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Email to the Secretary
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June 20, 2013

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
155 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:

Please include the following two documents with the comment letters for the above cited Rulemaking.

1. Costs of the Commission's Proposed Residual Interest Requirement Compared with the FIA Alternative (June 18, 2013)

2. Memorandum to the Commission: Interpretation of 4d of the Commodity Exchange Act. (June 18, 2013)

Sincerely,

Barbara Wierzynski
General Counsel and EVP

June 18, 2013

MEMORANDUM

Interpretation of Section 4d of the Commodity Exchange Act

The Commodity Futures Trading Commission ("Commission") has proposed to amend Rules 1.20(i)(4), 22.2(f)(6) and 30.7(a) to require each futures commission merchant ("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.[1] The Commission has indicated (i) that the amendments are required "to provide a mechanism for ensuring compliance with the prohibition of the funds of one customer being used to margin or guarantee the positions of another customer under the [Commodity Exchange] Act and existing regulations" and (ii) that the plain reading of section 4d(a)(2) of the Act (with respect to futures traded on a designated contract market) and of section 4d(f)(2)(B) (with respect to swaps cleared through a registered derivatives clearing organization) does not allow a different interpretation.

We strongly disagree. As demonstrated below, the Commission and its predecessor agency, the Commodity Exchange Authority ("CEA") have long held the position that an FCM is deemed to be in compliance with the segregation requirements of section 4d of the Act and applicable rules, if the FCM holds as residual interest in a customer funds account the amount required by performing the daily segregation calculation required under Commission Rule 1.32.[2] Rather than requiring an 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, the Rule 1.32 calculation requires an FCM to hold an amount at least equal to the sum of the unsecured net liquidating deficits and net debit balances in the FCM's customer accounts.[3] Moreover, the calculation is required to be made as of specific point in time, *i.e.*, as of the close of each business day, but no later than noon the next business day.[4]

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1 "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).

2 Commission Rule 1.32 provides, in part:

> (a) Each futures commission merchant must compute as of the close of each business day, on a currency-by-currency basis: (1) The total amount of futures customer funds on deposit in segregated accounts on behalf of futures customers; (2) The amount of such futures customer funds required by the Act and these regulations to be on deposit in segregated accounts on behalf of such futures customers; and (3) The amount of the futures commission merchant's residual interest in such futures customer funds.

3 "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 [not offset by readily marketable securities]. 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).

4 "The Commission also did not intend to require FCMs to make additional segregation calculations on a routine basis, but only to do so if a problem arises that could trigger the reporting requirement under new Rule 1.12(h)." *Id.*

The Commission has stated, and we agree, that FCMs are required to comply with the segregation provisions of the Act at all times.[5] However, the Commission has also made clear that compliance with the segregation requirements is determined by reference to the calculation required under Rule 1.32. "It is the Commission's intent that" whether an FCM "knows or should know" that it is undersegregated "be implemented by FCMs using existing sources and calculations."[6]

The provisions of section 4d 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,"[7] has been the lynchpin of customer funds protection since the Commodity Exchange Act was enacted in 1936. Significantly, however, we are not aware that the either Commission or the CEA has ever interpreted the statute to require the real time calculation of margin deficits that it is currently proposing. To the contrary, since at least 1963, compliance with the requirements of Rule 1.32 has been deemed to be the means by which an FCM demonstrates compliance with the provisions of section 4d of the Act:

> Section 4d(2) of the [A]ct forbids the commission merchant to commingle [sic] 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 [A]ct, 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.[8]

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[5] See, e.g., Maintenance of minimum financial requirements by futures commission merchants and introducing brokers, 63 Fed.Reg. 2188, 2190 (January 14, 1998); Applicability of CFTC and SEC customer protection, recordkeeping, reporting and bankruptcy rules, and Securities Investor Protection Act of 1970 to accounts holding securities futures products (October 4, 2001).

[6] Maintenance of minimum financial requirements by futures commission merchants and introducing brokers, 63 Fed.Reg. 45711, 45713 (August 27, 1998).

[7] Act, § 4d(a)(2).

[8] As the federal agency charged with administration of the Act, the CEA's interpretation of specific provisions of the Act is entitled to deference.

It is important to recognize that at the time the CEA issued this Administrative Determination, Rule 1.32 stated simply:

> The amount of money, securities, and property which must be in segregated accounts in order to comply with the requirements of section 4d(2) of the Act shall be computed by each futures commission merchant as of the close of the market each business day, based on his accounting records. A record of such computation shall be made and kept, together with all supporting data, in accordance with the requirements of § 1.31.

