From:	Pam.Suarez@chi.frb.org on behalf of David.Marshall@chi.frb.org
Sent:	Tuesday, September 21, 2010 4:07 PM
To:	acknowledgmentletter <acknowledgmentletter@CFTC.gov>
Cc:	John.McPartland@chi.frb.org
Subject:	Fw: RIN 3038-AC72
Attach:	FRBC Comment Letter RIN3038 AC72 10SEP.pdf

Resending Comment Letter of September 10th.

David Marshall
Senior Vice President
Financial Markets Group
Federal Reserve Bank of Chicago
(312) 322-5102

----- Forwarded by Pam Suarez/CHI/FRS on 09/21/2010 02:59 PM -----

RIN 3038-AC72

David Marshall to: Acknowledgmentletter 09/10/2010 12:41 PM

Sent by: **Pam Suarez**

David Marshall
Senior Vice President
Financial Markets Group
Federal Reserve Bank of Chicago
(312) 322-5102

FEDERAL RESERVE BANK
OF CHICAGO

DAVID A. MARSHALL
Senior Vice President
Financial Markets Group

September 8, 2010

Mr. David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Re: Proposed Acknowledgement Letters for Customer Funds and Secured Amount Funds (RIN 3038-AC72)

Dear Mr. Stawick:

The Federal Reserve Bank of Chicago's Financial Markets Group appreciates the opportunity to provide comments on the Commodity Futures Trading Commission's (CFTC or Commission) proposed text to standardize the acknowledgement letters for customer segregated funds and secured amount funds.

It seems appropriate to standardize the text of the acknowledgement letters that Futures Commission Merchants (FCMs) and Derivatives Clearing Organizations (DCOs) are required to obtain from financial institutions. Doing so should encourage a uniform understanding of the rights and obligations of those financial institutions that account for customer segregated assets on behalf of FCMs and DCOs.

We also applaud the initiative to have FCMs and DCOs electronically file such acknowledgement letters with the CFTC. Doing so would give the CFTC, the National Futures Association and other relevant Designated Self Regulatory Organizations ready access to this information. It would also provide the CFTC with a convenient and up to date list of all of the financial institutions that are holding customer assets pursuant to Section 4d of the Commodity Exchange Act (CEA).

<u>The Nexus of Daylight Credit and the Right to Set Off Against the Segregation Pool</u>
It is important that the interpretation of the terms contained in the proposed text of the standardized acknowledgement letter do not restrict the rights of the financial institutions such that they would be forced, by reasonable and customary banking practices, to unduly restrict the provision of daylight credit to the relevant pool(s) of segregated assets (Segregation Pool). The exchange-traded derivatives industry, perhaps more than any other, is dependent on time critical settlement payments between clients and FCMs and FCM clearing members and DCOs. Settlement banks often provide daylight credit to FCMs and DCOs in anticipation of receipt of covering settlement payments, allowing outgoing payments to be made promptly before incoming payments are received. The

230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60604-1413
(312) 322-5102 (312) 322-5943 (Fax)

settlement system would not operate nearly as efficiently were it not for this "just-in-time" liquidity[1] that is currently provided by settlement banks.

If financial institutions have limited access to the Segregation Pool and can realistically look only to the funds then in the house accounts of FCMs and DCOs, common sense and sound banking practices will likely cause those financial institutions to materially curtail the types of financial transactions that they will be willing to process in customer segregated accounts. The second attachment to this letter details several kinds of financial transactions that banks routinely process for FCMs and DCOs. The transactions detailed in the second attachment typify those transactions that might be most adversely affected by an interpretation or policy clarification by the CFTC that would limit a bank's ability to recover funds advanced to the Segregation Pool for the benefit of the Segregation Pool.

It would be helpful if the CFTC would publish a single comprehensive policy document on this subject that would summarize and clarify the sum of all policy issues currently contained in its Rules, Interpretations and No-Action Letters. As noted in the *Over-the-Counter Acknowledgement Letter* section of this comment letter, the sheer number of acknowledgement letters will likely increase materially due to a provision of the Dodd-Frank Bill. Many of those new acknowledgement letters will be executed by banks servicing financial and non-financial companies that accept collateral from counterparties on Over-the-Counter derivatives contracts. It is reasonable to assume that a single, comprehensive policy document on this subject would be particularly welcomed by banks signing such acknowledgment letters for the first time.

