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By Commission Website

February 15, 2013

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: RIN 3038-AD88: Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 77 Fed.Reg. 67866 (November 14, 2012)

Dear Ms. Jurgens:

The Futures Industry Association ("FIA")[1] welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comment on its proposed amendments designed to afford greater protections to customers and customer assets. FIA strongly endorses the regulatory purpose underlying the proposed rules, *i.e.*, restoring customer confidence in the markets and in the safeguards for the protection of customer funds. This confidence, which is essential to the long-term viability of the futures and derivatives industry, was seriously eroded by the collapse of MF Global Inc. in October 2011 and, more recently, Peregrine Financial Group, Inc.

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1 FIA is the leading trade organization for the futures, options and over-the-counter ("OTC") cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world's largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations ("DCOs"), our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA's core constituency consists of futures commission merchants ("FCMs"), the majority of which are either registered with the Securities and Exchange Commission as broker-dealers or are affiliates of registered broker-dealers. Our larger members are part of integrated financial services companies, with affiliates world-wide. The primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA's regular members, which act as the majority clearing members of the US exchanges, handle more than 90 percent of the customer funds held for trading on US futures exchanges.

To a significant extent, the proposed rules build upon and codify the recommendations that FIA made, and rules that the National Futures Association ("NFA") and the Chicago Mercantile Exchange ("CME") adopted, in early 2012. As the Commission will recall, in January 2012, FIA formed a special committee, the Futures Markets Financial Integrity Task Force, to develop and recommend specific measures that could be implemented in the near term through both industry best practice and regulatory change to address the issues arising from the bankruptcy of MF Global Inc. With the assistance of FIA's Financial Management Committee, whose members include representatives of FIA member firms, DCOs and depository institutions, the Task Force released its Initial Recommendations for the Protection of Customer Funds on February 28, 2012 ("Initial Recommendations"). The Task Force concluded that, with the possible exception of the rules governing the offer and sale of foreign futures and foreign options, the current regulatory framework is fundamentally sound. The Initial Recommendations, which reflect best practices that the FCMs represented on the Committee currently follow, were designed to enhance, not replace, the existing protections.[2]

Concurrently, we issued *Frequently Asked Questions on Customer Funds Protections*, which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets. We revised this document in June 2012 and plan further revisions as we gather comments from regulators on other areas that should be covered, including, as discussed below, certain of the proposed disclosures.[3]

The Commission's proposed rulemaking is complex, affecting virtually every segment of an FCM's business, including financial reporting, operations, compliance and legal, as well as each FCM's affiliates, the depositories in which customer funds are held and, most important, the FCM's customers. Broadly, the proposed rules would seek to strengthen customer protection by requiring each FCM to: (i) maintain more detailed records and submit more detailed reports regarding the location and investment of customer funds; (ii) disclose more detailed information regarding the FCM and its affiliates that may be material to a customer's decision to do business with the FCM; and (iii) enforce a system of policies and procedures to strengthen their risk management programs.

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[2] A copy of the Initial Recommendations may be found at: http://www.futuresindustry.org/downloads/Initial_Recommendations_for_Customer_Funds_Protection.pdf. As a further step in our review of steps to enhance customer protections, FIA joined with the CME Group, NFA and the Institute for Financial Markets in December 2012, to commission Compass Lexecon to conduct an independent study of the costs and benefits of adopting an insurance regime for the US futures industry. Dr. Christopher Culp, an expert in derivatives, risk management, insurance and clearing, is leading the study. The study, which will examine various models for providing insurance in the futures industry and assess a range of variables for each model, will be completed in the spring.

[3] A copy of the *Frequently Asked Questions on Customer Funds Protections* may be found at http://www.futuresindustry.org/downloads/PCF-FAQs.PDF.

Most important, the proposed amendments would require each FCM to maintain a residual interest in each class of customer funds account, *i.e.*, customer segregated account, foreign futures and foreign options secured amount account and cleared swaps customer collateral account, sufficient to exceed *at all times* the sum of all customer margin deficits. As discussed in detail below, the proposed amendments relating to the calculation and maintenance of the residual interest would implement an entirely new interpretation of an FCM's obligations under section 4d(a) of the Commodity Exchange Act ("Act") that will cause a fundamental shift in the manner in which FCMs and their customers have conducted business for a half-century or more and will have a profound impact on the structure of the markets.[4]

Although FIA strongly endorses the regulatory purposes underlying the proposed amendments, we have a number of comments on their specific provisions.[5] Our comments are designed to achieve two principal purposes. First, they are designed to assist the Commission in striking an appropriate balance among its several proposals, in particular the proposed amendments to the Commission's financial rules, to assure that the producers, processors and commercial market participants that use the derivatives markets to manage the risks of their businesses will be able to continue to have cost-effective access to the markets and a choice of FCMs. Second, they are designed to assure that the obligations of FCMs under the proposed rules are clear and that customers receive information that is both consistent and relevant to their evaluation of FCMs.

EXECUTIVE SUMMARY

For the Commission's convenience, set out immediately below is an executive summary of our comments on the proposed amendments. The page numbers on which each of the issues identified are discussed in greater detail follow each bullet point.

- In order to avoid customer confusion in certain circumstances and to assure that FCMs are not subject to duplicative and, perhaps, conflicting reporting and disclosure requirements, FIA encourages the Commission to coordinate its reporting and disclosure requirements with the requirements of the Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA") and the relevant bank regulatory authorities. In particular, it is essential that definitions of certain critical terms be consistent among the several regulatory authorities, e.g., "leverage," "liquidity," "material." (Page 12)

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4 In the context of today's global marketplace, it is also important that the Commission continue to coordinate its regulatory reform proposals with the rules being adopted in response to the G-20 commitment for OTC derivatives reform.

5 We express no view on the proposed amendments to Commission Rule 1.52.

- **Calculation of residual interest.** The proposed amendments to Rule 1.20(i)(4), 22.2(f)(6) and 30.7(a) would require each FCM to maintain at all times a residual interest in each class of customer funds account sufficient to exceed the sum of all customer margin deficits. (Page 12)

    - The proposed amendments would impose a tremendous operational and financial burden on the industry, requiring the development and implementation of entirely new systems to assure compliance. It is essential, therefore, that the Commission not move forward with these amendments until the Commission and all market participants have had an opportunity to consider fully the implications of the proposed amendments and are able to implement them. (Page 13)

    - Implementation of these rules will result in a tremendous drain on liquidity that (i) will make trading significantly more expensive for customers that use the markets to hedge their financial or commercial risks, and (ii) will adversely affect the ability of many FCMs to operate effectively. To the extent the increased costs imposed by the proposed amendments cause traders to withdraw from the markets, market liquidity will be adversely affected and the markets will be less efficient. The price discovery and risk management purposes of the markets, which greatly benefit American consumers and the economy in general, would be significantly impaired. (Page 17)

    - Based on limited data reviewed to date, we estimate that compliance with the provisions of proposed Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) (and related rules) would require FCMs or, more likely, their customers to contribute significantly in excess of $100 billion into customer funds accounts beyond the sum required to meet initial margin requirements. (Page 14)

    - The estimate of the aggregate residual amount is at best imprecise, and almost certainly low. It does not, for example, take into account periods of high volatility or the risk management policies of particular FCMs that may require significantly more funds to be held in customer funds accounts. Nor does it take into account the initial margin requirements on foreign boards of trade. (Page 15)

    - Further, this amount does not include the initial margin requirements for cleared swaps. We understand that ISDA has conducted a separate analysis with regard to the potential impact of these amendments on FCM cleared swaps collateral requirements and has determined that FCMs will require an additional $335 billion in increased funding or margin from cleared swaps customers. (Page 15)

  - To determine the costs of this increased residual interest or margin requirement, we assume that FCMs or their customers will be required to finance this increase. For interest rates, we used the five-year US Treasury Note rate for January 2013 (0.81%) to account for today's low interest rate environment and January 1990 (8.125%) for an indication of the cost in a high interest rate environment. Using this formula, the annual financing costs would range from $810 million ($100 billion x 0.0081) to $8.125 billion ($100 billion x 0.08125). (Page 16)

  - The proposed amendments appear to be based on the Commission's assumption that in order to comply with the provisions of section 4d(a) of the Act, an FCM must assume that all customers with margin requirements will fail to meet that requirement. That has not been the view expressed by the Commission or its predecessor agency, the Commodity Exchange Authority, for more than fifty years. Rather, compliance with the segregation requirements of the Act and the Commission's rules is assured by a number of Commission rules. (Page 18)

  - **Recommended alternative.** If the Commission elects to proceed with this rulemaking, FIA recommends that the Commission consider authorizing FCMs to calculate the sum of the margin deficits once each day, as of the close of business on the first business day following trade date. This alternative will achieve the Commission's regulatory goals without imposing damaging financial and operational burdens on FCMs, and the resulting financial burdens on customers. (Page 23)

  - This schedule will afford FCMs the time to make their margin calls on customers in the morning following trade date, as they do today, and to receive payment during that same business day prior to computing the sum of their margin deficits and adding to their required residual amount, if necessary. (Page 24)

  - This schedule will reduce the significant financial burdens that would otherwise be imposed on customers and FCMs alike under the Commission's proposal, and the resulting adverse impact on market liquidity, while further enhancing the protection of customer funds. (Page 24)

- **Proposed revisions to Form 1-FR-FCM.** The proposed revisions to Form 1-FR-FCM would require an FCM, in demonstrating compliance with proposed Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a), to cover equity debits twice. (Page 25)

  - We believe this result was inadvertent and, therefore, request the Commission to revise the proposed schedules to assure that a customer's net liquidating deficit is not counted twice. (Page 25)

- **Undermargined capital charge.** FIA generally supports the proposed amendments to Commission Rule 1.17(c)(5)(viii) to require an FCM to take a capital charge with respect to any unmet customer maintenance margin requirement that is outstanding more than one business day. (Page 26)

    - To accommodate customers, in particular members of the agricultural community that depend on financing from banks to fund margin requirements, FIA recommends that the proposed amendment be revised to provide that an FCM would be required to take a capital charge with respect to an unmet maintenance margin requirement that is outstanding more than one business day only if the customer's margin deficiency is in excess of \$500,000. If the customer's margin deficiency is \$500,000 or less, an FCM would not be required to take a capital charge until an unmet maintenance margin requirement is outstanding more than two business days. Because an FCM will have met the customer's margin obligation no later than the business day following trade date, this proposed revision will not endanger other customer funds, while providing limited relief to an important segment of the derivatives markets. (Page 27)

- **Residual Interest of FCM in Customer Funds Accounts; Additions and Withdrawals.** FIA supports the proposed amendments to Rules 1.23, 22.17 and 30.7(g), which provide that: (i) an FCM may not withdraw any of its residual interest from a customer funds account for its own proprietary use until it has completed its daily segregation calculation; (ii) an FCM may not withdraw funds for its own proprietary use from customer funds accounts, if such withdrawal(s) would exceed 25 percent of the FCM's residual interest in such accounts as computed as of the close of business on the previous business day, unless the FCM's CEO, CFO or other senior official approves the withdrawal in writing and the FCM files written notice of the withdrawal with the Commission and with its DSRO immediately thereafter; and (iii) if an FCM withdraws a portion of its residual interest for its own proprietary use, and the withdrawal causes the amount held in the customer segregated account to fall below the FCM's targeted residual interest, the FCM must either restore the residual interest to the targeted amount by the close of business the next business day or, if appropriate, revise its targeted residual interest. (Page 27)

    - However, with respect to proposed Rule 1.23(d), FIA believes notice should be required only if the withdrawals exceed 25 percent of an FCM's targeted residual interest, not 25 percent of the FCM's residual interest as reported on the FCM's most recent daily segregation calculation. Under the proposed rules, an FCM that conservatively manages its residual interest may be required to file frequent notices with the Commission, even if it never falls below its targeted residual interest. (Page 29)

- **Location and investment of customer funds.** FIA supports the proposed amendments to Commission Rule 1.32, which would require an FCM to provide more detailed information regarding the computation of the FCM's segregated account calculation and the holding of customer segregated funds. (Page 30)

- **Losses resulting from investment losses.** FIA supports the proposed amendment to Rule 1.29(b) to provide that an FCM or DCO, as applicable, will be solely responsible for any losses resulting from the investment of customer funds under Rule 1.25. (Page 31)

  - In response to the Commission's request for comment, FIA does not believe the Commission's rules 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. FIA believes the 1971 Administrative Determination issued by the Commodity Exchange Authority, the Commission's predecessor agency, sets an appropriate standard of liability in the event of a default of a bank holding customer funds, *i.e.*, an FCM would not be liable if it (i) had used due care in selecting the bank, (ii) had not otherwise breached its fiduciary responsibilities toward the customers, and (iii) had fully complied with the requirements of the Act and the Commission regulations relating to the handling of customers' funds. (Page 32)

- **Capital structure; leverage and liquidity.** FIA supports the proposed amendment to Rule 1.10(b)(5), which would require each FCM, in filing its monthly calculation of adjusted net capital, to include the measure of the FCM's leverage. (Page 33)

  - As noted earlier, however, we believe it is essential that the definition of "leverage" be consistent among the several regulatory authorities with supervisory authority over FCMs. Therefore, FIA encourages the Commission to coordinate with the SEC and the several SRO's to assure that a consistent leverage ratio definition is applied across the industry in order for regulators and customers to have a consistent basis for their review. (Page 33)

  - In this regard, we understand that the Commission's proposed definition of "leverage" is similar to the definition used by FINRA and NFA and that this definition may result in disparate treatment of dually-registered FCM/broker-dealers, on one hand, and stand-alone FCMs, on the other. Such results are subject to misinterpretation. (Page 34)

  - In these circumstances, although FIA does not oppose providing leverage information to the Commission, the Commission should not require disclosure of an FCM's leverage calculation until it is certain that the calculation provides the most appropriate measure of risk. (Page 34)

- The Commission has also proposed to amend Rule 1.17(a)(4) to provide that an FCM that cannot certify to the Commission immediately upon request, and demonstrate with verifiable evidence, that is has sufficient liquidity to continue operating as a going concern must transfer all customer accounts and immediately cease doing business as an FCM until such time as the firm is able to demonstrate compliance. (Page 34)

    - FIA agrees with the regulatory purpose underlying this proposed amendment. However, the Commission should not adopt the rule before it clearly articulates the standards by which it will determine that an FCM has "sufficient liquidity." Standing alone, this term does not establish an objective standard, while vesting considerable authority in the Director of Clearing and Risk and the Director of Swap Dealer and Intermediary Oversight, by delegated authority, to require an FCM to cease doing business. (Page 34)

    - We ask the Commission to confirm that an FCM would be deemed to have demonstrated sufficient liquidity for purposes of Rule 1.17(a)(4) if the required written analysis showing the sources and uses of funds over a short period of time not to exceed one week is prepared in accordance with the procedures established under Rules 1.11 and 1.73. (Page 35)

- **Prohibition on commingling of customer funds.** FIA fully supports the proposed amendments implementing the provisions of sections 4d(a) and 4d(f) of the Act. (Page 36)

    - We ask the Commission to confirm that the proposed amendments would not prohibit a customer that trades multiple products from meeting its multiple margin obligations by making a single payment to the FCM, as is common in the industry today. Single currency payments, pursuant to which funds are received in a single payment and then transferred among the relevant account classes as an equity system transfer across account classes, reduce the FCM's credit risk, are operationally more efficient for both the FCM and its customers, and indirectly reduce customer settlement risk. (Page 36)

- **Limitation on holding the foreign futures and foreign options secured amount outside of the US.** FIA agrees that an FCM should not hold excess funds outside of the US beyond those reasonably necessary to meet the foreign futures and foreign options obligations of its customers. (Page 36)

