

## **CLSM IS A PLACEBO, NOT A SOLUTION**

Customers and Congress are concerned about two kinds of risk: "fellow-customer risk" presented by the commingled customer accounts and the risk that an FCM will misappropriate segregated customer funds. The CFTC proposes to alleviate those concerns by providing "legal" segregation while minimally disrupting existing operational practices in the industry. We are convinced, however, that the Complete Legal Segregation Model ("CLSM") will fail on both counts. The benefits it seeks to provide are illusory, because it offers no protection against fellow customer risk in the most likely failure scenarios and no protection against misappropriation in any scenario. Moreover, even to support CLSM on an ongoing basis will require substantial operational changes that will drive up the cost of clearing swaps for all market users, including hedgers. These cost increases may discourage the use of cleared swaps for risk management and will have no countervailing benefit because CLSM cannot achieve its intended objectives. Worse still, the Commission's implementation of CLSM will be heralded as a cure for the MF Global and fellow-customer risk problems. The Commission's pronouncements respecting the impact of its amendment of Regulation §1.25 are an instructive, if distressing, example for the messaging that will be employed in this case. The purported remedial benefits of CLSM will either be unmasked immediately, which will be a black eye for the Commission, or be brought to light if there is another failure that leaves customers facing a shortfall in funds. Either result is horrible for CFTC-regulated markets and the participants we serve.

Our August 8, 2011, 24 page letter respecting the proposed rule explains the lack of positive impact of CLSM in detail. In short, CLSM does nothing to protect customers against misappropriation of segregated funds by their clearing member. It also does nothing to protect customers against fellow customer risk that occurs before the clearing firm's failure, which is the time at which it will occur. One easy example adapted from our comment letter should make this clear.

Assume the customers of a clearing member firm are fully margined, to the sum of \$2 billion, but hold large volatile positions. Assume further that a major market disruption occurs and that the intraday settlement requires the clearing house to pay the firm's customers that gained \$5 billion and to collect from the firm's customers that lost \$4.5 billion. Under the procedures of CLSM, the clearing house would net the pays and collects and pay \$0.5 billion to the firm's customer origin account at the clearing house. Unfortunately for the winning customers, when the firm is unable to collect the loss from its losing customers, the firm will be unable to pay the gains to the winning customers beyond the \$1 billion it is holding in collateral from the losing customers plus the 0.5 billion that the clearing house paid. The firm fails. This means that the winning customers suffer a loss of \$3.5 billion because of fellow customer risk. Worse, those customers believed that the CFTC eliminated that risk and the level of anger and distrust will be even more devastating to the agency and to the industry than the MF Global episode.

MF Global hurt real people. We should be doing everything we can to prevent a repeat performance. Real solutions will achieve that goal. CLSM fails that test. It should not be adopted.