We suggest that the CFTC convene a public roundtable to include the relevant banks to discuss in detail the potential implications on the future provision of banking services to FCMs and DCOs if banks may only look to house assets to cover credit extended to the Segregation Pool for the benefit of the Segregation Pool.

Account Documentation

The proposed text includes the following language:

"This letter agreement constitutes the entire understanding of the parties with respect to its subject matter and supersedes and replaces all prior writings, including any applicable agreement between the parties in connection with the Account(s), with respect thereto."

It is not clear whether the purpose of this text is to limit the understanding between the bank or custodian and the account holder solely to issues related to Section 4d of the CEA or whether this text would render moot all other legal agreements between the bank and account holder relative to the "Account(s)", such as corporate resolutions and standard account opening documentation.

A financial institution agreeing to open a customer segregated account must assure itself that the individual presenting the documentation is duly authorized by his or her corporation to do so. Such standard account opening documents typically include corporate resolutions authorizing certain persons (some by name, some by title) to open accounts, sign checks, endorse checks, borrow money, make applications for Letters of Credit, make wire transfers, confirm wire transfers and the like.

[1] See Heckinger, Marshall and Steigerwald, Chicago Fed Letter, "Financial Market Utilities and the Challenge of Just-in-Time Liquidity", Number 268a, Federal Reserve Bank of Chicago, November, 2009. For convenience, this document is included as the first attachment.

The words "This letter agreement constitutes the entire understanding of the parties … in conjunction with the Account(s), with respect to thereto" could easily be read to mean the financial institutions would no longer be able to rely upon the legal certainty of corporate authority for customer segregated accounts as they can for all other bank accounts. Banks may, and often do, incorporate, by reference, these corporate resolutions when providing automated wire transfer and balance reporting services and standardized agreements governing Repurchase Agreements.

The proposed acknowledgement letter should constitute the entire understanding between the account holder and the bank with respect to matters specific to Section 4d of the CEA. The bank's standard account opening agreements, corporate resolutions and other agreements incorporated by reference should govern the remainder of the account relationship, *not* specific to Section 4d of the CEA. Should there be a conflict, the acknowledgement letter should govern matters specific to Section 4d of the CEA.

Authentication

The proposed text contains language whereby the account holder would give the bank the authority to rely upon instructions from the CFTC to immediately transfer customer property to another account and potentially to another bank. As it is assumed that such unusual authority would be used only in exigent circumstances, significant customer assets could be at stake. The CFTC should inaugurate some practical authentication process so that the banks signing such acknowledgement letters may have some reasonable basis to confirm the authenticity of such communication.

Since all of the acknowledgement letters will have been filed electronically with the CFTC, the Commission will know all of the banks that have signed such letters, their location and basic contact information. Some basic but unique authentication identifier should be established for each institution that will have filed one or more letters.

Over-the-Counter Acknowledgement Letter

Section 721(a)(28) of Title VII of the Dodd–Frank Bill will require that any person that accepts collateral of any kind from another person for (a) a futures contract (b) a securities futures product (c) a swap or is acting as a counterparty to any swap to secure performance, must register with the CFTC as an FCM. This will require that hundreds if not thousands of financial and non-financial companies will be required to register with the CFTC as FCMs. They, in turn will be required to obtain some form of Seg. Offset Acknowledgement Letters from all of their own financial institutions and custodians.

We suggest that (1) this development will cause the need for appropriate authentication to become even more critical and (2) the text of the currently proposed Seg. Offset Acknowledgement Letter, even with any refinements, may not be the appropriate text to address industry practices among Over-the-Counter collateral practitioners.

Money Market Mutual Funds (MMMF)

The proposal would require the mutual fund itself to execute the document. This is inconsistent with industry structure. The MMMF vendor, the enterprise that operates the MMMF, would be the appropriate party to execute the proposed document. The MMMF is the passive legal structure within which persons own co-proprietary interests in the MMMF portfolio.

The defined term "Funds" should more appropriately be "Shares". (The definition is otherwise reasonable). The MMMF provider is only in a position to segregate shares, not funds. The presence of the word "funds" could erroneously be read to mean that Rule 1.26 MMMF providers would

somehow now be required to bifurcate portfolio assets of a comingled portfolio of cash, securities, and repurchase agreements into portfolio assets that support MMMF shares that happen to be held by persons subject to CFTC regulations from portfolio assets supporting MMMF shares of the same fund owned by persons that have nothing to do with derivatives.