- The proposed amendment is more restrictive than the provisions of Rule 1.49, which set out the terms and conditions pursuant to which an FCM may hold customer segregated funds and cleared swaps customer collateral outside of the US. We suggest that the proposed amendment to Rule 30.7 should be revised to permit an FCM to hold funds comprising the foreign futures and foreign options secured amount in depositories outside of the US to the same extent that an FCM may hold customer segregated funds and cleared swaps customer collateral outside of the US. (Page 37)

- **Proposed early warning requirements.** The Commission has proposed several amendments to Commission Rule 1.12, which would require an FCM to provide written notice to the Commission and the FCM's DSRO in certain circumstances. Each new requirement would require immediate notice. (Page 37)

  - Although FIA member firms generally are not opposed to providing prompt notice to the Commission and to such member firm's DSRO in the proposed circumstances, we question the need for immediate notice in each instance. If the Commission determines that such early warning notices are required, we believe notice within 24 hours if such event is financial in nature and within 48 hours for business-related events would be appropriate in order to afford FCMs the time to determine the cause of the event and to take appropriate corrective action. (Page 37)

- **Template acknowledgment letters.** FIA strongly supports the adoption of template acknowledgment letters. However, we have concerns regarding specific provisions of the template letters as proposed. (Page 39)

  - We have had the opportunity to review the comment letter filed by several banks with respect to the acknowledgment letters. FIA member firms agree with the concerns expressed and recommendations set out in that letter. (Page 39)

  - In particular, we agree that the standard of liability, which provides that a depository may presume that "any withdrawal from the Account(s) and the balances maintained therein are in conformity with the Act and CFTC regulations without any further inquiry, *provided* that you have no notice of or actual knowledge of, *or could not reasonably know of, a violation of the Act or other provision of law* by us" would expand the obligation of depository institutions to monitor and assure compliance far beyond existing requirements and what is practicable. (Page 39)

  - Compliance with this requirement would likely result in substantial delays in processing transactions and increased costs. (Page 39)

- Separately, although we recognize and appreciate the Commission's desire to have the ability to instruct a depository to transfer customer funds immediately upon notice from appropriate Commission staff, we remain concerned such action may be subject to challenge. We believe that section 6c sets out the procedures that the Commission must follow before seeking to transfer customer funds held by an FCM. These procedures provide for prompt resolution of the issues, while vesting a court, not the Commission, with the authority to determine whether an FCM should be entitled to be heard before an order is issued. (Page 40)

- **Proposed amendments to the risk disclosure statement.** FIA supports the proposed amendments to the risk disclosure statement, subject to certain clarifications. (Page 41)

- **Proposed Disclosure Document.** Proposed Rule 1.55(i) and (j) would require an FCM, prior to entering into an account agreement or first accepting funds from a customer, to furnish such customer a "Disclosure Document" that would include all information about the FCM (i) that would be material to the customer's decision to do business with the FCM and (ii) that is otherwise necessary for full and fair disclosure, including its business, operations, risk profile, and affiliates. (Page 41)

    - FIA supports enhanced disclosure to customers regarding: (i) the risks of trading derivatives; (ii) the relevant provisions of law and the Commission's rules governing the protection of customer funds; and (iii) the FCM through which the customer may elect to trade. (Page 41)

    - We strongly urge the Commission to determine that an FCM that is part of a publicly-traded company, whether US or non-US, or is otherwise required to prepare and make public an annual report including information comparable to that required under this proposed rule may comply with this rule by making such annual report, and any amendments thereto, available on its website. (Page 43)

    - We ask the Commission to confirm that the level of detail required to be provided by privately-held companies should be consistent with that provided in the annual reports of publicly-traded companies. (Page 44)

    - We have divided the information proposed to be included in the Disclosure Document into four categories: (i) information regarding the FCM and its affiliates, which may be provided by making its annual report available on its website; (ii) information that is FCM-specific and, therefore, may be disclosed in a supplemental statement available on its website; (iii) information that is generic to all FCMs and not FCM-specific, which would be discussed in a generic disclosure document that an FCM makes available on its website; and (iv) information that is (or will be) available on NFA's website. (Page 44)

- Information that is (or will be) available on NFA's website should not be required to be provided on the FCM's website. By directing customers to the NFA website, the customer will have access to information with respect to each firm from a single website and can be assured that the information is presented in a consistent manner. (Page 51)

- We believe that neither (i) an FCM's targeted residual interest, nor (ii) the sum of margin deficits in the customer funds account should be made public. Disclosure of the targeted residual interest or the margin deficits without context, e.g., type of customers, markets and products traded, quality of risk management program, serves no meaningful purpose. Further, any changes in the targeted residual interest or margin deficiencies may also be misinterpreted and could unintentionally create a market event. (Page 52)

- For the same reasons, we believe that the daily segregation, secured amount or cleared swaps customer account calculations should not be made available. As the Commission is aware, NFA currently makes this information available on its website as of the 15th and last business day of each month. We believe disclosure twice each month should be sufficient. If the Commission concludes more frequent disclosure is necessary, we recommend that disclosure should be required no more often than weekly, i.e., as of the close of business each Friday (or the last business day of the week if Friday is a holiday). (Page 52)

- **Risk management program.** FIA supports the Commission's proposed new Rule 1.11, which would require each FCM to establish and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the FCM. (Page 52)

    - The standard of liability to which a Chief Compliance Officer is held under proposed Rule 1.11 should be no different from the standard of liability set out in Commission Rule 3.3. That is, the Chief Compliance Officer should not be liable for matters that are beyond the Chief Compliance Officer's knowledge and reasonable belief. (Page 55)

DETAILED DISCUSSION

The Commission should coordinate its reporting and disclosure requirements with the requirements of the SEC, FINRA and the relevant bank regulatory authorities. As an initial and overarching comment, we estimate that, based on the Commission's most recent selected financial data report, approximately 90 percent of all customer funds are held by FCMs that are also (i) registered with the SEC as broker-dealers, (ii) part of a bank holding company, or (iii) are part of a publicly-traded company. As such, these FCMs are required to submit to other financial regulators, or make available to the public, reports that include information comparable to that which the Commission is proposing to require. In order to avoid customer confusion in certain circumstances and to assure that FCMs are not subject to duplicative and, potentially, conflicting reporting and disclosure requirements, FIA encourages the Commission to coordinate its reporting and disclosure requirements with the requirements of the SEC, FINRA and relevant the bank regulatory authorities. In particular, it is essential that definitions of certain terms be consistent among the several regulatory authorities, *e.g.*, "leverage," "liquidity," "material."

We begin our comments on specific rules with the proposed amendments to the Commission's financial and reporting requirements that, collectively, are intended to enhance the protection of customer funds.

I. PROPOSED AMENDMENTS TO THE COMMISSION'S FINANCIAL AND REPORTING REQUIREMENTS[6]

1. Calculation of Residual Interest[7]

Proposed Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) would require each FCM to maintain *at all times* a residual interest in each class of customer funds account sufficient to exceed the sum of all customer margin deficits.[8] The purpose of the proposed amendments is "to provide a mechanism for ensuring compliance with the prohibition of the funds of one customer being

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6 Our comments focus primarily on the proposed amendments to Part 1 of the Commission's rules. However, our comments apply equally to the parallel provisions set out in Part 22 and Part 30 of the rules identified herein.

7 Commission Rules 1.23 and 22.2(e) currently authorize each FCM, notwithstanding the provisions of section 4d(a)(2) and 4d(f), respectively, to hold a portion of its proprietary funds in a customer funds account "as it may deem necessary to ensure any and all futures customers' accounts from becoming undersegregated at any time." Commission Rule 1.23. The sum of the proprietary funds held in a customer funds account is described as the FCM's "residual interest" in that account.

8 Proposed Rules 1.22(a), 1.23(c), 22.17(b), 30.7(f)(1), 30.7(g)(2) and 30.7(l) similarly provide that an FCM's residual interest must at all times exceed the sum of all margin deficits that the customers in the relevant account class have in their accounts. "A margin deficit occurs when the value of the futures customer funds for a futures customer's account is less than the total amount of collateral required by DCOs for that account's contracts." 77 Fed.Reg. 67866, 67882 (November 14, 2012).

used to margin or guarantee the positions of another customer under the Act and existing regulations."[9]

This obligation, of course, is not new. The provisions of section 4d(a) of the Act prohibiting an FCM from using the funds of one customer "to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held,"[10] has been the lynchpin of customer funds protection since the Commodity Exchange Act was enacted in 1936. The current regulatory regime, discussed below, has been inordinately successful in assuring compliance with these provisions of the Act.[11]

We strongly support reasonable efforts to further enhance the protections afforded customer funds and suggest an alternative approach to achieving the Commission's regulatory goals later in this letter. However, as proposed by the Commission, the amendments will cause a fundamental shift in the manner in which FCMs and their customers have conducted business for a half-century or more and will have a profound impact on the structure of the markets. It is essential, therefore, that the Commission not move forward with these amendments until the Commission and all market participants have had an opportunity to consider fully the implications of the proposed amendments and are able to implement them.

Unfortunately, it is not evident from the Federal Register release accompanying the proposed amendments that the Commission considered the proposed rules' potential consequences in their entirety. The Commission's analysis of the potential costs of the proposed rules appears to focus solely on (i) the potential limitation on investment options that would be available to FCMs and (ii) the potential desire of some FCMs to increase their capital to meet operational needs.[12] We do not believe the potential costs are so benign. To the contrary, the proposed amendments would impose a tremendous operational and financial burden on the industry, requiring the development and implementation of entirely new systems to assure compliance. As important, we believe that the proposed rules will have a significant impact on liquidity, both in the markets and among market participants, and on competition among FCMs.

In this latter regard, FIA has retained an experienced consultant to assist in collecting and analyzing certain FCM financial data (public and non-public) and other publicly-available financial data critical to a more complete understanding of the potential impact of these rules

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9 *Id.*, at 67875.

10 Act, § 4d(a)(2).

11 No regulatory regime is able to protect completely against fraud or gross misconduct.

12 *Id.*, at 67916. With regard to the benefits of the proposed rules, the Commission simply states: "The proposed rule would specify that FCMs must maintain residual interest in customer segregated accounts that is larger than the sum of all customer margin deficits, which would ensure that the FCM is not using one customer's funds to purchase, margin, secure, or settle positions for another customer."

on particular firms and the industry generally. This effort is still in its early stages, and we respectfully reserve the right to file additional comments as the analysis moves forward. However, we believe only the Commission has access to industry-wide information, or the ability to obtain such information, that will allow a more complete, holistic consideration of the costs and benefits of these proposed rules. We urge the Commission to do so.

Nonetheless, based on the limited data reviewed to date, we estimate that compliance with the provisions of proposed Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) (and related rules), in particular the requirement that each FCM maintain at all times a residual interest sufficient to exceed the sum of all margin deficits that the customers in each account class have, would require FCMs or, more likely, their customers to contribute significantly in excess of $100 billion into customer funds accounts beyond the sum required to meet initial margin requirements.

As noted, the proposed rules require each FCM *at all times*[13] to maintain residual interest in each customer account class sufficient to exceed the sum of all margin deficits that the customers in that class have in their accounts. To assure compliance with these rules, an FCM would be required to calculate, with a high level of confidence, the potential amount of margin that the FCM may be required to deposit with each DCO daily to margin new and existing customer positions before receiving the necessary reports from the DCO. Although each firm is different, Commission Rule 39.13(g) provides an appropriate guide for making this calculation. This rule requires each DCO to establish initial margin requirements "sufficient to cover the [DCO's] potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the [DCO] estimates that it would be able to liquidate a defaulting clearing member's positions. . . . The actual coverage of the initial margin requirements . . . shall meet an established confidence level of at least 99 percent."[14]

This method yields a simple result: the minimum residual interest that an FCM would be required to hold in each customer funds account is equal to the average gross initial margin requirement for all customers in the account class. This sum is in addition to the initial margin required for each new position.

The Chicago Mercantile Exchange ("CME"), ICE Clear US and ICE Clear Europe (collectively, "ICE") have provided us with the average gross customer initial margin requirements for selected periods for transactions executed on US designated contract

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[13] As explained below, based on discussions between Commission staff and FIA representatives, we believe Commission staff may recommend that this provision of the proposed rules be revised to be at least consistent with the requirements currently imposed on FCMs under Part 22 of the Commission's rules relating to cleared swaps customer accounts. That is, an FCM's obligation to assure that the firm's contributed asset amount covers margin deficiencies should be determined not *at all times*, but at a fixed time each business day. This expected revision does not change the analysis that follows.

[14] Commission Rule 39.13(g)(2)(ii) and (iii).

markets. The CME and ICE have advised us that for periods since the January 15, 2013 compliance date of Commission Rule 39.13(g)(8), requiring DCOs to collect initial margin on a gross basis, the average daily gross customer initial margin requirement has been approximately $61 billion and $37.8 billion, respectively. Therefore, under the proposed formula for sizing residual interest, CME and ICE clearing members would be required, at a minimum, to contribute in the aggregate approximately $100 billion in residual interest into their total segregated accounts.

We recognize that the amount of residual interest required would be reduced by the amount of excess funds an FCM may require its customers to deposit. However, a significant number of customers, in particular institutional customers, currently do not maintain excess margin with their FCMs. Rather, they do not receive, and are not required to meet, a margin call until the day following the date on which the trade has been executed.[15] Requiring a large percentage of customers to hold excess margin in a customer funds account, therefore, would substantially alter the established relationships between FCMs and their customers.

We emphasize that the estimate of the aggregate residual amount above is at best imprecise, and almost certainly low. It does not, for example, take into account periods of high volatility or the risk management policies of particular FCMs that may require significantly more funds to be held in customer funds accounts. Nor does it take into account the initial margin requirements on foreign boards of trade. In these circumstances, therefore, we believe it is appropriate to conclude that that compliance with the proposed amendments would require FCMs or, more likely, their customers to hold significantly in excess of $100 billion in customer funds accounts beyond the sum required to meet initial margin requirements. When further analysis is complete, we believe that the amount of additional funds required to be held in the customer funds accounts, either in the form of additional margin or increased residual interest will, conservatively, be significantly more.

Further, this amount does not include the initial margin requirements for cleared swaps. In this regard, we understand that ISDA has conducted a separate analysis with regard to the potential impact of these amendments on FCM cleared swaps collateral requirements and has determined that FCMs will require an additional $335 billion in increased funding or margin from cleared swaps customers.

For purposes of determining the costs of this increased residual interest or margin requirement, our consultant assumed that FCMs or their customers will be required to

[15] The Commission acknowledged this longstanding industry practice in proposing an amendment to Rule 1.17(c)(5)(viii), discussed below. In explaining its proposal to reduce the period of time before an FCM would be required to take a charge for an unmet customer margin requirement from three business days to one business day, the Commission explained: "For purposes of these Commission regulations, a margin call is presumed to be issued by the FCM the day after an account becomes undermargined." 77 Fed.Reg. 67866, 67881 (November 14, 2012).

finance this increase.[16] Therefore, we next considered the financing costs that could be incurred for the industry. For interest rates, our consultant used the five-year US Treasury Note rate for January 2013 (0.81%) to account for today's low interest rate environment and January 1990 (8.125%) for an indication of the cost in a high interest rate environment.[17] Using this formula, the annual financing costs would range from $810 million ($100 billion x 0.0081) to $8.125 billion ($100 billion x 0.08125).[18]

To examine the potential impact on individual FCMs, our consultant analyzed data received from fourteen FCMs representing a broad spectrum of the FCM community, *i.e.*, adjusted net capital (from $10 billion and above to $100 million and below), market participants served (investment managers and hedge funds, pension plans, the agricultural community and retail speculators) and markets traded (financial, energy markets, agricultural and precious metals).[19] Each firm that responded provided data regarding (i) its average and highest single day net liquidating deficits, and (ii) its average and highest single day margin deficits over the preceding 18 months (July 2011-December 2012). It should be noted that, although the markets experienced increased volatility during the second half of 2011, volatility did not approach the levels seen in 2008. As such these estimates should be seen only as a representation of recent activity and not as an absolute maximum funding impact.

