STATE STREET.

Stefan M. Gavell
Executive Vice President and Head of
Regulatory and Industry Affairs

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, MA 02111-2900

Telephone: 617.664.8673
Facsimile: 617.664.4270
smgavell@statestreet.com

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Via: http://comments.cftc.gov

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

Re: Comments on the Proposed Rules for Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations. (RIN 3038-AD88, 77 Fed. Reg. 67866, November 14, 2012) (the "Proposed FCM Customer Protection Rules")

Ladies and Gentlemen:

State Street Corporation ("State Street") is one of the world's leading providers of financial services to institutional investors including investment servicing, investment management and investment research and trading. State Street appreciates the opportunity to provide comments on the Proposed FCM Customer Protection Rules.

Enhancing the protection of customer funds held by a futures commission merchant (an "FCM") can be accomplished in a number of ways. One such option that State Street believes the Commission should reconsider, especially in light of recent events concerning the MF Global and Peregrine defaults, is allowing customers to deposit margin funds in a safekeeping or custodial account (otherwise known as a "third-party custodial account") in lieu of posting such funds directly with an FCM. The option would also afford futures customers with the same choice to use a third-party custodial account for the posting of margin as the Commission has recently provided cleared swap customers.

Prior to 2005, such arrangements were permitted to the extent structured in compliance with the Commission's Financial and Segregation Interpretation No. 10 (May 23, 1984) ("Original Interpretation 10"). On May 5, 2005, however, the Commission issued an amendment to

Interpretation 10 (such amendment, "Interpretation 10-1") that, with limited exceptions, prohibited customers from using third-party custodial accounts for purposes of posting margin to cover their futures activity cleared through an FCM, citing certain concerns over an FCM's access to such funds. As described in more detail below, industry developments since 2005 have addressed the concerns raised by the Commission in the adoption of Interpretation 10-1.

In light of those developments, in response to concerns of FCM customers raised by the MF Global and Peregrine insolvency cases, and in order to harmonize the treatment of futures customers and cleared swap customers with respect to third-party custodial accounts, State Street now asks the Commission to reconsider its position on the use of third-party custodial accounts, specifically to repeal Interpretation 10-1 and to reinstate Original Interpretation 10, thereby permitting, as an option for FCM customers, the posting of margin in a third-party custodial account. State Street believes that these actions are justified because of the benefits of third-party custodial account arrangements, prior objections to these arrangements no longer being valid and the availability of further protections for FCMs and their customers that are being proposed by the Commission.

I. Benefits of Third-Party Custodial Account Arrangements

Transparency is critical to customer confidence in today's markets. Posting margin to a third-party custodial account will enhance transparency in ways that will be beneficial to an FCM's customer. A customer that posts margin with a custodial bank will receive daily or other periodic statements of activity in the custodial account from a source independent of the FCM. As such, the customer will have greater transparency as to whether its posted margin is in the custodial account.

This enhanced level of transparency may be highly attractive to an FCM's customer base given the experience of the MF Global and Peregrine insolvency cases. In those cases, as the Commission well knows, FCM customers were completely unaware that their customer funds had been inappropriately used by the FCM. The customer's ability to monitor margin through posting with a third party bank custodian coupled with the natural impediments such an arrangement would create against the ability of an FCM to misuse such customer funds when compared with funds posted directly to the FCM will be enormously helpful to restore customer confidence and minimize the type of surprises encountered in the MF Global and Peregrine insolvency cases.

While State Street believes that the benefit of transparency in providing an FCM customer with the option to post margin in a third-party custodial account is in and of itself desirable, there are additional benefits. By affording this option, the Commission would also be harmonizing the treatment of futures with respect to the use of third-party custodial accounts with cleared swaps

and avoiding disparate treatment for cleared swap customers and FCM customers in this respect.[1] Moreover, the Commission would be harmonizing the use of third-party custodial accounts with common market practice with respect to futures clearing in Europe.

II. Addressing Prior Objections

In Interpretation 10-1, the Commission raised three objections to the posting of margin with a custodial bank. The first objection was that under a custodial bank arrangement the FCM would not have immediate and unfettered access to the funds posted by the customer as margin. The second objection was that a custodial bank arrangement has the potential to pose systemic liquidity risk. The third objection was that the custodial bank arrangement might lead to confusion and administrative risk in achieving parity of customer treatment in the case of a bankruptcy of the FCM.

These objections all reflect an emphasis on the FCM's access to the funds posted by the customer, which access is clearly critical for a system that relies upon the posting of margin to cover customer defaults. The objections, however, do not reflect a balanced approach that takes into account the legitimate concerns of the FCM's customers, and more importantly, have largely been addressed through important developments in third-party custodial arrangements and technological advances in the wake of the 2008 financial crisis. We address below each of the objections.

