December 22, 2011

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

Re: Further Comments on the Proposed Rules for Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions (RIN 3038-AC99)

Dear Mr. Stawick:

The Committee on Investment of Employee Benefit Assets ("CIEBA") would like to take the opportunity in light of recent events to provide additional comments regarding the June 9, 2011 notice of proposed rulemaking [1] ("NPR") concerning the protection of margin posted by customers who are clearing swaps and the implementation of the related statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").

CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than $1.4 trillion of defined benefit and defined contribution plan assets on behalf of 17 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

CIEBA has a strong interest in the adoption of an effective regulatory structure to protect collateral posted in connection with cleared derivatives trades and to protect the assets of the investing public in connection with the implementation of Dodd-Frank. CIEBA previously submitted a comment letter to the CFTC regarding the NPR on August 8, 2011, in which we commended the Commission for its proposal of the legally separate but operationally commingled model ("LSOC")[2] for the holding of cleared swap margin provided to a customer's futures commission merchant ("FCM"), while also strongly urging the Commission to require FCMs to give its customers the option to post margin for cleared swaps into individual physically segregated accounts, such as the individual settlement account structure (*see* Appendix A for a diagram and description of this structure) discussed in this letter.

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[1] CFTC Proposed Rule: Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818 (June 9, 2011) (to be codified at 17 C.F.R. pts. 22 and 190).

[2] Defined in the NPR as the "Complete Legal Segregation Model".

We support Dodd-Frank's swap clearing mandate and the Commission's efforts to implement it, and we believe that the protection of cleared customer swaps margin is a crucial element of this mandate. However, in light of the recent events relating to the bankruptcy of MF Global, it is now even more clear that the Commission's LSOC proposal will not provide customers with adequate protection for their assets and will expose them to greater risks than they face today. ***Therefore, the Commission should not permit mandatory clearing of swaps to become effective until a physical segregation option, such as the individual settlement account outlined below or another satisfactory structure, has been made available to swaps customers.***

Furthermore, in light of the European crisis, and other market considerations, many customers may decide to begin clearing swaps before clearing is mandated, and so we urge the Commission to confirm without delay that derivatives clearing organizations ("DCO") and FCMs are permitted under present law to offer customers physical segregation of margin held at accounts with a DCO settlement bank, and that the amended Financial and Segregation Interpretation No. 10 issued by Commission staff in 2005 does not apply to DCOs and does not prohibit the physical segregation of swap customer funds at an account held with a DCO Settlement Bank. Such confirmation will enhance customer protection by encouraging DCOs and FCMs to offer swap customers the full physical segregation option today, before the Commission has completed its final rules to protect customer margin.

In addition, we believe the Commission should take into consideration the costs of not providing an FCM "bankruptcy remote" physical segregation option for customer margin. The collapse of MF Global has demonstrated that customers such as publicly traded companies and mutual funds are subject to untenable uncertainty regarding the status of their margin in the event of a default by their FCM. Poor or incomplete recordkeeping by an FCM should not lead its customer companies or their shareholders to be uncertain whether or not the company has properly margined hedges for its material commercial exposures (such as oil, or other commodities). Such hedging uncertainty could lead to the suspension of trading of a company's shares until more information becomes available and leave mutual funds unable to value their shares and thus suspending redemptions and purchases to the detriment of shareholders. Such uncertainty may even prevent companies from accurately valuing their pension plans. When considering models for the protection of customer collateral, the Commission should give proper weight to the significant costs that this potential uncertainty places on the economy.

Finally, we urge the Commission to consider requiring DCOs and FCMs to offer futures and option customers the right to elect physical segregation of their margin. The inability of MF Global's futures and option customers to recover all of their funds in a timely manner, if at all, illustrates that the current margin protections for futures and option customers are inadequate. We request that the Commission revisit the staff's 2005 Interpretation No. 10 restricting the use of third party custodial accounts for futures and option customers, and take whatever actions are appropriate to encourage FCMs and DCOs to give futures and option customers the ability to elect physical segregation of margin, and in the future, require FCMs and DCOs to give futures and option customers the right to elect physical segregation of margin.

I. BACKGROUND

The Commission is proposing to mandate the LSOC model for cleared swap margin, which is based on the current futures margin segregation approach. However, as the recent collapse of MF Global has demonstrated, that model is materially imperfect when compared to the mandate of Dodd-Frank to "promote the financial stability of the United States…and to protect consumers from abusive financial services practices."[3] In contrast, a physical segregation option for swap margin segregation would further Dodd-Frank's goals, and should be offered to customers as a choice.

Because the proposed physical segregation model would give each customer the choice to utilize an individual segregated account at the DCO's settlement bank over which the DCO has control, it enhances systemic stability and customer protection. Systemic stability would be enhanced by providing more clarity and transparency to the clearing system, giving customers, FCMs, DCOs and regulators real time access to the records of DCO settlement banks. Physical segregation would protect customers by allowing them to elect the same high standards of protection they now can achieve in the over-the-counter market, the cleared securities options market and with certain European derivatives clearing organizations. A physical segregation would also be consistent with rules proposed by European regulators, which would ensure that American customers are able to receive the same protection for their margin as customers in other jurisdictions. Finally, physical segregation would also provide greater protection to customers from FCM insolvency, misappropriation or poor recordkeeping.

Despite the clear systemic and customer benefits of physical segregation, some market professionals oppose giving customers that choice and claim that implementing a physical segregation option for swaps margins is either impractical or too costly.

These opponents of physical segregation for swaps margins neglect to mention that (i) the CFTC permitted physical segregation for futures margin until 2005, which experience refutes the "operational costs of physical segregation are too expensive" argument made against the physical segregation option for swaps, (ii) every mutual fund and many pension plans in the US which trade over-the-counter swaps currently have full physical segregation for their margin, (iii) physical segregation of margin is currently available to exchange traded securities options customers in the United States and is not "too costly", and (iv) full physical segregation is being offered for cleared swaps in Europe, so giving customers a physical segregation option would further Dodd-Frank's mandate of establishing consistent international standards. The stability and customer protection goals of Dodd-Frank should override any potential cost objections, which is why the CFTC should not consider cost objections as a barrier to requiring FCMs and DCOs to offer customers the choice to physically segregate their cleared swap margin.

II. PHYSICAL SEGREGATION HAS BEEN AND IS CURRENTLY A VIABLE OPTION

A. Physical Segregation Was Previously Permitted For Futures Margin by the CFTC and Has Been Extensively Used For Over 20 Years.

[3] The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, H.R. 4173.

