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*NOT ADMITTED TO THE NEW YORK BAR

February 15, 2013

Via Comments Online, <http://comments.cftc.gov>

Ms. Natisa Stowe
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**Re: Comments on Proposed Rule Relating to “Enhancing
Protections Afforded Customers and Customer Funds Held by
Futures Commission Merchants and Derivatives Clearing
Organizations”**

CFTC RIN 3038—AD88

Ladies and Gentlemen:

We are submitting this letter on behalf of a financial institution client in response to your request for comments on proposed rules published by the Commodity Futures Trading Commission (the “*Commission*”) on November 14, 2012 relating to “*Enhancing Protections Afforded Customers and Customer Funds Held by Futures*

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*Commission Merchants and Derivatives Clearing Organizations*¹ (hereafter referred to as the “**Proposed Rulemaking**”). In the Proposed Rulemaking, the Commission is proposing to adopt, among others, certain regulations relating to customer protection, risk management programs, internal monitoring, and capital and liquidity standards in customer accounts. We respectfully submit the following comments addressing concerns of our client regarding certain timing and technical aspects raised by the Proposed Rulemaking.

I. Summary of our Comments

We appreciate the opportunity to comment on some of the aspects of the Proposed Rulemaking with the goal of clarifying timing requirements and other technical details relating to the maintenance of residual interest amounts by a futures commission merchant (“*FCM*”) in each of the three customer account types. Our client shares, and fully endorses, the Commission’s policy objectives in issuing the Proposed Rulemaking to enhance customer protections and buttress controls around FCM risk management, disclosure requirements, and auditing and examination programs. In our comments, we recommend that the Commission (i) revise part of the language implementing the proposed residual interest requirements to clarify that the residual interest amount must be sufficient to exceed the sum of all margin deficits *at the time of any end-of-day or intra-day payment cycle in respect of such margin deficits by an FCM to any clearing organization, clearing member intermediary or other permitted depositories* rather than “at all times,” and (ii) further clarify that, for purposes of satisfying the afore-mentioned residual interest amount requirement, the requirements of Commission Regulation 1.49 with respect to denomination or jurisdiction will not apply.

II. Our Client’s Interest in the Proposed Rulemaking

Our client is a global financial services firm that, through a wholly-owned subsidiary, an FCM registered with the Commission, provides execution and clearing brokerage services in futures and options on futures, foreign futures and foreign options, and cleared swaps to a diverse group of customers. Through its trading and clearing memberships, as well as its global network of affiliate and agent brokerage relationships, our client provides access for its customers to over 60 domestic and foreign futures and derivatives exchanges.

¹ See Commodity Futures Trading Commission— *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations; Proposed Rule*— published at 77 FR 67866 (November 14, 2012).

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III. The Proposed Rulemaking Relating to Residual Interest Amounts Should Be Revised to Clarify the Timing of the FCM's Financial Obligation

The Proposed Rulemaking would require that the FCM's residual interest in each of the segregated futures, foreign futures and foreign options, and cleared swaps customer accounts "at all times" exceeds the sum of outstanding margin deficits. The policy rationale of this proposal is "to provide a mechanism for ensuring compliance with the prohibition of the funds of one customer being used to margin or guarantee the positions of another customer under the [Commodity Exchange] Act and existing [Commission] regulations."²

The Commission specifically requested comment on whether, for purposes of margin deficit calculations, it should address issues surrounding the timing of when an FCM must have sufficient funds in the segregated customer account to cover all margin deficits.³ We believe that the Commission should address such issues.

As used by the Commission, a "margin deficit" occurs when the value of customer funds in a customer account is less than the total amount of collateral required by a derivatives clearing organization (or other clearing house or clearing intermediary) for that account's open positions.⁴ The Commission proposes to affirmatively require an FCM to maintain sufficient funds in each customer account to cover all margin deficits. In particular, an FCM must maintain such residual interest in the relevant account "at all times."⁵

In principle, our client supports the Commission's proposal to establish the residual interest amount to be maintained by an FCM as a measure of the aggregate margin deficits. However, we submit that the Proposed Rulemaking should be clarified in this regard such that the determination of the applicable residual interest amount in respect of margin deficits under all customer transactions would be required *at the time* that the FCM is obligated to margin, guarantee, or secure those transactions. In other words, the amount of required residual interest should be crystallized at the time the FCM is obliged to transfer margin to the applicable clearing house(s) (or clearing intermediaries) in respect of such transactions.

