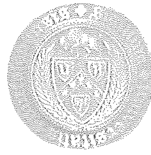


SUNY Buffalo Law School
The State University of New York

March 19, 2013

Ms. Natise Stowe
Executive Correspondence Assistant
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Received CFTC
2013 MAR 21 PM 3:38
Office of the Secretariat

Re: RIN 3038-AD88

COMMENT

Dear Ms. Stowe:

We are a team of students from the State University of New York at Buffalo Law School. We write to submit a correct version of our comment letter to your proposed rules on customer fund protection.

Please disregard the prior comment letter that was dated March 14, 2013. We addressed the prior submission to a different addressee, and we also updated our comment letter for your review.

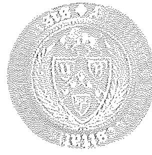
We have attached a corrected version of our letter for your records.

Thank you.

Sincerely,

Andrew Eastham
Alex Markhasin
Peter Nguyen
George Seaman

John Lord O'Brian Hall, Buffalo, NY 14260-1100
Web: www.law.buffalo.edu



SUNY Buffalo Law School
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March 19, 2013

Ms. Natise Stowe
Executive Correspondence Assistant
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Re: 17 CFR Parts 1, 3, 22, 30 and 140
RIN 3038-AD88

Dear Ms. Stowe:

We are a team of four State University of New York Buffalo Law School students who are participating in our school's 2013 Program in Finance and Law in New York City. This program is designed to introduce its participants to topics in finance and law, covering areas such as banking, financial markets, and regulations. Our team is studying customer fund protection reform, particularly in the futures and options markets. After speaking with professionals in the field, we have learned a great deal and have reviewed the proposed Commodity Futures Trading Commission's ("CFTC" or "Commission") proposed regulations to enhance customer protections and protection of their funds at future commission merchants ("FCMs") and derivatives clearing organizations ("DCOs"). Unlike earlier comment writers, our team is composed of students, and we are not participants in the futures and options markets or clearing industry. Thus, we believe we can provide a unique analysis of the proposed CFTC regulations.

We are encouraged that the proposed regulations provide for the CFTC to be more directly involved in monitoring the FCMs, thereby ensuring independent oversight distinct from that of self-regulatory organizations.

However, we do have several major concerns about the likely effectiveness of the proposed rules. First, we believe that the CFTC does not have the sufficient resources to effectively implement the proposed rules. Second, we join the view expressed in other comment letters, such as the Futures Industry Association letter of February 15, 2013, expressing concern over the insufficient cost-benefit analysis conducted in connection with the proposed rules. The unknown

costs of compliance with some of the requirements, particularly the new rules on residual interest, may drive small and medium size FCMs out of business. This reduction in FCMs will only reduce competition and ultimately harm customers. Moreover, the potential of a futures and derivatives market dominated by a few giant FCMs may inadvertently create a "too big to fail" scenario comparable to that of the banking sector in 2008.

Finally, we fear the proposals to increase public disclosure of expanded FCM compliance information - segregation and secured amount schedules of futures accounts and cleared swaps segregation schedules of swaps accounts - may inadvertently trigger a market panic from an otherwise manageable risk.

I. INSUFFICIENT CFTC RESOURCES TO EFFECTIVELY IMPLEMENT THE PROPOSED RULES.

Objectively, it appears that the Commission lacks the resources it will require to process the proposed increase in mandated reported financial data from the FCMs. Sequestration will reduce CFTC's already tight budget, which totaled just over $200 million in 2012, by an additional $10 million.[1] CFTC Chairman Gary Gensler told lawmakers during a recent appearance before Senate subcommittee that the CFTC was "shelving" enforcement cases because its budget was too tight to properly police the futures and swaps markets.[2] "The CFTC also said that looming federal spending cuts would hamper the implementation of the Dodd-Frank law aimed at preventing a repeat of the 2007-09 financial crisis."[3] Yet, even if the federal fiscal crisis is resolved, it is unlikely that a reallocation of $10 million dollars to the CFTC's budget would resolve the agency's resource constraint; this problem existed prior to the sequestration mandated cuts. It is naturally prudent for the Commission to devise a blueprint as to how it plans to attain the necessary resources to effectively monitor and enforce compliance with the proposed requirements.

