



## Alternative Investment Management Association

David A. Stawick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

By electronic submission: <http://comments.cftc.gov>

15 February 2013

Dear Sirs,

### **AIMA response to Commodity Futures Trading Commission's Proposed Rule, 'Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations' (RIN 3038-AD88)**

The Alternative Investment Management Association Limited (AIMA)<sup>1</sup> welcomes the opportunity to respond to the Commodity Futures Trading Commission's (the Commission) 'Proposed Rules on Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivative Clearing Organizations'<sup>2</sup> (the Proposed Rules).

AIMA applauds the Commission's efforts to enhance customer protections and the risk management programs of futures commission merchants (FCMs), particularly those provisions within the Proposed Rules which aim to:

- i. provide greater certainty to market participants that the customer funds entrusted to FCMs will be protected;
- ii. establish a robust risk management program for FCMs;
- iii. afford the Commission and self-regulatory organizations read only access to accounts holding customer funds and additional information on depositories and the customer funds held in such depositories; and
- iv. increase the information provided to customers concerning the risks of trading with FCMs.

However, while the Proposed Rules go some way to achieving the above aims, this response recommends that the Commission strengthen its approach with respect to point iv above. Our more detailed recommendations in this regard are set out below.

AIMA also recommends that the Commission reconsider its approach in the Proposed Rules to the requirements governing how FCMs maintain a residual interest and incur a capital charge in respect of an under-margined customer account.<sup>3</sup>

#### **1. Disclosure**

AIMA supports the Commission's proposals, within the Proposed Rules, to enhance disclosures provided to customers and potential customers. These proposals include:

- i. public disclosure of certain firm specific information (in the 'Firm Specific Disclosure Document') regarding the FCM's financial condition, including the requirement to update this information on a regular basis;<sup>4</sup>

<sup>1</sup> AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, funds of hedge fund managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 50 countries.

<sup>2</sup> The Proposed Rules, available at: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-26435a.pdf>

<sup>3</sup> Proposed Rule s1.17(c)(5) and s1.20(i)(4), respectively.

<sup>4</sup> Proposed Rule s1.55(i)

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- ii. enhancements to the disclosures provided to customers and potential customers regarding the extent to which customer funds are protected when deposited with an FCM as margin or to guarantee performance for trading commodity interests;<sup>5</sup>
- iii. enhancements to the risk disclosure regime, specifically those requirements that the 'Risk Disclosure Statement' notify customers where: (a) customer funds are not protected by insurance in the event of the bankruptcy or insolvency of the FCM, or if customer funds are misappropriated in the event of fraud; (b) customer funds are not protected by the Securities Investor Protection Act, even if the FCM is a broker dealer registered with the Securities and Exchange Commission; and (c) customer funds are not insured by a derivatives clearing organization in the event of the bankruptcy or insolvency of the FCM holding the customer funds;<sup>6</sup> and
- iv. requirements for an FCM to disclose that each customer's funds are not held in an individual segregated account by an FCM, but rather are commingled in one or more accounts, and that FCMs may invest funds deposited by customers in a defined list of financial instruments.<sup>7</sup> The Proposed Rules would also require FCMs to disclose that funds deposited by customers may be deposited with affiliated entities of the FCM, including affiliated banks and brokers.<sup>8</sup>

Notwithstanding the above efforts to increase transparency, it is key that the Commission sets FCM disclosure standards at a level which ensures customers are on notice of all of the risks of futures trading and the FCMs with which they do business. Under the Commission's current 'legally-segregated, operationally-commingled' model ('LSOC'), upon an FCM's bankruptcy, a customer may still be subject to a *pro rata* distribution of assets *per* section 766 (H) of Chapter 7 of the Bankruptcy Code. LSOC does not provide complete protection from investment risk or FCM malfeasance risk, nor does it completely eliminate certain forms of 'fellow customer risk'. Under LSOC, customer collateral is still operationally commingled hence an FCM must continually monitor and ensure that its obligations to customers are met by a sufficient value of assets on deposit. It is, therefore, vitally important that customers are fully informed of the financial condition and regulatory compliance of the FCM. AIMA, therefore, recommends that the Proposed Rules should ensure that the following information - which an FCM would otherwise be required to provide to the Commission and its designated self-regulatory organization (DSRO) - should also be made available to customers and/or publicly disclosed on the FCM's website (to the extent that the Commission or the DSRO has not already made this information publicly available):