Among the FCMs represented (for segregated and secured amount accounts combined), average net liquidating deficits during this 18-month period ranged from approximately $68,000 to $31.9 million, while the highest single day net liquidating deficits incurred over this period ranged from approximately $6.8 million to $450.6 million.

In contrast, among the FCMs represented (for segregated and secured amount accounts combined), the average margin deficits during this period ranged from approximately $32.6 million to approximately $884.5 million, while the highest single day margin deficits ranged from approximately $101.2 million to approximately $6.1 billion.

In order to assure compliance with the proposed amendments, we assume that each firm would be required to maintain as its residual interest (or require its customers to maintain as excess margin) an amount that exceeds the highest single day margin deficits that the firm has experienced. Using the same five-year US Treasury Note interest rates above, the annual financing costs for each FCM represented would range from approximately $820,000 ($101.2 million x 0.0081) to $49.4 million ($6.1 billion x 0.0081) in today's low interest rate

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16 We understand that FCMs that obtain financing from an affiliate will nonetheless be charged a market rate for use of the funds.

17 We understand that firms that are affiliated with large financial enterprises would raise the money in the capital markets over five years to assure that the funds would be available in times of stress

18 Since these interest rates do not reflect counterparty credit risk, the estimates are conservative.

19 In order to preserve confidentiality, each FCM provided the data directly to FIA's outside counsel and through counsel to FIA's consultant. This information was not shared with FIA staff.

environment. In a higher interest rate environment similar to January 1990, the annual financing costs for each FCM represented would range from approximately $8.2 million ($101.2 million x 0.08125) to approximately $495.6 million ($6.1 billion x 0.08125). As above, since these interest rates do not reflect counterparty credit risk, the estimated financing costs are conservative.

In many cases, especially among mid-size firms, the FCM's liquidity would have been severely stressed if the firm had been required to hold the full amount of the margin deficits in the customer funds accounts. In these circumstances, in order to reduce the risk that they will be required to increase substantially, and perhaps rapidly, their aggregate residual interest in the customer funds accounts, and thereby adversely affect their liquidity, many FCMs are likely to have no choice but to require additional margin from their customers.[20] Such a result conflicts with customers' desire, particularly following the failure of MF Global Inc. and Peregrine Financial Group, to reduce the amount of funds maintained with their FCMs.

In either case, implementation of these proposed amendments will result in a tremendous drain on liquidity that (i) will make trading significantly more expensive for customers hedging their financial or commercial risks, and (ii) will adversely affect the ability of many FCMs to operate effectively. To the extent the increased costs imposed by the proposed amendments cause traders to withdraw from the markets, market liquidity and the costs to customers hedging their financial or commercial risks will be further adversely affected.

The proposed amendments mark a significant change in the manner in which the residual amount is calculated. As the Commission is aware, the proposed change in the manner in which an FCM is required to calculate its residual interest is a significant departure from the interpretation of this requirement that precedes the creation of the Commission. Under the existing interpretation, an FCM is deemed to be in compliance with the segregation requirements of the Commodity Exchange Act and the Commission's rules, if the FCM holds residual interest in a customer funds account in the amount required by performing the daily segregation calculation required under Commission Rule 1.32 to prevent the account from becoming undersegregated.[21] This calculation requires an FCM to

[20] The potential risks to which an FCM would be exposed is emphasized by the Commission's proposed amendments to Rule 1.17(a)(4), which provides that an FCM that cannot certify to the Commission immediately upon request, and demonstrate with verifiable evidence, that is has sufficient liquidity to continue operating as a going concern must transfer all customer accounts and immediately cease doing business as an FCM until such time as the firm is able to demonstrate compliance.

[21] "Section 4d(2) of the act forbids the commission merchant to commingle customers' money, securities, or property with his own, to use customers' funds to finance his own business, or to use one customer's funds to finance the transactions of another. Section 1.32 of the regulations, which is designed to help implement this section of the act, requires a computation showing the amount of money, securities, and property which must be in segregation in order to comply with the requirements of the Act." Commodity Exchange Authority Administrative Determination No. 195, October 30, 1963.

hold an amount at least equal to the sum of the net liquidating deficits and net debit balances in the FCM's customer accounts.[22] FCMs, however, generally hold as residual interest, *i.e.*, their targeted residual amount, an amount considerably in excess of this amount.

The Commission acknowledged this interpretation as recently as 2001 in adopting an amendment to Commission Rule 1.32 to permit an FCM, in computing the amount of customer funds required to be held in segregated accounts to offset a net liquidating deficit or debit ledger balance in a customer's account with securities that have a "ready market", as defined by SEC Rule 15c3–1(c)(11), and that are deposited by such customer to margin or guarantee the futures and option positions in such customer's account. In describing Rule 1.32, the Commission observed:

> Section 4d of the Act . . . prohibits an FCM from using the money, securities, or property of one customer to margin or secure futures or option positions of another customer. Commission Regulations 1.20 through 1.30 implement the segregation of funds provisions of Section 4d. Rule 1.32, a related recordkeeping regulation, requires each FCM to prepare a daily computation which shows: (1) The amount of funds that an FCM is required to segregate for customers who are trading on U.S. commodity exchanges pursuant to the Act and Commission regulations; (2) the amount of funds the FCM actually has in segregated accounts; and (3) the amount, if any, of the FCM's residual interest in the customer funds segregated.[23]

Other Commission rules currently assure compliance with the provisions of section 4d(a) of the Act. The proposed amendments appear to be based on the Commission's assumption that in order to comply with the provisions of section 4d(a) of the Act, an FCM must assume that *all* customers with margin requirements will fail to meet that requirement. That has not been the view expressed by the Commission or its predecessor agency, the Commodity Exchange Authority, for more than fifty years. Rather, compliance with the segregation requirements of the Act and the Commission's rules is assured by a number of Commission rules.[24]

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[22] As the Commission has previously explained: "A distinction is sometimes drawn between a net liquidating deficit and a debit balance. A net liquidating deficit is an amount owed to the FCM resulting from the combination of the customer's debit or credit ledger balance and the mark-to-market gain or loss on any open positions in the customer's account. A debit balance is the amount owed to the FCM by the customer represented by the debit ledger balance, and implies that there are no open positions in the account." 66 Fed.Reg. 41131 (August 7, 2001).

[23] *Id.*

[24] Nor is this view consistent with the Commission's view of the obligations of DCOs to protect against default. The Commission previously proposed that a systemically important DCO be required to maintain financial resources sufficient to enable it to meet its financial obligations to its clearing members notwithstanding a default by the two clearing members creating the largest combined financial exposure for the

Most important in this regard are the Commission's minimum net capital rules, pursuant to which an FCM's adjusted minimum net capital requirement increases in tandem with the margin obligations of its customer and non-customer margin obligations. Rule 1.17(a)(1)(i)(B) provides that an FCM must maintain adjusted net capital at least equal to the FCM's "risk-based capital requirement, computed as eight percent of the total risk margin requirement for positions carried by the [FCM] in customer accounts and noncustomer accounts."[25]

The capital rules also require an FCM to take an undermargined capital charge in the full amount of any unmet minimum margin requirement less credit equity outstanding more than three business days.[26] The Commission has proposed in this rulemaking to amend this rule to require an FCM to take a capital charge in the full amount of any unmet maintenance margin requirement outstanding for more than one business day. The purpose of the capital charge is to assure that FCMs have the resources to meet a margin call in the event that the account owner fails to do.[27]

Another rule proposed in this rulemaking that further supports compliance with the segregation requirements is proposed Rule 1.11(e)(3)(i), which would require each FCM to establish, maintain and enforce written policies and procedures reasonably designed to

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systemically important derivatives clearing organization in extreme but plausible market conditions. *Financial Resources Requirements for Derivatives Clearing Organizations*, 75 Fed.Reg. 63113, 63119 (October 14, 2010). Although the Commission subsequently deferred taking final action on this proposal, we note that the proposal is consistent with the CPSS-IOSCO *Principles for Financial Market Infrastructures*, published in April 2012:

> [A] CCP that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. Principle 4: Credit Risk, p. 36.

We respectfully suggest that, if a systemically important DCO is required to hold financial resources sufficient to cover the default of only its *two* largest participants, it is not appropriate to require an FCM to hold collateral as its residual amount sufficient to cover the default of *all* customers.

[25] Further, in accordance with Rule 1.12(b)(2), an FCM must notify the Commission and its DSRO within 24 hours if its adjusted net capital at any time is less than 110 percent of its minimum adjusted net capital requirement.

[26] Rule 1.17(c)(5)(viii). Pursuant to the provisions of Commission Rule 1.17(c)(5)(ix), an FCM is required to take an undermargined capital charge in the full amount of an unmet minimum margin requirement, when a non-customer or customer omnibus account margin call is outstanding more than two business days.

[27] As discussed below, FIA generally supports the proposed amendment to Rule 1.17(c)(5)(viii). However, if the Commission elects to adopt the amendments to Rule 1.20(i)(4), 22.(f)(6) and 30.7(a) as proposed, the Commission may wish to consider whether the undermargined capital charge will be necessary, since the FCM will already have transferred funds to the customer funds account to meet the minimum margin requirement..

ensure that customer funds are separately accounted for and segregated or secured as belonging to customers, as required. Such policies and procedures must describe the process by which the FCM establishes the targeted residual interest that the FCM seeks to maintain as its residual interest in the customer funds accounts. These policies and procedures must be approved by senior management and be designed to reasonably assure that the FCM maintains its targeted residual amount and remains in compliance with the customer funds requirements at all times.[28]

Also important are the proposed amendments to Commission Rule 1.23, discussed below, which provide that: (i) an FCM may not withdraw any of its residual interest from the customer funds account for its own proprietary use until it has completed its daily segregation calculation;[29] (ii) an FCM may not withdraw funds for its own proprietary use from customer funds accounts, if such withdrawal(s) would exceed 25 percent of the FCM's residual interest in such accounts as computed as of the close of business on the previous business day, unless the FCM's CEO, CFO or other senior official approves the withdrawal in writing and the FCM files written notice of the withdrawal with the Commission and with its designated self-regulatory organization ("DSRO") immediately thereafter;[30] and (iii) if an FCM withdraws a portion of its residual interest for its own proprietary use, and the withdrawal causes the amount held in the customer segregated account to fall below the FCM's targeted residual interest, the FCM must either restore the residual interest to the targeted amount by the close of business the next business day or, if appropriate, revise its targeted residual interest.[31]

Separately, the provisions of proposed Rule 1.32(f) require an FCM to report to the Commission and the FCM's DSRO the names of all banks, trust companies, FCMs, DCOs, or any other depository or custodian holding customer funds as of the fifteenth day of the month, or the first business day thereafter, and the last business day of each month.[32]

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[28] These provisions of Rule 1.11 mirror the requirements of Section 16 of NFA's Financial Requirements adopted in 2012. We understand that Commission staff have visited a number of FCM's to discuss the manner in which they are complying with the NFA requirement.

[29] Proposed Rule 22.17(b) and proposed Rule 30.7(g)(2) impose the same requirements with respect to the cleared swaps customer collateral account and foreign secured amount account, respectively.

[30] Proposed Rule 22.17(b) and proposed Rule 30.7(g)(3)-(4) impose the same requirements with respect to the cleared swaps customer collateral account and foreign secured amount account, respectively. As discussed below, FIA is recommending that Rule 1.23(d) be revised to provide that notice should be required only if the withdrawals exceed 25 percent of an FCM's targeted residual interest, not 25 percent of the FCM's residual interest as reported on the FCM's most recent daily segregation calculation.

[31] Proposed Rule 22.17(d) and proposed Rule 30.7(g)(6) impose the same requirements with respect to the cleared swaps customer collateral account and the foreign secured amount account, respectively.

[32] These proposed amendments mirror the requirements of CME Rule 971 and Section 16 of NFA's Financial Requirements adopted in 2012.

Further, the Commission has adopted Rule 1.73, requiring each clearing member FCM to establish risk-based limits in the proprietary account and in each customer account and to screen orders for compliance with such risk-based limits, conduct weekly stress tests of positions held in customer accounts, and evaluate the ability to orderly liquidate customer accounts on a quarterly basis. The Commission has also proposed Rule 1.11 to require each FCM to establish, maintain and enforce a comprehensive risk management program "designed to monitor and manage the risks associated with the activities of" an FCM. Finally, Rule 39.13(g)(8) requires each DCO to "collect initial margin on a gross basis for each clearing member's customer account(s) equal to the sum of the initial margin amounts that would be required by the [DCO] for each individual customer within that account if each individual customer were a clearing member."

These rules, in the aggregate, assure compliance with the requirements for the protection of customer funds set out in the Act and the Commission's rules thereunder. Additionally, the rules serve to reduce fellow customer risk by assuring that more funds are on deposit at the DCO and by placing more explicit risk management responsibilities on the FCM. In light of the numerous customer funds protections already in place, and the significant costs that the proposed amendments to Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) would impose on FCMs, their customers and the markets generally, we respectfully submit that the Commission should not proceed to adopt them until the Commission and all market participants have had an opportunity to experience the additional customer protections that the Commission is proposing and to consider fully the implications of the proposed amendments.[33]

Implementation of the proposed amendments would be operationally burdensome, if not impossible. The proposed amendments require FCMs to have the ability to know *at all times* the status of each customer's account. FCM systems currently do not permit *at all times* calculations, and designing, developing and implementing the changes necessary to permit *at all times* calculations would be a multiyear project, requiring radical changes to the current processing procedures.[34]

The backbone for all applicable data related to customer accounts is the end-of-day batch processing, which occurs overnight following the close of trading each day. Margin and commission processing (including all exchange and DCO fee calculations) take several hours to run. Intraday runs would be a major drain on technology resources and would cause many other essential systems to slow or fail.[35] DCOs would be required to coordinate

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[33] If the Commission adopts our recommendation, the Commission should further consider any conforming amendments to Proposed Rules 1.22(a), 1.23(c), 22.17(b), 30.7(f)(1), 30.7(g)(2) and 30.7(l) that may be required.

[34] Finally, we note that multi-currency trading, settlements and timing of conversions and payments will delay the valuation processes.

[35] Downstream regulatory reports, which are currently available only after the end-of-day batch processing would also need to be created for the intraday runs.

the times at which they provide information to their clearing members in order to prevent FCMs from having to conduct multiple intraday runs.

End-of-day cash and collateral valuations are also processed during the nightly batch processing following receipt of the necessary data from the relevant DCO. Intraday valuations would be imprecise, at best, requiring (i) receipt of updated SPAN arrays, trade pricing and options valuations from each DCO, and (ii) coordination among various departments within the FCM, including treasury, asset servicing and wire transfers. Moreover, the movement of cash through the banking system can be subject to delays and customers have limited control over the time that funds will actually be delivered to the FCM.

Further, as the Commission is aware, a significant number of trades, if not a majority, are executed and cleared pursuant to give-up arrangements, *i.e.*, the trade is executed by or through one clearing member and subsequently given up for clearing to another clearing member. With respect to bunched orders placed by an investment manager, these trades may first be average-priced before being given up to several clearing members. As a result, it may be several hours following the execution of a trade before a clearing member is even aware that the trade will be allocated to its customer's account. Particularly with respect to bunched orders and give-up transactions, therefore, the clearing member will not be aware of all of its customers' net positions intraday.