Subsequent Review

The CFTC should revisit the appropriateness of the proposed text against prevailing industry practices in approximately 12-18 months. The exchange traded and Over-the-Counter derivatives industry is particularly innovative. This proposed text and the relevant Interpretations and No-Action Letters may have the unintended consequence of freezing the list of financial transactions for which a financial institution can set off against a Segregation Pool. The public interest may not be optimally served by freezing the universe of credit and non-credit services that financial institutions are willing to provide to FCMs and DCOs as of the third quarter 2010.

The Financial Markets Group of the Federal Reserve Bank of Chicago appreciates the opportunity to submit these comments for your consideration. Should these comments raise any questions or should you require any additional information, kindly contact John McPartland (312.322.8118) or Robert Steigerwald (312.322.2414).

Attachments: (2)

Chicago FedLetter, "Financial Market Utilities and the Challenge of Just-in-Time Liquidity"

Routine Transactions that Might be Adversely Affected by Constrained Daylight Credit Availability: A Detailed Analysis

Sincerely,

David A. Marshall

David A. Marshall
Senior Vice President
Financial Markets Group
Federal Reserve Bank of Chicago

230 SOUTH LA SALLE STREET
CHICAGO, ILLINOIS 60604-1413
(312) 322-5102 (312) 322-5943 (Fax)

ESSAYS ON ISSUES | THE FEDERAL RESERVE BANK OF CHICAGO | NOVEMBER 2009 NUMBER 268a

Chicago Fed Letter

Financial market utilities and the challenge of just-in-time liquidity

by Richard Heckinger, senior policy advisor, Financial Markets Group, David Marshall, senior vice president, Financial Markets Group, and Robert Steigerwald, senior financial markets advisor, Financial Markets Group

Financial market utilities ensure that clearing, settlement, and payments operations go smoothly. This article explores how these systems mitigate settlement risk, using precisely targeted "just-in-time" liquidity, and discusses the risks for financial stability implied by the increasing role of just-in-time liquidity in our financial markets.

Financial market utilities are institutions that perform critical post-trade functions, such as conveying financial assets and corresponding payments between buyers and sellers.

Every day, trillions of dollars, euros, yen, and many other currencies flow among participants in markets for foreign currency, securities, and derivatives contracts.[1] This vast flow of payments happens largely below the radar screen of most people, thanks to a collection of institutions known as financial market utilities (FMUs). The basic function FMUs perform is simple. After a financial trade has been agreed upon, a mechanism must exist to convey the financial asset from seller to buyer and reciprocally to convey compensation from buyer to seller. FMUs provide this mechanism. In particular, FMUs mitigate settlement risk (the risk that trades will not be settled or completed as expected) and the particular form of settlement risk known as counterparty credit risk (the risk that a party involved in a transaction might fail to deliver funds or securities as promised).

A key insight about FMU operations, which we discuss in detail, is that all of the key FMUs mitigate settlement risk through essentially the same mechanism: precisely targeted liquidity that requires the FMUs and their participants to make payments according to a tight within-day timetable. We refer to this as *just-in-time* liquidity: liquidity that must be available *at a particular location, in a particular currency,* and *in a precise time frame* measured not in days, but in hours or even minutes.

The need for just-in-time liquidity poses challenges for both FMUs and their participants. Financial market participants must be able to manage their liquidity requirements on an ongoing basis as their payment and settlement obligations fall due. FMUs, in turn, must be able to manage their liquidity requirements in the event a participant defaults. This liquidity-dependent structure for FMUs raises an important question for the stability of financial markets: Does this dependence on precisely timed liquidity actually make financial markets *more* vulnerable to episodes when liquidity becomes less available? Put another way, do these FMUs succeed in reducing settlement risk only by increasing liquidity risk?

In this *Chicago Fed Letter*, we describe the evolution of FMUs. Then we focus on certain key FMUs, describing the particular credit risk they are designed to mitigate and how they depend on just-in-time liquidity. Finally, we consider the risks for financial stability implied by the increasing role of just-in-time liquidity in our financial markets.

