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Mr. David A. Stawick, Secretary
Commodity and Futures Trading Commission
1155 21st Street, NW
Washington, D.C.
20581

Re: Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commissions Merchants and Derivatives Clearing Organizations

Dear Mr. Stawick,

CFA Institute[1] appreciates the opportunity to comment on the Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commissions Merchants and Derivatives Clearing Organizations consultation (the "Proposal") as proposed by the Commodity and Futures Trading Commission ("CFTC" or the "Commission"). The Proposal considers adopting new regulations and amending others to require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosures, and auditing and examination programs for futures commission merchants ("FCMs"), and also addresses certain related issues concerning derivatives clearing organizations ("DCOs") and chief compliance officers ("CCOs").

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the integrity and accountability of global financial markets.

As a global organization of investment professionals, CFA Institute is particularly concerned with issues that create systemic turmoil and failure within financial markets. Consequently, we are strongly supportive of efforts to 1) increase transparency of the swaps and derivatives

[1] CFA Institute is a global, not-for-profit professional association of more than 114,000 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom nearly 106,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

markets globally; 2) to carefully consider, manage and regulate central clearing of swaps; 3) to trade standardized and standardizable swap instruments on transparent organized trading venues; and 4) to ensure global coordination in the adoption and implementation of swaps regulations to reduce the frequency and effect of regulatory arbitrage.

Executive Summary

CFA Institute supports the objectives of the Proposal, namely to afford customers and customer funds protections through risk management and monitoring, including segregation. In particular, we support enhancing risk management practices of FCMs in tandem with the oversight of the appropriate derivatives self-regulatory organizations ("DSROs") and the CFTC. The calculation and overall safekeeping of collateral for futures, options, and OTC derivatives transactions provides a critical buffer in the event of default of one of the counterparties and helps manage systemic risk.

The comments below introduce positions that we describe more fully in the discussion section of this document:

- Given the proven problems and conflicts banks have had using internal models for determination of capital in recent years, we strongly oppose letting FCMs use internal models for calculating their own capital requirements.
- While we recognize that the events surrounding MF Global's illegal confiscation of client funds is a rare breach of Commodity Exchange Act rules, we believe these events highlight a significant weakness that, unless closed could lead to further customer losses and loss of investor trust. Therefore, we support requirements that customer accounts remain segregated from FCM proprietary accounts, and that individuals illegally engaged in violation of these laws are held criminally accountable.
- FCMs should be held responsible for covering losses occurring from their investment of customer accounts.
- FCMs should have to disclose critical information about such matters as the ability of FCMs to commingle customer funds in one or more accounts, including accounts provided by affiliates of the FCM, and that in the event of an FCM's bankruptcy that such funds are not guaranteed by a clearing entity.
- Protections and requirements for foreign customers of FCMs should be as strong as those for domestic customers.

Finally, we do not believe that the SEC and CFTC should adopt different approaches to regulating similar issues because disharmony of this kind will lead to confusion and increase the cost of dealing with the enormous complexities of the swaps market. Moreover, it would likely create regulatory arbitrage opportunities for firms trading OTC derivatives.

Discussion

The questions we have answered and comments we have made relate to the following issues:

1) FCM risk management policies,

2) Liability that should be attributable to the CCO of an FCM,
3) Using internal models to determine FCM capital and margin requirements,
4) Segregation and use of FCM customer funds,
5) Expanding the counterparty concentration limits of reverse repo agreements,
6) Duty of an FCM to replenish a customer account when shortfalls occur in certain situations,
7) Proposed FCM risk disclosure requirements,
8) Treatment of collateral for futures and centrally-cleared swaps not held at the clearing house, and
9) Protections for foreign customers of FCMs.

In general, we strongly support enhancing protections for customers and customer funds held by FCMs and DCOs. We believe appropriate risk management and customer protections are critical to the overall goal of mitigating systemic risk and improving investor protection.

Specifically on the issues of margin requirements and segregation, we also advocate that:

1) Regulatory agencies should not exempt non-centrally cleared derivatives from margin requirements.

2) Clearinghouses should be permitted to accept a broad range of collateral types for margin requirements as long as the instruments are liquid with readily available prices, appropriate valuation discounts are reflected, and regulatory approval is provided.

3) Position margin should be segregated by client and may be operationally commingled with margin from other clients, but fully segregated from proprietary assets.

4) Central counterparties ("CCPs") and clearing members should publicly disclose the levels of protection and costs associated with the different levels of segregation that they offer.

5) Details of the different levels of segregation should include a description of the main legal implications of the respective levels of segregation offered including information on the insolvency law applicable in the relevant jurisdictions.