- i. information relating to the financial condition of the FCM or the protection of customer funds held by the FCM currently required to be disclosed to the Commission;<sup>9</sup>
- ii. 'additional reportable events' as proposed in the Proposed Rules, including where an FCM:
  - a. cannot compute or document its actual capital at the time it knows that it is undercapitalized;
  - b. fails to hold sufficient funds in segregated account for cleared swaps customers to meet its obligations;
  - c. discovers or is informed that it has invested funds held for customers in investments that are not permitted investments or holds permitted investments in a manner that is not in compliance with rule 1.25;<sup>10</sup>
  - d. does not hold an amount of funds in segregated accounts for futures customers, cleared swaps customers or for 30.7 Customers<sup>11</sup> sufficient to meet the firm's targeted residual interest in one or more of these account, or if the firm's residual interest is less than the sum of any outstanding margin deficits for such accounts;
  - e. experiences a material adverse impact to its creditworthiness or its ability to fund its obligations (or of its parent or a material affiliate);
- iii. experiences material adverse impact to the financial condition of the firm or a material change to the firm's operations;<sup>12</sup>
- iv. the 'Segregation Schedule';<sup>13</sup>
- v. the 'Secured Amount Schedule';<sup>14</sup>
- vi. the 'Cleared Swaps Schedule';<sup>15</sup> and

<sup>5</sup> Proposed Rule amendments to Commission Regulation 17 Code of Federal Regulations (CFR) §1.55

<sup>6</sup> Proposed Rule amendments to Commission Regulation 17 CFR §1.55(b)

<sup>7</sup> As prescribed in Commission Regulation 17 CFR §1.25

<sup>8</sup> Proposed Rule amendments to Commission Regulation 17 CFR §1.55

<sup>9</sup> Commission Regulation 17 CFR §1.12

<sup>10</sup> Commission Regulation 17 CFR §1.25

<sup>11</sup> Commission Regulation 17 CFR §30.7 governs an FCM's treatment of customer money, securities, and property associated with positions in foreign futures and foreign options.

<sup>12</sup> Proposed Rule amendments to Commission Regulation 17 CFR §1.12

<sup>13</sup> Commission Regulation 17 CFR §1.10

<sup>14</sup> *Ibid*



vii. the summary balance sheet and income statement information for the most recent twelve months.

AIMA places particular emphasis on the need for public disclosure/disclosure to customers of: (i) any information related to the segregated funds held to cover customer equity; (ii) the monthly report on residual interest, including daily level and average monthly balances; and (iii) the number of customers in a respective FCMs' customer pool.

The above information is either required to be provided by an FCM to the Commission or its DSRO under existing Commission regulations or required to be provided by an FCM to the Commission or its DSRO under the Proposed Rules. AIMA, therefore, does not believe that its recommendation for increased FCM disclosure would result in a substantial increase in costs for FCMs. Any increase in costs would, in fact, be relatively low when weighed against the overall benefits of increased transparency for customers.

## 2. Protection of customer funds

AIMA supports the Commission's proposals to provide greater protection to customer funds, including those proposals which would enhance existing prohibitions on FCMs from: (i) commingling futures customer funds with FCM proprietary funds; (ii) commingling funds deposited by futures customers with funds deposited by 30.7 customers or cleared swap customers; and (iii) using one customer's funds to margin or secure another customer's positions and from using a customer's funds to extend credit to any other person.

While AIMA supports the Commission's requirements that FCMs maintain a residual interest and/or incur a capital charge in respect of under-margined customer, non-customer, and omnibus commodity futures and commodity option accounts, we are concerned about the cumulative effect of the application of these requirements,<sup>16</sup> and among other matters, seek confirmation from the Commission that these obligations are not duplicative i.e., that where an FCM maintains a residual interest amount to offset a deficit, the FCM is not also subject to a corresponding capital charge on such deficit.