For instance, proposed § 1.11 requires each FCM that carries customer accounts to establish a risk management program designed to monitor and manage the risks associated with the FCM's activities as an FCM.[4] The FCMs must then report the analysis of their risk management

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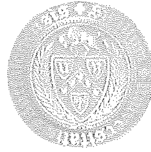
[1] Douwe Miedema, *CFTC Head Says Tight Budget Will Hurt Enforcement*, REUTERS (Wed Feb 27, 2013, 7:34 PM), http://www.reuters.com/article/2013/02/28/us-cftc-budget-idUSBRE91R01I20130228.

[2] *Id.*

[3] *Id.*

[4] 17 CFR Part 1.



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programs at application for registration and thereafter upon request, not only to their designated SRO, but to the Commission too in order to "allow it to duplicate the calculations and test the assumptions."[5] Such duplicative reporting to the CFTC would require additional staff for it to review the submissions with proper care. Although, subsequent to FCM registration, further risk management program and procedures reporting is "upon request," the lack of sufficient CFTC resources to process this compliance data, renders this proposals in essence toothless.

Arguably even if the reported financial data may go unprocessed, mandating this data to be produced to the CFTC may incentivize FCMs to more fully comply with the requirements. However, there is a counter argument: given the constraint on CFTC resources, any potential oversight failure may actually amplify a blow to market confidence should something go wrong at an FCM. The public may react negatively if it sees that CFTC regulators are unable to keep a grasp on the market even when crucial financial data is available to them.

II. COST AND ECONOMIC IMPACT OF PROPOSED RULES

We believe the proposed rules will force FCMs to raise unnecessary amounts of residual interest. In addition, we fear that the rules will actually reduce the liquidity of the markets, and hedgers and consumers of commodities will ultimately be injured. One of the most concerning aspects of the proposed rules is the Commission's own admitted uncertainty over the economic costs of implementing the amendments to the rules. For example, the proposed amendments alter requirements for residual interest, requiring FCMs to maintain residual interest in customer funds accounts which is greater than any potential margin deficits.[6] Yet, the CFTC in its own comments on the proposed rules noted that it:

> *does not have sufficient data to estimate the amount of additional residual interes*t FCMs are likely to need as a consequence of proposed, *the amount of additional capital they may hold for operational purposes*, the *cost of capital* for FCMs, or the *opportunity costs FCMs may experience* because of restrictions on the amount of customer funds they can hold overseas, each of which would be necessary in order to estimate such costs.[7]

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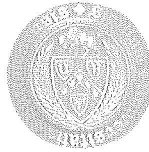
[5] 17 CFR § 1.11 (b)(4)

[6] 77 Fed. Reg. 67866, §§ 1.20(i)(4), 22.2(f)(6), 30.7(a).

[7] 77 Fed. Reg. 67902, n. 96 (emphasis added).



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As the Futures Industry Association noted in its February 15th comment letter,[8] FCMs will be required to maintain, "at all times," an amount of residual interest, in each class of customer account, that is greater than the sum of all margin deficits for that account class.[9] The FIA has calculated that this "at all times" residual interest requirement will force FCMs to raise at least $100 billion in residual interest, beyond the amounts already required as initial margin.[10] For cleared swaps accounts, the "at all times" residual interest requirement may cost even more: $335 billion.[11] Given the uncertainty and potentially high costs of implementing the amended rules, the Commission should further study the specific economic impact of these rules.

In addition to the direct financial burden, if FCMs are required to hold excess margin for each customer, the futures and options markets will become significantly less liquid. According to the CME, it is currently impossible for FCMs to accurately and in "real time" determine customer deficits.[12] Thus, to comply with the "at all times" requirement for residual interest, FCMs will either have to: 1) personally contribute a greater level of residual interest to top off customer accounts, or 2) demand greater margin, in the form of collateral, from customers before clearing. Either course will drain FCMs and their customers of funds that would otherwise be available for trading. The CME considers this to be an "unnecessary drain on liquidity."[13]

Beyond the economic harm to FCMs, the proposed rules could also significantly damage hedgers, especially those in the agricultural markets, such as farmers and ranchers.[14] Agricultural customers have historically used the futures and options markets to hedge risks resulting from

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[8] Letter from Walt Lukken, President and Chief Executive Officer, Futures Industry Association, to to Melissa Jurgens, Secretary, Commodity Futures Trading Commission 4 (Feb. 15, 2013), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59201&SearchText=.