² See 77 FR 67875 FN. 36; see also 77 FR 67896.

³ *Id.* at 67882-83. Although the Commission posed the question with respect to revisions proposed for the segregated futures account origin, we construe and address it as applied to all three customer account origins.

⁴ *Id.* at 67882.

⁵ See, e.g., proposed Commission Regulation 1.20(i)(4), Regulation 22.2(f)(6) and Regulation 30.7(a).

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In a Regulatory Update⁶ following the Commission's promulgation of the cleared swaps customer collateral regulations, the Joint Audit Committee developed a method for sizing the residual interest amount for cleared swaps customer accounts in relation to LSOC margin deficiencies. JAC Update 12-03 is intended to establish a financial control process to ensure that an FCM has contributed a sufficient amount of its own funds to the cleared swaps customer accounts held by it to cover the aggregate gross margin deficiencies of all of its cleared swaps customers.⁷ The process ensures that collateral of one cleared swaps customer is not used to margin the positions of another cleared swaps customer.⁸ Accordingly, the compliance calculation set forth in JAC Update 12-03 is well-suited to apply to the calculation of an FCM's residual interest contribution to any other customer account type as well.

In JAC Update 12-03, the Joint Account Committee adopted a "point-of-payment" approach to the determination of the adequate size of the residual interest buffer.⁹ The stated policy goal of the Joint Audit Committee fits neatly with the primary objective of the Proposed Rulemaking, namely, to ensure that an FCM has appropriately sized the residual interest buffer to cover the aggregated gross margin deficiencies in respect of customer transactions in the relevant account origin. This in turn ensures that collateral of one customer is never used to margin the newly established positions of another cleared swaps customer. Importantly, the determination of the correct residual interest amount should be made at the time of any end-of-day, intra-day or special call payment by an FCM to the derivatives clearing organization (or other clearing house or clearing intermediary) because these are the relevant points in time at which the FCM is obligated to transfer such margin.¹⁰ As set forth in JAC Update 12-03 for cleared swaps customer accounts, the Commission should require that the determination of the adequate residual interest amount be made with respect to all customer transactions prior to any end-of-day or intra-day payment cycle in respect of margin deficits by an FCM to a DCO, clearing house or clearing intermediary relating to such transactions. The point-of-payment calculation ensures that the aggregate of any margin deficits in customer accounts is covered at the point when it actually accrues and crystallizes, thereby ensuring the fundamental policy objective that the collateral of one (futures, 30.7, or

⁶ Joint Audit Committee Regulatory Update #12-03—*Part 22 of CFTC Regulations – Treatment of Cleared Swaps Customer Collateral – Legally Segregated Operationally Commingled ("LSOC") Compliance Calculation*—October 18, 2012 (hereinafter referred to as ("**JAC Update 12-03**")). The Joint Audit Committee is a representative committee of U.S. futures exchanges and regulatory organizations including the: CBOT, CCFE, CFE, CME, COMEX, ELX, Eris Exchange, KCBOT, MGEX, NFA, ICE Clear Credit, ICE Futures U.S., Inc., INET, NADEX, NFX, NYMEX, NYSE Liffe US, and OCX.

⁷ See JAC Update 12-03 at pages 2-4.

⁸ See *id.* at page 4.

⁹ See *id.* (stating that FCM should deposit additional funds to meet the LSOC margin deficiency "before payment is made" to any designated clearing organization).

¹⁰ See JAC Update 12-03 at page 3 and FNs. 3, 4.

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cleared swaps) customer is never used to cover the obligations of another (futures, 30.7 or cleared swaps) customer. Any requirement to determine the residual interest “at all times” is overly burdensome and unnecessary to achieve the stated policy objective.

Accordingly, we propose that the Commission clarify its proposal regarding the sizing of residual interest amounts. An FCM should be required, consistent with the procedures set forth in JAC Update 12-03, to compute the sum of margin deficits in each segregated customer account, and contribute an amount sufficient to cover any such sum (to the extent customer funds have not otherwise been contributed), *prior to the point in time when payment must be made* by the FCM to any derivatives clearing organization (or other clearing intermediary) in respect of the margin requirements relating to such deficits. To implement this clarification, we suggest revising proposed Commission Regulation 1.20(i)(4) to read as follows:

§1.20 Futures customer funds to be segregated and separately accounted for.