The requirement that FCMs maintain residual interest in a customer funds account *at all times* sufficient to exceed the sum of all margin deficits that the customers have in their accounts is inconsistent with the Commission's current policy with respect to the cleared swaps customer collateral account. Over a period of approximately six months beginning in late Spring 2012, Commission staff met with members of the Joint Audit Committee ("JAC") and members of an FIA working group, including a broad spectrum of market participants, to develop policies and procedures to implement the requirements of the Commission's Part 22 rules. At the conclusion of those meetings, the staff concluded that the obligation to assure that an FCM's firm contributed asset amount covers margin deficiencies should be determined not at all times, but at the time a payment is required to be made to a DCO. This policy reflects the conclusion that funds are not used to satisfy customer obligations until a payment is made to a DCO to satisfy initial or variation margin calls. As the JAC explained:

> For clarity, at the end of each day, an FCM should complete its LSOC Compliance Calculation prior to the first end-of-day settlement payment (occurring on the following business day). Such calculation will be the basis for all end-of-day payments, unless an intra-day or special call is made by a DCO before an end-of-day payment is made. In such case, the LSOC Compliance Calculation will need to be updated for the intra-day/special call along with any collateral settlements made with any cleared swaps customers

> depositories. Likewise, the LSOC Compliance Calculation will need to be updated prior to any intra-day call in the same manner.[36]

Elsewhere in the JAC Update, the JAC reconfirms that an FCM will be in compliance with Commission rules and notice requirements if the LSOC Compliance Calculation reflects a shortfall in firm contributed assets to cover the LSOC margin deficiency, *provided* the FCM deposits additional funds to meet the shortfall before payment is made to any DCO. Absent an LSOC Compliance Calculation, an FCM may use its own funds exclusively to satisfy payment to a DCO.[37]

If the Commission elects to proceed with this rulemaking, FIA recommends that the Commission consider authorizing FCMs to calculate the sum of the margin deficits once each day, as of the close of business on the first business day following trade date. This alternative will achieve the Commission's regulatory goals without imposing damaging financial and operational burdens on FCMs, and the resulting financial burdens on customers. For the reasons explained above, we believe the Commission should not move forward with these amendments until the Commission and all market participants have had an opportunity to consider fully their implications. If the Commission nonetheless elects to proceed with the rulemaking, we submit that an FCM should not be required to calculate the margin deficits in each customer account class more than once each business day and, further, that such calculation be made as of the close of business on the first business day following trade date.

Under this suggested alternative to the Commission's proposal, each FCM would continue to meet DCO settlement payments within the time required by the DCO and to perform its daily segregation calculations (as proposed to be amended) by noon the following business day. As under current rules, therefore, each FCM would continue to be required to maintain a residual interest in its customer funds accounts at least sufficient to meet the aggregate of its customers' net liquidating deficits.[38] In addition, at a point in time prior to the end of each trade date (*e.g.*, 4:00 pm), the FCM would compute the sum of its margin deficits remaining for the preceding trade date. By the close of business on each business day, the FCM would be required to maintain a residual interest in its customer funds accounts at least equal to its customers' aggregate margin deficits for the prior trade date.

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36 Joint Audit Committee Update 12-03, Part 22 of Commission Regulations – Treatment of Cleared Swaps Customer Collateral – Legally Segregated Operationally Commingled ("LSOC") Compliance Calculation (October 18, 2012).

37 To the extent that a DCO, such LCH.Clearnet Ltd., makes intraday margin calls, an FCM is able to comply with the requirements of Part 22 by depositing its own funds with the DCO.

38 As discussed above, FCMs generally hold as residual interest in the customer funds accounts, *i.e.*, their targeted residual amount, an amount considerably in excess of this amount.

In other words, each segregation computation would include margin deficiencies of those accounts maintaining margin calls aged more than one business day. For example, a deficiency created as of close of business Monday would be excluded from the close of business Monday segregation computation. However, if the FCM is unable to collect the deficiency on Tuesday, the FCM's residual interest would be required to cover the deficiency as of close of business Tuesday. In order to avoid the double counting of an equity debit, the margin deficiency for this purpose would never exceed the applicable maintenance margin requirement.[39]

This schedule will afford FCMs the time to make their margin calls on customers in the morning following trade date, as they do today, and to receive payment during that same business day prior to computing the sum of their margin deficits and adding to their residual amount, if necessary.[40] We submit that this schedule will reduce the significant financial burdens that would otherwise be imposed on customers and FCMs alike under the Commission's proposal, and the resulting adverse impact on market liquidity, while further enhancing the protection of customer funds.[41]

In order to implement this alternative proposal, proposed Rule 1.20(i)(4) would be revised to read as follows:

> 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 as of close of business each business day ~~at all times~~ maintain residual interest in segregated funds sufficient to exceed the sum of all uncollected margin deficits from the previous close of business that the futures customers of the futures commission merchant have outstanding in their accounts, calculated as the amount of funds required in each such account to meet minimum margin requirements related to such positions as required by the applicable board of trade or derivatives clearing organization; *provided*, that, to the extent a net liquidating equity deficit exists in such account, the amount shall not exceed the account's applicable board of trade

[39] No additional "LSOC Compliance Calculation" will be required, although FCMs will be required to monitor for the receipt of funds throughout the day in order to fund for deficiencies where the customer failed to meet their margin call.

[40] We have not had an opportunity to collect data demonstrate the effect of this proposed alternative. We would be pleased to work with the Commission to collect any data it would consider relevant in its consideration of the proposal.

[41] As explained above, we believe that the Commission's existing regulatory regime already assures the protection of customer funds as required under section 4d(a) of the Act.

> or derivatives clearing organization minimum margin requirement. Such residual interest may not be withdrawn pursuant to § 1.23 of this part.

Similar revisions would be made to the parallel provisions of Commission Rules 22.2 and 30.7.

2. Proposed revisions to the Form 1-FR-FCM to implement the provisions of Rule 1.20(i)(4) result in an FCM being required to cover any accounts maintaining an equity debit twice.

To demonstrate compliance with proposed Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a), the Commission proposed revisions to the segregation computations included as schedules to the Form 1-FR-FCM. Specifically, a line item for "Sum of Margin Deficits" would be inserted and compared with "Excess/Deficiency Funds in Segregation" (*i.e.*, residual interest). However, debit equity maintained in trading accounts which are also undermargined will be captured in both the "Sum of Margin Deficits" and residual interest amounts. Consider the following example:

	Account 1
Ledger Balance	100,000
Open Trade Equity	(250,000)
Net Option Value	-0-
Net Liquidating Value	(150,000)
Securities on Deposit	-0-
Initial Margin Requirement	50,000
Margin Excess (Deficiency)	(200,000)

In order to maintain sufficient residual interest in customer funds accounts under the current rule, an FCM will be required to assure that it has contributed at least $150,000 to segregation, since the customer's trading account does not maintain the financial wherewithal to cover the variation margin amount due for the positions it holds. If the FCM were to compute its residual interest as required under the proposed schedule, however, it would need to contribute an additional $200,000 to the customer funds account. This would result in the FCM covering the $150,000 net liquidating deficit in the account twice. We believe this result was inadvertent and, therefore, request the Commission to revise the proposed schedules to assure that a customer's net liquidating deficit is not counted twice.[42]

3. Undermargined Capital Charge

As noted earlier, the Commission has proposed to amend Rule 1.17(c)(5)(viii) to require an FCM to take a capital charge with respect to any unmet customer maintenance margin requirement that is outstanding more than one business day.[43] The rule currently requires an FCM to take a capital charge with respect to any unmet customer maintenance margin requirement that is outstanding more than three business days.[44]

In support of this proposed amendment, the Commission explains that "with the increasing use of technology, 24-hour-a-day trading, and the use of wire transfers to meet margin obligations, . . . the timeframe for taking a capital charge should be reduced both to incentivize FCMs to exercise prudent risk management and to strengthen the financial protection of FCMs, their customers and the clearing systems by requiring the FCMs to reserve capital for undermargined customer, noncustomer, and omnibus accounts that fail to meet margin calls on a timely basis."[45]

FIA agrees that institutional and many commercial market participants generally meet margin calls by means of wire transfer. Nonetheless, reducing the numbers of days to satisfy a margin call creates certain operational problems because it does not consider delays arising from accounts located in other time zones that cannot settle same day or ACH settlements, or the requirement to settle or convert certain non-USD currencies.

Moreover, a substantial number of less well-capitalized customers, in particular members of the agricultural community that use the derivatives markets to manage the risks of their businesses depend on financing from banks to fund margin requirements. The banks, in

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42 The comment with respect to the schedules to Form 1-FR-FCM is applicable whether the Commission elects to move forward with the amendments to Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) as proposed or to adopt a different approach.

43 The proposed amendment relates solely to unmet customer maintenance margin requirements for commodity futures and commodity options accounts. The rule does not currently require a capital charge for unmet customer maintenance margin requirements for swaps

44 Our comments with respect to Rule 1.17(c)(5)(viii) are subject to the Commission adopting the alternative proposal (or a similar alternative) with respect to Rules 1.20(i)(4), 22.2(f)(6) and 30.7 recommended above. If the Commission adopts the amendments to Rule 1.20(i)(4), 22.2(f)(6) and 30.7(a) as proposed, which would effectively require the FCM to meet all margin deficits when incurred, we ask the Commission to consider whether a capital charge for undermargined accounts is necessary at all. The purpose of the capital charge is to assure that FCMs have the resources to meet a margin call in the event that the account owner fails to do so. Since the FCM will have already met the minimum margin requirement, there appears to be no reason why the FCM should also take a capital charge.

45 77 Fed.Reg. 67866, 67881 (November 14, 2012).

turn, require evidence of a margin call before extending financing. Processing these payment requests frequently take more than one day.

To accommodate these and similarly situated customers, FIA recommends that the proposed amendment be revised to provide that an FCM would be required to take a capital charge with respect to an unmet maintenance margin requirement that is outstanding more than one business day only if the customer's margin deficiency is in excess of $500,000. If the customer's margin deficiency is $500,000 or less, an FCM would not be required to take a capital charge until an unmet maintenance margin requirement is outstanding more than two business days. Because an FCM will have met the customer's margin obligation no later than the business day following trade date, this proposed revision will not endanger other customer funds, while providing limited relief to an important segment of the derivatives markets.

4. Residual Interest of FCM in Customer Funds Accounts; Additions and Withdrawals

The Commission has also proposed to amend Rules 1.23, 22.17 and 30.7(g) to provide that: (i) an FCM may not withdraw any of its residual interest from a customer funds account for its own proprietary use until it has completed its daily segregation calculation; (ii) an FCM may not withdraw funds for its own proprietary use from customer funds accounts, if such withdrawal(s) would exceed 25 percent of the FCM's residual interest in such accounts as computed as of the close of business on the previous business day, unless the FCM's CEO, CFO or other senior official approves the withdrawal in writing[46] and the FCM files written notice of the withdrawal with the Commission and with its DSRO immediately thereafter;[47] and (iii) if an FCM withdraws a portion of its residual interest for its own proprietary use, and the withdrawal causes the amount held in the customer segregated account to fall below the FCM's targeted residual interest, the FCM must either restore the residual interest to the

46 FIA requests the Commission to confirm that such written approval may be provided by electronic means.

47 The written notice must: (i) be signed by the CEO, CFO or other senior official that approved the withdrawal; (ii) include a description of the reasons for the withdrawal or series of withdrawals; (iii) list the amount of funds provided to each recipient and each recipient's name; (iv) include the current estimate of the amount of the FCM's residual interest in the futures accounts after the withdrawal; and (v) contain a representation by the CEO, CFO or other senior official that approved the withdrawal, or series of withdrawals, that, after due diligence, to such person's knowledge and reasonable belief, the FCM remains in compliance with the segregation requirements after the withdrawal.

With respect to item (iii) above, we understand that an FCM generally will transfer funds comprising a portion of the firm's residual interest from a customer funds account to the FCM's operating account. We do not read the proposed rules to require an FCM to disclose the names of parties that receive funds from the FCM's operating accounts.

targeted amount by the close of business the next business day or, if appropriate, revise its targeted residual interest.[48]

The proposed rules further provide that, in approving the withdrawal from the customer funds account, the FCM's CEO, CFO or other senior official "must consider the daily segregation calculation as of the close of business on the previous business day and any other factors that may cause a material change in the [FCM's] residual interest since the close of business the previous business day, including known unsecured customer debits or deficits, current day market activity and any other withdrawals made from the [customer funds account]." We ask the Commission to confirm the scope of the individual's responsibility in this latter regard. Although FCMs monitor position risk on a continual basis, most FCMs' systems do not permit real-time calculation of an account's equity until the nightly batch processing is complete and prices are updated. A strict reading of this requirement, therefore, would effectively prohibit an FCM from ever withdrawing more than 25 percent of its residual interest on any day.[49]

The proposed rules are consistent with FIA's Initial Recommendations[50] and the provisions of Section 16 of NFA's Financial Requirements and CME Rule 971. FIA, therefore, generally supports the proposed amendments. However, with respect to proposed Rule

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48 As discussed earlier, Rule 1.11(e)(3)(i) would require each FCM to establish, maintain and enforce written policies and procedures, which must be approved by senior management, reasonably designed to ensure that customer funds are separately accounted for and segregated or secured as belonging to customers, as required.

49 Implementation of this latter requirement may be especially difficult with respect to funds properly held in accounts located outside of the US, in particular, funds held in the foreign futures and foreign options secured amount account. Currencies other than US dollars are subject to currency cut-offs that can be in the early morning hours of the day for same day settlement. By not providing for such withdrawals utilizing the previous day's segregation calculation, as currently permitted under NFA and CME rules, same day withdrawal of funds may not be permitted. In addition, in circumstances in which currency payments are settled on a forward date basis, it is not clear whether such withdrawals should be counted at the time they are processed and irrevocable or on the day of settlement.

We would propose that the Commission continue to permit the withdrawal of the residual interest on the basis of the most recently prepared secured amount calculation, less any amounts previously withdrawn and not yet settled. We further propose that amounts be counted as withdrawn for the purposes of the 25 percent withdrawal requirement on the day that the payment is processed as opposed to its settlement date, where different.

50 "The Committee recommends, as noted above, that the SROs require each FCM to document its policies and procedures regarding the maintenance of the FCM's residual interest in the customer segregated account. Such policies and procedures must be designed to reasonably assure that any withdrawals from the customer segregated account to the FCM's own account comprise the FCM's residual interest and will not result in a violation of the Act and the Commission's rules, or the FCM's targeted residual interest. The FCM's chief financial officer or the chief financial officer's delegate must approve in writing any withdrawal from the customer segregated account in violation of the policies and procedures, as well as any material change in the policies and procedures regarding the maintenance of the FCM's residual interest in the customer segregated account." *Initial Recommendations*, p. 9.

1.23(d), FIA believes notice should be required only if the withdrawals exceed 25 percent of an FCM's targeted residual interest, not 25 percent of the FCM's residual interest as reported on the FCM's most recent daily segregation calculation. FCMs should be allowed to withdraw any residual interest amount in excess of their target and further up to 25 percent of the target before having to provide notice. Under the proposed rules, an FCM that conservatively manages its residual interest may be required to file frequent notices with the Commission, even if it never falls below its targeted residual interest.

FCMs maintain a target level of residual interest that they manage on a daily basis. However, it is common practice to infuse additional proprietary funds intraday for known events that could potentially have an impact on residual interest. Customer deficits, exchanging one segregated asset for another, and facilitating currency activity are just a few examples of known events that can impact residual interest.

