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January 18, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: RIN 3038-AD99: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies 75 Fed.Reg. 75162 (December 2, 2010)

Dear Mr. Stawick:

The Futures Industry Association (õFIAö)[1] is pleased to submit this letter in response to the Commodity Futures Trading Commissionøs (õCommissionøsö) advanced notice of proposed rulemaking (õNoticeö), pursuant to which the Commission requests comment on various alternative models to protect collateral that customers post with an FCM, and indirectly through the FCM with a derivatives clearing organization (õDCOö), to margin, guarantee or secure swap transactions cleared through the DCO. Section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (õDodd-Frank Actö) amends the Commodity Exchange Act (õActö), *inter alia*, to provide for the segregation of customer collateral deposited by cleared swaps customers. As the Commission notes, new section 4d(f) is õsubstantially similar, though not identicalö[2] to the provisions of section 4d(a) of the Act, which provide for the segregation of collateral deposited by customers that trade futures and options on futures on US designated contract markets. The Commission, therefore, is considering whether a model different from that employed in connection with exchange-traded futures, which the Commission terms the õbaseline model,ö would be appropriate.

The different models offered by the Commission address one element of the statutory and regulatory regime designed to protect customer funds, which the Commission defines as õfellow-customer risk.ö[3] õFellow-customer riskö is the risk that one or more customers of an FCM will fail to meet their financial obligations to the FCM and that such loss will exceed the FCMøs

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1 FIA is a principal spokesman for the commodity futures and options industry. FIAøs regular membership is comprised of approximately 30 of the largest futures commission merchants (õFCMsö) in the United States. Among FIAøs associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

2 75 Fed.Reg. 75162 (December 2, 2010).

3 Significantly, the suggested models would affect only the treatment of cleared swaps customer funds held at a DCO and not funds that may be held at the defaulting FCM. Moreover, the suggested models would not address losses to cleared swaps customers that may arise from mismanagement or unlawful conduct on the part of the FCM.

ability, in turn, to meet its obligations to the DCOs, leaving a shortfall in the customer omnibus accounts that the clearing FCM maintains at one or more DCOs.[4] In these circumstances, under the õbaseline model,ö non-defaulting customers of the FCM may be required to share *pro rata* in the losses that arise from such shortfall.[5]

Assuring the financial integrity of the markets is a shared responsibility among the Commission, the several self-regulatory organizations (including DCOs) (õSROsö), Commission registrants (in particular, FCMs) and other market participants. FIA member firms take this responsibility seriously and have consistently supported efforts to enhance financial integrity.[6] Our members maintain robust risk management programs and work closely with the exchanges and DCOs of which they are members to develop and employ a full array of risk managements tools through which DCOs monitor on a day-to-day basis the financial well-being of their member FCMs and the risks these members assume in connection with their respective customer and proprietary positions.[7]

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[4] Consistent with the provisions of section 4d(a)(2) of the Act, Commission Rule 1.22 prohibits an FCM from using the funds of one customer to margin, guarantee or secure the obligations of any other customer.

[5] As reflected in the bylaws and rules of the several DCOs, the õbaseline modelö permits a DCO, in the event of an FCM default, to satisfy the defaulting FCMøs obligations to the DCO by applying all margin and other property of the FCM to which the DCO has access in the following order (*i.e.*, the õwaterfallö):
(i) the FCMøs property, *e.g.*, memberships, shares, default fund contribution and house account; (ii) the margin held in the customer omnibus account, but only if the default arises in the customer omnibus account; (iii) a portion of the DCOøs operating capital; and (iv) the default fund contributions of other members of the DCO.

[6] The Commission will recall that in 1995, following the collapse of Barings PLC, FIA formed a Global Task Force on Financial Integrity (õTask Forceö), which included representatives of major international exchanges and clearing organizations, brokers/intermediaries, and customers from 17 jurisdictions. The Task Force developed recommendations to enhance the protection of all market participants.
More recently, FIA commented favorably on the Commissionøs proposed rules implementing DCO Core Principle B and recommended that the Commission revise its proposed rule to require all DCOs to maintain financial resources that, at a minimum, exceed the total amount that would enable the DCO to meet its financial obligations to its clearing members notwithstanding a default by the two clearing members creating the largest financial exposure for the DCO in extreme but plausible market conditions.