Historical background

In the 1970s, markets relied on payment and settlement systems with significant settlement lags, meaning that payment of funds and delivery of securities for a given transaction would not be completed the day the transaction was initiated. The primary FMU through which banks exchanged large-value U.S. dollar payments for foreign currency transactions was the Clearing House Interbank Payments System (CHIPS). At that time, CHIPS operated as a *deferred net settlement* system, in which payments were not final until the next day.

Herstatt's counterparties faced huge losses on payments to Herstatt they had made without receiving counterpayment. The failure of Herstatt resulted in litigation over many years—both in Germany, where Herstatt was subject to liquidation proceedings, and in the U.S. Quite apart from the immediate impact on Herstatt's counterparties, however, the failure of Bankhaus Herstatt made financial market participants and policymakers aware of the risks inherent in foreign currency markets, which depend upon the completion of payments in different currencies through payments systems operating

The failure of Bankhaus Herstatt in 1974 exposed the risks inherent in foreign currency markets.

The risks associated with deferred settlement were brought to the world's attention in dramatic fashion by the 1974 failure of Bankhaus ID Herstatt KGaA, a commercial bank based in Köln (Cologne), Germany, which had been an active trader in foreign currency markets. At about 3:30 p.m. Central European Time (CET) on Wednesday, June 26, 1974, Bankhaus Herstatt had its banking license withdrawn by the German banking authority. That action took place after the close of the system for making interbank payments in Germany. Herstatt's counterparties in various foreign currency transactions had irrevocably paid deutsche marks to Herstatt on that day through the German payments system against anticipated receipts from Herstatt of U.S. dollars later the same day in New York. Herstatt's U.S. correspondent bank, Chase Manhattan, received news of Herstatt's failure shortly after 10:30 a.m. Eastern Time. Chase responded to the news by withholding some $620 million of U.S. dollar payments that were to be made to Herstatt's foreign currency counterparties. This action left Herstatt's counterparties exposed for the full value of the deutsche mark deliveries made and resulted in a temporary, but systemically disturbing, halt in the flow of payments through CHIPS. The potential for gridlock in the U.S. payments system was real.

across national borders and different time zones.

The immediate lesson that central bankers took from Herstatt was that existing deferred net settlement payments systems were insufficiently robust to stand up to the default of a market participant. The public policy response focused on two complementary developments. First, new systems needed to be created that would guarantee intraday finality of settlement. And second, there was a clear need to more closely coordinate all settlements associated with a given transaction (e.g., the payout in one currency and the receipt of another currency). As we shall see, each of these developments increased the financial markets' reliance on just-in-time liquidity.

Real-time gross settlement systems

To achieve intraday finality of payments, central banks began to replace then-predominant deferred net settlement systems with real-time gross settlement (RTGS) systems. Final settlement in an RTGS system is both immediate and continuous, subject to the proviso that a payment instruction will be processed if, and only if, the sending bank has sufficient covering balances or credit. This ensures finality to any payment initiated in the RTGS system, but unlike in a deferred net settlement system, an RTGS system requires the paying party to have sufficient liquidity resources at precisely the time the payment is made. For this reason, an RTGS payments system depends on just-in-time liquidity.

In 1974, the United States was the only country to have an RTGS system—the Fedwire Funds Transfer System. According to a recent survey by the World Bank, there are at least 98 RTGS systems in operation around the world today, serving 112 national payments systems.[2]

Coordinating settlements

The Herstatt incident illustrated not only the vulnerability of deferred net settlement systems, but also the risks associated with any transaction involving settlements that occur at different times. To take an example from the securities market, if the delivery of the security to the buyer occurs after payment is made to the seller, the risk exists that the seller might take the payment but fail to deliver the security. In a similar example involving a foreign currency transaction, if a payout in U.S. dollars occurs before the pay-in of another currency, the risk exists that the payout could be finalized but the pay-in might never be received.

To eliminate these sorts of risks, new systems for settling securities and currency transactions were developed that built on the adoption of RTGS systems worldwide in the late 1980s and 1990s. They use a similar strategy to synchronize all settlements associated with a financial transaction. In securities markets this strategy is known as delivery versus payment (DvP). In foreign currency markets the same strategy is referred to as payment versus payment (PvP). With DvP, the timing of the delivery of a security to the buyer is coordinated with the transfer of funds to the seller. With PvP, the timing of the payment in one currency is coordinated with the return payment in the second currency.

