

which the report is filed: *Provided, however*, that an introducing broker as defined in § 5.1(f)(1) of this chapter that is party to a guarantee agreement that has been terminated must cease doing business as an introducing broker from and after the effective date of such termination, and may not resume doing business as an introducing broker as defined in § 5.1(f)(1) of this chapter unless and until it files a new guarantee agreement.

(B) Each person filing a Form 1-FR-IB in accordance with this section must include with the financial report a statement describing the source of his current assets and representing that his capital has been contributed for the purpose of operating his business and will continue to be used for such purpose.

(k) *Filing option available to an introducing broker.* (1) Any introducing broker or applicant for registration as an introducing broker which is not operating or intending to operate pursuant to a guarantee agreement may comply with the requirements of this section by filing (in accordance with paragraphs (a), (b) and (c) of this section) a Form 1-FR-IB in lieu of a Form 1-FR-FCM.

(2) If an introducing broker or applicant therefor avails itself of the filing option available under paragraph (k)(1) of this section, the report required to be filed in accordance with § 1.16(c)(5) of this part must be filed as of the date of the Form 1-FR-IB being filed, and such an introducing broker or applicant therefor must maintain its financial records and make its monthly formal computation of its adjusted net capital, as required by § 1.18 of this part, in a manner consistent with Form 1-FR-IB.

(The information collection requirements contained in § 1.10 were approved by the Office of Management and Budget under control number 3038-0024; in paragraphs (a) and (b) under control number 3038-0023; and in paragraph (f) under control number 3038-0003.)

[43 FR 39967, Sept. 8, 1978]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.10, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

§ 1.11 Risk Management Program for futures commission merchants.

(a) *Applicability.* Nothing in this section shall apply to a futures commission merchant that does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result from soliciting or accepting orders for the purchase or sale of any commodity interest.

(b) *Definitions.* For purposes of this section:

(1) *Business unit* means any department, division, group, or personnel of a futures commission merchant or any of its affiliates, whether or not identified as such that:

(i) Engages in soliciting or in accepting orders for the purchase or sale of any commodity interest and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom; or

(ii) Otherwise handles segregated funds, including managing, investing, and overseeing the custody of segregated funds, or any documentation in connection therewith, other than for risk management purposes; and

(iii) Any personnel exercising direct supervisory authority of the performance of the activities described in paragraph (b)(1)(i) or (ii) of this section.

(2) *Customer* means a futures customer as defined in § 1.3, Cleared Swaps Customer as defined in § 22.1 of this chapter, and 30.7 customer as defined in § 30.1 of this chapter.

(3) *Governing body* means the proprietor, if the futures commission merchant is a sole proprietorship; a general partner, if the futures commission merchant is a partnership; the board of directors if the futures commission merchant is a corporation; the chief executive officer, the chief financial officer, the manager, the managing member, or those members vested with the management authority if the futures commission merchant is a limited liability company or limited liability partnership.

(4) *Segregated funds* means money, securities, or other property held by a futures commission merchant in separate accounts pursuant to §1.20 for futures customers, pursuant to §22.2 of this chapter for Cleared Swaps Customers, and pursuant to §30.7 of this chapter for 30.7 customers.

(5) *Senior management* means, any officer or officers specifically granted the authority and responsibility to fulfill the requirements of senior management by the governing body.

(c) *Risk Management Program.* (1) Each futures commission merchant shall establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the futures commission merchant as such. For purposes of this section, such policies and procedures shall be referred to collectively as a "Risk Management Program."

(2) Each futures commission merchant shall maintain written policies and procedures that describe the Risk Management Program of the futures commission merchant.

(3) The Risk Management Program and the written risk management policies and procedures, and any material changes thereto, shall be approved in writing by the governing body of the futures commission merchant.

(4) Each futures commission merchant shall furnish a copy of its written risk management policies and procedures to the Commission and its designated self-regulatory organization upon application for registration and thereafter upon request.

(d) *Risk management unit.* As part of the Risk Management Program, each futures commission merchant shall establish and maintain a risk management unit with sufficient authority; qualified personnel; and financial, operational, and other resources to carry out the risk management program established pursuant to this section. The risk management unit shall report directly to senior management and shall be independent from the business unit.

(e) *Elements of the Risk Management Program.* The Risk Management Program of each futures commission mer-

chant shall include, at a minimum, the following elements:

(1) *Identification of risks and risk tolerance limits.* (i) The Risk Management Program shall take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital, and any other applicable risks together with a description of the risk tolerance limits set by the futures commission merchant and the underlying methodology in the written policies and procedures. The risk tolerance limits shall be reviewed and approved quarterly by senior management and annually by the governing body. Exceptions to risk tolerance limits shall be subject to written policies and procedures.

(ii) The Risk Management Program shall take into account risks posed by affiliates, all lines of business of the futures commission merchant, and all other trading activity engaged in by the futures commission merchant. The Risk Management Program shall be integrated into risk management at the consolidated entity level.