II.B. Proposed Amendments to §1.10: Risk Management Program of Futures Commissions Merchants

Bullet #2 – Question: Does the proposed risk management program address the appropriate minimum elements that should be covered by an FCM risk management program?

Answer: Yes. The proposed policies and procedures include comprehensive measurement, controls, and reporting that we believe are sufficient minimum elements covered by an FCM risk management program.

In particular, we support the proposed program's requirement that FCMs have approved written policies and procedures that are submitted to the CFTC, including a risk management unit independent of the business unit. We also support the requirement that

FCMs provide copies of their risk management policies and procedures to the CFTC and to their designated self-regulatory organization ("DSRO") to enable them to monitor the status of risk management practices among FCMs.

Bullet #3 – Question: Regulation 3.3 requires the CCO of an FCM to provide an annual report to the Commission that must review each applicable requirement under the Act and Commission regulations, and with respect to each applicable requirement, identify the policies and procedures that are reasonably designed to ensure compliance with the requirement, and provide an assessment of the effectiveness of the policies and procedures. The annual report also must include a certification by the CCO that, to the best of his or her knowledge and reasonable belief, and under penalty of law, the information contained in the annual report is accurate and complete. The Commission requests comment on whether the standard for the CCO's certification in the annual report (i.e., based upon the CCO's knowledge and reasonable belief) is adequate for a certification of the FCM's compliance with policies and procedures for the safeguarding of customer funds. Should § 1.11 contain a separate CCO certification requirement that would impose a higher duty of strict liability or some other higher obligation on a CCO?

Answer: We support this proposed requirement. CCOs are an important element of defense against fraud and market manipulation for investors, counterparties and the market, in general. Therefore, the CCOs' certification in the annual report, backed by the liability the CCOs must bear, is an important indication that their firms have internal policies in place to comply with the Commission's regulations.

Bullet #4 – Question: Should the risk management program require an FCM to conduct quarterly or periodic audits to detect any breach of the policies and procedures that address the proper segregation of customer funds?

Answer: While we strongly support robust efforts to safeguard customer funds, we are concerned that quarterly audits may be prohibitively expensive, both for the firms as well as for the customers. In general, we support annual/periodic audits combined with periodic reviews to help detect breaches in policies and procedures relating to segregation of customer funds.

F. Proposed Amendments to § 1.17: Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers

General Comment:

As part of creating an appropriate capital rule for FCMs and broker-dealers ("BDs"), the Securities and Exchange Commission ("SEC") has proposed rules implementing the Dodd-Frank Act requirement to remove references to credit ratings in its regulations and substitute a standard for creditworthiness. In conjunction with these rules, the SEC also proposed that BDs would have to impose 100 percent discounts on the market value of nonmarketable commercial paper, convertible debt, and nonconvertible debt instruments. Lower discounts would be permitted for instruments if they are readily marketable and if the BD determines that the investments have only a minimal amount of credit risk as described in its written policies and procedures.

BDs may consider factors such as credit spreads, securities related research, internal or external risk assessments instead of exclusively relying on nationally recognized statistical rating organizations ("NRSROs") ratings in determining credit risk. Through this mechanism, BDs also would be permitted by the SEC proposal to apply the lesser discount currently specified in the SEC capital rule for commercial paper (i.e., between zero and ½ of 1 percent), nonconvertible debt (i.e., between 2 percent and 9 percent), and preferred stock (i.e., 10 percent).

FCMs that are dually-registered as BDs would benefit from any changes the SEC makes with regard to these discounts unless the CFTC specifically provides an alternate treatment. FCMs that are not dual registrants would have to take discounts of 15 percent for readily marketable securities. The CFTC has concluded that it is not appropriate to exclude standalone FCMs from using internal processes to assess the credit risk of certain securities and therefore, would permit an FCM that is not a BD to use the framework proposed by the SEC to apply lower deductions to those securities.

On the one hand, we believe it is important to recognize the effort of the SEC and CFTC to work together on joint proposals and regulation where appropriate. We believe it is critical to ensure that the marketplace is not confused, firms do not incur unreasonable additional costs, and to limit regulatory arbitrage. Nevertheless, we disagree with the joint CFTC/SEC proposal described above. While we agree with treating FCMs and BDs in the same manner for doing the same things so as not to create unfair advantages, we do not believe it is appropriate for FCMs to use internal models to determine minimum required capital. Capital models should be established by the relevant regulatory agencies for use by FCMs or BDs.

