

February 15, 2013

David A. Stanwick
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

Dear Mr. Stanwick:

Advantage Futures LLC (“Advantage”) is pleased to respond to the Commission’s request for comment on its proposed rules for Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants (“FCMs”) and Derivatives Clearing Organizations (“proposed rules” or “proposals”).

For decades the futures industry operated under the requirements of customer fund segregation, and did so without any loss of funds by customers. As the industry evolved over that time, regulations were developed and enhanced in an environment of collaboration and cooperation which provided for tremendous innovation and growth. Recently, of course, the industry was rocked by the failure of two firms (ironically occurring after a financial crisis which caused the demise or required the bailout of several large banks/financial institutions but through which the futures industry emerged unscathed). The loss of customer funds (or the long delay in their return, as MF Global customers will apparently see their funds returned in whole) shook confidence in our industry, leading to reduced participation/volumes, and called into question the effectiveness of our existing safeguards and regulatory oversight.

Clearly it was appropriate to review and amend existing regulations and procedures to reflect the issues raised by these two bankruptcies. Advantage believes that many of the rules recently enacted thoroughly address the MF Global and PFG problems, and do so in a cost effective manner (relative to benefit) that does not harm industry competitiveness or raise costs excessively to market participants. Advantage is concerned that portions of the proposed rules will yield unintended consequences detrimental to the industry and its users, while providing little if any additional protection of customer funds.

Specifically, Advantage believes that portions of these proposed rules, if implemented, will:

- Increase costs for customers by requiring they hold additional funds on deposit (pre-fund potential margin calls) for their positions. This is particularly true for customers of non-bank FCMs, creating a competitive disadvantage for non-bank FCMs. It should be noted that our experience post-MFG/PFG is that customers wish to hold *less* money on deposit, and fund their trading requirements on an as-needed basis.
- Reduce the ability of non-bank FCMs to compete, leading to an increased concentration of business at a smaller number of large bank FCMs. Greater business concentration and subsequent reduced competition will increase systemic market risk and lead to higher transactional costs for customers. Bank FCMs have the added flexibility of lending margin money to their customers through affiliated entities.
- Harm, as a result of these competitive issues, the segment of the FCM community that has typically served certain business lines (agricultural hedgers, smaller commercial hedgers, professional traders, retail customers, etc.) that large bank FCMs usually do not care to handle. Advantage knows this first hand as our firm was created to accept and serve the unwanted customers of a large bank FCM. Pushing these participants away from the futures markets, or increasing their costs to access the markets appears counterproductive.

Proposed Rule 1.11: Risk Management Program for Futures Commission Merchants; and Proposed Amendments to Rule 1.29: Increment or Interest Resulting From Investment of Customer Funds

Most aspects of this proposal are appropriate and unlikely to be burdensome as FCMs typically have most (if not all) of these requirements in place. Advantage acknowledges that consistency in the application of these requirements across the industry is beneficial for all participants. Advantage has two comments:

- The Commission asked for comment about establishing risk management requirements for FCMs based on certain criteria, such as size, type of clientele, etc. It seems logical that a one-size-fits-all approach is less than optimal. One suggestion is to establish minimum risk management standards for specific business lines/customer type, and then require that FCMs engaging in those lines of business/clearing that type of customer have those programs in place.
- One risk program requirement (1.11(e)(3)(i)(1)) had to do with the evaluation by the FCM of depositories into which customer funds are deposited. The proposal listed a series of metrics to be used when making these evaluations. As there are a limited number of institutions approved as settlement banks, one presumes that these firms have been properly

vetted by the relevant regulatory bodies (both banking and futures) and that any subsequent review by the FCM would be redundant at best, if not superficial and of little value. As for the use of banks not approved as settlement banks, due diligence on the part of the FCM is appropriate.

- Related to this, the Commission requests comment as to amending Rule 1.29 such that FCMs would be responsible for losses of customer funds resulting from the failure of a bank depository. Another amendment to this Rule is meant to clarify FCMs' responsibility for losses resulting from adverse movements in the investment of those funds. Advantage has no objection to that clarification as that is already the case (many FCMs were faced with that issue due to problems at the Reserve Fund or Sentinel). However, the deposit of customer funds into a bank is not an investment of those funds, and for the reasons noted in the second bullet point above, it is unreasonable to hold FCMs responsible for a failure of such a bank.