Customer deficits have a direct impact on an FCM's residual interest in the segregation computation. A spike in customer deficits will cause residual interest levels to decline. FCMs employ analytical measures to correlate market movements, especially in stress times, with fluctuations in client deficits. Adding proprietary funds intraday or for a day or two during market stress, large option expirations, or other events that may result in an increase in customer deficits, allows an FCM to manage these known events that can impact residual interest, while maintaining its residual interest target. Implementing restrictions on withdrawing residual interest may result in firms relying more on the established residual interest target and not infusing additional proprietary funds to conservatively increase client protection when necessary.

At the least, the proposed amendments should not require notification if the proprietary funds withdrawn were held in the customer funds account to accommodate the timing differences in completing certain transactions. For example, FCMs that invest customer funds in securities permitted under Rule 1.25 have operational exposure at times of maturity, during the delivery or the initial purchase of the securities in the segregation computation. It is common for FCMs to deliver large amounts of securities free into the customer funds account. Upon confirmation of the delivery, the FCM would withdraw the equal amount of cash, basically changing the segregated asset from cash to securities. To mitigate any operational risk, FCMs might leave the cash in segregation until the end of the day or the next business day to be sure the purchase of securities or free delivery occurred properly. If the amendment to Rule 1.23 is adopted as proposed, we are concerned more FCMs would hesitate leaving the cash in segregation and attempt to perform a simultaneous exchange of cash for securities to avoid the 25 percent notification.

Currency facilitation is common practice for FCMs that deal with customers on a global basis. These FCMs may swap currencies out of the customer funds accounts and deposit US dollars. Prior to the implementation of the CME and NFA rules, FCMs that swapped currencies for dollars would deposit the dollars into the customer funds accounts, and then after confirmation of receipt of the dollars, withdraw the currencies. Under the proposed amendment to Rule 1.23, unless the exchange of currencies for dollars occurs simultaneously, the withdrawal of the currencies could trigger a 25 percent notification. Currency exchanges, like other transactions, have operational risk. In the event one leg of the transaction does not occur as intended, the residual interest could be compromised. FCMs should be allowed to take the conservative approach and deposit the dollars, obtain confirmation of receipt prior to withdrawing currencies, and not be penalized by requiring a 25 percent notification.

5. Location and Investment of Customer Funds

The Commission has proposed several amendments to Rule 1.32, which would require FCMs to provide more detailed information regarding the computation of the FCM's segregated account calculation and the holding of customer segregated funds.[51]

The Commission has proposed to amend Rule 1.32(c) and add a new Rule 1.32(d) to require each FCM to document its segregation computation by preparing a Statement of Segregation Requirements and Funds in Segregation for Customers Trading on US Commodity Exchanges contained in the Form 1-FR-FCM as of the close of each business day, and to file such Statement with the Commission and the FCM's DSRO by noon the following business day.[52] In this connection, the Commission has proposed to amend the Form 1-FR-FCM to: (i) revise the Statement of Segregation Requirements and Funds in Segregation for Customers Trading on US Commodity Exchange, and the Statement of Secured Amounts and Funds held in Separate Accounts Pursuant to Commission Rule 30.7 and create a Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under 4d(f) of the CEA; and (ii) require that each statement include: (a) the management target amount for excess funds in such account; (b) the excess (deficiency) funds in such account over (under) management target excess; (c) the sum of margin deficits in such account; and (d) the excess (deficiency) of residual interest over the sum of margin deficits. The Commission has proposed that these schedules would be publicly available.

FIA generally supports these proposals. We note, however, that Commission Rule 1.32(a) requires an FCM to compute its daily segregation requirement on a currency-by-currency basis. It is unclear how an FCM is to complete these schedules on a currency-by-currency basis and request that the Commission confirm that a single schedule can be completed for each account class on a US dollar-equivalent basis.

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[51] Proposed Rule 22.2(g) and proposed Rule 30.7(l) impose the same requirements with respect to the cleared swaps customer collateral and the foreign secured amount account, respectively.

[52] Each FCM currently files the report required under Rule 1.32 with its DSRO, but not the Commission.

The Commission has proposed to add a new Rule 1.32(f), which would require each FCM to submit to the Commission and to the FCM's DSRO a report listing the names of all banks, trust companies, FCMs, DCOs, or any other depository or custodian holding futures customer funds as of the fifteenth day of the month, or the first business day thereafter, and the last business day of each month. This report must include: (i) the name and location of each entity holding futures customer funds; (ii) the total amount of futures customer funds held by each such entity; and (iii) the total amount of cash and investments that each such entity holds for the FCM.[53]

Finally, the Commission has proposed to add a new Rule 1.32(g) to require each FCM to (i) report the total amount of futures customer-owned securities held by the FCM as margin collateral, and (ii) list the names and locations of the depositories holding such margin collateral.

FIA generally supports this proposal, which is consistent with its Initial Recommendations.[54] However, we believe the detail regarding the investment of customer funds provided by NFA on its website is the appropriate level of detail that should be made public. Additional detail would disclose proprietary financial and business information.

In response to the Commission's request for comment, we recommend that NFA should act as the primary source for the disclosure of the manner in which FCMs hold customer funds. As we discuss below regarding the proposed amendments to Commission Rule 1.55, by directing customers to the NFA website, customers will have access to information with respect to each FCM from a single website and can be assured that the information is presented in a consistent manner.

Separately, the Commission has proposed to add a new Rule 1.29(b) to provide that an FCM or DCO, as applicable, will be solely responsible for any losses resulting from the investment of customer funds under Rule 1.25. Customers of the FCM will not bear any investment losses, and no losses may otherwise be allocated to the customers of the FCM. If

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[53] The FCM must report the following investments: (i) obligations of the US and obligations fully guaranteed as to principal and interest by the US (US government securities); (ii) general obligations of any State or of any political subdivision of a State (municipal securities); (iii) general obligation issued by any enterprise sponsored by the US (government sponsored enterprise securities); (iv) certificates of deposit issued by a bank; (v) commercial paper fully guaranteed as to principal and interest by the US under the Temporary Liquidity Guarantee Program; (vi) corporate notes or bonds fully guaranteed as to principal and interest by the United States under the Temporary Liquidity Guarantee Program; and (vii) interests in money market mutual funds.

[54] "The Committee recommends that the SROs require each FCM to file twice monthly reports, as of each month-end and as of the 15th of each month (or the next business day), identifying the sectors in which the FCM invests customer funds, the amount of customer funds invested in each sector and the weighted average maturity of the assets held in each sector." *Initial Recommendations*, p. 4.

customer funds are invested by a DCO, losses may not be allocated to the FCM.[55] FIA supports the proposed amendment, which is consistent with its Initial Recommendations.[56]

In proposing these amendments, the Commission also requested comment on how any losses associated with bank deposits should be addressed. The Commission explained that the Commodity Exchange Authority, its predecessor agency, issued an Administrative Determination ("AD") in 1971, which 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. Specifically, an FCM would not be liable if it (i) had used due care in selecting the bank, (ii) had not otherwise breached its fiduciary responsibilities toward the customers, and (iii) had fully complied with the requirements of the Act and the Commission regulations relating to the handling of customers' funds. The Commission asks if its rules 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, and whether there be a distinction drawn between US-domiciled and regulated banks and non-US-domiciled banks.[57]

FIA believes the 1971 AD sets an appropriate standard of liability in the event of a default of a bank holding customer funds. As an initial matter, we wish to emphasize that the deposit of customer funds in a bank or trust company is not an investment of customer funds under Rule 1.25 and related rules in Part 22 and Part 30. To the contrary, FCMs are required by law to deposit customer funds in a bank or trust company, except to the extent such funds are deposited with another FCM or a DCO.[58]

Just as FCMs cannot be strictly liable if a DCO fails, FCMs cannot be held strictly liable for a bank's failure. Such a standard would presume that FCMs would have the ability to know

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[55] Proposed Rule 22.2(e) and proposed Rule 30.7(g)(2) impose the same requirements with respect to the cleared swaps customer collateral account and the foreign secured amount account, respectively.

[56] "The Committee further recommends that the Commission consider amending Rule 1.25 for the purpose of confirming that an FCM investing customer funds in accordance with the rule bears the risk of loss arising from any such investment and must use its own funds to restore the value of the customer segregated account." *Initial Recommendations*, p. 7. In making this recommendation, the Committee expressed its view "that the responsibility of an FCM for losses incurred in connection with investments under Commission Rule 1.25 is clear and is implicit in the Act and the Commission's rules. Nonetheless, in order to remove any ambiguity, the Committee believes that the Commission's rules should make this obligation explicit." *Id.*

[57] 77 Fed.Reg. 67866, 67888 (November 14, 2012).

[58] Sections 4d(a)(2) and 4d(f)(3) of the Act. Foreign futures and foreign options customer funds may also be deposited with a foreign broker, a foreign clearing organization or such foreign broker's or clearing organization's designated depository. Commission Rule 30.7(c)(1)(v)-(vii). The Commission has proposed to amend Rule 30.7 to provide, in part, that an FCM may not deposit the foreign futures or foreign options secured amount in accounts outside of the US, except to meet margin requirements. *Id.*, at 67957.

more about a bank than the regulatory authorities responsible for overseeing them.[59] FCMs cannot be deemed to have such knowledge.[60]

The Commission has the statutory authority to adopt rules prescribing standards that banks must meet in order to be a permitted depository for customer funds. In this regard, Commission Rule 1.49 and 30.7 provide that an FCM may not deposit customer segregated funds or foreign futures and foreign options secured amount funds, respectively, in a bank located outside of the US, unless the bank has regulatory capital in excess of one billion dollars. If the Commission believes that FCMs should deposit customer funds only in US banks that meet certain additional prescribed standards, it should propose a rule to that effect.

Moreover, we note that the Commission's proposed Rule 1.11 will require each FCM to establish and enforce written policies and procedures reasonably designed to assure compliance with the segregation requirements, including: (i) a process for the evaluation of depositories; (ii) a program to monitor a depository on an ongoing basis, including a thorough due diligence review of each depository at least annually; and (iii) an account opening process to assure that customer funds are not deposited with a depository prior to the FCM receiving an acknowledgment letter.[61] These policies and procedures will be subject to review by the Commission and the FCM's DSRO. If either the Commission or the DSRO finds weaknesses with these policies and procedures, or the manner in which they are enforced, it is able to direct the FCM to revise them.

6. Capital Structure; Leverage and Liquidity

The Commission has proposed to amend Rule 1.10(b)(5) to require each FCM, in filing its monthly calculation of adjusted net capital to include the measure of the FCM's leverage (total balance sheet assets, less any instruments guaranteed by the US Government and held as an asset or to collateralize an asset) divided by total capital, computed in accordance with US GAAP. The Commission explains that the leverage ratio "will provide information regarding the amount of assets supported by the FCM's capital base" and is "an important element in assessing the FCM's financial condition and ability to support its investment decisions."[62]

We support this amendment. As noted earlier, however, we believe it is essential that the definition of "leverage" be consistent among the several regulatory authorities with supervisory authority over FCMs. Therefore, FIA encourages the Commission to coordinate

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59 At the largest banks, these regulators have staff on-site at all times.

60 We are not aware of any other regulatory authority that seeks to hold intermediaries strictly liable for the failure of the bank selected with due care.

61 Proposed Rule 1.11(e)(3)(i), 77 Fed.Reg. 67866, 67933-67934 (November 14, 2012).

62 *Id.*, at 67873.

with the SEC and the several SRO's to assure that a consistent leverage ratio definition is applied across the industry in order for regulators and customers to have a consistent basis for their review.

In this regard, we understand that the Commission's proposed definition of "leverage" is similar to the definition used by FINRA and NFA and that this definition may result in disparate treatment of dually-registered FCM/broker-dealers, on one hand, and stand-alone FCMs, on the other. Such results are subject to misinterpretation. In these circumstances, although FIA does not oppose providing leverage information to the Commission, the Commission should not require disclosure of an FCM's leverage calculation until it is certain that the calculation provides the most appropriate measure of risk.

Along similar lines, the Commission has also proposed to amend Rule 1.17(a)(4) to provide that an FCM that cannot certify to the Commission immediately upon request, and demonstrate with verifiable evidence, that is has sufficient liquidity to continue operating as a going concern must transfer all customer accounts and immediately cease doing business as an FCM until such time as the firm is able to demonstrate compliance. The FCM may trade for liquidation purposes only, unless otherwise directed by the Commission or the FCM's DSRO.

The Commission explains that the "ability to certify, and if requested, demonstrate with verifiable evidence, sufficient liquidity to operate as a going concern to meet immediate financial obligations, is a minimum financial requirement necessary to ensure an FCM will continue to meet its obligations as a registrant."[63] Further, the amendment would provide "additional protection to customers in the event of an imminent liquidity drain on [an FCM] that may not be immediately reflected in its accounting or regulatory capital business records."[64]

FIA agrees with the regulatory purpose underlying this proposed amendment. However, we submit that the Commission should not adopt the rule before it clearly articulates the standards by which it will determine that an FCM has "sufficient liquidity."[65] Standing alone, this term does not establish an objective standard, while vesting considerable authority in the Director of Clearing and Risk and the Director of Swap Dealer and

63 77 Fed.Reg. 67866, 67879 (November 14, 2012). The Commission explains that the proposed amendment "is not intended to provide a mechanism for the Commission to require FCMs to demonstrate that they are a going concern for an extended period of time into the future. Rather, the purpose of the proposal is to provide the Commission with a means of addressing exigent circumstances by requiring an FCM to produce a written analysis showing the sources and uses of funds over a short period of time *not to exceed one week*." [Emphasis supplied.] *Id.*

64 *Id.*

65 As noted earlier, we further encourage the Commission coordinate with the SEC and the banking regulators to establish a uniform standard of the term "liquidity."

Intermediary Oversight, by delegated authority, to require an FCM to cease doing business.[66]

We note that, in accordance with proposed Rule 1.11(e)(3)(iii), each FCM will have an obligation to establish and enforce a risk management program reasonably designed to assure that the FCM has sufficient capital to be in compliance with the Act and Commission rules, "and sufficient capital and liquidity to meet the reasonably foreseeable needs of the [FCM]." Such policies and procedures must be reviewed and tested on at least an annual basis.[67] Similarly, Rule 1.73 requires each FCM to conduct weekly stress tests that will effectively require the FCM to assess its liquidity. The manner in which each FCM complies with these rules will be subject to review by the Commission and the FCM's DSRO.

We ask the Commission to confirm, therefore, that an FCM should be deemed to have demonstrated sufficient liquidity for purposes of Rule 1.17(a)(4), if the required written analysis showing the sources and uses of funds over a short period of time not to exceed one week is prepared in accordance with the procedures established under Rules 1.11 and 1.73.[68]

7. Prohibition on Commingling of Customer Funds

The Commission has proposed to amend Rule 1.20 to prohibit an FCM from commingling futures customer funds with funds required to be deposited in a foreign futures and foreign options secured amount account under Rule 30.7 and a cleared swaps customer account under Rule 22.2, except as explicitly provided by the Commission pursuant to rule or order

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[66] Commission Rule 140.91(a)(6) provides:

The Commission hereby delegates, until such time as the Commission orders otherwise, the following functions to the Director of the Division of Clearing and Intermediary Oversight and to such members of the Commission's staff acting under his direction as he may designate from time to time:

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(6) All functions reserved to the Commission in § 1.17 of this chapter, except for those relating to non-enumerated cover cases set forth in § 1.17(j)(3) of this chapter.

The directors may, but are not required to, submit any matter which has been delegated to them under paragraph (a) of this section to the Commission for its consideration.