It was not until1981, with the adoption of rules establishing a domestic exchange-traded options program, that the Commission amended Rule 1.32 to prescribe the three-step calculation set out in footnote 2, above. 46 Fed.Reg. 54500 (November 3, 1981).

To our knowledge, the Commission has never challenged this position. Rather, as made clear in the following examples, the Commission and Commission staff have consistently cited Rule 1.32 as the means by which an FCM is to determine that it is in compliance with section 4d.[9]

Recordkeeping; Amendments to the Daily Computation of the Amount of Customer Funds Required to be Segregated, 65 Fed.Reg 64904 (October 31, 2000)

Section 4d(2) of the Act requires, among other things, that an FCM segregate from its own assets all money, securities, and other property held for customers as margin for their commodity futures and option contracts, as well as any gains accruing to such customers from open futures and option positions. The statute also prohibits an FCM from using the money, securities, or property of one customer to margin or secure futures or option positions of another customer. The segregation requirement is intended to: Protect customers who are dealing with an FCM by assuring the FCM has funds available to readily liquidate its obligations to its customers; assure an FCM has funds available to meet its daily variation margin obligations to the clearing organizations of contract markets; and prohibit an FCM from misappropriating customer funds for its own purposes.

Commission Regulations 1.20 through 1.30 implement the segregation of funds provisions of Section 4d(2) of the Act. 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 the Commission's 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. The computations required by Rule 1.32 are hereinafter collectively referred to as the "segregation computation".[10]

Denomination of Customer Funds and Location of Depositories, 68 Fed.Reg. 5545, 5548 (February 4, 2003)

As noted above, protection of customer funds is one of the most important purposes of the Act and the Commission's regulations. Customer funds must be segregated so as to assure that the obligations owed to customers will be met. Through segregation, customer funds are readily identifiable in the event that a registrant becomes insolvent. Accordingly, Rule 1.49 requires that the FCM or DCO, at the close of each business day, have in segregated accounts on behalf of its customers sufficient U.S. dollars held in the U.S. to meet all U.S. dollar obligations and sufficient funds in each other currency to meet obligations in such currency with certain permitted substitutions. The segregation requirements of the rule are meant to ensure that FCMs and DCOs maintain enough funds, and in the appropriate currency, to meet the obligations owed to customers.

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[9] We further note that the Act has been reauthorized numerous times since 1936 and, to our knowledge, neither the Commission nor any member of Congress has suggested that the use of Rule 1.32 to calculate an FCMs required residual interest was contrary to section 4d.

[10] The final rule contains the identical language. Recordkeeping Amendments to the Daily Computation of the Amount of Customer Funds Required to be Segregated, 66 Fed.Reg. 41131 (August 7, 2001).

* * *

B. Recordkeeping

The Commission is also amending Rule 1.32 to require FCMs to compute segregated funds on a currency-by-currency basis if they are held in other than U.S. dollars, in accordance with new Rule 1.49. Under Rule 1.49, customer funds may be held in the U.S., a money center country, or the country of origin of the currency. Rule 1.49 also would require FCMs and DCOs that hold funds in foreign currency or offshore to maintain records sufficient to demonstrate compliance with the additional segregation requirements set forth in Rule 1.49(e).

Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers, 68 Fed.Reg. 40835, 40836 (July 9, 2003)

The requirement that FCMs segregate customer funds is set forth in section 4d(a)(2) of the Act. Section 4d(a)(2) requires, among other things, that an FCM segregate from its own assets all money, securities, and other property held for customers as margin for their commodity futures and option contracts, as well as any gains accruing to such customers from open futures and option positions.

Commission Rules 1.20 through 1.30, as well as 1.32 and 1.36 implement the segregation of funds provisions of section 4d(a)(2) of the Act for FCMs holding funds for customers trading on U.S. commodity futures and options markets. These rules require FCMs to maintain, in segregated accounts, all of the money and other property deposited by customers to margin their futures and option positions on U.S. markets, as well as any funds accruing to such customers from open futures and option positions. The rules are intended to ensure that an FCM has readily available sufficient funds to meet its obligations, on a dollar-for-dollar basis, to its customers trading on U.S. futures and options markets at all times.