Until 2005, the CFTC permitted the use of third-party custodial accounts for futures margin by pension plans and investment companies registered under the 1940 Act ("investment companies").[4] In 1984, the CFTC issued Financial and Segregation Interpretation No. 10 ("Interpretation No. 10"), permitting the use of third party custodial accounts for the holding of customer property subject to certain conditions ensuring that an FCM would have immediate and unfettered access to customer funds.[5] In 2005, the CFTC amended Interpretation No. 10 so that an FCM would not be in compliance with the requirements of the Commodity Exchange Act (the "CEA") if it held customer funds in a third-party custodial account. The Commission's stated reason for the amendment was that third-party custodial accounts posed systemic liquidity risks by limiting an FCM's access to customer margin in a time when such capital was necessary to prevent a default. However, this concern would be eliminated under the full physical segregation model that has been proposed, the "individually segregated account" ("ISA") structure.[6]

Under the ISA proposal, customer funds are held at the settlement bank of the DCO in a custodial account in the name of the customer for the benefit of the DCO. The DCO has an unrestricted right to use the funds deposited in the segregated customer account to cover the margin and settlement obligations of that customer and the customer is not permitted to withdraw funds below the amount required to fulfill such obligations. There could not be a strain on systemic liquidity or diversion of capital because the customer funds required to cover customer swap obligations are directly accessible by a DCO. Therefore, the concern that led the CFTC to amend Interpretation No. 10 is fully addressed by the ISA structure.

In addition, we believe, and we urge the Commission to confirm, that Interpretation No. 10[7] does not apply to swaps and would not prohibit the physical segregation of swaps customer funds in an account in the customer’s name for the benefit of the DCO at a DCO Settlement Bank. While Interpretation No. 10 addressed customer funds held by an FCM to margin, guarantee, or secure futures and commodity options transactions, customer funds held in an individual settlement account ("ISA") would not be held by the FCM, and would not be held to margin futures or commodity options transactions, but would be held to margin swaps transactions. Further, we believe, and we urge the Commission to confirm, that nothing in the NPR would prohibit a DCO or FCM from offering customers the ability to physically segregate customer funds in an ISA held at the DCO's Settlement Bank, in the name of the customer and for the benefit of the DCO. In that regard, we urge the Commission in any final LSOC rulemaking to encourage DCOs and

[4] The CFTC permitted pension plans to use third-party custodial accounts to hold customer margin for many years after the U.S. Department of Labor ("DOL") permitted customer margin to be held by FCMs. In 1982, the Pension and Welfare Benefits Program of the U.S. Department of Labor issued an Advisory Opinion (ERISA Advisory Opinion 82-49A (U.S. Dep't. of Labor, 1982) stating that the funds of a pension plan for margining of futures positions could be maintained by an FCM so long as the account was in the name of the trustees of the pension plan. However, the CFTC permitted the use of third-party custodial accounts by pension funds as an alternative to having such funds held in an account with an FCM until 2005.

[5] This Interpretation was issued in part because, until the adoption of Rule 17f-6 in 1996, the Securities and Exchange Commission ("SEC") did not allow investment company margin to be held by an FCM, due to the risks posed by allowing an intermediary to hold investment company funds.

[6] As detailed in the August 8, 2011 comment letter to the CFTC filed by the Committee on Investment of Employee Benefit Assets (the "CIEBA Letter").

[7] Amendment of Interpretation, 70 FR 24768, May 11, 2005.

FCMs to voluntarily make full physical segregation available to swap customers pending the completion of additional rulemakings that would require DCOs and FCMs to make full physical segregation available to swap customers. Additionally, as discussed above, since the concern that led CFTC staff to amend Interpretation No. 10 is fully addressed by the ISA structure, we urge the Commission to direct its staff to revise or repeal Interpretation No. 10 so that futures and option customers may elect physical segregation of margin.

B. Every US Mutual Fund Currently Uses Physical Segregation for its OTC Swaps.

Protection of collateral is especially critical for entities such as pension plans and mutual funds that are governed by the Investment Company Act of 1940 (the "1940 Act"). In the OTC swap market, customers that are subject to regulation under the 1940 Act, such as mutual funds, are required by Rule 17f-1 of the 1940 Act to maintain collateral in an account maintained by a fund's custodian under an agreement requiring the fund's assets to be "individually segregated from the securities and investments of any other person and marked in such manner as to clearly identify as the property of such registered management company."[8] This rule protects mutual funds from the risk that their collateral would be commingled or misappropriated. A significant amount of pension plan assets are invested in mutual funds and would lose such protections if the CFTC's proposal is not modified. Pension plans want to retain the ability to physically segregate their margin for the swaps that they clear.

C. Customers Can and Do Physically Segregate Margin Today For Cleared Securities Derivatives in the U.S.

While physically segregated collateral is well established in the OTC swap market, it also operates today in the "cleared" environment as well. The Options Clearing Corporation (the "OCC"), which describes itself as the world's largest equity derivatives clearing organization,[9] currently permits its members to offer customers the choice of holding margin in an account with such member, an escrow account in the customer's name or a tri-party account at a custodian pursuant to an agreement between such member, the customer and a custodian. Therefore, each US mutual fund that trades listed options through the OCC holds its margin with a custodian.

D. Foreign Regulators Have Proposed Physical Segregation of Cleared Swaps Margin and Dodd-Frank Mandated the Commission to Coordinate with Foreign Regulators to Establish Consistent Regulations

The European Union's recent proposed rules on derivatives promulgated under the European Market Infrastructure Regulation ("EMIR"), which are designed to protect end users, require

[8] 17 CFR §270-17f-1(b)(1).

[9] "*What is OCC?*," *available at* http://www.theocc.com/about/corporate-information/default.jsp (2011).

each DCO to "allow clients to have a more detailed segregation of their assets and positions" and to "publicly disclose the risks and costs associated with the different levels of segregation."[10] Section 752 of Dodd-Frank provides that the Commission "shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation…of swaps,"[11] and Chairman Gensler has spoken of the need to promote "robust and consistent standards" of regulation.[12] However, if the Commission were to require American customers to rely solely on LSOC to protect their margin, it would result in American customers receiving protections inferior to European customers. This would be inconsistent with Dodd-Frank's mandate to protect consumers and develop internationally consistent standards.[13]

E. Physical Segregation Is Offered by Swap Clearing Organizations In Europe.

Any concern that a physical segregation option, such as the one proposed under EMIR, is not commercially feasible is rebutted by the recent announcements of European clearing organizations. On February 2, 2011, Eurex Clearing AG, one of the world's leading derivatives exchanges, issued a circular indicating that it would offer a new "Client Asset Protection" service to Eurex clearing members whereby individual accounts would be established and maintained in such a way as to keep customer collateral completely separate from the clearing member and other customers.[14] In addition, at least one European DCO (LCH.Clearnet) has already stated that it will give customers the option to physically segregate collateral.[15]

III. THE FUTURES MODEL, AND ITS PROGENY, LSOC, ARE FLAWED BECAUSE THEIR PROTECTIONS OF CUSTOMER MARGIN DEPEND ON THE ACCURATE RECORDKEEPING OF A FAILED FCM

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[10] *Proposal for a Regulation of the European Parliament and of the Council on OTC Derivative Transactions*, C*entral Counterparties and Trade Repositories*, Draft, General Secretariat of the Council, *Public Consultation on Derivatives and Market Infrastructures* (Oct. 4, 2011).