Key financial market utilities

In the U.S., the key FMUs that implement DvP settlement of securities are the Depository Trust and Clearing Corporation (DTCC) and its two main subsidiaries, the National Securities Clearing Corporation (NSCC)—for equities—and the Fixed Income Clearing

Corporation (FICC)—for fixed income securities. Both NSCC and FICC are particular types of FMUs known as central counterparties (CCPs). A CCP legally interposes itself between the two parties of a trade, guaranteeing that the trade will settle. Both of these CCPs use another DTCC subsidiary, the Depository Trust Company (DTC), as their central securities depository and settlement agent. While the details of this process are somewhat intricate, the key point is that delivery of securities to the purchaser and payment of funds to the seller occur if, and only if, the CCP is satisfied that each party has met its obligations. DvP securities settlements depend on just-in-time liquidity because participants must satisfy strict time deadlines for the settlement of open commitments. In addition, the CCP must have access to just-in-time liquidity to meet its guarantees in the event that one of its participants defaults.

PvP represents an analogous system to settle both legs of a foreign currency transaction. Currently, the key FMU that implements PvP is the CLS Bank,[3] which operates the Continuous Linked Settlement (CLS) system. CLS began operations in September 2002 and currently settles 17 actively traded currencies and 55% of all foreign currency transactions, making it the dominant settlement method for foreign currency trades.[4]

The way CLS works is an instructive example of how just-in-time liquidity is used to mitigate settlement risk. Eligible foreign currency transactions of CLS settlement participants must be submitted to CLS by a specific time and are settled in accordance with a sophisticated risk-management process. As a result of the settlement process, virtually all CLS participants will have obligations to CLS Bank in some currencies and receivables from CLS Bank in other currencies. Obligations to CLS Bank must be funded within the five-hour period from 7:00 a.m. to noon CET.[5] This is where just-in-time liquidity becomes crucial for the participants. CLS Bank will not pay out currencies owed to settlement participants if it would trigger a deficit across all currencies. To avoid such a situation, settlement participants must have access to sufficient just-in-time liquidity to meet promptly their pay-in obligations in currencies owed to CLS Bank. Failure to pay in according to this strict timetable constitutes default and would result in severe penalties for the defaulting bank. In addition, a default would require CLS itself to invoke its settlement failure procedures, which would require access to just-in-time liquidity, perhaps on very short notice.

Increasing reliance on just-in-time liquidity

For both securities and derivatives contracts, the CCP is the legal buyer to every seller and the legal seller to every buyer. Thus, CCPs take on significant credit risk, often for a considerable period.[6] To protect itself from this potentially long-term credit risk, CCPs typically require payment of an initial margin amount (also known as a performance bond). As market prices change following the initial trade, the CCP typically demands additional payments to ensure the ability of the CCP to fulfill its guarantee that the trade will settle.[7] To address counterparty risk and settlement risk, the CCP requires that all such payments be made according to strict time deadlines, introducing once again the need for just-in-time liquidity.

The time frame for these payments is very tight. In the U.S., the CME Group Clearing House Division (CME), based in Chicago, is the CCP that clears almost all U.S. exchange-traded futures. Its daily settlement operations involve two payments events: the morning settlement, based on prices from the "close" of trading the day prior, and a midday settlement, based on midday market prices. Both the morning and midday settlements must be made promptly when due. The morning settlements are due at or before 8:30 a.m. Central Time (CT); afternoon settlements are due within one hour of the time CME requests payment from its clearing members. These tight deadlines contribute to a reliance on just-in-time liquidity, since failure to meet either deadline would constitute a default by the clearing participant. Such a default would trigger the CME's failure resolution procedures, which also depend on just-in-time liquidity, since the CME would be obligated to replace within a narrow time frame the liquidity missing from the defaulting participant.