In the Matter of Farr Financial Inc., Docket No. 13-01 (October 9, 2012)

Commission Regulations require all FCMs to compute, as of the close of each business day, on a currency-by-currency basis (1) the total amount of customer funds on deposit in segregated accounts on behalf of commodity and option customers; (2) the amount of such customer funds required by the Act and these regulations to be on deposit in segregated accounts on behalf of such commodity and option customers; and (3) the amount of the futures commission merchant's residual interest in such customer funds. Regulation 1.32, 17 C.F.R. §1.32 (2012). Regulation 1.32 inherently requires that FCMs accurately compute these amounts.

CFTC Staff Letter No. 00-59. (Re: Use of Debt Securities issued by the Federal National Mortgage Association or The Federal Home Loan Mortgage Corporation to Offset a Deficit in a Customer Account for Segregation Purposes), (May 2, 2000)

Section 4d(2) of the Act provides, in relevant part, that an FCM: (1) must segregate from its own assets all money, securities and other property contributed by customers to margin

commodity futures and option contracts as well as any gains accruing to such customers from open futures and option positions; and (2) may not use money, securities, or property of one customer to margin or secure futures or option positions of another customer. Regulation 1.32 requires each FCM to compute daily the amount of customer funds that it holds in segregated accounts and the amount of funds that it is required to segregate under Section 4d(2) (the "segregation computation") to assure compliance with the segregation requirement.

Conclusion

Based on the foregoing, we submit that the provisions of section 4d(a)(2) and section 4d(f)(2)(B) can and, for at least the past 50 years, have admitted a different interpretation from that suggested in the proposed rules referenced above. The Commission certainly has the authority, acting in accordance with the provisions of the Administrative Procedure Act and other applicable laws, to adopt a different interpretation of section 4d and different requirements that an FCM must meet in order to comply with the requirements of this provision of the Act. If the Commission elects to proceed with rulemaking in this area, we encourage the Commission to adopt FIA's suggested alternative, which would authorize 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.

Costs of the Commission's Proposed Residual Interest Requirement Compared with the FIA Alternative

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In our comment letter on the Commission's proposed enhanced customer protection rules, FIA presented data, which demonstrated the significant costs that FCMs and their customers would incur if the Commission adopted its proposed rules requiring FCMs to maintain at all times residual interest in each class of customer funds account sufficient to exceed the sum of all customer margin deficits.[1] We concluded that, in many cases, especially among mid-size firms, an 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, FIA expressed its view that many FCMs would likely have no choice but to require additional margin from their customers.[2] FIA's concerns were shared by many representatives of the buy-side, including the Commodity Markets Council, the Commodity Customer Coalition, the Managed Funds Association, the International Swaps and Derivatives Association, and the Chicago Mercantile Exchange.[3] Representatives of these associations, as well as various agricultural trade associations, have continued to express their concerns to FIA.

In light of these concerns, FIA encouraged the Commission not to move forward with the proposed 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. Nonetheless, if the Commission determined to move forward, FIA recommended an alternative proposal that it believed would achieve the Commission's regulatory goals without imposing damaging financial and operational burdens on FCMs, and the resulting financial burdens on customers. The recommended alternative would authorize 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.

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[1] Letter from Walt L. Lukken, President and CEO, Futures Industry Association, to Melissa Jurgens, Secretary to the Commission, dated February 15, 2013, pp. 14-17.

"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).

[2] 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.

[3] Other buy-side representatives have supported the proposed amendments.

In subsequent discussions with Commission staff, FIA was asked to compare the costs of the residual interest requirement proposed by the Commission with the alternative recommended by FIA. This memorandum sets out our findings.

For purposes of this analysis, we have assumed that FCMs or their customers will be required to finance the increased requirement.[4] To assure consistency with our earlier analysis, 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.[5]

We analyzed data received from ten (10) 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).[6]

We assumed that, in order to assure compliance with the proposed amendments, 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. Therefore, each firm that responded provided data regarding its highest single day margin deficits over the preceding 23 months (July 2011-May 2013) and the margin deficits remaining at close of business on T+1.[7] Because FCMs' experience with cleared swaps collateral is limited, only customer segregated funds and the secured amount were considered.[8]

Among the FCMs represented (for segregated and secured amount accounts combined), the highest single day margin deficits ranged from approximately $162.6 million ($154.9 million segregated funds + $7.7 million secured amount) to approximately $6.1 billion ($5.2 billion segregated funds + $900 million secured amount).