* * * * *

(i) * * *

(4) The futures commission merchant must maintain in segregation an amount equal to the sum of any credit balances that the futures customers of the futures commission merchant have in their accounts, excluding from such sum any debit balances that the futures customers of the futures commission merchant have in their accounts. In addition, the futures commission merchant must *maintain prior to any end-of-day or intra-day payment cycle of margin by the futures commission merchant to a derivatives clearing organization* residual interest in segregated funds sufficient to exceed the sum of all margin deficits that the futures customers of the futures commission merchant have in their accounts. Such residual interest may not be withdrawn pursuant to § 1.23 of this part.

Consequently, we also suggest that the Commission adopt equivalent revisions to the language of proposed Commission Regulation 1.11(e)(3)(i)(D), Regulation 1.12(j) (with respect to the new residual interest amount requirements generally), Regulation 1.22(a), Regulation 1.23(c) and 1.23(e) (with respect to the segregated futures account), Regulation 22.2(d) and 22.2(f)(6), Regulation 22.17(b) and 22.17(d) (with respect to the cleared swaps customer account), and proposed Commission Regulations 30.7(a), 30.7(f)(1), 30.7(g)(2) and 30.7(g)(6) (with respect to the foreign futures and foreign options customer account).

IV. The Commission Should Clarify that Commission Regulation 1.49 Shall not Apply to Financing the Residual Interest Requirement

JAC Update 12-03 further provides that, for purposes of meeting any margin deficiency in the cleared swap customer account with a deposit of additional funds prior to payment to any derivatives clearing organization, the requirements of

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Commission Regulation 1.49 with respect to denomination or jurisdiction will not apply.¹¹ The Commission should provide the same interpretive relief to FCMs for the purpose of meeting any residual interest deficiency pursuant to the Proposed Rulemaking.

If an FCM determines at the end of a business day, in computing the sum of all margin deficits in its segregated customer accounts, that its customer accounts show a deficiency relative to the applicable clearing organization (or other clearing intermediary) margin requirement due the next morning, the FCM must deposit additional funds into the account to meet the residual interest amount requirement prior to making payment the next morning. Given that the Fedwire system will be closed after business hours, the FCM may not be able to do so while subject to the denominational and jurisdictional strictures of Commission Regulation 1.49. However, the FCM may satisfy the residual interest shortfall through an additional firm deposit into a segregated depository it has established in a jurisdiction where banks are open during hours when Fedwire is not, thus assuring that it will be compliant with its residual interest requirement at the time the clearing organization debits the FCM's account the next morning (or payment is otherwise made to the relevant clearing intermediary).

We request the Commission's clarification that such process would be satisfactory under the Proposed Rulemaking for the purpose of meeting the residual interest requirement, consistent with the approach adopted in JAC Update 12-03 for topping up any LSOC margin deficiency. Specifically, we request the Commission's confirmation that the requirements of denomination and jurisdiction of Commission Regulation 1.49 do not apply to an FCM's cash management procedures for meeting the proposed residual interest requirement as described herein. Any additional deposit required to eliminate a residual interest deficiency should only represent additional firm excess funds held in the relevant segregated customer account. In addition, any funds deposited to eliminate a residual interest deficiency that are not in compliance with the requirements of Commission Regulation 1.49 should be replaced (as soon as practicable during the next following U.S. banking day) in order to be considered as properly segregated in the relevant segregated customer account.¹² The requirements of Commission Regulation 1.49 would remain fully applicable to the segregation requirements for futures and cleared swaps customer accounts.

¹¹ See JAC Update 12-03 at page 4 and FN. 8.

¹² Additionally, an FCM may not hold customer funds in a restricted country subject to sanctions by the Office of Foreign Assets Control of the U.S. Department of the Treasury. See generally JAC Update 12-03 at page 4 and FN. 8.

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Please contact Manuel Frey (at 212-373-3127) or Edward So (at 212-373-3611) if you would like to discuss any aspect of our response in further detail.

Very truly yours,

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