Regardless of the type of firm, we have serious concerns that internal models used for calculating minimum capital requirements are prone to failure in crisis, precisely when capital is most needed. At the same time, we are concerned that such models can be easily manipulated to minimize capital charges prior to such crises. The potential for manipulation can create incentives for firms and their employees to take unnecessary risks, while creating real competitive advantages for larger firms relative to smaller firms engaged in the same activities.

We believe that management, boards, examiners, investors and counterparties deserve an objective and clear minimum risk-based capital baseline. Wherever possible, therefore, we believe that regulators should establish minimum capital requirements determined by standardized, simple, transparent, and regulator risk standards. Firms should use their models for internal risk management purposes and to help them identify additional risks.

H. Proposed Amendments to § 1.22: Use of Futures Customer Funds

General Comment:

We recognize that the events surrounding MF Global's illegal confiscation of client funds is, if not the first, then a rare breach of the Commodity Exchange Act rules relating to client funds. Nevertheless, we believe that these events have highlighted a significant weakness within the CEA structure that, unless closed through means such as those included in this Proposal, could lead to further customer losses and further impairment of investor trust.

We therefore agree with the proposed amendment to clarify that FCMs are prohibited from using one futures customer's funds to margin or secure the positions of another futures customer, or to

extend credit to another person. This proposed rule would apply at all times and not simply at the end of the day. The FCM also would be required to segregate futures customers' funds from its own funds. We also believe that no futures customer should be under-segregated at any time during the day for any reason. Furthermore, it is critical that regulators and FCMs are able to monitor segregation on a regular and spontaneous basis.

J. Proposed Amendments to § 1.25: Investment of Customer Funds

General Comment:

We firmly agree with the proposal to expand the 25 percent counterparty concentration limit for reverse repurchase agreements from a single counterparty to all counterparties under common control or ownership.

We also support the proposal that a DCO designated as systemically important (''SIDCO'') by the Financial Stability Oversight Council may keep securities transferred to it under a repurchase or reverse repurchase agreement in a safekeeping account with a Federal Reserve Bank, as authorized by the Dodd-Frank Act. We believe this will provide more security in the event of a counterparty default.

L. Proposed Amendments to § 1.29: Increment or Interest Resulting From Investment of Customer Funds

Question: The Commission requests comment on the proposed amendment to explicitly provide that losses resulting from the investment of customer funds may not be allocated by an FCM to customers. The Commission also requests comment on how any losses associated with bank deposits should be addressed. The Commodity Exchange Authority issued an Administrative Determination (''AD'') in 1971 that provides that an FCM may not be liable for losses resulting from the deposit of customer funds with a bank that subsequently closes or is unable to repay the FCM's deposit. The AD provides that an FCM would not be liable if it had used due care in selecting the bank, had not otherwise breached its fiduciary responsibilities toward the customers, and had fully complied with the requirements of the Act and the Commission regulations relating to the handling of customers' funds. The Commission requests comment on whether the regulations should be revised to impose an obligation on an FCM to repay customer funds in the event of a default by a bank holding customer funds. Should there be a distinction drawn between U.S.-domiciled and regulated banks and non-U.S.-domiciled banks?

> We agree with the CFTC's proposed amendment to explicitly provide that an FCM bears sole responsibility for any losses resulting from the investment of customer funds in permitted financial instruments. This provision will require that FCMs conduct adequate due diligence on the banks in which they place their customers' funds, a factor that should limit the effect of related future bank failures.

N. Proposed Amendments to § 1.32: Segregated Account: Daily Computation and Record

General Comment:

In concert with the SEC, the CFTC is proposing that in determining discounts for commercial paper, convertible debt instruments, and nonconvertible debt instruments deposited by customers to cover margin positions, the FCM may develop written policies and procedures to assess the credit risk of the securities as proposed by the SEC and discussed above. If the FCM's assessment is that the credit risk is minimal, the FCM may apply discounts that are lower than the 15 percent baseline under SEC Rule 15c3–1.

On the one hand, we believe it is important to recognize the effort of the SEC and CFTC to work together on joint proposals and regulation where appropriate. We believe it is critical to ensure that the marketplace is not confused, firms do not incur unreasonable additional costs, and to limit regulatory arbitrage. Nevertheless, we disagree with the joint CFTC/SEC proposal allowing this exception. We believe that these discounts may be subject to manipulation by the FCM. It also will hurt the ability of regulators to compare the relative health across FCMs.

In general, we accept internal models, based on those developed by CCPs, for use by FCMs to determine variation margin on non-cleared contracts, largely because of the lack of alternative means for calculating margin for such contracts. Nevertheless, we do not support use of these internal models to reduce the discounts on collateral used for margin below the regulatory baselines set by SEC Rule 15c3-1, regardless of the collateral used. To permit firms to reduce the discounts applied may lead to insufficiently collateralized positions in the future.