[11] The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111-203, § 752, H.R. 4173.

[12] "The global nature of the swaps markets makes it imperative that the United States consults and coordinates with foreign authorities. The Commission is actively communicating internationally to promote robust and consistent standards and avoid conflicting requirements, wherever possible." Chairman Gensler, testimony before the United States Senate Committee on Banking, Housing and Urban Affairs, Washington, D.C., Dec. 6, 2011.

[13] In addition, the Basel Committee on Bank Supervision will require banks to hold capital to protect themselves from the failure of a DCO, but notes that "[b]anks can also escape the charges if they can arrange for the clearing house to hold their collateral in a segregated entity that would not be caught up in a bankruptcy," indicating that physical segregation provides a safer option.

Brooke Masters, *Basel Sets Clearing Capital Rules*, Financial Times, Nov. 2, 2011.

[14] *Introduction of Client Asset Protection Service at Eurex Clearing AG*, Eurex Clearing Circular 006/11, Feb. 2, 2011; *See also Client Asset Protection - Setup for Individual Segregation*, Eurex Clearing Information Memorandum, Feb. 11, 2011.

[15] *Clearing House of the Year: LCH.Clearnet*, Risk.net, Jan. 10, 2011.

A. The LSOC Model Would Not Have Prevented the Crisis at MF Global

The viability and benefits of LSOC, including protection against "fellow-customer risk", depend very heavily on the accurate and proper recordkeeping by the customer's FCM. Because customer margin under LSOC would be held in an omnibus account on behalf of the FCM, only the FCM would be able to definitively determine what property actually belongs to the customer. This task is made more difficult by the FCMs' common practice to lend funds to customers and to rehypothecate customer funds, which makes individual assets very difficult to track and properly allocate to customers that share a commingled account. If FCM records proved insufficient to accurately attribute margin to specific customers, this purported benefit could be entirely illusory, because customers would effectively only have priority recourse to a commingled customer margin account and customers swap margin would be subject to the risk of an FCM insolvency.

However, it is precisely this recordkeeping that failed so dramatically in the case of MF Global! Although MF Global filed for bankruptcy nearly two months ago, neither the bankruptcy trustee nor the regulators have been able to locate more than $600 million of missing customer funds, and that figure may be as large as $1.2 billion.[16] According to the trustee, MF Global did not make accurate recordkeeping a top priority in the days and weeks leading up to its collapse. "The record-keeping was bad," said a spokesman for the trustee. "In many cases, there were no records of transactions that were done at the end because there was so much activity."[17] Even if the LSOC model had been in place at the time of MF Global's collapse, MF Global's recordkeeping failure would have resulted in the same conclusion.

Any benefits the LSOC model provides are dependent on the FCM's ability to maintain its records during times of financial difficulties and market turmoil, when an FCMs recordkeeping is most likely to be under stress. Given past and recent history of bad recordkeeping by FCMs like MF Global and Lehman Brothers, it is not reasonable to expect the records of failing FCMs to be accurate in the future. If the LSOC model cannot prevent crises such as MF Global, a physical segregation option should be made available to those customers that want the ability to protect their margin. The failure of MF Global has clearly demonstrated that the risks of not providing a physical segregation option are too high.

B. Even Before MF Global It Was Clear That The Futures Model Reliance on FCM's Records Was Flawed Because During An FCM's Collapse Its Accounting, Bookkeeping And Segregation Practices Become Compromised, In Some Cases Severely[18]

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[16] James O'Toole, *The MF Global Money Chase*, CNN Money, December 6, 2011.

[17] *Id*.

[18] It should be noted that, unlike Lehman, MF Global and the other failed FCMs discussed herein all collapsed during calm market periods, indicating that the current system offers insufficient protection even without significant market-stress.

There is a misconception that, prior to MF Global, the futures collateral segregation system had not experienced any problems associated with failing FCMs. Unfortunately, there have been a number of significant incidents, which are described below, that have harmed futures customers and jeopardized their margin and positions. In light of these incidents, as well as MF Global, we urge the Commission to reevaluate the inadequate margin protection choices available to options and futures customers today and require that the option to physically segregate margin be available to them as well.

1. Lehman Brothers

On August 30, 2010, Elizabeth James, a director at Barclays Capital Inc. provided testimony concerning Lehman's recordkeeping and segregation practices during an evidentiary hearing before the U.S. Bankruptcy Court which sheds light on the state of Lehman's futures positions and the related customer margin recordkeeping as it failed:[19]

"Q. [D]id you make an effort to learn as much as you could about the positions and the margin associated with the Lehman exchanged traded derivatives business?

A. We spent a lot of time with the Lehman futures employees, trying to understand where they had positions, what brokers they used, where they held their bank accounts, where they held their money market funds….Lehman's books and records were in such a mess, I don't even actually think they knew themselves where they were….

Q. Did you ever get a listing of all of the margin or collateral posted to the Lehman futures accounts?

A. No. We were given bits of information but we never got an exhaustive list….

Q. …was there a problem specifically in extracting the information about futures positions from Lehman?

A. …[t]hings weren't being booked so things were not clean. You couldn't tell what were our positions, you know, was a customer's account correct, was a house account correct. There was no way of knowing. The information couldn't be given to us."[20]

2. J.P. Morgan Futures Inc.

On September 9, 2009, J.P. Morgan Futures Inc. ("JPMFI"), a registered FCM, was subject to a CFTC order for under-segregating funds in the course of transferring $1.45 billion of assets into its "house account" and drawing upon the FCM's customers' assets in violation of the CEA

[19] Testimony of Elizabeth James, Director at Barclays Capital, Inc., Evidentiary Hearing RE: 60(b) Motions, on August 30, 2010, before the U.S. Bankruptcy Court for the Southern District of New York, In the Matter of Lehman Brothers Holdings, Inc. (Transcript at 18-19).

[20] As a comparison, to our knowledge, only Lehman customers whose collateral was physically segregated were able to promptly access their collateral in full.

segregation requirements.[21] JPMFI failed to properly compute its segregation requirements and did not timely notify the CFTC that its segregated accounts had been insufficiently funded. A $300,000 penalty and a cease and desist order were among the sanctions imposed by the CFTC, which, in retrospect, appears inadequate to deter violations by FCMs such as MF Global.