[7] To fulfill these responsibilities, DCOs enforce the following financial safeguards:

- **Performance Bonds/Concentration Performance Bonds.** Performance bond requirements cover expected price moves of at least 95 percent to 99 percent over varying time-frames. Concentration performance bond requirements are imposed when a clearing firmøs potential exposure becomes large relative to its financial resources.
- **Settlement Cycles**. Two full settlement cycles are performed daily: (i) open positions are marked-to-market; variation margin is paid and collected; and performance bond coverage is reset.
- **Stress Tests.** Daily stress tests are performed on clearing member positions on a portfolio basis and on the individual accounts of the clearing memberøs large traders; the clearing member may be required to increase performance bond requirements or reduce or transfer positions.
- **Capital Requirements.** Clearing members have significant minimum capital requirements.
- **Default Fund Contributions.** Clearing FCMs must make a significant contribution to the clearing organizationøs default fund.
- **Reporting Requirements.** FCMs calculate daily their segregation requirements and capital and report those numbers to their respective designated self-regulatory organization as required.

The success of the current risk management programs in assuring the financial integrity of the exchange-traded futures markets is evidenced by the very few clearing FCMs that have failed as a result of customer losses. These failures arose at relatively small clearing firms that catered to local traders. Losses were manageable and no futures customers other than the defaulting customers lost money.[8]

Although the õbaseline modelö has been successful, FIA appreciates that risk management tools must evolve with the markets. In this regard, FIA recognizes that swaps customers have expressed concerns, both at the October 22 Roundtable on Customer Collateral Protection and in separate conversations with FIA member firms, that they are unable to defend against, and should not be exposed to, õfellow-customer risk,ö however slight. We have resolved to work with our customers to attempt to address their concerns in a manner that does not inadvertently increase systemic risk generally.

As the Commission implements a regulatory program for cleared swaps, therefore, it is appropriate that the Commission and the industry re-examine current risk management programs, including the programs specifically designed to protect market participant collateral against õfellow-customer risk.ö In doing so, however, we recognize that no one ô the Commission, DCOs, clearing members or market participants ô has any meaningful experience with the structures of the cleared derivatives markets authorized under the Dodd-Frank Act. For example, the industry faces the prospect of customers trading the same swap on multiple trading facilities and clearing those swaps through multiple clearing organizations.

The additional financial and operational risks that market participants, clearing members and clearing organizations will be assuming in these circumstances are difficult to analyze properly. Further complicating the analysis is the potentially adverse effect that these structures may have on market liquidity.

Based on the limited description of the several models set out in the Notice, each of the suggested models raise a number of serious policy and operational concerns. In addition, the Commissionøs authority to adopt a different model may be constrained by the relevant provisions of the Act and the Bankruptcy Code (õCodeö). It is essential, therefore, that any change from the current model for the protection of customer funds be undertaken only after careful analysis of the legal, policy and operational implications of any such change. Customer protection is not enhanced, if a change in the regulatory regime for the protection of customer funds creates legal uncertainty.[9]

- **Early Warning Requirements.** Pursuant to Commission Rule 1.12, FCMs and clearing organizations are subject to certain early warning requirements.

[8] Neither Refco LLC and Lehman Brothers Inc. defaulted on their obligations to their exchange-traded futures customers or to the DCOs of which they were members. The financial stress that they experienced arose from activities conducted in affiliated entities.

[9] For example, certain swaps customers have suggested õcustomer choiceö as a possible means of addressing their concerns. This alternative presumably would be similar to the right afforded eligible contract participants under section 5a(f) of the Act to elect not to have their funds held in segregated accounts when trading on a derivatives transaction execution facility. õCustomer choiceö carries several benefits, including the potential for

Thus, while the Commission has understandably focused on the operational costs and benefits that may result from a change in models for the protection of cleared swap customer funds, we believe the examination should be broader. This is particularly so since, from an operational perspective, we are uncertain whether FCMs and DCOs could maintain separate models for exchange-traded futures and cleared swaps customer funds. Consequently, any changes that may be implemented would affect the entire industry.

The Commission must also be mindful that any proposal to reduce õfellow-customer riskö may increase õfellow-clearing member riskö and inadvertently discourage FCMs from holding excess capital at levels they otherwise might.