[67] Proposed Rule 1.11(f)

[68] We also recommend that the Commission establish and publish its own set of policies and procedures pursuant to which Commission staff are expected to implement and enforce the rules proposed to be adopted in this rulemaking, including but not limited to the authority granted under proposed Rule 1.17(a)(4) and the authority proposed to be granted to staff to require a depository to release funds held in a customer funds account in accordance with the acknowledgment letters required under proposed Commission Rules 1.20(g)(4), 1.26, and 30.7(d). Neither the Commission nor market participants should be required to rely on statements made in an adopting Federal Register release, especially as time passes.

or by DCO rule.[69] Similarly, a proposed amendment to Commission Rule 30.7 would prohibit an FCM from commingling funds required to be deposited in a foreign futures and foreign options secured amount account with funds required to be deposited in a customer segregated account or cleared swaps collateral account.[70]

The proposed amendments implement the provisions of sections 4d(a) and 4d(f) of the Act and FIA fully supports them. However, we ask the Commission to confirm that the proposed amendments would not prohibit a customer that trades multiple products from meeting its multiple margin obligations by making a single payment to the FCM, as is common in the industry today. Single currency payments, pursuant to which funds are received in a single payment and then transferred among the relevant account classes as an equity system transfer across account classes, reduce the FCM's credit risk, are operationally more efficient for both the FCM and its customers, and indirectly reduce customer settlement risk. Such margin payments are reflected in the account/account class to which the funds are received until such time as the equity system transfer and related fund movements are made.

8. Limitation on Holding the Foreign Futures and Foreign Options Secured Amount Outside of the US.

The Commission has proposed to amend Rule 30.7(c) to provide that an FCM may not deposit or hold the foreign futures or foreign options secured amount with any depository located outside of the US except to meet margin requirements, including prefunding margin requirements established by rule, regulation or order of a foreign board of trade or clearing organization, or to meet margin calls issued by foreign brokers carrying the customers' positions. The proposed amendment further provides that an FCM may hold in depositories located outside of the US an additional amount of up to 10 percent of the total amount of funds necessary to meet the margin and prefunding margin requirements.

The 10 percent cushion is intended to minimize the impact of the repatriation risk in the event of an FCM insolvency, while (i) providing an FCM flexibility in managing its daily cash movements, and (ii) assuring that the foreign futures or foreign options positions are not undermargined at foreign brokers or clearing organization. As the Commission explains: "The Commission recognizes that due to differences in time zones, trading hours, banking holidays, as well needs for cash transfers to foreign jurisdictions to settle and to be credited to accounts, a customer may not be able to immediately transfer funds to its FCM, and an FCM may not be able to immediately transfer funds to a foreign broker or foreign clearing organization to meet a margin call."[71]

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[69] Proposed Rule 1.20(e)(3).

[70] Proposed Rule 30.7(e)(3). Rule 22.2(c)(2) already prohibits commingling.

[71] 77 Fed.Reg. 67866, 67897 (November 14, 2012).

FIA agrees that an FCM should not hold excess funds beyond those reasonably necessary to meet the foreign futures and foreign options obligations of its customers. However, we believe the 10 percent limitation is too low to take account volatility and other factors. Therefore, it will not achieve the Commission's purpose of assuring that the foreign futures or foreign options positions are not undermargined at foreign brokers or clearing organization. FIA had earlier recommended that an FCM be permitted to maintain an excess of up to 50 percent of the amount that an FCM is required to deposit with a foreign broker to maintain customer foreign futures and foreign options positions.[72] At a minimum, we recommend that the Commission revise the amendment to Rule 30.7(c) to allow a cushion of 20 percent.

Further, we note that the proposed amendment is more restrictive than the provisions of Rule 1.49, which set out the terms and conditions pursuant to which an FCM may hold customer segregated funds and cleared swaps customer collateral outside of the US. We suggest that the proposed amendment to Rule 30.7 should be revised to permit an FCM to hold funds comprising the foreign futures and foreign options secured amount in a bank or trust company located outside of the US to the same extent that an FCM may hold customer segregated funds and cleared swaps customer collateral outside of the US. The 10 percent limitation should apply only to funds deposited with a foreign broker or foreign clearing organization.

Finally, we recommend that the proposed amendment be revised to provide a reasonable period of time to cure or make such withdrawal of amounts in excess of 10 percent that may have resulted from the previous day's trading or settlement activities. In order to take account of time zone differences and foreign currency settlement standards, we recommend that the proposed amendment to Rule 30.7(c) be revised to permit an FCM two business days after the event giving rise to such excess to adjust the amount of foreign futures and foreign options secured amount held outside of the US.

9. Proposed Early Warning Requirements

The Commission has proposed several amendments to Commission Rule 1.12, which would require an FCM to provide written notice to the Commission and the FCM's DSRO in certain circumstances. Each new requirement would require immediate notice. Although FIA member firms generally are not opposed to providing prompt notice to the Commission and to such member firm's DSRO in the proposed circumstances, we question the need for immediate notice. If the Commission determines that such early warning notices are required, we believe notice within 24 hours if such event is financial in nature and 48 hours for business-related events would be appropriate in order to afford FCMs the time to

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[72] This number is consistent with the provisions of Commission Rule 1.17(c)(5)(xiii)(C), which require an FCM to take a five (5) percent capital charge to the extent unsecured receivables with a foreign broker is greater than 150 percent of the current amount required to maintain futures and option positions in accounts with the foreign broker. *Initial Recommendations*, p. 11, fn. 9.

determine the cause of the event and to take appropriate corrective action. Financial events would include proposed Rule 1.12(i) and (k). Business-related events would include Rule 1.12(j), (l) and (m).

Separately, FIA does not believe that any of these reportable events should be made public. Such reports, which would be made without context, would be subject to misinterpretation and may create a market event.

Further comments with respect to certain of the proposed early warning requirements follow.[73]

Proposed Rule 1.12(j) would require immediate notice when the FCM's residual interest is below the FCM's targeted amount, or the residual amount is less than the sum of the customers' margin deficits. FIA believes this proposed early warning notice is unnecessary, since the FCM will file a report with the Commission on a daily basis that, in any event, will disclose if the FCM's residual interest has fallen below the FCM's targeted amount, or the residual amount is less than the sum of the customers' margin deficits. Even under the current rules, an FCM's residual interest will frequently fall below its targeted amount. If the Commission adopts the proposed amendments to Rule 1.20, 22.2 and 30.7 discussed earlier, this will likely be a daily event.

Proposed Rule 1.12(k) and (l), respectively, would require an FCM to provide immediate notice whenever: (i) the FCM or its parent or material affiliate, experiences a material adverse impact to its creditworthiness or ability to fund its obligations; or (ii) the FCM experiences a material change in its operations or risk profile, including a change in senior management of the FCM, the establishment or termination of a line of business, a material adverse change in the FCM's clearing arrangements, or a material adverse change in the FCM's credit arrangements, including a change that could adversely impact the firm's liquidity resources.

FIA submits that the proposed amendments do not provide an FCM sufficient guidance on the circumstances that would require notice. The Commission must define more precisely the events that would require notice. In this regard, as noted earlier, the Commission should coordinate with the SEC and the banking regulators to establish a uniform standard identifying "material adverse" changes or impacts. Separately, we do not believe that changes in senior management at an FCM requires an early warning notice of any kind. Such notice is already provided to NFA in the ordinary course.

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[73] The Commission has also proposed to amend Rule 1.12(f)(3), which requires an FCM to notify the Commission and its DSRO immediately whenever the FCM determines that an account it is carrying is under margined by an amount that exceeds the FCM's adjusted net capital, to remove the provision authorizing a DSRO to grant an exemption from the provisions of paragraph (f)(3) to an FCM with respect to any particular account on a continuous basis, *provided* the DSRO documents the reasons for granting such an exemption and continues to monitor any such account. 77 Fed.Reg. 67866, 67935 (November 14, 2012).

Proposed Rule 1.12(m) would require an FCM to provide immediate notice in the event an FCM receives a notice, examination report, or any other correspondence from a DSRO, the SEC or a securities SRO.

We suggest this requirement is too broad.[74] FCMs receive correspondence from their DSRO on a regular basis. For FCMs that are also registered broker-dealers and receive inquiries from their securities SRO and the SEC, the number of inquiries are multiplied. Such inquiries are overwhelmingly routine in nature and, frequently, do not even concern the FCM. We recommend that the Commission revise the proposed amendment to require an FCM to provide notice to the Commission only when it has received an examination report or has been advised that it is the subject of a formal investigation by a regulatory or self-regulatory authority.

10. Template Acknowledgment Letters

The Commission has proposed to amend Rules 1.20 (incorporated by reference in Rule 22.5), 1.26 and 30.7 to require any depository or money market mutual fund receiving customer segregated funds, foreign futures or foreign options secured amount funds or cleared swaps customer collateral, from a registered FCM or DCO to execute an acknowledgment letter in the form prescribed in the proposed rules. FIA continues to strongly support the adoption of template acknowledgment letters. However, we have concerns regarding specific provisions of the template letters as proposed.

In this regard, we have met with Commission staff and representatives of several of the largest depository and custodian banks serving FCMs and DCOs to discuss certain provisions of the templates that cause particular concern, including the provisions relating to: (i) standard of liability; (ii) permitted liens and offsets; (iii) immediate release of funds; (iv) real-time access to information. We also have had the opportunity to review the comment letter filed by several banks with respect to the acknowledgment letters. As both depositors of customer funds and, frequently, depositories for funds deposited by non-clearing member FCMs, FIA member firms agree with the concerns expressed and recommendations set out in that letter. We will not repeat them in detail here.

In particular, we agree that the standard of liability, which provides that a depository may presume that “any withdrawal from the Account(s) and the balances maintained therein are in conformity with the Act and CFTC regulations without any further inquiry, provided that you have no notice of or actual knowledge of, or could not reasonably know of, a violation of the Act or other provision of law by us” would expand the obligation of depository institutions to monitor and assure compliance far beyond existing requirements and what is

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[74] For example, the rule would appear to require an FCM to forward all types of correspondence, including notices of changes in margin levels or trading hours.

practicable. Compliance with this requirement would likely result in substantial delays in processing transactions and increased costs.

We also want to emphasize that, with respect to the proposed requirement for real-time access, FCM and foreign broker systems currently are unable to provide the Commission the type of real-time, on-line access that the templates contemplate. If the Commission concludes that it requires such access to FCM and foreign broker records, it will have to afford FCMs and their third-party vendors sufficient time to design, develop and implement the systems changes necessary to provide the required access.

More generally, we have not had an opportunity to discuss the proposed templates with the foreign brokers and foreign depositories with which FCMs maintain customer funds and, therefore, we do not know if these templates cause concern under the laws of any foreign jurisdiction. If it has not done so already, we encourage the Commission to consult with foreign regulators to assure that no provision of the proposed templates would prevent US customers from trading on foreign boards of trade or holding foreign currencies outside of the US in accordance with Commission Rule 1.49.

Separately, although we recognize and appreciate the Commission's desire to have the ability to instruct a depository to transfer customer funds immediately upon notice from appropriate Commission staff, we remain concerned such action may be subject to challenge. We assume that any action by the Commission (or its staff) to require the transfer of customer funds would be based on the Commission's (or its staff's) determination that the FCM is violating or is about to violate the provisions of the Act or the Commission's rules intended to protect customer funds. However, the Act does not appear to authorize the Commission to act in this manner *sua sponte*.

Rather, section 6c of the Act instructs the Commission "[w]henever it shall appear to the Commission that any registered entity or other person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of any provision of this Act or any rule, regulation, or order thereunder," to "bring an action in the proper district court of the United States . . . to enjoin such act or practice, or to enforce compliance with this Act, or any rule, regulation or order thereunder." Section 6c further provides that an order "which prohibits any person from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets, or other property" may be issued *ex parte*.

We believe that section 6c sets out the procedures that the Commission must follow before seeking to transfer customer funds held by an FCM. These procedures provide for prompt resolution of the issues, while vesting a court, not the Commission, with the authority to determine whether an FCM should be entitled to be heard before an order is issued. It is not at all clear to us that the Commission may require a registrant to waive these statutory protections as a condition to being authorized to engage in business as an FCM. We urge the Commission to consider carefully its statutory authority to adopt this provision.

II. PROPOSED AMENDMENTS TO DISCLOSURE REQUIREMENTS

FIA supports enhanced disclosure to customers regarding: (i) the risks of trading derivatives; (ii) the relevant provisions of law and the Commission's rules governing the protection of customer funds; and (iii) the FCM through which the customer may elect to trade. Many of the proposed amendments to Rule 1.55 are consistent with the *Initial Recommendations*. Concurrently, we issued *Frequently Asked Questions on Customer Funds Protections*,[75] which is being used by FCMs to provide their customers with increased disclosure on the scope of how the laws and regulations protect customers in the futures markets. We revised this document in June 2012 and plan further revisions as we gather comments from regulators on other areas that should be covered, including, as discussed below, certain of the proposed disclosures. In addition, we will be expanding the document to advise customers of the material information they should obtain in evaluating an FCM.

The comments that follow are intended to assure that customers receive information regarding FCMs that is both consistent and relevant to their evaluation of FCMs and to assure that the obligations of FCMs under the proposed amendments are clear.

1. Risk Disclosure Statement

The Commission has proposed to amend the prescribed risk disclosure document set out in Rule 1.55(b) to require certain additional disclosures. FIA supports the proposed amendments to Rule 1.55, subject to the following:

Proposed Rule 1.55(b)(2) states: "The funds you deposit with a futures commission merchant for trading futures positions are not protected by insurance in the event of the bankruptcy or insolvency of the futures commission merchant, or in the event your funds are misappropriated due to fraud."

- FIA recommends that the Commission delete the phrase "due to fraud." Customer funds may be misappropriated for any reason.

Proposed Rule 1.55(b)(4) states: "The funds you deposit with a futures commission merchant are not guaranteed or insured by a derivatives clearing organization in the event of the bankruptcy or insolvency of the futures commission merchant, or if the futures commission merchant is otherwise unable to refund your funds."

- Although this disclosure is generally accurate, following the default of MF Global, the CME Group established the Family Farmer and Rancher Protection Fund. As explained by the CME Group, this fund will provide up to $25,000 to qualifying individual farmers and ranchers and $100,000 to co-ops that hedge their risk in CME

[75] A copy of the *Frequently Asked Questions on Customer Funds Protections* may be found at http://www.futuresindustry.org/downloads/PCF-FAQs.PDF.

Group futures markets. FIA recommends that the Commission revise this disclosure to take account of the CME Group Fund.

Proposed Rule 1.55(b)(5) states: "The funds you deposit with a futures commission merchant are not held by the futures commission merchant in a separate account for your individual benefit. Futures commission merchants commingle the funds received from customers in one or more accounts and you may be exposed to losses incurred by other customers if the futures commission merchant does not have sufficient capital to cover such other customers' trading losses."

- We have been advised that customer funds are not always held in a commingled account. Rather, at the request of a customer, an FCM may agree to open a segregated account that references the customer's name and holds only collateral attributed to that customer. The FCM understands, and advises the customer, that such an account will not necessarily provide the customer any additional protection in the event of the FCM's bankruptcy. Although we do not believe it is necessary to revise the disclosure statement to address such individual accounts, we wanted to bring this to the Commission's attention.

The Commission requests comment on whether and how the new or revised Risk Disclosure Statement should be provided to existing customers. In addition, the Commission asks whether FCMs be required to obtain new signature acknowledgments from existing customers for a revised Risk Disclosure Statement.

- FIA is not opposed to a requirement that the revised risk disclosure statement be made available to existing customers that are otherwise required to receive the disclosure document. However, FCMs should not be required to obtain a written acknowledgment from such customers. Rather, it should be sufficient if the FCM makes each customer aware of the revised disclosure statement by any appropriate means, consistent with the means by which the FCM normally communicates important information to customers, including but not limited to a separate mailing.