3. Refco Inc..

In 2005, Refco Inc. ("Refco"), a large and publicly owned commodity brokerage house, was forced into filing bankruptcy. Shortly prior to its bankruptcy, Refco had conducted its initial public offering during which its underwriters (and their auditors) conducted due diligence, and was subject to regular audits, none of which detected any fraud. While customers were generally able to recover their margin held with Refco's FCM division, subsequent bankruptcy proceedings revealed that certain excess customer margin was held with an offshore Refco affiliate in order to earn higher returns. The customers that posted this margin became unsecured creditors of Refco's estate and received considerably less than the full margin they had posted in Refco's insolvency.[22] Notably, in 1996, Refco had been previously cited by the CFTC for violating customer segregation requirements and failing to supervise employees in violation of CFTC cease and desist orders in 1983, 1988 and 1990.[23]

4. Klein and Co. Futures Inc.

In May 2000, the omnibus margin account of Klein and Co. Futures Inc. ("Klein"), a broker, was liquidated by the New York Clearing Corporation. As in the case of Volume Investors (discussed in 6. below), Klein's omnibus account held all of its customers' margin, so all customers suffered losses with respect to their margin, not only customers that had substantial losses and were unable to meet margin calls.[24]

5. Griffin Trading Company.

In 1998, Griffin Trading Company (“Griffin”) filed for bankruptcy protection after a Griffin customer suffered losses on his positions on Eurex. Upon receiving the customer's assurance that he would deposit additional funds to meet his margin call, Griffin made a margin payment from the omnibus customer account to the DCO. The customer's subsequent failure to meet his margin call resulted in Griffin being in violation of CFTC capital requirements, and it was placed into bankruptcy proceedings shortly thereafter. Although customers of Griffin's US entity did not lose any margin, US customers of its London branch suffered losses on their margin and the bankruptcy proceedings to determine which assets could be used to repay Griffin's customers lasted more than two years.[25]

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[21] *In re J.P. Morgan Futures Inc.,* CFTC Docket No. 09-12 (CFTC Sept. 9, 2009).

[22] Will Acworth, *Containing a Crisis: How the Clearinghouses Responded to the Collapse of Refco*, Futures Industry Magazine, Jan./Feb. 2006.

[23] *Refco Agrees to Pay a $925,000 Civil Penalty to Settle,* CFTC Release No. 3888-96 (Jan. 23, 1996).

[24] Robert W. Kolb and James A. Overdahl, *Futures, Option, and Swaps* (Blackwell Publishing 2007), p. 19.

[25] *In re Griffin Trading Company*, 245 B.R. 291 (2000).

6. Volume Investors.

In 1985, a futures broker and clearing member of Commodity Exchange, Inc. (currently a division of NYMEX), Volume Inventors ("Volume"), defaulted.[26] The default was due to the failure of Volume's customers to meet margin calls after a change in the value of gold, which caused Volume to default on the clearinghouse's margin call, which exceeded Volume's assets. The clearinghouse seized the margin posted by Volume on behalf of all of its customers in order to pay other clearing members, leaving Volume's non-defaulting customers with no margin at the clearinghouse and forcing them to seek the remainder of their collateral from Volume's estate as well as from Volume's owners.[27]

C. Additional Disclosure and Audit Requirements for FCMs Are Insufficient to Mitigate the Risk of FCM Failure or Inadequate FCM Recordkeeping

A system of commingled segregation cannot be made sufficiently robust solely by requiring additional disclosure of risk or more thorough auditing if there is no choice of physical segregation. Any additional disclosure would merely invite regular, if not continuous, professional examination of an FCM's systems, practices and personnel which customers are not in a position to do. In addition, if an FCM were to misappropriate customer funds or keep inaccurate records, its disclosure would be equally inaccurate, making the disclosure of no help. Auditing, while a good risk management tool, will also not be sufficient to protect customers margin and positions. First, an audit is only accurate up to the day on which the audit concluded, so for the period until the next audit, it would be of almost no use in a market where massive amounts of cash and assets move rapidly. Furthermore, all of the FCMs that have recently collapsed were, in fact, audited. MF Global's auditors and the CME auditors signed off on its accounts, as the auditors and underwriters did in the case of Refco. Even Madoff's auditors signed off on his accounts![28]

IV. MARGIN HELD AT THE DCO IS NOT RISK-FREE, SO DCOS SHOULD ALSO OFFER THE PHYSICAL SEGREGATION OF MARGIN

A. The Cleared Swap Market Presents Risks to DCOs Due to Size, Complexity and Lack of Experience

The OTC swaps derivatives market is significantly larger in size than the futures market, so DCOs will be subject to larger financial risks involved with much larger amounts of positions being traded at once. Swaps also, unlike futures, vary significantly by duration which means they are less liquid and subject to more complexity and valuation uncertainty. Due to their

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[26] *Futures Commission Merchant Activities,* Office of the Comptroller of the Currency (Nov. 1995), p. 16.

[27] Robert W. Kolb and James A. Overdahl, *Futures, Option, and Swaps* (Blackwell Publishing 2007), p. 19.

[28] Stephen Gandel, *The Madoff Fraud: How Culpable Were the Auditors?,* Time Business, December 17, 2008.

bilateral nature, swaps have also developed a high amount of customization and lack recognized standardized terms in many markets. While swap terms and documentation will likely become more standardized with the maturation of clearing, this will take a significant amount of time and will leave the market far less liquid than the current futures market.

In addition, many over-the-counter swaps trade relatively infrequently and in large notional amounts, which is very different from the current futures market and makes swaps much harder to value. This valuation issue is a fundamental concern, as swaps are far more complex to value and subject to greater fluctuations. For instance, the futures model does not contemplate the possibility that a position can move to zero very quickly, as can be the case with a credit default swap. In addition, given the illiquidity of certain types of swaps, it may be difficult to determine accurate market values of certain positions on a daily basis. These complexities of swap valuation will create significant fluctuations in the value of swaps, which will then require large swings in the posting of margin, all of which will be magnified by the larger size of the swap market itself. This greatly increases the possibilities that a large swing in the swap market could cause a DCO insolvency, which would leave customer margin subject to the risks of a messy and unprecedented bankruptcy proceeding.

Historically, very few swaps have been centrally cleared, and in a considerably smaller volume than will soon be required by Dodd-Frank. Given the much larger size and complexity of the swap market, swap clearing is almost certain to experience growing pains in its early stages when the probability of a potential DCO failure is highest. Failing to acknowledge the greater risks of DCOs during this early period of the development of the cleared swap markets and treating it just like the futures market would be a perverse result, as additional protections are necessary to account for new and unforeseen risks that will undoubtedly arise. It is therefore imperative that swap customers have access to the highest standards of protection for their collateral in the emerging cleared swap market.

B. Is Collateral Held With DCOs Really "Risk-Free"? Not According To The Basel Committee On Banking Supervision

While it is true that there has been no outright default by a DCO in the United States, DCOs have failed in other jurisdictions[29] and anecdotal evidence suggests that DCOs in the United States have been severely financially stressed in the past:

1. In 1974, the Caisse de Liquidation in France became insolvent after upheaval in the white sugar market, which was due in part to its failure to adjust margin requirements in response to a rapid rise in prices. The sugar market did not reopen until June 1976, under new clearing rules.[30]

[29] Bob Hills, David Rule, Sarah Parkinson, and Chris Young, *Central counterparty clearing houses and financial stability*, Financial Stability Review (Bank of England, London, U.K.) Jun. 1999.