The rulemaking process, which relies on written submissions from parties with competing interests and may be subject to rigid timelines, is not the most appropriate vehicle for conducting this analysis. Rather, examination and resolution of these issues will take a concerted and collaborative effort on the part of all interested parties. We encourage the Commission to establish a new advisory committee composed of representatives of market participants, DCOs, FCMs and other experts able to devote the time necessary to work through these issues to reach a shared goal, protection of customer collateral.

FIA is committed to working with the Commission, the SROs and other market participants in any forum the Commission may deem appropriate to further enhance the financial integrity of the markets. In the meantime, if the Commission is required to move forward with the adoption of rules in order to comply with the Dodd-Frank Act before this study is complete, we believe the Commission should adopt a segregation regime for cleared swaps that parallels the segregation requirements for US exchange-traded futures.[10]

The remainder of this letter summarizes several of the legal, policy and operational issues that FIA has identified.[11] It does not purport to be a complete analysis of each issue nor a complete

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shifting the cost of additional protection to those willing to pay for it. It certainly is an alternative that should be carefully explored.

Before adopting such an alternative, however, we would want to be certain that this alternative would be fully supported by the Act and would be consistent with the commodity broker liquidation provisions of the Code. In this regard, we note that the Dodd-Frank Act repeals the provisions of section 5a of the Act relating to derivatives transaction execution facilities and did not provide similar relief from the segregation requirements to eligible contract participants trading swaps on swap execution facilities.

Likewise, we would want to be certain that this alternative would not increase systemic risk by encouraging FCMs to reduce their capital.

[10] In this regard, we have identified nothing in the Dodd-Frank Act or its legislative history that indicates that Congress intended to provide customer funds held in connection with cleared swaps a level of protection different from the protection of customer funds held in connection with exchange-traded futures. To the contrary, the provisions of section 724 of the Dodd-Frank Act, which provide, *inter alia*, that cleared swaps are õcommodity contractsö under section 761 of the Code, leads to the conclusion that Congress intended that customers trading cleared swaps would be treated exactly the same as customers trading exchange-traded futures. In contrast, Congress explicitly authorized individual segregated accounts in connection with uncleared swaps.

[11] The Commission requested information on the increased costs that market participants may face with the adoption of a model other than the õbaseline model.ö FIA has not prepared a separate analysis. We understand that both the Chicago Mercantile Exchange and the International Swap Dealers Association are preparing detailed cost estimates and defer instead to these entities.

list. Rather, our goal is simply to demonstrate the types of issues that we believe should be considered in any study that is undertaken.

Our efforts have been guided by the legislative purposes of the Dodd-Frank Act. The overriding purpose, of course, is the reduction of systemic risk. Throughout Title VII, in particular, the Commission, the Securities and Exchange Commission and the banking regulators are admonished to adopt rules that õlimitö, õreduceö or õmitigateö systemic risk.[12]

A secondary purpose of the Dodd-Frank Act is to foster competition among clearing organizations and among clearing members. In particular, section 725 of the Dodd-Frank Act amends Core Principle C in section 5b(c) of the Act to provide that the membership requirements of each DCO must (i) be objective, (ii) be publicly disclosed, and (iii) permit fair and open access.[13] Separately, Congress instructed the Commission, before commencing any rulemaking or issuing an order regarding swaps, swap dealers, major swap participants, swap data repositories, derivative clearing organizations with regard to swaps to consult and coordinate with the Securities and Exchange Commission to assure regulatory consistency and comparability, to the extent possible.[14]

We were also guided by our concern that the Commissionøs authority to adopt a different model may be constrained by the relevant provisions of the commodity broker liquidation provisions of the Bankruptcy Code. In particular, section 766(h) of the Code specifically recognizes that, upon the bankruptcy of an FCM, there may be a shortfall in the õcustomer propertyö available for distribution to customers and, in these circumstances, all customers in an account class must share any such losses *pro rata*. Moreover, other provisions of the Code affirm the authority of clearing organizations to act promptly and efficiently upon the default of a clearing member.[15] The Commission appears to have no authority either to alter this distribution scheme or affect the rights of the clearing organizations under the Code. To assure legal certainty, therefore, the Commission must take care that any changes to the õbaseline modelö it may propose do not indirectly affect the rights accorded DCOs, and other commodity brokers, under the Code.