- Customers would be (i) advised that the risk disclosure statement has been revised, (ii) provided with a link to the statement, and (iii) encouraged to review the statement. A paper version of the statement can be provided to a customer upon request. In addition to, or in lieu of, providing a link on the FCM's website, FIA will provide a link to the revised disclosure statement in its website.

We note that the Commission has not proposed to amend Rule 1.55(c), which provides, in relevant part:

> The Commission may approve for use in lieu of the risk disclosure document required by paragraph (b) of this section a risk disclosure statement approved by one or more foreign regulatory agencies or self-regulatory organizations if

> the Commission determines that such risk disclosure statement is reasonably calculated to provide the disclosure required by paragraph (b) of this section.

The Commission has approved an alternative risk disclosure statement set out in Appendix A to Rule 1.55, which has also been approved for use in the UK and Ireland. In the absence of any change to Rule 1.55(c), it would appear that FCMs are permitted to continue using the Risk Disclosure Statement for Futures and Options set out in Appendix A to Rule 1.55. We ask the Commission to confirm that FCMs may continue to use this alternative risk disclosure statement. We also encourage the Commission coordinate with other derivatives regulatory authorities to revise the alternative risk disclosure statement to meet the Commission's concerns.

2. Proposed Disclosure Document

The Commission has proposed to add a new Rule 1.55(i) and (j) which would require an FCM, prior to entering into an account agreement or first accepting funds from a customer, to furnish such customer a "Disclosure Document" that would include all information about the FCM (i) that would be material to the customer's decision to do business with the FCM and (ii) that is otherwise necessary for full and fair disclosure, including its business, operations, risk profile, and affiliates. The FCM must make the Disclosure Document, including any updates, available to customers and the general public by posting the Disclosure Document on its website or by other electronic means.[76]

As explained at the outset of this letter, we estimate that approximately 90 percent of all customer funds are held by FCMs that are also: (i) registered with the SEC as broker-dealers: (ii) part of a bank holding company: or (iii) part of a publicly-traded company. As such, they are required to submit to other financial regulators, and make available to the public, reports that include information comparable to that which the Commission is proposing to require. In order to avoid customer confusion in certain circumstances and to assure that FCMs are not subject to duplicative and, perhaps, conflicting disclosure requirements, we strongly urge the Commission to confirm that an FCM that is part of a

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[76] The proposed rule further provides that the Disclosure Document must be updated as and when necessary to keep such information accurate and complete, but at least annually. In connection with its obligation to update the disclosure, the FCM must take into account any material change to its business operation, financial condition and other factors material to the customer's decision to entrust the customer's funds and otherwise do business with the FCM since its most recent disclosure pursuant to this paragraph. For this purpose, FCMs must consider events that require periodic reporting required to be filed pursuant to Rule 1.12.

The Commission has requested comment on the means by which existing customers should be informed of the new Disclosure Document. As with the revised Risk Disclosure Statement, FIA believes it should be sufficient if the FCM makes each customer aware of the Disclosure Document by any appropriate means, including but not limited to a separate mailing. Customers would be (i) advised that the Disclosure Document is available, (ii) provided with a link to the Disclosure Document, and (iii) encouraged to review the Document. A paper version of the statement can be provided to a customer upon request.

publicly-traded company, whether US or non-US, or is otherwise required to prepare and make public an annual report including information comparable to that required under this proposed rule may comply with this rule by making such annual report, and any amendments thereto, available on its website.[77] This approach is consistent with our earlier recommendation that the Commission coordinate its reporting and disclosure requirements with the requirements of the SEC, FINRA and the relevant bank regulatory authorities.

In this regard, we note that the Management Discussion and Analysis ("MD&A") required under SEC rules (17 CFR 229.303) requires publicly-traded companies to discuss essentially the same topics required to be discussed under the proposed rules. Such topics include: business environment; critical accounting policies; use of estimates; results of operations; balance sheet and funding sources; off-balance-sheet arrangements and contractual obligations; overview and structure of risk management; liquidity risk management; market risk management; credit risk management; operational risk management; recent accounting developments; certain risk factors that may affect the company's businesses.[78]

With respect to those FCMs that are not part of a publicly-traded company, we ask the Commission to confirm that the level of detail required to be provided should be consistent with that provided in the annual reports of publicly-traded companies. Such privately-held companies will need time to prepare any Disclosure Document that may be required under the proposed rules. Consequently, we recommend that such FCMs be required to make the Disclosure Document available on their websites no earlier than six months following the effective date of the final rules.

Proposed Rule 1.55(k) sets out the specific topics that an FCM should discuss in the Disclosure Document. FIA's comments on certain paragraphs of the proposed rule follow. Our comments are in all cases subject to our recommendation that the level of detail provided should be consistent with that required under applicable SEC requirements for annual reports.

We have divided the information proposed to be included in the Disclosure Document into four categories: (i) information regarding the FCM and its affiliates, which may be provided by making its annual report available on its website; (ii) information that is FCM-specific and, therefore, may be disclosed in a supplemental statement available on its website; (iii) information that is generic to all FCMs and not FCM-specific, which would be discussed in

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[77] Similarly, the timing of any required amendments and the content of such requirements should be consistent with requirements of the SEC or the applicable prudential regulator.

[78] As with MD&A discussions, a safe harbor should be made available to FCMs for any forward looking statements. 17 CFR 229.303.

a generic disclosure document that an FCM makes available on its website; and (iv) information that is (or will be) available on NFA's website.[79]

Information regarding the FCM and its affiliates, which the FCM may provide by making its SEC-required annual report, and any amendments thereto, available on its website, includes:

- Proposed Rule 1.55(k)(3), which would require the FCM to discuss the significant types of business activities and product lines engaged in by the futures commission merchant, and the approximate percentage of the FCM's assets and capital that are used in each type of activity.
    - We note that the approximate percentage of the FCM's assets and capital used in each type of activity can change frequently. We recommend that an FCM should be required to update the description set out in its annual report, only if it adds a new business activity or product line that requires higher minimum capital under applicable capital rules.
- Proposed Rule 1.55(k)(5), which would require an FCM to discuss the material risks, accompanied by an explanation of how such risks may be material to its customers, of entrusting funds to the FCM, including, without limitation:
    - We recommend that the word "risks" be replaced with the word "information," and that the Commission remove the phrase "accompanied by an explanation of how such risks may be material to its customers." We believe it is sufficient that the FCM presents the required information to the customer. It is the customer's responsibility to analyze this information and determine the extent to which it is important or relevant to the customer's decision to open or maintain an account with the FCM. If the Commission believes FCMs should provide guidance to customers regarding the potential importance of specific information, we believe this guidance should be provided by means of a generic statement.
- (i) the nature of investments made by the FCM (including credit quality, weighted average maturity, and weighted average coupon);
    - We ask the Commission to confirm that the term "investments" is limited to investments of customer funds. The term should not include all investments made by the FCM as an entity.

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[79] FIA is considering developing a template Disclosure Document which would include links to information not otherwise set out in the document, *e.g.*, the annual report.

- (ii) the FCM's creditworthiness, leverage, capital, liquidity, principal liabilities, balance sheet leverage and other lines of business;

  - Importantly, we understand that FCMs that are registered with the SEC as broker-dealers or are part of a bank holding company are engaged in frequent discussions with the SEC and the Federal Reserve Board addressing issues such as the firm's leverage, capital, liquidity and similar issues. We encourage the Commission to participate in those discussions, which will assure that all relevant regulatory authorities are requesting the same information from a firm.

  - We recommend that the Commission delete the term "creditworthiness." In accordance with section 939A of the Dodd-Frank Act, the Commission is instructed to "remove any reference to or requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations." It is incongruous, therefore, to require an FCM to provide information regarding its creditworthiness.

  - We ask the Commission to confirm that the only lines of business that an FCM should be required to disclose are those that would require higher minimum capital under applicable capital rules, and that this information should only be required to be updated annually.

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- (iv) any significant liabilities, contingent or otherwise, and material commitments.

  - We recommend that the Commission, in coordination with the SEC and bank regulators, provide guidance on the types of liabilities and commitments that would be required to be disclosed.

  - FCMs should be required to update this information no more often than semi-annually. This would be consistent with the disclosure requirements applicable to broker-dealers.

- Proposed Rule 1.55(k)(10), which would require an FCM to disclose the following financial data as of the most recent month-end when the Disclosure Document is prepared:

  * * *

- (iv) the aggregate notional value, by asset class, of all non-hedged, principal over-the counter transactions into which the FCM has entered;

- It is not clear why information with respect to over-the-counter transactions is being requested. As the Commission has recognized, FCMs that are registered as broker-dealers and that, with their affiliates, are part of a holding company structure are engaged in a number of activities that affect the firm's leverage, liquidity and capital, and expose the firm to risk. This information is discussed in considerable detail in the firm's MD&A.

- In any event, this information is proprietary and, therefore, we oppose the proposed disclosure requirement.

- As important, however, such disclosure would be impractical. Firms do not manage their books in this way. (Swap dealers are not required to report whether a particular trade is hedged or non-hedged.) In any event, the categorization of a particular swap could change day-over-day.

- (v) the amount, generic source and purpose of any unsecured lines of credit (or similar short-term funding) the FCM has obtained but not yet drawn upon.

  - We recommend that the Commission distinguish between committed and uncommitted lines of credit. Only committed lines of credit should be included in this paragraph.

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- Proposed Rule 1.55(k)(11), which would require an FCM to provide a summary of the FCM's current risk practices, controls and procedures.

  - The Commission has recognized that an FCM's risk practices, controls and procedures may include proprietary information.[80] Therefore, we ask the Commission to confirm that the discussion of these issues may be general in nature.

Information that is FCM-specific and, therefore, should be permitted to be disclosed in a supplemental statement, includes:

- Proposed Rule 1.55(k)(4), which would require an FCM to discuss the FCM's business on behalf of its customers, including types of accounts, markets traded, international businesses, and clearinghouses and carrying brokers used, and the FCM's policies and procedures concerning the choice of bank depositories, custodians, and other counterparties.

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80 The Commission has previously declined to require swap dealers and major swap participants to disclose their risk management policies and procedures finding that such policies and procedures "may contain sensitive or proprietary information." 77 Fed.Reg. 20128, 20137 (April 3, 2012).

    - We ask the Commission to confirm that (i) the disclosure required under this paragraph is limited to the activities of the FCM in its capacity as such, (ii) the term "accounts" means "customers", and (iii) the term "counterparties" is limited to counterparties for Rule 1.25 investments.[81]

    - An FCM's policies and procedures concerning the choice of bank depositories, custodians, and other counterparties may include proprietary information. Therefore, we ask the Commission to confirm that the discussion of these issues may be general in nature.[82]

- Proposed Rule 1.55(k)(6), which would require the FCM to disclose (i) the name of the FCM's DSRO and its Web site address and (ii) the location where the FCM's annual audited financial statements are made available.

- Proposed Rule 1.55(k)(7), which would require an FCM to disclose any material administrative, civil, enforcement, or criminal action then pending, and any enforcement actions taken in last three years.

    - As an initial matter, we ask the Commission to confirm that a "pending" action is an action that has been filed but not concluded.

    - In addition, we recommend that the Commission confirm that the disclosure required under this paragraph would be limited to matters required to be disclosed in accordance with Rule 4.24(l)(2). This latter rule provides that, with respect to an FCM, an action is considered material if: (i) the action would be required to be disclosed in the notes to the [FCM's] financial statements prepared pursuant to GAAP; (ii) the action was brought by the Commission; Provided, however, that a concluded action that did not result in civil monetary penalties exceeding $50,000 need not be disclosed unless it involved allegations of fraud or other willful misconduct; or (iii) the action was brought by any other federal or state regulatory agency, a non-United States regulatory agency or a self-regulatory organization and involved allegations of fraud or other willful misconduct.

- Proposed Rule 1.55(k)(10) would require an FCM to disclose the following financial data as of the most recent month-end when the Disclosure Document is prepared:

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81 If policies and procedures concerning the choice of counterparties extends to counterparties generally, this information would be provided in the SEC-required annual report.

82 Such policies and procedures are a part of the risk management policies and procedures proposed to be required under Commission Rule 1.11. As noted above, the Commission has declined to require swap dealers and major swap participants to disclose their risk management policies and procedures finding that such policies and procedures "may contain sensitive or proprietary information." *Id.*

- (i) the FCM's total equity, regulatory capital, and net worth, all computed in accordance with U.S. Generally Accepted Accounting Principles and Rule 1.17, as applicable;

- (ii) the dollar value of the FCM's proprietary margin requirements as a percentage of the aggregate margin requirement for futures customers, cleared swaps customers, and 30.7 customers;

    - We agree that customers should be advised whether the FCM has proprietary accounts. However, we do not believe that an FCM should be required to disclose the dollar value of the FCM's proprietary margin requirements as a percentage of the aggregate margin requirement for customers. This percentage is likely to change frequently and, therefore, the percentage at any given time will have limited value.

    - Moreover, we question the implication that customers may be at greater risk if an FCM carries proprietary positions. This is not always the case. If there were a major customer default, the funds held to margin an FCM's proprietary positions would be available to the DCO to meet the obligations of the defaulting customer.

- (iii) the number of futures customers, cleared swaps customers, and 30.7 customers that comprise 50 percent of the FCM's total funds held for futures customers, cleared swaps customers, and 30.7 customers, respectively;

    - The manner in which an FCM is expected to calculate the number of customers that comprise 50 percent of the FCM's total funds held for customers is unclear, although we assume that the Commission would want an FCM to disclose the smallest number of customers that comprise 50 percent of the FCM's total funds held.

  * * *

- (vi) the aggregated amount of financing the FCM provides for customer transactions involving illiquid financial products for which it is difficult to obtain timely and accurate prices;

    - We ask the Commission to define the type of financing for which it is requesting information. We note that, if the FCM is a broker-dealer, there is a substantial amount of financing that takes place in connection with the firm's securities business.

    - The Commission should also define the term "illiquid financial products" and confirm whether the question relates to secured as well as unsecured financing. Under Commission Rule 1.30, an FCM is only permitted to finance a customer's margin requirements if the financing is adequately secured.

- (vii) the percentage of futures customer, cleared swaps customer, and 30.7 customer receivable balances that the FCM had to write-off as uncollectable during the past 12-month period, as compared to the current balance of funds held for futures customers, cleared swaps customers, and 30.7 customers.
    - We question the relevance of the requested information. This is a circumstance in which numbers, without proper context, may be misleading. For example, losses could be caused by one or two large customers or the aggregate of a number of smaller customers. Should the losses have been anticipated and, therefore, reflect a fault in the FCM's risk management program or were they the result of sudden market moves that could not be anticipated?
    - If the Commission elects to go forward with this requirement, normal business write-offs should not be included. Moreover, there ought to be a *de minimis* number (threshold), where reporting would not be required.

Information that is generic to all FCMs and not FCM-specific should be discussed in a generic disclosure document that an FCM makes available on its website.[83] Such information includes:

- Proposed Rule 1.55(k)(5), which would require an FCM to discuss the material risks, accompanied by an explanation of how such risks may be material to its customers, of entrusting funds to the FCM, including, without limitation:
    - We recommend that the word "risks" be replaced with the word "information," and that the Commission remove the phrase "accompanied by an explanation of how such risks may be material to its customers." We believe it is sufficient that the FCM presents the required information to the customer. It is the customer's responsibility to analyze this information and determine the extent to which it is important or relevant to the customer's decision to open or maintain an account with the FCM. If the Commission believes FCMs should provide guidance to customers regarding the potential importance of specific information, we believe this guidance should be provided by means of a generic statement described above.

[83] FIA is prepared to draft such a document, which will be subject to Commission review. Such a document will assure that prospective customers receive consistent information.