[30] *Id.*

2. In 1983 massive defaults on the Kuala Lumpur Commodity Exchange palm oil contracts caused the defaults of six brokers and suspension of trading. A task force set up by the Malaysian government "laid much of the blame for the crisis on management inaction in the clearing house" and noted that its officials lacked experience.[31]

3. During the market crash of 1987, the government of Hong Kong was forced to bail out its clearing house (ICCH (HK)).[32] The subsequent government report noted that there had been lapses in risk management, such as the failure to raise margin in line with significantly higher turnover of positions. The report also noted that prudent regulation of DCOs was "perhaps the single most important objective for market authorities and regulators."[33]

The potential for large market swings cannot be overestimated in these times, and it has been necessary for the U.S. government to intervene in the past to ensure U.S. DCO stability. As Ben Bernanke noted, in October 1987 the Federal Reserve induced banks to make loans to FCM clearing members on customary terms and "the principal effect of the loans was to transfer some trader default risk from the clearinghouses and their members to money-center banks."[34] Other regulators have recognized this risk as well. The recent consultation paper issued by the Basel Committee on Banking Supervision (the "Committee") recommends that customer margin posted with a DCO should be subject to a risk weight of 2-4%.[35] However, the Committee indicated that customer margin held at a third-party custodian that is bankruptcy-remote from the DCO would be subject to a 0% risk weight.

Given the history of DCO defaults and near-defaults and the views of regulators, it is clear that the risk of a DCO default is not insignificant. Given the potential market contagion such failure could unleash, it is imperative that customers at least have access to their collateral, which will be possible with the physical segregation option. In light of the European crisis and other market considerations, many customers may decide to begin clearing swaps before clearing is mandated. We urge the Commission to confirm without delay that DCOs and FCMs are permitted under present law to offer full physical segregation for swap margin. We urge the Commission to move expeditiously to require FCMs and DCOs to give customers the right to elect physical segregation of margin. As mentioned earlier, the Commission should clarify that Interpretation No. 10 does not apply to swaps, and FCMs and DCOs are currently permitted to offer swap customers the option to physically segregate margin. We also urge the Commission to direct staff to revise or repeal Interpretation No. 10, so that futures and option customers are also given the right to elect physically segregated margin.

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[31] *Id.*

[32] *Id.*

[33] Ian Hay Davison, et al., *The Operation and Regulation of the Hong Kong Securities Industry: Report of the Securities Review Committee*, May 27, 1988.

[34] *Clearing and Settlement during the Crash*, Ben S. Bernanke, 3(1) Rev. Financ. Stud. 133 (1990).

[35] *Capitalisation of Bank Exposures to Central Counterparties*, Consultative Document, Basel Committee on Banking Supervision (Nov.2011).

C. Are DCOs Now as Safe as They Have Been In the Past?

Even the tightest regulatory oversight cannot universally overcome the risk taking appetite of for-profit enterprise. Many DCOs today are not, in fact, like their more conservative and safe traditional predecessors. While traditionally DCOs operated as "utilities" that were owned by their members and charged those members fees for executing transactions, that role has significantly changed in recent years. Many DCOs today are publicly-owned for-profit entities, driven to provide their investors and owners higher returns on their capital. In some cases, this increases incentives to decrease their costs and increase their margins, which can result in additional risk taking.

The mandatory clearing requirement of Dodd-Frank will therefore require customers to clear through DCOs that are now profit seeking entities. This could very significantly benefit DCOs, as they will be clearing a vastly larger amount of swaps. However, the mandatory clearing requirement is dependent upon what is likely to be a small number of very large, for-profit DCOs for its systemic safety. Not only will heightened regulation of DCOs be required due to the possibilities of default as well as the new complexities of the swap market, but beyond that, structural changes for the protection of customer funds are needed. DCOs should provide customers the option to physically segregate customer margin. Even if such segregation would decrease the DCOs profitability, systemic integrity and customer protection should be the paramount priorities for the regulation of the swaps market.

V. WHY ARE SOME MARKET PROFESSIONALS CLAIMING THAT "COSTS" PREVENT A BETTER APPROACH?

A. Brokers Rely on Income from Investing Customer Funds

MF Global submitted a public comment letter to the CFTC on December 2, 2010 [36] urging the Commission to permit investment in foreign sovereign debt by FCMs; if it is true that, as is reported, MF Global used customer funds to purchase sovereign debt, the case for permitting customers to hold collateral with a custodian is compelling for this reason alone. As the Volcker Rule would not apply to MF Global Inc. and many other clearing brokers, these entities are incentivized to trade for their own accounts and the MF Global experience suggests that customer funds could be directly or indirectly jeopardized.

[36] Letter of Laurie F. Ferber, Executive Vice President and General Counsel, MF Global, and Gary DeWaal, Senior managing Director and Group General Counsel, Newedge USA LLC to David Stawick, Secretary of the Commodity Futures Trading Commission at 5 (December 2, 2010) ("The CFTC proposes to disallow the investment of customer segregated funds in foreign sovereign debt, citing an undisclosed Staff survey conducted some years ago which the Commission asserts 'revealed negligible investment [by FCMs] in foreign sovereign debt,' and to 'recent events undermining confidence in the solvency of a number of foreign countries.' In our view, the CFTC's proposal is unnecessary, and will eliminate a liquid, secure, profitable and necessary category of investment for FCMs.").

In its letter, MF Global argued that the CFTC's new rules could "significantly decrease the income FCM's derive from prudently investing customer segregated funds."[37] However, swap margin is not meant to enhance the swap dealers' bottom line, but to protect the system against counterparty failure. Income derived by swap dealers from customer margin should not be a consideration for implementing collateral segregation rules, and doing so would only jeopardize the integrity of the clearing system.

Some FCMs have also argued that their access to customer swap margin will provide greater stability by creating a larger pool of capital to absorb systemic shocks. If additional pools of capital or higher margins are really necessary to ensure systemic stability, then the market and the regulators should seek to quantify these costs and require FCMs to have materially higher capital. Requiring all customers to hold their swap margin in omnibus accounts with FCMs also serves to mutualize the potential risk without properly incentivizing market participants, as riskier customers like hedge funds are secretly subsidized by creditworthy institutions like pension funds.

B. Needed Customer Protection Should Not Be Rejected Due To Concerns About Investment Manager Inconvenience and Additional Cost

Each mutual fund advisor charges a management fee to a mutual fund for investment services. In the current OTC swap market, mutual funds use tri-party custody arrangements for their swap collateral, the cost of which is borne by the mutual fund's investors.[38] However, the tri-party custody arrangement also requires the mutual fund advisors' operation personnel to deal with tri-party arrangement and reconciliations, which costs are borne by the mutual fund advisors from their fees.[39] A physical segregation option for mutual funds will therefore increase investment advisors' costs, but this is not a valid reason to reject customer protection that is clearly needed, as evidenced by Lehman and MF Global.