Using the five-year US Treasury Note interest rates above, the annual financing costs for each FCM represented would range from approximately $1.3 million ($162.6 million x 0.0081) to $49.4 million ($6.1 billion x 0.0081) in today's low interest rate environment. In a higher interest rate environment similar to January 1990, the annual financing costs for each FCM

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

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

6 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.

7 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.

8 Notwithstanding the limited empirical data with respect to cleared swaps, FCMs anticipate that the financing costs will increase dramatically.

represented would range from approximately $13.2 million ($162.2 million x 0.08125) to approximately $495.6 million ($6.1 billion x 0.08125).

The increased financing costs of the Commission's proposal for each FCM compared with FIA's suggested alternative, therefore, would range from approximately $1.3 million ($1.3 million - $-0-) to $45 million ($49.4 million - $4.4 million) in a low interest rate environment. In a high interest rate environment, the increased financing costs of the Commission's proposal for each FCM would range from $13.2 Million ($13.2 million - $-0-) to $451.1 million ($495.6 million – $44.5 million).

In contrast, the highest single day margin deficits remaining at COB T+1 ranged from $-0- to approximately $547.8 million ($350.6 million segregated funds + $197.2 million secured amount).[9] Using the same five-year US Treasury Note interest rates above, the annual financing costs for each FCM represented would range from $-0- ($-0- x 0.0081) to $4.4 million ($547.8 million x 0.0081) in today's low interest rate environment. In a higher interest rate environment similar to January 1990, the annual financing costs for each FCM represented would range from $-0- ($-0- x 0.08125) to approximately $44.5 million ($547.8 million x 0.08125).

The increased financing costs under the Commission's proposal, therefore, would be approximately ten times the financing costs under the FIA suggested alternative. The differences in financing costs summarized above are consistent with FIA's findings in a separate survey of FCMs, in which it was determined that, among the FCMs represented, the FCMs collected, on average, more than 90 percent of margin deficits by COB T+1, with a majority of FCMs represented collecting more than 95 percent of margin deficits by COB T+1.[10] Separately, the survey found that the bulk of margin funds collected were received relatively late in the day.

Conclusion

The information above confirms FIA's belief that its suggested alternative will "provide a mechanism for ensuring compliance with the prohibition of the funds of one customer being used to margin or guarantee the positions of another customer under the Act and existing regulations"[11] without imposing damaging financial and operational burdens on FCMs discussed in detail in our earlier comment letter and the resulting financial burdens on customers.[12] If the Commission elects to move forward with an amendment to its rules relating to the calculation of required residual interest, therefore, FIA encourages the Commission to adopt the FIA alternative.

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[9] With one exception, each FCM's remaining margin deficits at COB T+1 were less than the FCM's excess funds held in the relevant customer funds account.

[10] The survey focused on the two week period April 15-April 26. The same ten FCMs responded to each survey. One additional FCM responded to this latter survey.

[11] 77 Fed.Reg. 67866, 67875 (November 14, 2012).

[12] As described in our earlier letter, compliance with the segregation requirements of the Act and the Commission's rules thereunder is also assured by a number of Commission rules.

FIA Residual Interest Cost/Benefit Analysis Summary

	Single Day Gross Margin Deficit					
	Low Range (in millions)			High Range (in millions)		
	1.20 Seg	30.7 Secured	Combined	1.20 Seg	30.7 Secured	Combined
Single Highest Margin Deficit	$ 154.9	$ 7.7	$ 162.6	$ 5,200	$ 900	$ 6,100
Cost utilizing Jan 2013 - 5 year T Note	0.81%		$ 1.3			$ 49.4
Cost utilizing Jan 1990 -5 year T Note	8.125%		$ 13.2			$ 495.6

	Single Day - Outstanding Uncollected Margin T+1					
	Low Range (in millions)			High Range (in millions)		
	1.20 Seg	30.7 Secured	Combined	1.20 Seg	30.7 Secured	Combined
T+1 COB Uncollected Margin Deficit	$ -	$ -	$ -	$ 350.6	$ 197.2	$ 547.8
Cost utilizing Jan 2013 - 5 year T Note	0.81%		$ -			$ 4.4
Cost utilizing Jan 1990 - 5 year T Note	8.125%		$ -			$ 44.5

	Cost Reduction for FIA Proposal T+1 Outstanding Uncollected Margin					
Cost Reduction for T+1	Low Range (in millions)			High Range (in millions)		
Cost utilizing Jan 2013 - 5 year T Note			$ 1.3			$ 45.0
Cost utilizing Jan 1990 - 5 year T Note			$ 13.2			$ 451.1