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By Electronic Mail

January 12, 2018

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: CME Direct Funding Participant Clearing Membership – IF 17-003

Dear Mr. Kirkpatrick:

The Futures Industry Association ("**FIA**")[1] welcomes the opportunity to submit these comments on the proposed rules that the CME Group exchanges (collectively, the "**CME**") have submitted for the Commodity Futures Trading Commission's ("**Commission's**") approval, pursuant to Commission Rule 40.10(a).[2] As the CME explains, the proposed rules would implement a Direct Funding Participant ("**DFP**") clearing membership, pursuant to which a qualified firm may clear trades solely for its own account, provided that the DFP's obligations to the CME Clearing House are guaranteed by at least one clearing member, called a DFP Guarantor, that is a registered futures commission merchant ("**FCM**").

Members of the FIA Law and Compliance Executive Committee and FIA Capital Working Group have carefully reviewed the proposed rules and the CME's description of the DFP program. We have also held several conference calls with CME staff to understand better the obligations that could be imposed on a clearing member that elects to become a DFP Guarantor. We appreciate the willingness of the CME staff to work with us in addressing many of our concerns. Nonetheless, a number of key issues remain unresolved, in particular,

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[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, DC. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to: (i) support open, transparent and competitive markets; (ii) protect and enhance the integrity of the financial system, and (iii) promote high standards of professional conduct.

As the principal members of derivatives clearinghouses worldwide, FIA's clearing firm members play a critical role in the reduction of systemic risk in global financial markets.

[2] Commission Rule 40.10(a) requires a registered derivatives clearing organization ("**DCO**") that has been designated by the Financial Stability Oversight Council as systemically important to provide the Commission at least 60 days prior notice of any proposed change in its rules, procedures or operations "that could materially affect the nature or level of risks presented by the systemically important [DCO]."

the extent to which an FCM, acting solely in its capacity as a DFP Guarantor, will be expected to comply with Commission rules that otherwise govern an FCM's relationship with its customers. Similarly, it is important that the CME make clear the extent to which its rules imposing obligations on FCMs with respect to its customers' transactions on CME Group exchanges may apply.[3]

For our part, we believe that a DFP should never be deemed a "customer" of an FCM for purposes of either the Commission's or the CME's rules when the FCM is acting solely in its capacity as a DFP Guarantor.[4] If the Commission approves the proposed rules, the Commission and the CME should concurrently confirm this position and the CME should amend its rules accordingly. Since neither the Commission's rules nor the CME's rules were adopted with the DFP structure in mind, FCMs will face significant legal and regulatory uncertainty without such confirmation.

Compliance with Commission Rules

We have considered the extent to which the DFP program could implicate Commission rules governing FCMs. Although we have identified certain such rules, discussed below, it is incumbent on the Commission to confirm that an FCM, acting solely in its capacity of a DFP Guarantor, would not be required to comply with any Commission rules that would otherwise be applicable to FCMs.[5]

We have identified, in particular, the following Commission rules that may be implicated by the DFP program: (i) Rule 1.11, risk management program for FCMs; (ii) Rule 1.30, loans by FCMs; (iii) Rule 1.22 and Rule 22.2, with respect to the maintenance of residual interest; (iv) Rule 1.56, prohibition of guarantees against loss; and (v) Rule 1.73, clearing FCM risk management.

To the extent that a DFP is not otherwise deemed to be a customer of the FCM that is a DFP Guarantor, Rules 1.30, 1.22, 22.2 and 1.56 should not be implicated by the DFP program. That is, the guarantee should not be viewed as an unsecured loan in violation of Rule 1.30, or as a guarantee against loss in violation of Rule 1.56. Nor should it be necessary for a DFP Guarantor to hold residual interest in its FCM customer segregated account or cleared swaps

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[3] The Commission will recall that we filed initial comments with respect to the CME's proposed DFP program by letter in October 2016. *See*, letter from Allison Lurton, Senior Vice President and General Counsel, FIA, to Christopher J. Kirkpatrick, Secretary to the Commission, dated October 17, 2016. The comments herein repeat and supplement several of our initial comments.

[4] For purposes of this letter, the Commission's and CME's rules should be read to include related rules governing the relationship between an FCM and its customers, including but not limited to anti-money laundering and know your customer rules.

[5] Similarly, the CME should clarify the extent to which an FCM, acting solely in its capacity of a DFP Guarantor, would be required to comply with CME rules applicable to FCMs.

collateral account to reflect a DFP's margin obligations as required by Rule 1.22 and Rule 22.2.[6]

A DFP Guarantor's potential obligations under Rules 1.11 and 1.73 are less certain. The proposed rules provide that a DFP Guarantor "must prescribe risk-based limits and pre-trade risk controls on all DFPs for which it acts as a guarantor as if each DFP were a customer and as if the DFP Guarantor were required to comply in a manner consistent with" Commission Rule 1.73.[7] We fully expect that, in light of the guarantee, a DFP Guarantor would prescribe risk requirements as contemplated under the proposed rules. However, it is not clear whether, as a result of the CME's rule, the Commission would intend that a DFP be considered a customer for purposes of Rule 1.11 and Rule 1.73. We ask the Commission to confirm that a DFP would not be considered a customer of the DFP Guarantor for purposes of these rules.