The Options Clearing Corporation (OCC), also based in Chicago, is a CCP that clears all options on stocks traded on U.S. exchanges. The OCC is also dependent on just-in-time liquidity to manage credit risk. In particular, each morning the OCC settles payment obligations incurred the previous business day. These payments include options premiums (passed through the OCC from buyer to seller), margin, and collateral securities. The OCC requires that all payments due to it be received by 9:00 a.m. CT. The OCC, in turn, is obligated to make all payments required of it to its clearing participants by 10:00 a.m. CT. If any clearing participant were to default on a payment, the OCC would be obligated to obtain the liquidity needed to replace the defaulted payment by 10:00 a.m. in order to meet its payout obligations. This one-hour time frame enables the OCC to tightly manage the settlement process, but exacerbates its dependence on timely liquidity.

Conclusion

In this article, we have documented how strategies implemented to mitigate credit

ISSN 0895-0164

risk in the settlement process have increased FMUs' dependence on just-in-time liquidity. Timely liquidity is essential during the routine settlement process. But, it is just as important in a default scenario, when the ability of an FMU to complete settlement depends on access to sufficient backup liquidity to permit the FMU to fill the funding gap left by the defaulting participant. In addition, central securities depositories and CCPs must have sufficient liquidity to close out the defaulting participant's positions.

The liquidity needs we have outlined here raise important questions for risk management and public policy. How might the inability of a key institution to deliver on its just-in-time liquidity obligations impact other market participants? More specifically, in light of the liquidity crises that affected markets in March 2008 and, more severely, in September and October 2008, can we take it for granted that just-in-time liquidity will be available to FMUs at a time when multiple market participants are in danger of defaulting? The key objective of an FMU in such a case would be to turn whatever collateral or other noncash instruments are available to it—including lines of credit, guarantee funds, and insurance—into cash in the shortest possible amount of time. This reliance on private sources of liquidity presumes that banks and other lenders would be available and would have the capacity to take on such transactions at reasonable rates and on very short notice. During a period of extreme market disruption, these presumptions may not hold.

The recent global financial crises have shown that stable and liquid funding may not always be available and that liquidity risk must be taken seriously. For example, Bear Stearns was nearly brought to bankruptcy in March 2008 by its inability to obtain short-term secured funding, a source of liquidity that it had previously counted on. With the increasing dependence of FMUs on just-in-time liquidity, the impact of such liquidity risk on financial markets should be a particular focus of vigilance by market participants and regulators; and it is an important issue to keep in mind as we consider potential changes to the regulatory process.

---

[1] A derivatives contract is a financial contract that derives its value from some underlying commodity or asset. Examples include futures, options, and swaps.

[2] Peter Allsopp, Bruce Summers, and John Veale, 2008, "The evolution of real-time gross settlement: Access, liquidity and credit, and pricing," Financial Infrastructure Series, Payment Systems Policy and Research, World Bank, report, February, available at http://siteresources.worldbank.org/EXTPAYMENTREMMITTANCE/Resources/TheEvolutionofRTGS.pdf.

[3] CLS Bank International is chartered by the Board of Governors of the Federal Reserve System and headquartered in New York.

[4] See Bank for International Settlements, Committee on Payment and Settlement Systems, 2003, "Payment and settlement systems in selected countries," report, Basel, Switzerland, April, p. 462, available at www.bis.org/publ/cpss53.pdf. Also, Bank for International Settlements, Committee on Payment and Settlement Systems, 2008, "Progress in reducing foreign exchange settlement risk," report, Basel, Switzerland, May, available at www.bis.org/publ/cpss83.pdf.

[5] Asia-Pacific currency obligations must be funded between 7:00 a.m. and 10:00 a.m. CET.

[6] For example, credit default swaps, which have recently started to be centrally cleared, can have maturities as long as five years.

[7] In derivatives markets, this additional payment is known as variation margin.

Second Attachment

Routine Transactions that Might be Adversely Affected by Constrained Daylight Credit Availability: A Detailed Analysis

The accompanying text in the Federal Register Notice could be read to mean that, in general, a financial institution that provides a customer segregated account cannot set off against the assets of the Segregation Pool for many customary financial transactions that were made for the benefit of the Segregation Pool. The Commission appears to be taking the position (especially in the text that addresses the Katten comment letter) that an overdraft in a customer segregated account that was caused by one or more transactions processed for the benefit of the Segregation Pool, is solely the obligation of the FCM. If this is the correct interpretation, banks providing daylight credit would be secured only up to the amount of cash and securities then on deposit in the house account(s) of the account holder (the FCM or DCO). Any provision of daylight credit to the Segregation Poll over and above that amount would have to be deemed to be unsecured credit.