Proposed Amendments to 1.12: Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers; and Proposed Amendments to 1.55: Public Disclosures by Futures Commission Merchants

Advantage believes in transparency of its operations and has taken steps (as have other FCMs) to increase presentation of certain information to its customers and potential customers. While this level of disclosure has not historically been necessary, recent events have led to increased interest in this information on the part of customers. Most notably, this disclosure has involved the investments made with customer funds. Similarly, all regulators have increased their level of inquiry as to the risk and financial integrity of each FCMs' business. Aside from the genuine prospect of "reporting overkill," Advantage generally believes this greater transparency can be beneficial. However, care must be taken with certain aspects:

- With respect to reportable events, the Commission asked for comment as to the appropriateness of public disclosure of such occurrences. Without breaking down each possible scenario at this time, Advantage believes care must be exercised in disclosing certain information. Even an event deemed to fall into a category requiring disclosure may have been the result of a technical issue and not representative of a potential risk to an FCM or its customers (or worthy of inclusion in the due diligence of a potential customer). Publicly reporting certain events without appropriate context or explanation could cause unnecessary reputational or financial harm to the FCM where no risk to the customer existed. Why risk potentially creating a "run" on an FCM unnecessarily? Advantage recommends additional dialogue on this issue before any such requirement is implemented.

- Similarly, requiring disclosure of certain financial information, such as the “target residual interest” creates potential problems when taken out of context or without adequate explanation. Under Rule 1.11, FCMs are required to consider multiple aspects of their specific business in determining this residual interest level. Disclosing those figures for comparison in “gross” terms – without appropriate consideration of the basis for the number – creates a distorted view of the relative safety of specific firms which may or may not be accurate. One would need to study much non-public information about the firms in considerable detail in order to discern more accurately their relative riskiness. Firms with the largest excess may also have the largest customer margin variations. Promoting that bigger is better—which this leads to--may be misleading. Not long ago MF was a big firm. It is likely that small and mid-sized firms are disadvantaged unnecessarily by this requirement despite their prudent and often long history of success.
- The Commission asked for comment on several items related to the Firm Specific Risk Disclosure. The potential requirements of this disclosure are significant and should be considered in more detail at a later date, prior to implementation.

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

The Commission proposes amending 1.17(c)(5)(viii) and (ix) to require an FCM to take under margin capital charges for customers who remain under margin more than one day after a margin call is issued (three days after generation). This compares to the current requirement that such charges be taken three days (for most customers, two for omnibus accounts) after a call is issued (five or four days, respectively, after generation). The goal is more prudent risk management based on a faster collection of margin. Concomitant with this proposal (further discussed in another section), the Commission proposes requiring FCMs to “top off” their target residual interest by the amount of all margin calls as of the day the margin call is generated.

- Advantage understands that rapid collection of margin deficiencies is one factor in prudent risk management. For certain FCMs and their customers, this requirement would not pose a significant change in methodology. However, the Commission should be aware that this may not be the case for all FCMs and their customers.
- Despite a greater prevalence of the use of wire transfers etc., certain customers (particularly those in rural areas) still utilize checks for payment of margin calls. These customers would face additional costs in the form

of having to increase the amount of funding they maintain at the FCM and/or face the prospect of positions being liquidated at inopportune times. In the face of increased costs, many such participants may find it easier to simply stop utilizing these markets. Non-domestic customers may also face difficulties if holidays etc. in their countries preclude the timely wiring of funds.

- Should the Commission elect to enact this requirement, however, it further renders the proposal of increasing the target residual interest by the amount of total margin deficiencies as somewhat redundant and unnecessary.
- The FCM industry has not had a problem with customer margin collections. Instead of protecting customers this will likely cause many small customers to discontinue futures trading.