External models also should be allowed to assist firms in properly mitigating risks; but it is incumbent on the FCMs to determine the robustness of such models. We believe the most important factors are the intricacies of the buffers and what is included in the approved models.

P. Proposed Amendments to § 1.55: Public Disclosures by Futures Commission Merchants

Bullet 1 – Question: Do the existing and proposed disclosures required to be included in the Risk Disclosure Statement and Firm Specific Disclosure Document adequately convey to retail and/or institutional investors the market and firm specific risks of engaging in futures trading and the risks of using an FCM to execute trades on customers' behalf and to hold customers' funds? If not, how should the Risk Disclosure Statement and Firm Specific Disclosure Document be amended?

> We strongly agree with the CFTCs proposed amendment to enhance the disclosures provided to existing and potential customers regarding the extent to which they are protected against loss by an FCM when depositing. Moreover, we are pleased with the additional proposed required disclosures in the Firm Specific Disclosure Document to describe the FCM's financial condition and operations. These new rules would allow existing and potential customers to conduct due diligence and thoroughly assess the risks of engaging and entrusting their funds to the FCM. At this level of disclosure, institutional and retail firms should be well informed when deciding whether to use a specific FCM.

Bullet 6 – Question: The Commission requests comment on how the new or revised Risk Disclosure Statement and Disclosure Documents should be provided to existing customers. Should FCMs be required to obtain new signature acknowledgments from existing customers for a revised Risk Disclosure Statement? How should existing customers be informed of the new Firm Specific Disclosure Statement? How can the Commission be assured that all existing customers have been informed of the new disclosure documents, and the availability of the FCM financial data?

> It will be very important for FCMs and their DSROs to ascertain whether existing and potential customers have acknowledged receipt of their Risk Disclosure Statements and are aware of the Firm Specific Disclosure Document's existence. Whether or not FCMs provide this information in written or electronic form, they should obtain and keep records of acknowledgements that they were received.
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> As proposed, we believe that FCMs should update the information no less than annually or when significant changes are made. Existing and potential customers should be given revised documentation when significant changes occur or on an annual basis, and FCMs should keep records of acknowledgments that they have received whether written or electronic. If an FCM elects to correspond with their current and future customers electronically, we would expect FCMs to notify customers of any updates to their Risk Disclosure Statements and Firm Specific Risk Disclosure Statements, together with descriptions of the changes, and acknowledgement of the changes.

Q. Proposed Amendments to Part 22

General Comment:

We agree with the recently adopted final regulations in Part 22 implementing the provisions of the Dodd Frank Act that protect Cleared Swaps Customer contracts and collateral. Although under this section of the Proposal, substantive differences exist at the clearing level in the segregation regimes between futures and cleared swaps, requirements with respect to collateral not posted to clearinghouses and maintained by FCMs for Cleared Swaps Customers replicate or incorporate many of the same regulatory requirements applicable to the segregation of futures customer funds elsewhere in the Act.

For example, holding funds separate and apart from proprietary funds, limitations on an FCM's use of customer funds, titling of depository accounts, acknowledgment letters from depository requirements, and limitations on investment of swap customers' funds are currently contained in Part 22 regulations. We believe that segregation of collateral for futures and cleared swaps not posted at the clearing house and kept at the FCM should be treated with similar care.

R. Amendments to § 1.3: Definitions; and § 30.7: Treatment of Foreign Futures or Foreign Options Secured Amount

General Comment:

Under CFTC's regulations adopted in 1987 that govern trading of foreign futures, foreign futures or foreign options, customers receive substantially less protection for their account deposits under the alternative method than domestic-based futures customers receive for their account

deposits under other sections of the Act and CFTC regulations. Among other things, regulations require FCMs to segregate into separate accounts sufficient funds to satisfy the full account equities of all of its futures customers trading on designated contract markets (i.e., the Net Liquidating Equity Method).

We support treating customers from all parts of the globe who invest in foreign options and futures. This is not only good policy, but it inspires similar treatment of United States customers by foreign regulators. Ultimately, such rules make markets more inviting to investors from other parts of the world.

Conclusion

We appreciate the opportunity to comment on the CFTC Proposal on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commissions Merchants and Derivatives Clearing Organizations. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Beth Kaiser, CFA, CIPM at beth.kaiser@cfainstitute.org or 434.951.5614.

Sincerely,

/s/ Kurt N. Schacht

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