Commission, 1155 21st Street, N.W., Washington, D.C. 20581. In addition, comments may be sent by facsimile transmission to facsimile number (202) 418–5221 or by electronic mail to secretary@cftc.gov. Reference should be made to ''Early Warning Amendments''.

FOR FURTHER INFORMATION CONTACT: Paul H. Bjarnason, Jr., Deputy Director and Chief Accountant, Lawrence B. Patent, Associate Chief Counsel, Lawrence T. Eckert, Attorney-Advisor, or Charles T. O'Brien, Attorney-Advisor, Division of Trading and Markets, Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C. 20581; Telephone (202) 418–5430.

SUPPLEMENTARY INFORMATION:

I. Background

Rule 1.12 requires each FCM [2] to report to the Commission and to the FCM's DSRO certain events pertaining to the FCM's: (i) Financial condition; and (ii) procedures for safeguarding customer and firm assets; and (iii) ability to monitor its financial condition through an appropriate system of records and reports. Rule 1.12's purpose is to notify the Commission and the FCM's DSRO of circumstances that have or could have a negative impact on the FCM's ability to carry on normal business operations or that pose a threat to customer funds or the FCM's financial integrity. Reportable events currently include, among others, the FCM's adjusted net capital's falling below its ''early warning'' level (*i.e.,* 150 percent of the minimum required); [3] failure to maintain current books and records; the existence of material inadequacies in the FCM's accounting systems or internal controls; and the issuance of a margin call exceeding the FCM's adjusted net capital. Collectively, these are known as the Commission's ''early warning'' reporting requirements.

The ''segregation'' requirements of the Commodity Exchange Act (''Act'') and Commission rules are the primary safeguard against the loss of customer funds resulting from the financial failure of an FCM. Section 4d(2) of the Act [4] and Rule 1.20 require that an FCM segregate customer funds from the firm's proprietary funds and that one customer's funds not be used to margin, guarantee or secure the trades or contracts, or to secure or extend the credit, of another customer.[5] Other important elements of the segregation rules govern the investment of customer funds [6] and require a daily record of segregation requirements and funds in segregation.[7] Rule 30.7 contains similar protections relating to customers maintaining positions on non-U.S. exchanges.[8]

Given the importance of these rules in enabling the Commission to carry out its customer and market protection functions, it is critical that the Commission and an FCM's DSRO be made aware at the earliest possible moment of an FCM's failure to satisfy these requirements.[9] The proposed CFTC rule would require an FCM to provide immediate telephonic notice, to be confirmed immediately by facsimile or telegram,[10] to the Commission and the FCM's DISRO when the FCM knows or should know that it has failed to maintain sufficient funds in segregation or in separate set-aside accounts.[11]

[2] Certain portions of Rule 1.12 also apply to IBs. However, the proposed rule amendments discussed herein relate mostly to segregated funds and the secured amount, which involves FCM's but not IBs. Therefore, this release focuses upon Rule 1.12 as it pertains to FCMs.

[3] The minimum adjusted net capital requirement for an FCM is set forth in Rule 1.17(a)(1)(i) and basically requires an FCM to maintain adjusted net capital equal to the greatest of $250,000, four percent of the amount of customer funds or the amount required by an SRO of which the FCM is a member. Therefore, assuming no higher applicable SRO requirement, the early warning reporting is triggered if adjusted net capital is less than the greater of $375,000 or six percent of customer funds.

[4] 7 U.S.C. 6d(2).

[5] Rule 1.23 states that the prohibition against commingling an FCM's own funds with the FCM's customer funds does not prevent an FCM from adding any of its own funds to segregated customer funds as necessary to prevent any or all customer's accounts from becoming undermargined. The Commission recently adopted amendments to Rule 1.23 that permit FCMs to use Treasury securities in addition to cash to increase their interests in customer segregated accounts, facilitating the use of FCM funds to prevent the undermargining of customer accounts. See 62 FR 42398 (Aug. 7, 1997).

[6] Section 4d(2) of the Act and Rules 1.25–1.29.

[7] Rule 1.32.

[8] A more detailed presentation concerning these protections can be found in Chapter 12 of the Form 1–FR–FCM instructions.

[9] The Commission notes that, in the **Federal Register** release proposing the Commission's overhaul of minimum financial requirements over twenty years ago, the Commission stated its intention to propose an early warning notice for undersegregation of customer funds. *See* 42 FR 27166, 27173 (May 26, 1997). However, the Commission did not subsequently include such a rule as part of its early warning requirements.

[10] Telegraphic notification has been the traditional method of required notice under Rule 1.12, whereby an FCM or an IB sends a telegram to the Commission and the DSRO concerning a particular event.

[11] The Chicago Mercantile Exchange (''CME'') currently has a rule requiring that FCMs for which it acts as the DSRO provide written notice to it in such circumstances, although the CME's rule requires such notification within twenty-four hours following such events. Rules of the Chicago Mercantile Exchange, Rule 971 Segregation and Secured Requirements (1997).

II. Proposed Rule Amendments

FCMs occasionally have become undersegregated as a result of market movements which cause deficits in the accounts they carry on behalf of their customers. Generally, the undersegregated condition is corrected the following business day with funds available from an FCM's own proprietary funds or through collection of deficits. However, during the market downturn on October 27, 1997, the Commission was made aware that a few FCMs experienced undersegregation to a degree that they were unable to make up the shortfall from their own internal proprietary funds. Infusions of external capital were required in those cases to correct the undersegregated conditions.

An evaluation of the Commission's current early warning notification rules indicated that these rules, which require notice to the Commission upon an FCM falling below the net capital early warning level, may not result in notice to the Commission until as much as a day or a day and a half after the occurrence of a major market event which causes an undersegregated condition. In particular, on October 27, some firms knew they had a major problem by noon of that day, but did not provide notice of these problems to the Commission until on or about the close of business on October 28.

The Commission believes that it needs to be notified as soon as an FCM knows that it may have a problem meeting segregation requirements. The proposed rule is designed to require notice as soon as an FCM ''should know'' of an undersegregated condition. Because of the linkage between segregation and net capital, the proposed rule will also result in the Commission knowing of a net capital impairment earlier than under the existing rule and should facilitate a resolution of the problem with the least harmful impact upon an FCM's customers and other market participants.

As proposed, new Rule 1.12(h) [12] would require an FCM to notify the Commission and its DSRO immediately after it knows or should know that funds segregated for customers trading on U.S. markets or set aside for customers trading on non-U.S. markets are less than the amount required to be segregated or set aside by the Act or Commission rules. In this context, the term ''funds'' includes funds on deposit and funds due to or from the FCM's clearing organizations or carrying

[12] The Commission is proposing to redesignate current paragraph (h) of Rule 1.12 as paragraph (i) and to include the new rule in a new paragraph (h).