(iii) The Risk Management Program shall include policies and procedures for detecting breaches of risk tolerance limits set by the futures commission merchant, and alerting supervisors within the risk management unit and senior management, as appropriate.

(2) *Periodic Risk Exposure Reports.* (i) The risk management unit of each futures commission merchant shall provide to senior management and to its governing body quarterly written reports setting forth all applicable risk exposures of the futures commission merchant; any recommended or completed changes to the Risk Management Program; the recommended time frame for implementing recommended changes; and the status of any incomplete implementation of previously recommended changes to the Risk Management Program. For purposes of this section, such reports shall be referred to as "Risk Exposure Reports." The Risk Exposure Reports also shall be provided to the senior management and the governing body immediately upon detection of any material change in the risk exposure of the futures commission merchant.

(ii) *Furnishing to the Commission.* Each futures commission merchant shall furnish copies of its Risk Exposure Reports to the Commission within five (5) business days of providing such reports to its senior management.

(3) *Specific risk management considerations.* The Risk Management Program of each futures commission merchant shall include, but not be limited to, policies and procedures necessary to monitor and manage the following risks:

(i) *Segregation risk.* The written policies and procedures shall be reasonably designed to ensure that segregated funds are separately accounted for and segregated or secured as belonging to customers as required by the Act and Commission regulations and must, at a minimum, include or address the following:

(A) A process for the evaluation of depositories of segregated funds, including, at a minimum, documented criteria that any depository that will hold segregated funds, including an entity affiliated with the futures commission merchant, must meet, including criteria addressing the depository's capitalization, creditworthiness, operational reliability, and access to liquidity. The criteria should further consider the extent to which segregated funds are concentrated with any depository or group of depositories. The criteria also should include the availability of deposit insurance and the extent of the regulation and supervision of the depository;

(B) A program to monitor an approved depository on an ongoing basis to assess its continued satisfaction of the futures commission merchant's established criteria, including a thorough due diligence review of each depository at least annually;

(C) An account opening process for depositories, including documented authorization requirements, procedures that ensure that segregated funds are not deposited with a depository prior to the futures commission merchant receiving the acknowledgment letter required from such depository pursuant to § 1.20, and §§ 22.2 and 30.7 of this chapter, and procedures that ensure that such account is properly titled to reflect that it is holding segregated funds

pursuant to the Act and Commission regulations;

(D) A process for establishing a targeted amount of residual interest that the futures commission merchant seeks to maintain as its residual interest in the segregated funds accounts and such process must be designed to reasonably ensure that the futures commission merchant maintains the targeted residual amounts and remains in compliance with the segregated funds requirements at all times. The policies and procedures must require that senior management, in establishing the total amount of the targeted residual interest in the segregated funds accounts, perform appropriate due diligence and consider various factors, as applicable, relating to the nature of the futures commission merchant's business including, but not limited to, the composition of the futures commission merchant's customer base, the general creditworthiness of the customer base, the general trading activity of the customers, the types of markets and products traded by the customers, the proprietary trading of the futures commission merchant, the general volatility and liquidity of the markets and products traded by customers, the futures commission merchant's own liquidity and capital needs, and the historical trends in customer segregated fund balances, including undermargined amounts and net deficit balances in customers' accounts. The analysis and calculation of the targeted amount of the future commission merchant's residual interest must be described in writing with the specificity necessary to allow the Commission and the futures commission merchant's designated self-regulatory organization to duplicate the analysis and calculation and test the assumptions made by the futures commission merchant. The adequacy of the targeted residual interest and the process for establishing the targeted residual interest must be reassessed periodically by Senior Management and revised as necessary;

(E) A process for the withdrawal of cash, securities, or other property from accounts holding segregated funds, where the withdrawal is not for the purpose of payments to or on behalf of

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the futures commission merchant's customers. Such policies and procedures must satisfy the requirements of § 1.23, § 22.17 of this chapter, or § 30.7 of this chapter, as applicable;

(F) A process for assessing the appropriateness of specific investments of segregated funds in permitted investments in accordance with § 1.25. Such policies and procedures must take into consideration the market, credit, counterparty, operational, and liquidity risks associated with such investments, and assess whether such investments comply with the requirements in § 1.25 including that the futures commission merchant manage the permitted investments consistent with the objectives of preserving principal and maintaining liquidity;

(G) Procedures requiring the appropriate separation of duties among individuals responsible for compliance with the Act and Commission regulations relating to the protection and financial reporting of segregated funds, including the separation of duties among personnel that are responsible for advising customers on trading activities, approving or overseeing cash receipts and disbursements (including investment operations), and recording and reporting financial transactions. The policies and procedures must require that any movement of funds to affiliated companies and parties are properly approved and documented;

(H) A process for the timely recording of all transactions, including transactions impacting customers' accounts, in the firm's books of record;