[9] *Id.* (citing 17 C.F.R. §§ 1.20(i)(4), 22.2(f)(6), 30.7(a)).

[10] Lukken, *supra* note 8 at 14-15.

[11] Letter from Robert Pickel, Chief Executive Officer, International Swaps and Derivatives Association, to Melissa Jurgens, Secretary, Commodity Futures Trading Commission 5 (Feb. 15, 2013), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59219&SearchText= (cited in Lukken, *supra* note 8 at 15).

[12] Letter from Kim Taylor, President, CME Clearing, to Melissa Jurgens, Secretary, Commodity Futures Trading Commission 5 (Feb. 15, 2013), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59206&SearchText=.

[13] *Id.*

[14] Letter from Diana Klemme, Chair of Risk Management Comm., National Grain and Feed Association, to Sauntia Warfield, Assistant Secretary, Commodity Futures Trading Commission (Feb. 15 2013), http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59178&SearchText=.

the nature of their businesses, such as farmers trying to hedge against the price risk when selling their crops or other products. For example, the National Grain and Feed Association has observed that proposed rule 1.17 "would require an FCM to take capital charges for customer, noncustomer and omnibus accounts that are undermargined for more than one business day after a margin call is issued."[15] As the NGFA observed in its comment letter, the 1 business day requirement is unrealistic.[16] The process by which agricultural and smaller hedgers transfer funds to satisfy margin calls requires telephone calls and wire transfers, and is potentially subject to routine delays of more than 1 business day.[17]

Moreover, proposed Rule 1.17 will likely force small and medium size FCMs, which provide clearing for hedgers, such as those in the agricultural markets, to demand greater margin in advance from their customers to satisfy any potential margin calls during the day.[18] These FCMs lack the financial strength of larger FCMs, such as . . . This will put increasing liquidity demands on these smaller customers, who may lack the financial resources to meet them.[19]

Even worse, as the CME observed in its February 15, 2013 letter, this could also harm the consumers of commodities.[20] Agricultural hedgers and other affected hedgers may pass the higher costs from these additional margin requirements onto the consumers of commodities. As a result, as hedgers pay more to hedge their risks, the consumers of commodities like gasoline or wheat may suddenly find the costs of these essentials increasing.

Yet another fear is that, despite the Dodd-Frank commercial end-user exception to the new swaps clearing requirements, the costs of compliance may lead entities to stop hedging entirely.[21] This is the concern expressed by the CME, which has observed that even:

> [T]hose who qualify as eligible contract participants can move to an *uncleared and less regulated swaps space and decline to sue centralized clearing*, even if they've been using it for years. They *may also move to other markets or instruments for risk*

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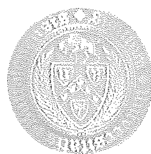
[15] *Id.* at 3.
[16] *Id.* at 3.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] Taylor, *supra* note 12 at 5-6.
[21] *Id.* at 6-7.



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management and move completely out of the Commission's oversight.[22]

The end-user exemption notwithstanding, agricultural customers and other hedgers who fear the misuse of customer funds, as seen in MF Global, will still be forced to send more money as margin to FCMs. By putting more customer funds into the care of FCMs, there is an increased risk that those funds will be adversely affected by other customer accounts or the FCMs themselves.[23] Another consequence of the amendment to Rule 1.17 is decreased competition among FCMs, as smaller and mid-size FCMs are driven out of business from the additional margining requirements. As the CME has pointed out, fewer FCMs will result in even greater systemic risk, as more customers are forced to use these entities and worse, to give them even more money to prevent margin deficits.[24]

III. EXCESSIVE PUBLIC DISCLOSURE CAN TRIGGER ALREADY VOLATILE MARKETS INTO PANIC

Our final concern is that the CFTC is expanding public disclosure requirements beyond what is prudent. Each month, a FCM must file its Form 1-FR-FCM, which includes two components that are made available to the public - the Secured Amount Schedule and the Segregation Schedule. The rest of the Form 1-FR-FCM is not subject to mandatory public disclosure under the Freedom of Information Act and the Government in the Sunshine Act. Currently, a FCM is required to report the total amount of funds held in its segregated or secured accounts, the amount it must hold in these accounts to meet its obligations to futures, foreign futures, and foreign options customers, and whether the firm holds excess funds in these accounts.