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- (iii) risks to the FCM created by its affiliates and their activities, including investment of customer funds in an affiliated entity;
    - We ask the Commission to confirm that the term "***investment*** of customer funds with an affiliated entity" refers to the "***deposit*** of customer funds in an affiliated bank."
- Proposed Rule 1.55(k)(8), which would require an FCM to provide a basic overview of customer funds segregation, FCM collateral management and investments.
- Proposed Rule 1.55(k)(9) would require an FCM to describe how a customer may obtain information regarding filing a complaint about the FCM with the Commission or with the FCM's DSRO.

Information that is (or will be) available on NFA's website should not be required to be provided on the FCM's website. By directing customers to the NFA website, the customer will have access to information with respect to each firm from a single website and can be assured that the information is presented in a consistent manner. Such information includes:

- Proposed Rule 1.55(k)(2), which would require an FCM to disclose the names and business addresses of the FCM's directors and senior management, including titles, business background, areas of responsibility, and the nature of duties of each.
    - We recommend that such disclosure should be limited to those individuals identified as principals on NFA BASIC. [84]
- Proposed Rule 1.55(o)(1), which would require each FCM to make available on its website certain financial information, including: (i) the daily Statement of Segregation Requirements and Funds in Segregation for Customers Trading on US Exchanges for the most current 12-month period; (ii) the daily Statement of Secured Amounts and Funds Held in Separate Accounts for 30.7 Customers Pursuant to Commission Regulation 30.7 for the most current 12-month period; (iii) the daily Statement of Cleared Swaps Customer Segregation Requirements and Funds in Cleared Swaps Customer Accounts Under Section 4d(f) of the Act for the most current 12-month period; and (iv) a summary schedule of the FCM's adjusted net capital, net capital, and excess net capital, all computed in accordance with Rule 1.17

[84] If the Commission determines that such information should be provided in an FCM-specific supplemental statement, we ask the Commission to confirm that the discussion of the individuals' business background should be consistent with the detail provided in an annual report. Nature of duties and areas of responsibility should be general in nature, since specific responsibilities can change frequently.

of this part and reflecting balances as of the month-end for the 12 most recent months.

- We believe that neither (i) an FCM's targeted residual interest, nor (ii) the sum of margin deficits in the customer funds account should be made public. Disclosure of the targeted residual interest or the margin deficits without context, *e.g.*, type of customers, markets and products traded, quality of risk management program, serves no meaningful purpose. Further, any changes in the targeted residual interest or margin deficiencies may also be misinterpreted and could unintentionally create a market event.

- For the same reasons, we believe that the daily segregation, secured amount or cleared swaps customer account calculations should not be made available. As the Commission is aware, NFA currently makes this information available on its website as of the 15th and last business day of each month. We believe disclosure twice each month should be sufficient. If the Commission concludes more frequent disclosure is necessary, we recommend that disclosure should be required no more often than weekly, *i.e.*, as of the close of business each Friday (or the last business day of the week if Friday is a holiday).

III. PROPOSED RULES REQUIRING FCMS TO ESTABLISH, MAINTAIN AND ENFORCE A RISK MANAGEMENT PROGRAM

FIA supports the Commission's proposed new Rule 1.11, which would require each FCM to establish and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the FCM. The risk management program must be enforced by a "risk management unit," with sufficient authority, qualified personnel, and financial, operational and other resources to carry out the program. The risk management unit must report directly to senior management and, importantly, must be independent of the FCM's "business unit."[85]

As proposed, the risk management program must (i) be in writing, and (ii) be approved by the FCM's governing body. The risk management program must:

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[85] The "business unit" is defined to mean any department, division, group, or personnel of an FCM or any of its affiliates, whether or not identified as such that: (i) engages in soliciting or in accepting orders for the purchase or sale of any commodity interest and that, in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom; or (ii) otherwise handles segregated funds, including managing, investing, and overseeing the custody of segregated funds, or any documentation in connection therewith, other than for risk management purposes; and (iii) any personnel exercising direct supervisory authority of the performance of the activities described in (i) or (ii) of this paragraph.

- Take into account market, credit, liquidity, foreign currency, legal, operational, settlement, segregation, technological, capital and any other applicable risks, together with a description of risk tolerance limits set by the FCM and the underlying methodology in the written policies and procedures. Risk tolerance limits must be reviewed and approved quarterly by senior management and annually by the FCM's governing body;

- Take into account risks posed by affiliates, all lines of business of the FCM and all other trading activity of the FCM;

- Include policies and procedures for detecting breaches of risk tolerance limits set by the FCM and alerting supervisors within the risk management unit and senior management as appropriate;

- Require that the FCM's senior management and Governing Body be provided with written reports quarterly, and immediately upon detection of any material change in the risk exposure of the FCM, setting out: (i) all applicable risk exposures of the FCM; (ii) any recommended or completed changes to the risk management program; (iii) the recommended time frame for implementing any recommended changes; and (iv) the status of any incomplete implementation of previously recommended changes to the risk management program;

- Include policies and procedures reasonably designed to ensure that segregated funds are properly accounted for, including: (i) a process for evaluating the depositories of segregated funds, addressing the depository's capitalization, creditworthiness, operational reliability, and access to liquidity; and (ii) a process for monitoring an approved depository on an ongoing basis, including a thorough due diligence review of each depository at least annually;[86]

- Include a process for establishing a targeted amount of residual interest reasonably designed to ensure that the FCM remains in compliance with the segregation requirements at all times. In establishing the targeted residual amount, senior management must take into account: (i) the composition of the FCM's customer base; (ii) the general creditworthiness of the customer base; (iii) the types of markets and products traded; (iv) the FCM's proprietary trading; (v) the general volatility of the markets and products traded by the FCM's customers; the FCM's own liquidity and capital needs; and historical trends of customer balances, including margin debit and net deficit balances in customer accounts;[87]

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86 This requirement is consistent with the *Initial Recommendations*.

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- Include a process for the withdrawal of cash, securities and other property from accounts holding segregated funds where the withdrawal is not for the benefit of customers;[88]

- Include a process for assessing the appropriateness of specific investments made in accordance with Commission Rule 1.25;

- Include procedures requiring the appropriate separation of duties among individuals responsible for compliance with the segregation requirements;[89]

- Include a process for annual training of all finance, treasury, operations, regulatory, compliance, settlement and other relevant officers and employees regarding the segregation requirements;[90]

- Include procedures for assessing the liquidity, marketability and mark-to-market valuation of all securities and other non-cash assets held in segregation to ensure that all such securities are readily marketable and highly liquid;[91]

- Include automated financial risk management controls designed to prevent the placing of erroneous orders; and

- Include policies and procedures to ensure that the FCM has sufficient capital to be in compliance with the Commodity Exchange Act and the Commission's rules, and sufficient capital and liquidity to meet the FCM's reasonably foreseeable needs.

As the Commission is aware, the proposed rules are similar in most respects to the Commission's rules governing risk management programs for swap dealers and major swap participants.[92] In adopting these latter rules, the Commission clarified the interpretation of certain provisions, and we ask the Commission confirm that such clarifications apply equally to the provision of proposed Rule 1.11.

In this regard, we ask the Commission to confirm its position that requirements of the rules do not prescribe rigid organizational structures. The "policies and procedures" approach provides an adequate amount of flexibility that will allow FCMs to rely upon any existing compliance or risk management capabilities to meet the requirements of the proposed rules.

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88 This requirement is consistent with the *Initial Recommendations*.

89 This requirement is consistent with the *Initial Recommendations*.

90 This requirement is consistent with the *Initial Recommendations*, but appears to require training of a greater number of employees.

91 This requirement is consistent with the *Initial Recommendations*.

92 17 CFR § 23.600.

Moreover, nothing would prevent firms from relying upon existing compliance and risk management programs to a significant degree.

Further, we ask the Commission to confirm that the proposed rule does not require an FCM's risk management unit to be a formal division in the FCM's organizational structure, provided the FCM will be able to identify all personnel responsible for required risk management activities as its "risk management unit" even if such personnel fulfill other functions in addition to their risk management activities. In addition, the rule allows FCMs to establish dual reporting lines for risk management personnel performing functions in addition to their risk management duties, provided the rule would not permit a member of the risk management unit to report to any officer in the business trading unit for any non-risk management activity.

Finally, we ask the Commission to confirm its position that, to the extent that many FCMs are part of a larger holding company structure that may include affiliates that are engaged in a wide array of business activities, the Commission understands that, in some instances, the top level company in the holding company structure, which has the benefit of an organization-wide view, is in the best position to evaluate the risks that an affiliate of an FCM may pose to the FCM. Therefore, to the extent an FCM is part of a holding company with an integrated risk management program, the FCM may address affiliate risks and comply with the rule through its participation in a consolidated entity risk management program.

The standard of liability to which a Chief Compliance Officer is held under proposed Rule 1.11 should be no different from the standard of liability set out in Commission Rule 3.3. In describing proposed Rule 1.11, the Commission noted that, under Commission Rule 3.3, the Chief Compliance Officer's ("CCO's") annual report 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. The Commission asks whether Rule 1.11 should contain a separate CCO certification requirement that would impose a higher duty of strict liability or some other higher obligation on a CCO.

FIA firmly believes that the standard of liability to which a CCO is held under Rule 3.3 is the correct standard, and we see no reason why the Commission would adopt a separate standard here. As the Commission has previously noted:

> The Commission is of the view that limiting the certification with the qualifier "to the best of his or her knowledge and reasonable belief" addresses commenters' concerns of overbroad liability because the rule

> would not impose liability for compliance matters that are beyond the certifying officer's knowledge and reasonable belief at the time of certification. If the certifying officer has complied in good faith with reasonable policies and procedures designed to confirm the accuracy and completeness of the information in the annual report, both the registrant and the certifying officer would have a basis of defending accusations of false, incomplete or misleading statements or representations made in the annual report.[93]

The Commission should not want to bring an enforcement action against such an individual nor should it have the authority to do so.

When the Commission proposed Rule 3.3, several commenters expressed concerns of overbroad liability. They argued that the requirement to certify under penalty of law is not fair or practical because the certifying officer will have to rely on many individuals to compile the report, and the CCO should not be liable for firm infractions. The adopting release stated that the Commission was of the view that the knowledge qualifier addresses these concerns. If the Commission imposes strict liability, these concerns will be renewed. It may be difficult for FCMs to find qualified individuals to fill the CCO position if they will be exposed to such overbroad liability.

Comparable officer certification requirements in other contexts are limited by knowledge qualifiers. The Sarbanes-Oxley Act ("SOX") requires two sets of officer certifications to be included in the periodic reports that public companies are required to file under the Securities Exchange Act of 1934 ("Exchange Act"). SOX section 302 requires the CEO and chief financial officer ("CFO") to certify that, among other things, the report does not contain any untrue statement or omission of a material fact, and that the financial information in the report fairly presents the company's financial condition, results of operations and cash flows. The certifications are qualified by the signing officer's knowledge. SOX section 906 adds a provision to the federal criminal code requiring the CEO and CFO to certify that the report fully complies with the relevant Exchange Act requirements and that the information in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer. The penalties under SOX section 906 only apply to persons who knowingly or willfully certify noncompliant or misleading reports.

A review of the legislative history of SOX sections 302 and 906 reveals that imposing strict liability for officer certifications of Exchange Act periodic reports was not seriously considered. Rather, it was always contemplated that the provisions would include

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[93] Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants. 77 Fed.Reg. 20128, 20163 (April 3, 2102).

knowledge qualifiers. This approach was advocated by witnesses at committee hearings. At a hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Lynn E. Turner, Chief Accountant of the SEC from 1998 to 2001, stated:

> The CEO and CFO should be required to sign and certify to the audit committee and investors, as is done in some foreign jurisdictions, that the financial statements comply with the applicable rules and include disclosure of all material information. There should be civil penalties for negligence and criminal and civil penalties for intentional misrepresentations to the public or to the auditors.

Notably, Mr. Turner did not recommend that strict liability apply. At a hearing before the Senate Banking Committee, G. William Miller, former Secretary of the Treasury and former Chairman of the Federal Reserve Board, explained why imposing a strict liability standard for management certifications would be unfair and inappropriate:

> The proposal is logical in that sense, but as I understand it, it recognizes that senior officers—CEOs, CFOs, chairmen—cannot personally audit the books of a complex company. There is no way they can do that. Thousands and thousands of hours are spent auditing a complex company.
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> So one would expect that the intent of this particular requirement would be that these officers exercise due diligence, that they make proper investigation, they hire honest people, they supervise them properly, and they involve themselves in making sure that procedures are in place to assure that the statements are correct.

Mr. Miller's reasoning applies with equal force to CCO certifications of FCMs' compliance with policies and procedures for safeguarding customer funds. CCOs cannot personally observe compliance with all such policies and procedures. They will have to rely on other individuals and on subcertifications. The CCO certification rules should require the CCO to exercise due diligence, make proper investigation and comply in good faith with policies and procedures reasonably designed to confirm the accuracy and completeness of the information in the annual report.

Finally, as a general matter, imposing strict liability would be inappropriate in the context of officer certification of compliance with policies and procedures designed for the safeguarding of customer funds. Strict liability offenses are typically found in the regulation of activities involving public health, safety and welfare. In his section-by-section analysis of Title IX of SOX, then-Senator Joseph R. Biden, Jr., one of its primary authors, stated that Congress did not intend SOX section 906 to be a "so-called 'public welfare law' which would create strict liability." Given the similar purpose of the CCO certifications under Dodd-Frank, it is unlikely that Congress intended those requirements to be public welfare laws that would create strict liability for CCOs.

Conclusion

FIA appreciates the opportunity to submit these comments with regard to the Commission's proposed amendment designed to enhance the protections afforded customers and customer funds under the Commodity Exchange Act. FIA strongly endorses the regulatory purpose underlying the proposed amendments and has offered these comments to assist the Commission in striking an appropriate balance among its several proposals.

In particular, as discussed in detail above, we support many of the proposed changes but are concerned that the proposed amendments to the Commission's rules will have serious adverse consequences for all market participants and the markets generally. Implementation of these identified provisions will result in a tremendous drain on liquidity that (i) will make trading significantly more expensive for customers that use the markets to hedge their financial or commercial risks, and (ii) will adversely affect the ability of many FCMs to operate effectively. To the extent the increased costs imposed by the proposed amendments cause traders to withdraw from the markets, market liquidity will be adversely affected and the markets will be less efficient. The price discovery and risk management purposes of the markets, which greatly benefit American consumers and the economy in general, would be significantly harmed.

Certainly, more can be done to protect customer funds. FIA has worked hard since the events surrounding MF Global Inc. and Peregrine Financial Group to restore customer confidence in our markets. As noted above, we support many of the changes suggested in this rulemaking, and we look forward to working with the Commission and its staff in developing a comprehensive and balanced regulatory scheme. Before moving forward with these rules, however, we urge the Commission to pause and allow time for the additional safeguards that have already been approved to take effect. The Commission, the DSROs and the industry, have all taken significant and meaningful steps to improve greater transparency through daily flows of information, electronic verification of segregated account balances and enhanced and more frequent inspections. We believe it would be premature to impose additional requirements before fully assessing the impact of the safeguards that have already been adopted. Had these existing enhancements been in effect, the misuse of customer funds accounts that led to the bankruptcies of MF Global Inc. and Peregrine Financial Group would have been detected much earlier and customer losses either would have been prevented or mitigated.

If the Commission has any questions concerning the matters discussed above, please contact Barbara Wierzynski, FIA's General Counsel, at 202.466.5460.

Sincerely,

Walt L. Lukken

Walt Lukken
President and CEO

cc: Honorable Gary Gensler, Chairman
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner
Honorable Mark Wetjen, Commissioner

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