Policy Concerns.

With this preface, set out below are several of the policy concerns we believe must be considered:

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[12] The core principles for DCOs set out in section 5b(c) of the Act, as amended by section 725(c) of the Dodd-Frank Act, further this legislative purpose. For example: Core Principle D(iii) requires each DCO, through margin and other risk control mechanisms, to limit the exposure of the DCO to potential losses from defaults from members and participants of the DCO to ensure that the operations of the DCO would not be disrupted and non-defaulting members and participants would not be exposed to losses that non-defaulting members or participants cannot anticipate or control; and Core Principle G, requires each DCO to have rules and procedures designed to (i) allow for the efficient, fair and safe management of events during which members or participants become insolvent or otherwise default on their obligations to the DCO; and (ii) ensure that the DCO may take timely action to contain losses and liquidity pressures and to continue to meet each obligation of the DCO.

[13] Concurrently, Core Principle C recognizes that such membership requirements may require that clearing members have sufficient financial resources and operational capacity to meet obligations arising from participation in the derivatives clearing organization for members of, and participants in, the derivatives clearing organization.

[14] Dodd-Frank Act, § 712(a).

[15] *E.g.*, Code §§ 362(b)(6), 546, 548, 556.

- Is it appropriate to provide different levels of protection with respect to similar products that are traded on US markets and cleared through the same DCO? Different levels of protection may cause customers to trade swaps on particular commodities when trading in the related futures contract may be more appropriate.

- Is it appropriate to provide the funds of cleared swaps customers potentially greater protection than funds deposited by exchange-traded customers? These customers are required to be eligible contract participants and, therefore, are presumed to be more sophisticated and better able to understand the risks and bear the costs of trading.

- Is õcustomer choiceö a viable alternative model?

- Will a different model result in less margin available to support customer positions? Because cleared swaps customer funds held at the FCM would be treated in the same manner as exchange-traded futures customer funds under the Commissionøs rules, cleared swaps customers may conclude that funds held at the FCM will receive less protection and, as a result, they may be unwilling to deposit more than the exchange or DCO minimum margin requirement with an FCM.

- Will a different model for cleared swaps customer funds interfere with the development of portfolio margining, both across securities and commodities accounts and across different commodities accounts, *i.e.*, futures and cleared swaps accounts?

- Will a different model for cleared swaps customer funds adversely affect liquidity and competition ? Each of the suggested models is likely to result in an increase in initial margin requirements, clearing member default fund contributions, or both. Increases in margin may lead certain customers to refrain from trading; increases in the default fund may result in certain FCMs electing either to withdraw as clearing members or not apply to become a clearing member in the first instance.

- Will a different model for cleared swaps customer funds deter end-users from electing to clear swap transactions? Section 723 of the Dodd-Frank Act amends section 2(h) of the Act to exempt certain end-users from the mandatory clearing requirement of that provision. Moreover, congressional sponsors of the Dodd-Frank Act have expressed the view that end-users should not be subject to margin requirements in connection with uncleared swaps. If a different model results in a significant increase in initial margin requirements, end-users may be less willing to submit their transactions for clearing.

- Will a different model for cleared swaps customer funds deter DCOs from accepting certain swaps for clearing? If a different model results in a DCO assuming greater risk in connection with certain swaps, the DCO may choose not to clear such transactions.

- Will a different model for cleared swaps customer funds increase systemic risk by exposing non-defaulting FCMs earlier to the risk of loss arising from a defaulting FCM?

- Will a different model for cleared swaps customer funds encourage FCMs to reduce the amount of excess capital they hold, thus increasing systemic risk?

- Will a different model for cleared swaps customer funds facilitate or complicate the liquidation of an FCM carrying accounts of customers trading both cleared swaps and exchange-traded futures?

- Will a different model for cleared swaps customer funds result in inefficiencies in long option financing, thereby reducing liquidity in option markets?

- Will a different model for cleared swaps customer funds adversely affect market structure more generally? If a different model effectively prohibits omnibus accounts, the consequences for smaller exchanges and clearing organizations could be serious. Moreover, the ability of foreign participants to trade on US markets could be severely affected.