(I) A program for conducting annual training of all finance, treasury, operations, regulatory, compliance, settlement, and other relevant officers and employees regarding the segregation requirements for segregated funds required by the Act and regulations, the requirements for notices under § 1.12, procedures for reporting suspected breaches of the policies and procedures required by this section to the chief compliance officer, without fear of retaliation, and the consequences of failing to comply with the segregation requirements of the Act and regulations; and

(J) Policies and procedures for assessing the liquidity, marketability and

mark-to-market valuation of all securities or other non-cash assets held as segregated funds, including permitted investments under § 1.25, to ensure that all non-cash assets held in the customer segregated accounts, both customer-owned securities and investments in accordance with § 1.25, are readily marketable and highly liquid. Such policies and procedures must require daily measurement of liquidity needs with respect to customers; assessment of procedures to liquidate all non-cash collateral in a timely manner and without significant effect on price; and application of appropriate collateral haircuts that accurately reflect market and credit risk.

(ii) *Operational risk.* The Risk Management Program shall include automated financial risk management controls reasonably designed to prevent the placing of erroneous orders, including those that exceed pre-set capital, credit, or volume thresholds. The Risk Management Program shall ensure that the use of automated trading programs is subject to policies and procedures governing the use, supervision, maintenance, testing, and inspection of such programs.

(iii) *Capital risk.* The written policies and procedures shall be reasonably designed to ensure that the futures commission merchant has sufficient capital to be in compliance with the Act and the regulations, and sufficient capital and liquidity to meet the reasonably foreseeable needs of the futures commission merchant.

(4) *Supervision of the Risk Management Program.* The Risk Management Program shall include a supervisory system that is reasonably designed to ensure that the policies and procedures required by this section are diligently followed.

(f) *Review and testing.* (1) The Risk Management Program of each futures commission merchant shall be reviewed and tested on at least an annual basis, or upon any material change in the business of the futures commission merchant that is reasonably likely to alter the risk profile of the futures commission merchant.

(2) The annual reviews of the Risk Management Program shall include an

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analysis of adherence to, and the effectiveness of, the risk management policies and procedures, and any recommendations for modifications to the Risk Management Program. The annual testing shall be performed by qualified internal audit staff that are independent of the business unit, or by a qualified third party audit service reporting to staff that are independent of the business unit. The results of the annual review of the Risk Management Program shall be promptly reported to and reviewed by the chief compliance officer, senior management, and governing body of the futures commission merchant.

(3) Each futures commission merchant shall document all internal and external reviews and testing of its Risk Management Program and written risk management policies and procedures including the date of the review or test; the results; any deficiencies identified; the corrective action taken; and the date that corrective action was taken. Such documentation shall be provided to Commission staff, upon request.

(g) *Distribution of risk management policies and procedures.* The Risk Management Program shall include procedures for the timely distribution of its written risk management policies and procedures to relevant supervisory personnel. Each futures commission merchant shall maintain records of the persons to whom the risk management policies and procedures were distributed and when they were distributed.

(h) *Recordkeeping.* (1) Each futures commission merchant shall maintain copies of all written approvals required by this section.

(2) All records or reports, including, but not limited to, the written policies and procedures and any changes thereto that a futures commission merchant is required to maintain pursuant to this regulation shall be maintained in accordance with § 1.31 and shall be made available promptly upon request to representatives of the Commission.

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§ 1.12 Maintenance of minimum financial requirements by futures commission merchants and introducing brokers.

(a) Each person registered as a futures commission merchant or who files an application for registration as a futures commission merchant, and each person registered as an introducing broker or who files an application for registration as an introducing broker (except for an introducing broker or applicant for registration as an introducing broker operating pursuant to, or who has filed concurrently with its application for registration, a guarantee agreement and who is not also a securities broker or dealer), who knows or should have known that its adjusted net capital at any time is less than the minimum required by § 1.17 or by the capital rule of any self-regulatory organization to which such person is subject, if any, must:

(1) Give notice, as set forth in paragraph (n) of this section, that the applicant's or registrant's adjusted net capital is less than required by § 1.17 or by other capital rule, identifying the applicable capital rule. The notice must be given immediately after the applicant or registrant knows or should have known that its adjusted net capital is less than required by any of the aforesaid rules to which the applicant or registrant is subject; and

(2) Provide together with such notice documentation, in such form as necessary, to adequately reflect the applicant's or registrant's capital condition as of any date on which such person's adjusted net capital is less than the minimum required; *Provided, however*, that if the applicant or registrant cannot calculate or otherwise immediately determine its financial condition, it must provide the notice required by paragraph (a)(1) of this section and include in such notice a statement that the entity cannot presently calculate its financial condition. The applicant or registrant must provide similar documentation of its financial condition for other days as the Commission may request.

(b) Each person registered as a futures commission merchant, or who files an application for registration as a futures commission merchant, who