If financial institutions have limited access to the Segregation Pool and can realistically look only to the funds then in the house accounts of FCMs and DCOs, common sense and sound banking practices will likely cause those financial institutions to materially curtail the types of financial transactions that they will be willing to process in customer segregated accounts.

This discussion may benefit from a few practical examples which follow.

Settlement Transfers with Customers

FCMs typically exchange settlement variation transfers with large corporate clients daily. Clients having a variation margin entitlement will have funds transferred to their respective accounts by the FCM. Clients having a variation margin obligation transfer funds to the account of the FCM. The FCM can only control the timing of the outbound payments that it makes; it cannot control the timing of the payments that it receives during the course of the day. If the availability of daylight credit is restricted by banks that have agreed to the terms of the proposed acknowledgement letter, FCMs will likely be permitted to transfer variation margin to their customers only as the FCM receives variation

margin payments from its other customers, thus minimizing the unsecured daylight exposure that the bank has to the account holder. While this may be challenging but manageable on days with typical market volatility, it may be less so on days with considerable market volatility. As the relevant sums get larger and larger it is logical to assume that outbound payments to clients would be made later and later in the day.

The Federal Register Notice, the relevant Interpretations and No-Action Letters taken together would appear to grant the bank the right to recover funds advanced "for the purposes of variation settlement or posting original margin" presumably between the FCM and the DCO. It is not clear that the bank would have an equivalent right to recover funds advanced to the Segregation Pool to allow the FCM to pay variation margin to its some of its clients (and potentially creating a daylight overdraft by doing so) prior to receipt of variation margin payments from other clients. It would be helpful if this could be clarified.

Multiple Customer Segregated Accounts

If a bank or custodian provides multiple Customer Segregated Funds accounts (all for the same account holder) in different non-USD currencies, the proposed text does not appear to grant the bank or custodian the right to set off against one non-USD customer account having a positive balance to remedy another non-USD customer account that is overdrawn.

If a bank, including all of its branches provides multiple Customer Segregated Funds accounts (all for the same account holder) the proposed text does not appear to grant the bank or custodian the right to set off against one USD customer account having a positive balance to remedy another USD customer account that is overdrawn.

Balancing Transfers among DCOs' Settlement Banks

These same issues are germane to DCOs, only in a more critical way. There are expectations of all market participants, but particularly clearing members, that their obligations to DCOs and their entitlements from DCOs will be extinguished according to well established time deadlines. Failure of a DCO to pay clearing members variation on a timely basis is often misperceived as a shortcoming on the part of the DCO to have promptly collected variation margin from other clearing members. If the proposed acknowledgement letter has the unintended consequence of constraining the availability of daylight credit to DCOs, it is logical to assume that clearing members may receive access to variation margin payments later in the day than is presently the case.

Purchase of Treasury Securities with Customer Funds

FCMs often purchase US Treasury securities with customer segregated funds. US Treasury securities are delivered to the Federal Reserve account of the FCM's bank *versus payment* of funds. If the FCM does not then have sufficient funds in its customer segregated account, the FCM's bank must have the ability to deem that security as *not paid for* or *not fully paid for*, depending on the available funds in the customer segregated account. If the customer account closes the business day in an overdrawn state, the FCM's bank (which has paid the sender in full for the security) must have the ability to deem the security in question to be the legal property of the FCM's bank and not the property of the Segregation Pool.

If financial institutions that provide banking services to FCMs and DCOs materially curtail the availability of daylight credit, it would be increasingly likely that those financial institutions will simply begin to send the US Treasury securities back to the sender, or to "DK"[1] the purchase. This particular issue needs clarification as the sums involved are often critical, as is the proper investment of customer funds.

Policy by Principle versus Policy by Iteration

Rather than attempting to explicitly define permissible and impermissible financial transactions through an historic sequence of Interpretations and No Action Letters, a principles based approach might be advisable. Such a principle would simply state that a bank could look to other assets in the Segregation Pool to cover indebtedness of the Segregation Pool if the transaction or transactions that gave rise to the indebtedness were made *for the benefit of the Segregation Pool.*

[1] In securities settlement vernacular, "DK" stands for "don't know" that is, "I don't recognize" this transaction and am reversing the delivery of the security back to the sender.