Operational Concerns.[16] Although each of the alternative models the Commission has suggested pose operational challenges, the operational and financial burdens of Model One, full segregation, would be overwhelming.[17] Under this model, each customerøs account, and all property collateralizing that account, would be maintained separately for and on behalf of that customer at every level, *i.e.*, the FCM, the DCO and each depository. The collateral deposited by one customer could never be available as a DCO default resource.

Model One raises the following operational concerns:[18]

- Separate bank accounts would be required to be established and maintained at the FCM level and separately at each DCO on behalf of each customer.[19] The ability and willingness of settlement banks to maintain, and the costs of maintaining, such a large number of accounts is uncertain. (Presumably, a settlement bank would be required to execute a separate acknowledgment letter under Commission Rule 1.20 with respect to each account.)

- FCMøs would be required to trace each customerøs assets from the time received until the assets are returned to the customer, including specific assets deposited with each DCO. DCOs would be required to duplicate each FCMøs books and records.

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[16] Our comments are based on the limited description of the models contained in the Notice. If the Commission were to elect to move forward with a proposed rule, any such proposal, by necessity, would explain in far more detail the manner in which the model would be expected to be implemented. When these details become available, we would be in a position to submit additional comments.

[17] From an operational perspective, Model Two and Model Three are similar and appear to be feasible. However, because the report will always be one day behind, its accuracy and, therefore, its value is in doubt. Determining customer positions that are fully collateralized, *i.e.*, the accounts in which the defaulting FCM has not advanced margin to the DCO on behalf of the customer, may be complicated, inhibiting the potential transfer of positions.

[18] Finally, we note that, from an operational perspective, it is uncertain whether FCMs and DCOs could maintain two separate models for exchange-traded futures and cleared swaps customer funds. Therefore, our comments assume that any model for the protection of customer funds would apply to both cleared swaps and exchange-traded futures.

[19] In our recent letter to the Commission on the proposed rules to create a new ownership and control reporting program, FIA submitted cost information received from 12 FCMs. As indicated therein, these firms alone carry in excess of 340,000 accounts. Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated December 23, 2010.

- Because each customerøs account would be required to be separately margined, FCMs would no longer be able to post Treasury bills or other permitted collateral with a DCO to meet the obligations of its customers on an omnibus basis.

- The requirement to maintain separate accounts for each customer would effectively deny FCMs and DCOs the ability to invest customer funds in accordance with Commission Rule 1.25.

- Customers would no longer be able to settle margin calls on a consolidated basis across global markets. Rather, margin calls at each DCO would be required to be met separately.

- There would be a significant increase in the number of intraday cash payments to assure that FCM and DCO books remain synchronized.

- The number of reconciliations required each day would increase exponentially.

- The payment system would likely be congested as the number of wire transmissions would increase dramatically.

The Advanced Notice of Proposed Rulemaking Cannot be Addressed In Isolation

FIA recently filed with the Commission a revised comment letter in connection with the Commission proposed ownership and control report rules.[20] We noted therein that the Commission has published (or shortly will publish) for comment a myriad of proposed rulemakings, including this Notice that, collectively, contemplate a complete overhaul of the recordkeeping and reporting requirements to which FCMs, US exchanges and clearing organizations are subject.[21] We argued that, in the absence of such a coordinated analysis of all of the pending recordkeeping and reporting requirements, and the estimated costs and benefits of each, it is impossible to calculate the aggregate financial and operational burdens these various proposals will have on the industry. We reiterate these views here and again encourage the Commission to authorize the participation of the Commission staff in such an analysis in any manner the Commission deems appropriate.

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[20] Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated December 23, 2010.

[21] These proposals include: (i) core principles and other requirements for designated contract markets; (ii) risk management requirements for derivatives clearing organizations; (iii) information management requirements for derivatives clearing organizations; (iv) position limits for derivatives; (v) core principles and other requirements for swap execution facilities; and (vi) swap data recordkeeping and reporting requirements.

Conclusion

FIA appreciates the opportunity to submit these comments. Our member firms take their responsibility to protect the financial integrity of the markets seriously, and we look forward to working with the Commission, SROs and market participants to further enhance the financial integrity of the markets for the benefit of all market participants. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIAøs Executive Vice President and General Counsel.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott OøMalia, Commissioner

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