If investment advisors are permitted to allow customers to choose between different margin segregation options, conflict of interest concerns could preclude investment advisors from recommending the physical segregation option due to additional costs. This could be cumbersome for mutual fund advisors since mutual fund boards will likely seek their advice on collateral segregation. But again, inconvenience for mutual fund advisors is not a reason to reject protections that we know are critical, based on the lessons of the last few years.

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[37] *Id.*

[38] If there are additional costs that are passed on to investors, the investment advisors' clients should be the ones to decided if they wish to pay such additional costs.

[39] We note that certain costs of physical segregation likely cannot be passed onto clients and would be expected as a business matter (such as the additional cost of an investment advisor's operation personnel in dealing with reconciliation and margin movement) to be borne by the investment managers as it is today. While some investment advisors that are more concerned about protecting their clients' assets and fulfilling their fiduciary duties rather incrementally increasing their margins have agreed to bear such costs, other investment advisors who oppose giving their clients the physical segregation option may be doing so due to a conflict of interest.

Finally, some investment advisors have suggested that if the physical segregation option is permitted, low risk counterparties, such as pension funds, will choose this option which will weaken the credit quality of the omnibus customer margin pools with the FCMs. However, forcing more creditworthy customers to remain in the omnibus pool results in those customers subsidizing the less creditworthy entities, which do not want to pay for physical segregation because they would likely default prior to their FCM. Furthermore, many of the creditworthy customers are entities such as pension plans, who are not seeking to protect their business models or profit margins, but only their beneficiaries. They should not be forced to subsidize less creditworthy customers and expose themselves to additional risk to protect the margins of other market participants.

C. Arguments About the Burdens of "Increased Costs" Cannot Stand Up to Scrutiny

Certain DCOs have argued that the added costs of a physical segregation option would represent a significant increase in costs and would therefore discourage market participation. However, this argument plainly cannot stand up to scrutiny since the physical segregation approach has been used repeatedly in the past and continues to be a viable option today without any chilling effects on markets or market access brought about by such "added costs" as discussed in the following section. DCOs have been massive beneficiaries of Dodd-Frank due to the mandatory clearing requirement (as discussed above), so will be more than able to, and should, bear some additional costs to ensure market stability and protection of customer margin, which some DCOs like LCH already do.

VI. THE INDIVIDUALLY SEGREGATED ACCOUNT STRUCTURE

A. The Individually Segregated Account Structure Permits Customers the Option to Physically Segregate Collateral

The ISA structure, which the Chicago Mercantile Exchange has reviewed as an operational matter and advised that they believe would work as an effective segregation option for cleared swap customers, would be as follows:

A customer that maintains an account with an FCM through which swap contracts are carried and cleared (a "Swap Account") will be permitted to establish a physically segregated ISA pursuant to an agreement (a "Quad-party Agreement") among the DCO, the FCM, the customer and a settlement bank of the DCO (the "Settlement Bank"). The ISA would be in the name of the customer (for the benefit of the DCO) at the Settlement Bank and the Quad-party Agreement would provide that the ISA and its proceeds are property of the Customer and not of the FCM, and that the FCM has no recourse to the ISA. Assets standing to the credit of the ISA will be used for the purpose of satisfying all of the customer's Swap Account settlement and margin obligations to the DCO and the customer using an ISA would not have its assets transferred through accounts of the FCM but directly to the DCO. Any payments or returns of margin from the DCO to the Customer will also be deposited directly into the ISA.

The DCO will have an unrestricted right to use the collateral and variation margin deposited in the Customer's ISA to cover that Customer's Swap Account obligations to the DCO. The DCO will directly instruct the Settlement Bank with respect to ISA collateral and margin payments. The FCM will remain responsible to the DCO for the performance of the Customer's Swap Account.

Attached as Appendix A is a diagram and description of the ISA structure. For comparison, a diagram and description of the existing model is attached as Appendix B.

B. The ISA Structure Enhances Systemic Stability

A DCO's ability to access capital is the bedrock of the stability provided by clearing, and the ISA structure will permit DCOs to have operationally easier, more secure and clearer access to customer margin. Allowing customer margin to be held in physically segregated accounts at the DCO's settlement bank will provide a clearer view of capital available to the DCO from customers, which will also permit DCOs and regulators to more accurately manage systemic risks. For instance, the risk that an FCM whose net position to the DCO does not change will fail due to a large customer being unable to meet its margin obligations (as happened with Griffin) would be eliminated with respect to customers who choose physical segregation. The ISA structure will also permit DCOs and regulators to see customer margin positions held with DCO's settlement bank whose recordkeeping would not deteriorate due to the failure of an FCM. Holding margin in ISAs to cover portions of an identified customer will also permit DCOs to better understand customer positions and margining patterns across all FCMs, which will given them greater ability to earlier detect any potential problems in positions held by large customers. Finally, the ISA model would shorten the chain between customer and DCO, reduce operational impediments to DCO margin receipt and increase operational efficiencies.

C. The ISA Structure Enhances Protection for Swap Customer Margin

Physical segregation will also eliminate FCMs' ability to speculate with or misappropriate customer margin, as it will be held in an ISA at the DCO settlement bank for the benefit of the DCO. In addition, customers will be able to rely on the recordkeeping and segregation of settlement banks rather than FCMs, which may ignore or fail to perform these functions properly in times of crisis and negate the purported advantages of LSOC. Also, due to the ease of determining customer margin, porting positions after an FCM liquidation will be operationally easier and reduce uncertainty regarding customer positions and margin.

D. The ISA Structure is Permitted under the Bankruptcy Code and the CEA

1. The ISA Structure Is Permitted Under the Bankruptcy Code.

Customer assets within the proposed ISA structure are protected from an FCM's insolvency by remaining separate from the bankruptcy estate. Under the U.S. Bankruptcy Code (the "Code"), a bankruptcy trustee must distribute "customer property" of an insolvent FCM ratably.[40] "Customer property" is defined as property "...acquired or held by or for the account of the debtor."[41] However, since margin in the ISA is not held by, or for the account of an FCM, it does not fall under the definition of customer property of an FCM. The proposed ISAs are held by the DCO Settlement Bank under the customer's name, and not by the FCM, which will have no contractual or other right or interest in the ISA.[42] Because the FCM has no direct or indirect claim against the ISA, the ISA would not be part of the FCM's bankruptcy estate and not subject to an automatic bankruptcy stay or any delays in transferring margin.