Proposed Amendments to 1.20: Futures Customer Funds to be Segregated and Separately Accounted For; and Proposed Amendments to 1.22: Use of Futures Customer Funds

The most major change proposed is the requirement that FCMs add to their target residual interest the total amount of all customer margin deficiencies as of the day these calls are generated. The basis for this requirement seems to be two-fold: an interpretation of Rule 1.20 which appears to be considerably different than that under which the industry has heretofore operated; and a presumption that margin calls on their face translate into a debit risk that threatens customers' funds. Advantage opposes this proposal for the reasons noted below:

- The rule prohibiting an FCM from margining the positions in one customer account with funds from another customer account is enforced at the FCM level. All accounts are clearly identified by name and number, and any margin deficiency in an account remains the obligation of that customer only. The FCM does not transfer another customer's funds into the account of a margin deficient customer in order to resolve a margin call. Quite the contrary, the FCM issues a margin call to that deficient customer and proceeds to either collect funds or effect the liquidation of positions in order to resolve the call. Presuming this interpretation centers on the practice of sending customer funds to a DCO in order to meet the margin requirements of an FCM's customers at that DCO, the segregated assets to which each customer lays claim are not affected. The FCM continues to identify and properly segregate the account balances due to each customer, which are available for withdrawal to the extent the respective customer has margin excess available.

- A margin call in and of itself does not translate into risk (and certainly not immediate/same day risk) to segregated/30.7 assets and by no means should necessitate the need to hold additional segregated/secured assets, especially over and above the excess target already in place. Under margin does not mean under segregated.
- Even if one wishes to claim that a margin call in and of itself represents risk to the segregated/30.7 assets of all customers, not all margin calls carry the same level of exposure. For instance, a \$5 million call in an account with \$45 million in net liquidating value (NLV) is not the same as a \$5 million call in an account with \$1 million in NLV, yet the FCM is forced to treat them identically under this proposal. Not all customers are the same. An institutional customer operating on a first-day wire transfer basis is not the same as customers sending a check, yet the calls carry the same weight under this requirement. Even if a customer has a history of meeting every daily margin call for the past 10 years, this rule would treat all customer margins identically. Finally, the proposal ignores the 24-hour nature of our current trading environment and the reality that many margin calls that exist at an arbitrary closing time are resolved upon the market's reopening. The US and global banking systems do not accommodate 24 hour banking to collect monies on a continuous real-time basis. Until that day arrives, we live in somewhat of a batch-processing world where each day is a batch. Every FCM is acutely aware of its responsibility to collect monies related to the day's batch of trades. The tremendously wide array of customers trading these markets does not lend itself to a one size fits all solution. Managing customer margin calls is a core competency of the FCM community and our industry's collective history reflects this job is well done.
- There are already mechanisms in place to address the threat or occurrence of debits and subsequent risk to customers' funds. The calculation of the target residual interest reflects the FCM's consideration of its business, including its clientele, their style of trading, their financial wherewithal to support that trading, including the debit risk posed on any given day. If that risk is realized and the FCM has a customer debit, the FCM is required to fund that debit in its segregated/30.7 assets with its own capital on the day the debit occurs, as well as maintain the target residual interest which continues to afford customers protection from all known risks. Thus, the daily segregated/30.7 calculations and target residual interest already include existing debits as well as the estimated risk of future debits.
- Taking this point a step further, to require that the target residual interest include the total of all margin calls is equivalent to considering all margin calls as though they were debits, dollar for dollar. There is no statistical basis for such an extreme consideration.

- Existing rules are in place to account for the risks faced by an FCM, via the use of capital requirements. An FCM is required to have capital available to cover 8% of its risk based maintenance margin. Additionally, an aged margin call (four/five days currently, three days as proposed and discussed above) requires an additional dollar for dollar charge to capital equal to the difference between the customer's NLV and their risk based maintenance margin. Presumably this latter requirement exists based on the belief that an aged margin call potentially poses additional risk of a debit occurring. If this rule recognizes that a margin call carries additional debit risk after four/five (or three) days, why does the proposal consider this risk to be occurring the first (top) day? This is logically inconsistent.
- The proposal contradicts other rules in place, such as the ability (on some exchanges) for a member to use some portion of the value of a membership toward their margin requirement, and continue trading while margin deficient from a cash perspective. As the membership is not a good segregated/30.7 asset, it would require the FCM to fund this deficiency even though the customer and FCM are operating within the relevant rules. These rules are sensible and permit some consideration of the current bid-side value of exchange memberships.
- The proposal is unworkable in practice. For option positions in particular, the FCM would be required to issue a margin call/obtain funds for a requirement that cannot even be accurately calculated prior to the release of closing risk arrays (about 8 PM Eastern). Likewise, calculations of margin for omnibus accounts cannot be determined prior to receipt of offsets which may not be obtained until late in the day. Late market movements may generate calls that cannot physically be met on the first (top) day but would be cleared at the next available opportunity following normal business practices. Customer location and time zone difference present another obstacle. Prudent risk management may necessitate the need for an intraday margin call requiring funding or liquidation in order to prevent a debit situation, but that is separate from requiring this addition to the segregated/30.7 target residual interest.
- The impact of this proposal would be very disruptive. FCMs would likely require customers to hold additional funds on deposit, raising the customers' cost of doing business. It would likely result in faster, more aggressive liquidations, particularly during extreme market moves. This would create the unintended consequence of making markets more volatile. Severe market moves often create margin calls for customers who are positioned the "wrong" way. FCMs may demand immediate full funding of margins from customers. If the market move is late in the trading day, money will not be able to arrive before the close. This will force FCMs to liquidate customer positions that are not fully margined in

