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Morgan Stanley

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Via Comments Online, http://comments.cftc.gov

Mr. David Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions

Dear Mr. Stawick:

Morgan Stanley appreciates the opportunity to submit this letter in response to the request of the U.S. Commodity Futures Trading Commission ("Commission") for comment on proposed revisions to Commission Rule 1.25, Investment of Customer Funds, and Commission Rule 30.7, Treatment of Foreign Futures or Foreign Options Secured Amount.[1] As discussed in detail below, Morgan Stanley respectfully recommends that the Commission (1) reconsider its proposed elimination of in-house transactions, and in the alternative, consider (i) preserving in-house transactions subject to a concentration limit of 25 percent of total assets held in segregation or secured amount, as applicable, or (ii) raising the proposed counterparty concentration limit for reverse repurchase agreements from 5 percent of total assets held in segregation or secured amount to 25 percent; and (2) clarify that a futures commission merchant may, consistent with the proposed revisions, invest (both directly and through permitted repurchase and reverse repurchase transactions) collateral in foreign sovereign debt instruments to the extent of, and for the purpose of satisfying, margin requirements of its foreign futures or foreign options customers.

[1] Morgan Stanley supports the comments and recommendations filed by the Futures Industry Association, Inc. ("FIA") and International Swaps and Derivatives Association, Inc. ("ISDA") in response to the Commission's request for comments on proposed amendments to Commission Rule 1.25, Investment of Customer Funds, and Rule 30.7, Treatment of Foreign Futures or Futures Options Secured Amount. Letter to the Commission from John Damgard, President, FIA, and Robert A. Pickel, Executive Vice Chairman, ISDA, dated December 2, 2010.

I. Summary of Morgan Stanley's Response

Morgan Stanley shares, and fully endorses, the Commission's policy objectives that customer segregated and secured amount funds be invested so as to (i) minimize their exposure to credit, liquidity, and market risks; (ii) preserve principal and maintain liquidity; (iii) assure their availability to customers; and (iv) avoid systemic risk. Morgan Stanley is concerned, however, that certain aspects of the proposed revisions would have the unintended result of undermining these objectives. Specifically, we believe that in-house transactions have been targeted for elimination without due consideration of how such facilities enhance not just capital efficiency, but also liquidity. In addition, Morgan Stanley requests that the Commission clarify that its proposed revisions to the permitted investments rules would accommodate the purchase of foreign sovereign debt for the purpose of satisfying margin requirements of its foreign futures and foreign options customers trading on foreign boards of trade.

II. Morgan Stanley's Interest in the Permitted Investment Regulations

Morgan Stanley is a global financial services firm that, through its wholly-owned subsidiary, Morgan Stanley & Co. Incorporated ("MS&Co."), a futures commission merchant registered with the Commission, provides execution and clearing brokerage services in futures and options on futures, foreign futures and foreign options and cleared OTC derivatives and cleared swaps to a diverse group of customers. Through its trading and clearing memberships, as well as its global network of affiliate and agent brokerage relationships, MS&Co. provides access for its customers to over 60 domestic and foreign futures and derivatives exchanges.

III. The Proposed Removal of In-House Transactions as a Permitted Investment Potentially Heightens Systemic Risk

The Commission cites concentration of credit risk in support of its proposal to remove in-house transactions as permitted investments. Morgan Stanley respectfully submits that the proper response to concentration risk arising from the use of in-house transactions is not prohibition. In adopting in-house transactions as a permitted investment in 2005, the Commission noted that their "key benefit"

> is that they can assist an FCM both in achieving greater capital efficiency *and in accomplishing important risk management goals*, including internal diversification targets. For example, customer-deposited securities that are not acceptable as collateral for DCO performance bond requirements could be exchanged for securities that are acceptable. This would permit the more efficient use of an FCM/BD's total holdings. There also would be

> certain operational efficiencies given the ability to readily substitute forms of collateral prior to delivering that collateral to a DCO.[2]

The risk management goals that the Commission highlighted in approving in-house transactions remain important touchstones for the FCM's day-to-day processes around collateral subject to the segregation and secured amount regimes. As the Commission is aware, the range of collateral types which an FCM may accept from its customers under DCO rules is often materially broader in practice than the range of collateral which DCOs actually accept from their clearing members.[3] Accordingly, FCMs routinely find themselves having to provide financing of customer margin requirements, secured by collateral that, although acceptable to the FCM under applicable exchange rules, may not be passed through to margin customer positions at the clearing house. As the Commission anticipated, in-house transactions established in compliance with CFTC Rule 1.25(e) have in fact proven a reliable and operationally efficient means of bridging that gap.