2. The ISA Structure Is Not Prohibited Under the CEA and Requires Minimal CFTC Rulemaking.

Neither the CEA nor any CFTC rules or regulations (including, as discussed above, Interpretation No. 10) prohibit the proposed ISA structure. Although the CEA gives the CFTC power to classify ISAs as "customer property" under the Code,[43] to date, the CFTC has declined to exercise this power. Furthermore, FCMs are not prohibited from standing behind customer obligations with respect to a Swap Account despite not holding the margin used to secure such customer's obligations. The CEA does not require swap collateral to be held by FCMs, nor does it require customer obligations processed by a FCM to be satisfied with customer assets. FCMs may fulfill their obligations to a DCO with respect to customer obligations under swaps by means of a direct customer-to-DCO transfer. Finally, the introduction of ISAs furthers the core principal of maintaining adequate risk management that each DCO must comply with under the CEA.[44] DCOs are not prohibited from dealing with customers if their property is not held by an FCM and may direct transfers of variation margin or collateral between a DCO and a customer.

VII. FULL PHYSICAL SEGREGATION IS APPROPRIATE FOR FUTURES AND OPTIONS MARGIN AS WELL

The existing margin protections available to futures and option customers are inadequate. This has been illustrated in several instances, as described above, including most recently by the inability of MF Global to timely retrieve futures and option customer funds. Therefore, we urge

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[40] 11 U.S.C. § 766(h) (2011).

[41] 11 U.S.C. § 761(1) (2011).

[42] The structure discussed in our prior letter provided that the FCM would be granted a secondary lien in the ISA subordinated to the DCO's primary lien. This lien created some risk that the assets in the ISA would be subject to the automatic bankruptcy stay (and thus not be easily transferrable or portable) due to a claim by an FCM's estate. However, the structure described in this Letter does not contain a secondary lien, so because the FCM's estate would have no claim at all against the ISA, it should not be subject to the automatic bankruptcy stay or the transfer risk.

[43] 7 U.S.C. § 24 (2011).

[44] 7 U.S.C. § 5(b)(c)(2) (2011).

the Commission to reconsider the margin protections currently available to futures and option customers. As discussed above, in 2005, staff at the Commission amended Financial and Segregation Interpretation No. 10 to state that an FCM would not be in compliance with the requirements of the CEA if it held futures and option customer funds in a third-party custodial account. We therefore request that the Commission direct its staff to revise or repeal Interpretation No. 10 to permit FCMs and DCOs to voluntarily offer physical segregation of margin to futures and option customers as soon as possible. Moreover, we urge the Commission to take additional future action to require FCMs and DCOs to give futures and option customers the right to elect physical segregation of margin.

VIII. CONCLUSION

Despite the losses that are likely to be suffered by customers of MF Global and other prior failed FCMs, and despite the fact that mutual funds and pension plans have been able to obtain the highest standard of protection for their swap margin in the OTC markets for years and despite the willingness of pension plans and investment companies to bear the additional costs of such segregation, the CFTC proposal would ban pension plans from protecting their margin. The CFTC proposal would also ban FCMs and DCOs from offering greater margin protection to those customers seeking it. Considering that mandatory swap clearing was designed to further the Dodd-Frank objectives of enhancing market stability and protecting customers, this would be a perverse result due to which customers would receive less protection in the United States than in foreign markets. We support Dodd-Frank's swap clearing mandate and the Commission's efforts to implement it, but urge the Commission not to permit mandatory clearing to become effective until a physical segregation option has been made available to customers.

We seek confirmation without delay from the Commission that DCOs and FCMs are permitted under present law, including Interpretation No. 10, to offer swap customers the physical segregation of swap customer funds at an account held by a DCO Settlement Bank. The Commission should urge DCOs and FCMs to offer swap customers such physical segregation immediately. Additionally, we believe the Commission should revisit the margin protections available to futures and options customers, so that futures and options customer funds are afforded the protection of physically segregated margin.

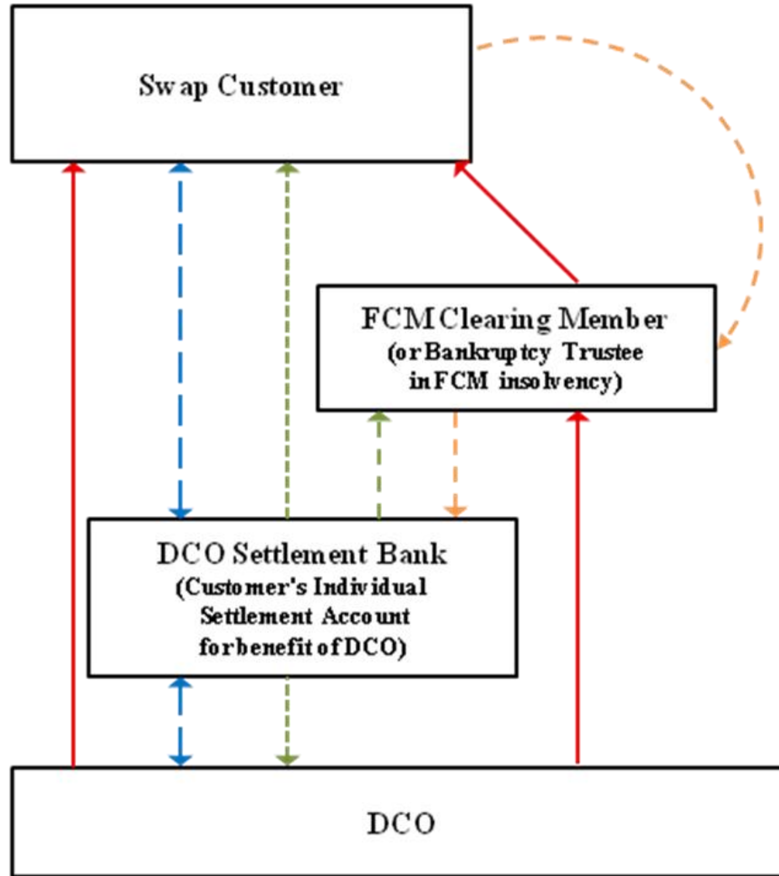
In light of the risks posed to customer margin held in omnibus accounts at FCMs and DCOs and the not yet mature cleared swap market, the protection of customer margin should be paramount. Other regulators and European market participants have recognized this, and we believe that US regulators should as well. The swaps market needs a margin protection system that is significantly, not marginally, better than the broken futures margin system, which is why the CFTC should require FCMs and DCOs to offer customers the option to physically segregate their margin.

* * *

We appreciate the opportunity to further comment on the NPR. CIEBA would be pleased to provide any further information or respond to any questions that the CFTC’s staff may have.

THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

APPENDIX A. Diagram and Description of Proposed Individual Settlement Account Data and Cash/Property Flow for Cleared Swap Margin



Margin Call: Margin calls are made by DCO to the Customer and FCM, and FCM also notifies the Customer of the margin call.

Cash/Property Flow: Customer transfers assets directly into the Individual Settlement Account and assets are then transferred directly on the instruction of the DCO to meet any margin calls (or provide initial margin) or settlement amounts. The flow is reversed upon return of margin to customer.

Data Flow: Information about the assets in the Individual Settlement Account will be provided by the DCO Settlement Bank to the DCO, FCM and Customer.