Immediate and Unfettered Access

It is customary for a custodial bank arrangement to be documented so that the custodial bank must, as a contractual matter, comply with entitlement orders and instructions from the secured party as to funds in the custodial account without further consent of the customer. Such a contractual provision is critical to the secured party being viewed under the Uniform Commercial Code as having a security interest in the margin perfected by "control". The Commission suggested in Interpretation 10-1, though, that the custodian will often be under the influence of the customer with whom the custodian has an existing relationship. That relationship, the Commission concluded, might influence the custodian not to comply, or at least to delay in complying, with the FCM's entitlement orders or instructions if the customer objects. The Commission even cited instances disclosed on audits in which funds had been released to the customer from the custodial account without the knowledge or consent of the FCM.

[1] In adopting final rules regarding the protection of cleared swaps customer collateral (s*ee* Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (February 7, 2012); RIN 3038–AC99), the Commission noted that Interpretation 10-1 does not apply to cleared swaps and that FCMs and their cleared swaps customers can use third-party custodial accounts in compliance with the conditions listed in the Original Interpretation 10 . The Commission did not articulate any policy rationale for the disparate treatment between margin posted for futures and cleared swaps, but instead elected to leave the door open to a unified approach by commenting that it may address this disparate treatment in the future.

Since the 2008 financial crisis, however, third-party custodial arrangements have become widely used by market participants and, in many cases, required by regulators. Indeed, the Dodd-Frank Act makes the use of third-party custodial arrangements a required option for the posting of initial margin to secure certain uncleared bi-lateral swaps.[2] Furthermore, the Commission has recently permitted the use of third-party custodial arrangements for cleared swaps.[3]

Given market practice today, an FCM would have the same immediate and unfettered access to funds in third-party custodial that it would have to funds held at any other depositary of the FCM. Documentation for third-party custodial arrangements typically requires the custodial bank to act as soon as it has had a reasonable time to react to the receipt of an entitlement order or instruction from a secured party. That standard is no different than the standard imposed on a depositary bank for dealing with stop payment orders on checks and creditor process.[4] A custodial bank today must have the technology and operational systems in place to meet those obligations. A custodial bank that fails to comply with those obligations potentially will be exposing itself to significant contractual liability to the secured party. In addition, custodial banks that serve as third-party custodians rely on their reputations in the market in order to maintain their business. A custodial bank that fails to act in accordance with its contractual obligations will ultimately be hurting itself more generally in the market, as it will become known by secured parties as an untrustworthy custodian and would not be accepted by such secured parties as a depository.

Potential Systemic Liquidity Risk

The Commission suggested in Interpretation 10-1 that posting margin with a custodial bank also poses systemic liquidity risk. To be sure, when a third-party custodial account arrangement is used to hold customer funds, the FCM will not have access to those funds other than upon a customer default, and thus the FCM will be required to provide liquidity in posting initial margin to the clearing house. This is not a unique circumstance, however, as it is similar to the situation when initial margin on cleared swaps will be held under a third-party custodial account arrangement, or when an FCM's customer posts initial margin with the FCM of a type ineligible for posting to the clearing house.

Any incremental or potential liquidity issues presented by use of third-party custodial arrangements for futures should be addressed by safeguards that the FCM will be required to have in place. FCMs are expected to establish and maintain a prudent liquidity management infrastructure that includes liquidity risk controls. FCM policies and procedures will likely provide for selective use of third-party custodial arrangements and will require certain contractual protections when they are used. Customers may be charged additional fees for use of

[2] Dodd-Frank Act sec. 724(c).
[3] Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (February 7, 2012); RIN 3038–AC99.
[4] *See* Uniform Commercial Code Sections 4-303 and 4-403 (1990).

the third-party custodial account arrangement in order to compensate the FCM to the extent that the FCM uses its own funds to post as initial margin at the clearing house.

The Commission further suggested that posting margin with a custodial bank could pose systemic risk because, in contrast to general banking services, only a relatively few number of banks offer significant custodial services, leaving FCMs with the concentration risk of the custodial banks that they would use.

Providing an option to an FCM customer to post margin in a third-party custodial account, though, could actually be helpful in addressing concentration risk. Given the consolidation in the financial services industry, the number of depositary banks available to FCMs may be viewed as smaller than might be optimal. The addition of custodial banks as custodians of margin posted by FCM customers could actually serve to reduce concentration risk

Moreover, any concentration risk should be considered in conjunction with the strengths of those banks offering custodial services. In contrast to the more general trend of industry consolidation during the financial crisis, none of the major custodial banks consolidated or merged. Those institutions are subject to extensive and increasingly rigorous regulation. Even if, despite those measures, there was an insolvency proceeding involving a custodial bank, there would be a swift and efficient resolution process in federal bank receivership for which the Federal Deposit Insurance Corporation would be the receiver. Under that resolution process, securities posted as margin, such U.S. Treasury bills, would be considered custodial assets, typically held in book entry form in central securities depositories, and would not be subject to the claims of the custodial bank's proprietary creditors, and domestic cash deposit claims would generally be given priority over the claims of other general unsecured creditors and would generally be entitled, within applicable limits, to federal deposit insurance. The insolvency treatment of domestic cash deposits, of course, would be no different for an insured bank custodian than for any insured depositary institution where an FCM would otherwise hold customer funds.

