any such order, decree, judgment or levy shall be reversed, modified, set aside or vacated.

The terms of this letter agreement shall remain binding upon the parties, their successors and assigns and, for the avoidance of doubt, regardless of a change in the name of either party. This letter agreement supersedes and replaces any prior agreement between the parties in connection with the Account(s), including but not limited to any prior acknowledgment letter agreement, to the extent that such prior agreement is inconsistent with the terms hereof. In the event of any conflict between this letter agreement and any other agreement between the parties in connection with the Account(s), this letter agreement shall govern with respect to matters specific to [*Rules 1.20 and 22.5:* Section 4d] [*Rule 30.7:* Section 4(b)] of the Act and the CFTC's regulations thereunder, as amended.

This letter agreement shall be governed by and construed in accordance with the laws of [Insert governing law] without regard to the principles of choice of law.

Please acknowledge that you agree to abide by the requirements and conditions set forth above by signing and returning to us the enclosed copy of this letter agreement, and that you further agree to provide a copy of this fully executed letter agreement directly to the CFTC (via electronic means in a format and manner determined by the CFTC) and to [Name of DSRO], acting in its capacity as our DSRO. We hereby authorize and direct you to provide such copies without further notice to or consent from us, no later than three business days after opening the Account(s) or revising this letter agreement, as applicable.

[Name of Futures Commission Merchant]

By:_____
Print Name:
Title:

ACKNOWLEDGED AND AGREED:

[Name of Depository]

By:_____
Print Name:
Title:

Contact Information:
[Insert phone number and email address]

Date:_____