Pre-Funding/Repayment: The FCM may make loans to the Customer to cover margin shortfalls by topping up its Customer segregated account and transferring from those assets, as necessary, to the Customer's individual settlement account at the DCO Settlement Bank, and Customer will repay such loans by transferring assets to the FCM.

Description of Proposed Individual Settlement Account Data and Cash/Property Flow for Cleared Swap Margin

A swap customer that maintains an account with an FCM through which swap contracts are carried and cleared (a "Swap Account") will establish a physically segregated individual settlement account ("ISA") pursuant to an agreement (a "Quad-party Agreement") among the relevant DCO, the FCM, the customer and a custodian that is also a settlement bank of the DCO (the "Custodian"). The ISA would be an account held in the name of the customer (for the benefit of the DCO) at the Custodian and the Quad-party Agreement would expressly provide that the ISA and its proceeds are property of the customer, and not of the FCM, and that the FCM has no recourse to the ISA. Assets standing to the credit of the ISA will be used for the purpose of satisfying all of the customer's swap margin obligations to the DCO, and the customer using an ISA would not have its assets transferred through accounts of the FCM but directly to the DCO.

The DCO will have an unrestricted right to use the collateral and variation margin deposited in the customer's ISA to cover that customer's Swap Account obligations to the DCO. Each ISA established with a DCO will also be subject to any additional rules the DCO may establish from time to time. The rights and responsibilities of the parties, as described above, will be established under the Quad-party Agreement. Nothing in the Quad-party Agreement will change the FCM's liability to the DCO for the customer's transactions, so the FCM will remain liable to the DCO for the customer's performance.

Flow of Funds

Unlike the current model for cleared futures, a swap customer using an ISA would not have its assets transferred through the accounts of the FCM. Instead, the swap customer will transfer margin for its Swap Account directly to the ISA. Such assets will then be transferred from the ISA to the DCO to fund margin payments for the customer's Swap Account. Any payments by the DCO or returns of margin from the DCO will also be deposited into the ISA. In addition, an FCM may make loans to the customer to cover margin shortfalls by depositing the loaned funds directly into the ISA. The customer would repay such loans by directly transferring funds to the FCM, but the FCM would have no claim or interest in the ISA.

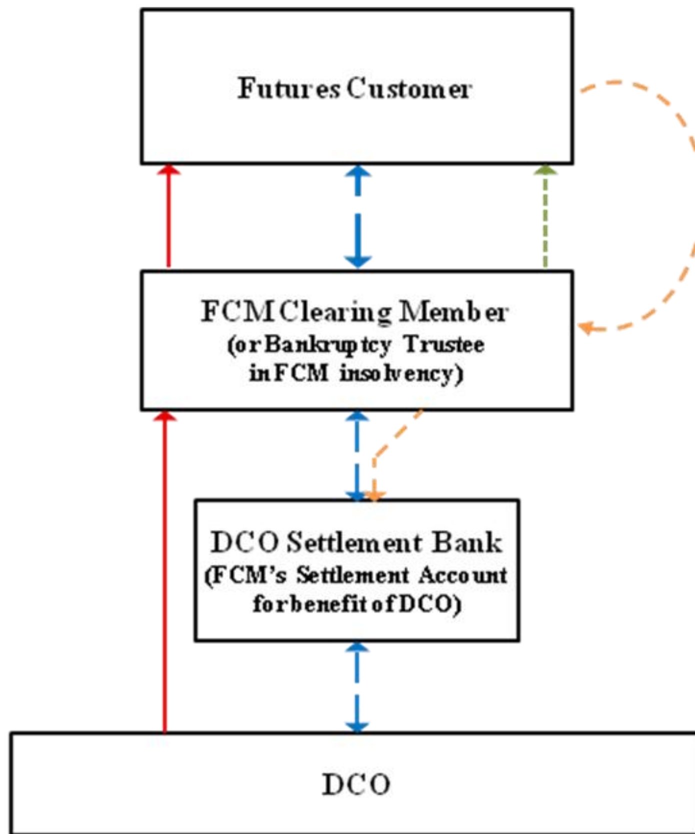
Flow of Information

For any swap transaction, the customer will notify the FCM of its order. The FCM will execute the trade on the relevant marketplace (either a designated contract market or a swap execution facility). The FCM will then clear the trade through a DCO, submitting the appropriate information to the DCO. The DCO will inform the swap customer and the FCM of the DCO's margin and settlement requirements and the FCM will also inform the swap customer of the relevant margin and settlement requirements. The customer would be required to make transfers to the ISA to meet the relevant margin and settlement requirements. At the termination of a trade, the DCO will make payments directly to the ISA. The Custodian will inform the FCM and the customer of the receipt of funds into the ISA. In addition, the Custodian will inform the customer on a periodic basis of amounts in the ISA.

Customer Relationship with the FCM

A swap customer that deposits margin in an ISA will remain a customer of the FCM. Aside from the transfer of assets to the ISA, the nature of the swap customer's relationship to the FCM would remain essentially unchanged.

APPENDIX B. Diagram and Description of Current Data and Cash/Property Flow for Cleared Futures Margin



Margin Call: Margin calls are made by DCO to FCM and FCM notifies the Customer of the margin call.

Cash/Property Flow: Customer transfers assets to the FCM (customer segregated account), and the FCM transfers assets to the DCO Settlement Bank, as necessary, to meet any margin calls (or provide initial margin) or settlement amounts. The flow is reversed upon return of margin to customer.

Data Flow: The Customer receives information about its assets held in the FCM's omnibus customer segregated account from the FCM.

Pre-Funding/Repayment: The FCM may make loans to the customer to cover margin shortfalls by topping up its customer segregated account and transferring from those assets, as necessary, to the FCM's account at the DCO Settlement Bank, and customer will repay such loans by depositing assets with the FCM or by the FCM's set-off against amounts owed to the customer.

Description of Current Data and Cash/Property Flow for Cleared Futures Margin

Under the current model used for futures and option customer accounts, orders flow from the customer to or through its FCM. The FCM will execute the trade on a designated contract market, and clear the trade through a DCO, submitting the appropriate non-customer specific information to the DCO. Margin calls are made by a DCO to an FCM, also on a non-customer specific basis, and the FCM notifies its customer of its particular margin call. The customer transfers assets to the FCM's omnibus customer segregated account, which the FCM then transfers to its settlement account at the DCO settlement bank, as necessary, to meet the overall margin call or settlement amount, retaining any excess amounts. The DCO does not normally observe the FCM's margin calls to its customers or the timeliness or adequacy of the customer's response. If an FCM makes loans to the customer to cover margin shortfalls, it does so by adding funds to its omnibus customer segregated account and transferring from those assets, as necessary, to the FCM's account at the DCO Settlement Bank, normally without informing the DCO of the loan. The futures customer will repay such amounts by depositing assets with the FCM or by the FCM's set-off against amounts owed to the customer.