order to reduce or eliminate their margin call. This will further exacerbate the situation and make the extreme market move even more extreme. This in turn will trigger more customers to be on call and lead to more forced liquidations by FCMs. The avalanche of buying or selling that this rule will induce contradicts decades of effort by the entire industry to thwart market panics and provide markets with liquidity and stability. The cascading price action will also be fueled by FCM caution in permitting the typical liquidity providers from taking the other side of the trade under those conditions. This *increases* the risk of loss for customers and FCMs, surely not the aim of this proposal. Finally, for reasons noted above, this proposal is extremely prejudicial to small and mid-size FCMs and their customers, resulting in rising costs and reduced market access for certain participants.

- In light of these considerations Advantage strongly recommends that this proposal not be enacted, and that further dialogue take place aimed at addressing the concerns the Commission has in this area.

Proposed Amendments to 30.7: Treatment of Foreign Futures or Foreign Options Secured Amount

Proposed Rule 30.7(c) would prohibit an FCM from holding 30.7 customer funds outside of the United States, except to the extent that the funds are necessary to margin, guarantee or secure 30.7 customer positions.

- The Commission needs to provide further clarification on how this proposed regulation would be applied to U.S. FCMs. As the proposed regulation currently reads, an FCM would only be able to hold 30.7 customer funds at a non-U.S. broker or foreign clearing organization, as funds held in a foreign bank would not be directly used to margin, guarantee or secure 30.7 customer positions. This language contradicts the provisions of Rule 30.7(b), which states that 30.7 customer funds may be deposited at a bank or trust company located outside the United States.
- Foreign clearing organizations require clearing members to maintain banking relationships outside of the United States in order to meet cutoff times for various clearing processes such as fees, margin requirements and cash settlements. The Commission has recognized in this proposal that an FCM may not be able to immediately transfer funds to a foreign broker or foreign clearing organization due to various factors. If an FCM is not able to maintain funds at foreign banks it would further inhibit this ability to the extent that it would not be operationally feasible for an FCM to maintain a clearing relationship with a foreign clearing organization.

- Proposed Rule 30.7(c) would therefore require U.S. FCMs to utilize non-U.S. brokers that are not regulated by the CFTC for foreign futures and foreign options activity. Advantage believes that 30.7 customer funds are equally as protected at a bank or trust company located outside of the United States as Rule 30.7(b) already requires such foreign banks to have in excess of \$1 billion of regulatory capital. The Commission has acknowledged in a previous order dated October 9, 2012 that the U.K Financial Services Authority is a signatory to several information sharing agreements with the Commission and “is located in a jurisdiction that has been deemed, pursuant to Commission Regulation 30.10, to have a regulatory regime that is comparable to the U.S. regulatory regime for the futures industry.” The language in proposed Rule 30.7(c) is not consistent with this view as it relates to holding 30.7 customer funds in the U.K.

Advantage shares the Commission’s goals of protecting the funds deposited at FCMs by futures market participants. We were negatively impacted by recent events and are aware and sensitive to the issues faced by customers who now clear at Advantage after having been subject to recent bankruptcies. We believe it counterproductive to create new problems while pursuing solutions to other issues. Advantage believes many of the regulations recently enacted address and correct deficiencies that existed at MF Global and PFG, both at the FCMs and in their regulatory oversight. Many of the proposals addressed above, however, do not have the same impact, and carry with them tremendous costs and outsized risks. Advantage is appreciative of the opportunity to comment on these proposals and is always willing to participate in dialogue aimed at reaching the common goal of protecting customers and improving our industry.

Respectfully submitted,

Joseph M. Guinan Jr.
Chairman and Chief Executive Officer
Advantage Futures LLC