This salient advantage of in-house transactions – namely, ease of convertibility of customer collateral from one form to another – also serves the key policy objective of keeping permitted investments liquid. Consider the example of a customer who wishes to trade Japanese Government Bond futures and wishes to collateralize those trades using US Treasuries. By an in-house transaction in compliance with Commission Rule 1.25(e), the FCM exchanges the Treasuries for JGBs (a form of collateral approved by the Tokyo Stock Exchange, where a variety of JGB futures and options on futures are listed) and furnishes the JGBs to its agent clearing broker at the TSE to margin its customer's trades. Because the in-house transaction can be effected and recorded through book entries on the FCM/broker-dealer's general ledger, it can be accomplished through automated internal processes that are subject to a high level of control. The same is not routinely true of third-party repurchase arrangements, which often involve greater time lags than do in-house transactions between execution and settlement and also typically require more manual processing than their in-house counterparts.

It might be maintained in response that the financing and collateral substitution functions served by in-house transactions are replicable through third-party repurchase and reverse repurchase arrangements. Morgan Stanley respectfully submits that relying entirely on third-party arrangements to replicate these functions will materially increase operational risk in an area where it is negligible today. The Commission will recall that certain third-party custodial arrangements relating to customer segregated collateral held by the Lehman FCM seized up

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[2] 70 FR 5577, 5581 (February 3, 2005) (emphasis added).

[3] Compare, for example, CME Rule 930.C (governing forms of collateral acceptable by clearing members) and CME Rule 820 (governing forms of collateral acceptable by the clearing house). The provisions are equivalent on their face, but the collateral specified under Rule 820 is subject to "terms and conditions as approved by Exchange staff." The CME schedule of collateral types accepted details how those terms and conditions apply in practice (available at http://www.cmegroup.com/clearing/financial-and-collateral-management/collateral-types-accepted.html).

during the September 2008 financial turmoil. It is, unfortunately, easy to imagine something similar happening to third-party repurchase and reverse repurchase facilities holding customer segregated and secured amount collateral in similar circumstances. This risk would be exacerbated were the ban on in-house transactions implemented alongside the Commission's proposed five percent counterparty concentration limit on third-party reverse repurchase facilities. Such a low concentration limit would require many FCMs, including MS&Co., to establish multiple repurchase facilities, each with a different counterparty. This will inevitably multiply the administrative and book-keeping burdens on the FCM back offices, and, no less inevitably, increase stress on controls and the concomitant risk of operational failure. In addition, it will replace internal arrangements that effect transactions rapidly and through automated processes with a complicated web of more manual, operationally intensive arrangements among the small group of dealers prepared to furnish repurchase facilities.

For these reasons, Morgan Stanley urges the Commission to reconsider its elimination of in-house transactions. In the alternative, the Commission should consider (i) preserving in-house transactions, subject to a concentration limit of 25 percent of total assets held in segregation or secured amount; or (ii) if it is determined to eliminate in-house transactions, raising the proposed concentration limit for reverse repurchase transactions to 25 percent of total assets held in segregation or secured amount.

IV. The Proposed Removal of Foreign Sovereign Debt as a Permitted Investment Should Be Clarified

Morgan Stanley respectfully requests that the Commission clarify with respect to the proposed elimination of foreign sovereign debt from the list of permitted investments that the following transactions would remain a permissible use of customer collateral by an FCM facilitating customer transactions on a foreign board of trade: (i) customer wishes to collateralize its foreign futures or foreign options using either U.S. Treasuries or foreign currency; (ii) the FCM either a) enters into a permitted reverse repurchase transaction converting the Treasuries to a form of foreign sovereign debt or b) uses the foreign currency directly to purchase a form of foreign sovereign debt that is acceptable margin collateral at the foreign board of trade; and (iii) the FCM collateralizes its customer's trades using the foreign sovereign debt.

Morgan Stanley respectfully submits that this transaction should not be viewed as falling within the scope of Commission Rule 1.25. Its purpose is not to realize interest or increment under Commission Rule 1.29 resulting from an investment in foreign sovereign debt. Its purpose is to facilitate a customer's foreign futures trades in a capital-efficient manner. If the Commission adopts the proposed elimination of foreign sovereign debt without clarifying this point, such transactions will be subject to a material level of legal uncertainty. Accordingly, Morgan Stanley urges the Commission to clarify that, notwithstanding the proposed elimination of foreign sovereign debt as a permitted investment, such transactions would remain permissible for FCMs, consistent with Commission Rule 1.25, subject to the conditions that the transactions

be for the purpose of satisfying, and not exceed in value, the margin requirements of such FCMs' foreign futures or foreign options customers.

V. Conclusion

We hope that the Commission and its staff find our comments and recommendations helpful in formulating its final rules on permitted investments. Please contact Stephen Morris, Executive Director, at (212) 762-4986 or me at (914) 225-5540, if you would like to discuss these issues in further detail.

Respectfully submitted,

William F. McCoy
Managing Director and Counsel