The Commission's proposed amendments to 1.10 would expand on what a FCM must include in its monthly Segregation Schedule, as well as in its monthly Secured Amount Schedule.[25] Under these amendments, each schedule would be required to disclose the target amount of residual interest that the FCM is required to maintain in these segregated and secured accounts. In addition, the schedules would list the sum of outstanding margin deficits of the relevant customers for each computation to ensure that the residual interest is always in excess of these deficits. The Commission's proposed rules also calls for the creation of a third publically-

[22] *Id.* (emphasis added).
[23] *Id.*
[24] Taylor, *supra* note 12 at 6.
[25] 77 Fed. Reg. 67872.

available schedule, the "Cleared Swaps Segregation Schedule," in order to implement section 724(a) of the Dodd-Frank Act.[26] This new schedule would report a FCM's segregation of any money, securities, and other property deposited by a Cleared Swaps Customer from its own assets, demonstrating the FCM's compliance with its obligation to keep sufficient funds to cover its obligations to its Cleared Swaps Customers.

The creation of the Cleared Swaps Segregation Schedule and the expansion of the Secured Amount and Segregation Schedules are good ideas, providing the CFTC with the information that the Commission needs to ensure greater consumer protection. However, we believe that making the new Cleared Swaps Segregation Schedule public information, along with the new reporting requirements of the Secured Amount and Segregation Schedule constitutes an oversight on the part of the CFTC. Most importantly, the proposed expansion of public disclosure may produce seriously adverse consequences. The CFTC believes that making these FCM documents public will benefit customers by increasing transparency, thus allowing the public to assess FCMs themselves. Yet historically, unmitigated transparency bears inherent risks of market panic. The case of MF Global's collapse in 2011 is a good example of this premise.

In late October, 2011, MF Global underwent a rapid deterioration into insolvency. Roughly two months prior to MF Global's collapse, the U.S. Financial Industry Regulatory Authority ("FINRA") and the U.S. Securities and Exchange Commission ("SEC") required MF Global to take a $2 million capital charge due to the accounting methods they used to determine haircuts on European Bonds they held.[27] Although MF Global originally believed that its accounting method was permissible, FINRA and the SEC concluded that "...the net capital rule required MF Global to take 'capital charge' against European sovereign bond positions as if they were on the company's balance sheet, notwithstanding that the bonds were accounted for as "sold" under GAAP."[28] MF Global attempted to dispute the capital charges, but it ultimately acquiesced.[29] MF Global successfully raised additional funds to satisfy the minimum net capital requirements as well as early warning requirements specified by FINRA and to account for the capital charge.[30] However, FINRA's rules required MF Global to report a net deficiency for July 2011, and MF

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[26] 77 Fed. Reg. 67932, § 1.10(g)(2).
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[27] Staff of H. Fin. Serv. Subcomm. on Oversight and Investig., 112th Cong., *Rep. on MF Global* 50-51 (2012).
[28] *Id.*
[29] *Id.* at 51-54.
[30] *Id.* at 55.

Global was forced to file notices of net capital deficiency with the SEC and CFTC.[31] In addition, it was required to amend its 10-Q statement. Initially, there was no response from the public.[32]

Although this charge was imposed and reflected in the 10-Q on September 1st, MF Global's downfall did not begin until October 17th, when the Wall Street Journal published an article detailing these capital charges.[33] As soon as news of this reached the public, prices of MF Global stock began to plummet, and confidence in the company waned.[34] MF Global's credit rating sank quickly, and large customers began to close or empty their accounts with MF Global.[35] By October 31st, MF Global had been placed into a liquidation proceeding by the SIPC.[36]

The MF Global case is a testament to how public panic can rapidly accelerate a company's collapse by exacerbating the effects of financial injuries that might otherwise be manageable. This same principle also played a part during the fall of Bear Stearns in 2008. Lenders and customers were reluctant to do business with Bear Stearns after a report to the SEC that contained an accounting error by Bear showing that the company had less than $5 billion in liquidity.[37] Bear Stearns was then required to report its liquidity daily to the SEC, which spooked the company's customers, despite the fact that Bear still had sufficient liquidity.[38] Both the MF Global and Bear Stearns cases illustrate the potential damaging effects that public disclosure can have on the market, and demonstrate why we are concerned about the further expansion of public disclosure pertaining to FCMs and the potential risks this entails.