AIMA recognizes that the Commission's requirement that FCMs maintain residual interest potentially increases the likelihood an FCM will not use one customer's funds to margin or secure another customer's positions, thus reducing the manifestation of 'fellow customer risk', however, this benefit needs to be weighed against the potential disproportionate increase in costs to customers that the proposed changes could lead to.<sup>17</sup> In particular, AIMA would not welcome the introduction of sections 1.17(c)(5) and 1.20(i)(4) if such obligations were to exist independently of one another, such that each obligation would arise in addition to the other. AIMA believes the consequence of both a capital charge and a residual interest requirement arising in respect of the same 'margin deficit' would yield a substantial increase in costs for customers since FCMs would simply pass this increase on to customers. This is compounded by the requirement under section 1.20(i)(4) to maintain the residual interest amount "at all times". By providing for the continuous application of section 1.20(i)(4), intraday margin calls to customers could arise on a continuous basis, and AIMA believes that it is unlikely an FCM would fund any margin deficit without either requiring the pre-funding of margin by customers or defaulting their customers where such margin is not provided.<sup>18</sup> AIMA believes that if FCMs are compelled to require their customers to pre-fund margin or to be subject to routine intraday margin calls, that this would mark a significant departure from current market practice and could have a material adverse impact on the liquidity and smooth functioning of the futures and swaps markets.

AIMA, therefore, respectfully requests that the Commission clarify that sections 1.17(c)(5) and 1.20(i)(4) are not duplicative, and further consider the cost and benefits of its proposed changes as to: (i) when and how residual interest requirements are calculated and applied; and (ii) when capital charges are incurred. AIMA also recommends that the Commission implement any changes to the FCM requirement to maintain residual interest only to the extent that this would not lead to a disproportionate increase in costs to customers, such as a requirement for the pre-funding of margin.

## 3. Improvements to the risk management program of an FCM

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<sup>15</sup> *Ibid*

<sup>16</sup> Proposed Rule s1.17(c)(5) and s1.20(i)(4).

<sup>17</sup> In this regard, we note the Commission's of uncertainty as to the costs of maintaining a residual interest at 67916, Proposed Rule.

<sup>18</sup> AIMA further notes that in respect of cleared swaps, the continuous application of s1.20(i)(4) also assumes that the 'LSOC Compliance Calculation' can be performed on a continuous basis, rather than at a point in time (prior to the FCM to making a margin to the relevant derivatives clearing organization).



Under the Proposed Rules, the Commission would require each FCM which carries customer accounts to establish a risk management program designed to monitor and manage the risks associated with its activities as an FCM. This risk management program would include, among other things, an evaluation and monitoring process against which depositories would be assessed, as would the FCM's procedures for assessing the appropriateness of investing customer funds.

As mentioned in section 1 above, it is vital that FCMs, under LSOC, monitor and ensure that their obligations to customers are met by a sufficient value of assets on deposit. AIMA would, therefore, like to register its approval of the Commission's proposals to improve the risk management program of FCMs, as this would go some way to reducing fellow customer risk. We do, however, encourage the Commission to consider the requirement for an FCM's risk management program to include provisions for the establishment and maintenance of an adequate targeted amount of excess funds in customer accounts against the backdrop of the concerns we raise in section 2, above.

#### 4. Full physical segregation

AIMA is supportive of any attempts by the Commission to enhance customer protections and, overall, feels that the Proposed Rules comprise an important part of the wider regulatory regime relating to the oversight of FCMs. We would also encourage the Commission to consider the protections contained in the Proposed Rules, alongside its efforts to foster the development of an optional full physical segregation model. We feel that these efforts, along with the incorporation of AIMA's recommendations for increased transparency and requests for further clarity with respect to sections 1.20(i)(4) and 1.17(c)(5) of the Proposed Rules, are key to the Commission's aim to "...afford greater assurances to market participants that: customer segregated funds and secured amounts are protected...".<sup>19</sup>

Please let us know if you would like to discuss any of the above comments in more detail.

Yours faithfully,

A handwritten signature in blue ink, appearing to read "Jiri Krol". The signature is fluid and cursive, with a large loop at the end.

Jiri Krol  
Director of Government and Regulatory Affairs

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<sup>19</sup> Proposed Rule at 67866