Parity of Customer Treatment in Bankruptcy

The Commission stated that, although the law is clear that funds posted as margin with a custodial bank will be considered customer property in a bankruptcy case involving the FCM as debtor, it is concerned that there may be confusion on this issue and administrative risk. The risk of confusion and administrative risk on this point, however, is significantly lower today than it was in 2005. Parties today, having experienced so many financial services firm insolvencies and near insolvencies during the financial crisis, are much more knowledgeable on bankruptcy treatment of customer funds than they were in 2005 when Interpretation 10-1 was issued, and have implemented processes and procedures to address risks exposed during the financial crisis.[5]

[5] *See, e.g.*, Sec. Investor Prot. Corp. v. Lehman Bros. Inc., 433 B.R. 127 (Bankr. S.D.N.Y. 2010), where in a liquidation proceeding under the Securities Investor Protection Act the bankruptcy court found that assets in a third

III. FCM and FCM Customer Protections

Any remaining concerns by the Commission are addressed by the protections for the FCM and the FCM customer that follow naturally from a combination of the reinstatement of Original Interpretation 10 and the Proposed FCM Customer Protection Rules as well as additional suggestions referred to below.

- If Original Interpretation 10 were reinstated, the third-party custodial account would be required to be an account of the FCM rather than an account of the FCM's customer. It would be absolutely clear that the custodial bank must accept entitlement orders and instructions from the FCM even though access to account statements would remain available to the FCM's customer.
- The custodial arrangements must be in writing and the custodial bank would be required, consistent with market practice, to comply with an entitlement order or instruction from the FCM promptly once the custodial bank has had a reasonable time to react to the entitlement order or instruction. If Original Interpretation 10 were reinstated, the only requirement that could be imposed on the FCM as a condition to accessing the funds in the third-party custodial account outside of an insolvency proceeding of the FCM would be for the FCM to state that the FCM customer is in default on the customer's margin or deposit obligations to the FCM.
- The documentation for a permitted custodial bank arrangement would be required to contain a prohibition on the FCM's customer having any access rights to the funds in the custodial account except through the FCM, even in the event of a default by the FCM under its obligations to the FCM customer.
- If Original Interpretation 10 were reinstated, a third-party custodial account would be treated as a depositary account,[6] and, accordingly, the enhanced protections of the Proposed FCM Customer Protection Rules would apply to the third-party custodial account. Accordingly, documentation for a permitted custodial bank arrangement would also be required to include letter agreements similar to the Acknowledgement Letters contemplated by the proposed amendments to Sections 1.20[7] and Part 30,[8] giving the Commission itself direct access to custodial account information and rights to give entitlement orders and instructions relating to the custodial account where necessary.[9] Likewise an FCM would be obligated to employ the same strengthened due diligence investigation on a custodial bank as it would be required to do under the Proposed FCM Customer Protection Rules on its own depositary.[10]

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party custodial account pledged as margin were customer property under that Act even though the jurisprudence under that Act was far less clear than under Section 766 of the Bankruptcy Code and 17 CFR 190.08.

[6] CFTC Advisory No. 37-96 (Responsibilities of Futures Commission Merchants and Relevant Depositories with Respect to Third Party Custodial Accounts) http://www.cftc.gov/opa/press96/opa37-96.htm.

[7] *See* Proposed FCM Customer Protection Rules 77 Fed. Reg. 67941-42 (providing a template Acknowledgement Letter for 4d funds).

[8] *See* Proposed FCM Customer Protection Rules 77 Fed. Reg. 67961-62 (providing a template Acknowledgement Letter for 30.7 funds).

[9] A designated self-regulatory organization may require similar information access to a custodial account. .See Proposed FCM Customer Protection Rules (discussing the National Futures Association rules amendments paralleling the Commission's current efforts).

[10] *See* Proposed FCM Customer Protection Rules 77 Fed. Reg. 67874-75, fn. 31.

- Any educational concern about customer parity in the event of the FCM's bankruptcy could be addressed further by requiring that a notice that the funds in the custodial account will be customer property in the FCM's bankruptcy case be included in the documentation for the custodial arrangements. In fact, the forms of Acknowledgement Letters already contemplate similar disclosure.
- All of these matters could be added to the standard risk disclosure Questions and Answers promulgated by the National Futures Association.

IV. Conclusion

State Street believes that the Commission should repeal Interpretation 10-1 and reinstate Original Interpretation 10. Permitting a customer of an FCM, if it so elects, to post margin with a custodial bank in a third-party custodial account in lieu of posting futures margin with the FCM would enhance the protection of customer funds and boost customer confidence in the futures market. In State Street's view, the concerns that the Commission expressed about custodial bank arrangements when adopting Interpretation 10-1 are no longer valid concerns today and in any event should be balanced by the legitimate concerns of FCM customers for transparency and the benefits of harmonization, taken together with other improvements to FCM and FCM customer protections.

Thank you for your consideration of this comment letter. We would be happy to discuss further any of the matters raised in this letter.

Sincerely,

Stefan M. Gavell