One of our other concerns is that we believe this newfound disclosure, coupled with the focus on having customers keep an eye on residual interest, could end up harming responsible FCMs for any potential withdrawal of their residual interest. Conversely, FCMs may also be discouraged, by the hostile public reaction, from acting responsibly to increase their residual interest levels, especially in volatile markets. We believe the following examples illustrate this.

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[31] *Id.*
[32] *Id.*
[33] *Id.* at 56.
[34] *Id.*
[35] *Id.* at 57-59.
[36] *Id.* at 73.
[37] U.S. Fin. Crisis Inquiry Comm'n, *The Financial Crisis Inquiry Report: Final Report of the National Commission of the Causes of the Financial and Economic Crisis of the United States* 268 (2008).
[38] *Id.*

For example, a FCM that had disclosed to the public its excessive residual interest on its Segregated and Secured Amounts Schedules may inadvertently create an expected "standard" of coverage in the public eye, one that the FCM would violate by withdrawing some of that interest. Should that FCM have reported excessive coverage for several months, nervous customers may perceive that level of residual interest to be "normal". But should that same FCM withdraw the interest, lowering the amount to a still acceptable level, it could spark panic. Customers accustomed to higher residual interest might panic if their expectations are not met in the future.

Here, although the CFTC would not intend to punish the FCM, the publication of the expanded Segregation and Secured Amount schedules would provoke a negative customer response which, in effect, would still harm the FCM. Thus, a FCM that met all its obligations and decided that it was in its best interest to withdraw some of its own money could be indirectly punished by its customers for doing so. We believe that this outcome is entirely possible under the new public disclosure rules, and it is something that ought to be avoided.

Another less obvious example is useful here. Given the same facts as in the earlier example, let us assume that the FCM's excessive residual interest was actually too low and that the markets are particularly volatile. The FCM later realizes its excessive residual interest level was inadequate, and the FCM prudently begins adding to that amount. This amount is also disclosed in the Segregated and Secured Amounts Schedules. Customers that have expected a certain standard of excess residual interest may be shocked if a FCM suddenly begins *adding* to its excessive residual interest levels. As in the prior example, increased public scrutiny could also turn into panic, as customers question whether the FCM is financially sound. Even worse, given the hostile public reaction, an FCM may actually be discouraged from acting responsibly to increase residual interest.

Under the current proposal, a FCM will disclose its calculated target residual interest for the month and whether its actual residual interest satisfies this requirement. The proposed changes would draw a great deal of new public scrutiny to interest levels and targets, something we believe could endanger FCMs. But at the same time, we believe that having FCMs report this information to the Commission, in addition to the Designated Self Regulatory Organizations, through expanded disclosure requirements is an excellent idea, and a step in the right direction. Instead of focusing on disclosure to the public, the CFTC should focus on having FCMs disclose this information to the Commission itself. Market confidence can be easily broken, as seen with Bear Stearns and MF Global, and disastrous results can result. An FCM whose margin deficits

exceed its targeted residual interest is already in a weakened state - requiring it to publically disclose this weakness would only make things worse.

We believe that the level of public disclosure proposed in the rules is unnecessary and presents a higher chance of a MF Global-type event. While there is no doubt that MF Global had other issues that contributed to its failure, a major catalyst of its downfall was public panic. An already-sensitive market gaining access to the compliance information of all FCMs could cause panic at the slightest deviation from expectations. As they stand now, these proposed regulations seem too broad with their public disclosure requirements. A company must have sufficient residual interest to cover all its obligations at all times. A company that fails to do so must publicly report a temporary, otherwise survivable deficit, which could result in a bad situation becoming far worse.

Conclusion

Overall, we believe that the proposed changes represent a move in the right direction for the Commission, and that such changes are necessary after the financial crisis. However, we still have our concerns about the feasibility of these proposed rules, the financial consequences to both FCMs and their customers, and the necessity of disclosing sensitive information to the public. We appreciate the opportunity to comment on these proposed changes, and we hope that our comments might shed light on important issues facing the futures market.

Sincerely,

Andrew Eastham
Alex Markhasin
Peter Nguyen
George Seaman