Although Commission confirmation regarding the application of its rules when an FCM is acting solely in its capacity of a DFP Guarantor is a necessary first step, we appreciate that an FCM frequently will not be acting only as a DFP Guarantor. To the contrary, it is likely that the DFP will be a "customer" of the DFP Guarantor for other reasons. For example, a DFP may elect to become a DFP only for certain products traded on CME Group exchanges, *e.g.*, cleared swaps or interest rate futures contracts, or for some, but not all, of the CME Group exchanges. The DFP may also trade on designated contract markets for which the CME is not the DCO. Assuming the DFP would clear products for which it is not a DFP through the DFP Guarantor, the DFP would be a customer of the DFP Guarantor with respect to such other products or exchanges. Separately, unless the DFP elects to execute all trades directly, the DFP Guarantor may be asked to execute certain trades as agent on behalf of the DFP, *e.g.*, block trades or exchange of futures for related positions.

In either case, the DFP would be a "customer" under Commission Rule 1.3(k), *i.e.*, a person that uses an FCM as an agent in connection with trading in any commodity interests. The DFP, therefore, would be a "customer" of the DFP Guarantor for certain products or transactions, but would not be a "customer" with respect to other products or transactions. In these circumstances, the analysis regarding the proper application of the Commission's rules is considerably more complicated and Commission guidance is essential.

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[6] We note that proposed CME Rule 900.C.2.d provides, in part, that a DFP Guarantor may prescribe risk requirements for each guaranteed DFP, including minimum margin requirements and collateral requirements, and the CME "shall give effect to any such limits, requirements and controls prescribed by a DFP Guarantor provided to the Clearing House." As we understand the proposed rule, if a DFP Guarantor were to require additional margin or collateral, the DFP would deposit such collateral with the CME rather than deposit such funds in an account owned or controlled by the DFP Guarantor. Therefore, we do not anticipate that an FCM, in its capacity as a DFP Guarantor, would ever hold collateral posted by a DFP and the collateral will never become "futures customer funds" as defined Commission Rule 1.3(jjjj) or "cleared swaps customer collateral" as defined in Commission Rule 22.1.

[7] Proposed Rule 900.C.2.d.

DFP Guarantor Bankruptcy

To the extent that a DFP is not otherwise a customer of the DFP Guarantor, we agree with the CME and its counsel that the DFP's collateral should not be exposed to the risk of *pro rata* loss in the event of the FCM's bankruptcy.[8] In particular, we note that Section 761(9) of the Bankruptcy Code defines a "customer" of an FCM as a person that holds a claim against such FCM arising out of (i) the making, liquidation, or change in the value of a commodity contract or (ii) a deposit or payment of cash, a security or other property with such FCM for the purpose of making or margining a commodity contract. A DFP that otherwise has no relationship with the DFP Guarantor is unlikely to have a claim against a bankrupt FCM and, therefore, should not be a "customer" subject to *pro rata* distribution in the event of a shortfall in customer funds.

However, the result is less certain if the DFP is also a customer of the DFP Guarantor for purposes of trading in products other than those for which it has qualified as a DFP. We ask the Commission to confirm that, in these circumstances, the DFP's assets held at CME would not be subject to a claim by the trustee of a bankrupt DFP Guarantor.

DFP Membership

We understand that a DFP applicant would be expected to meet all of the non-financial requirements for membership set out in CME Rule 901.[9] However, there would be no requirement that a DFP applicant "demonstrate financial capitalization commensurate with Exchange requirements." Further, a DFP would have no continuing obligation to meet minimum financial requirements or to file periodic financial statements with the CME. Instead, the CME would look exclusively to the DFP Guarantor to meet the DFP's financial obligations to the CME.

All other self-clearing members must meet minimum financial requirements and file periodic financial statement with the CME, and we see no reason why a DFP similarly should not be subject to these financial requirements. The failure of the CME to impose such minimum requirements and to assume any responsibility for the creditworthiness of the DFP exposes all clearing members, whether or not a DFP Guarantor, to greater risk. We ask the Commission to require the CME to adopt minimum financial requirements for DFPs, including procedures

[8] We have had an opportunity to review the memorandum of law provided by Sidley Austin LLP and generally agree with the conclusions set out therein.

[9] We note, however, that CME staff have the authority to grant exemptions from these requirements "if it is determined that such an exemption will not jeopardize the financial integrity of the Clearing House." The CME should be asked to clarify the circumstances that might lead the staff to grant an exemption from these requirements.

to monitor the financial strength of DFPs, as the CME requires for all of its other self-clearing members.

DFP Termination

In the event a DFP fails to meet its obligations to an exchange or the Clearing House, or the DFP becomes bankrupt, the proposed rules provide that the Clearing House will liquidate the DFP's portfolio. Critically, the proposed rules further provide that, if called upon by the Clearing House, the DFP Guarantor will be obligated to act as liquidating agent for the Clearing House, and that a DFP Guarantor will be responsible to the Clearing House for any DFP loss and will indemnify the Clearing House against any claim arising from such DFP Guarantor's performance as liquidating agent.

Although we believe the obligation of a DFP Guarantor to act as liquidating agent for the Clearing House should be voluntary, we appreciate the CME's position that the DFP Guarantor will likely be in the best position to know how to manage the DFP through a default, "as the DFP Guarantor guarantees the DFP's financial obligations to the Clearing House and risk-manages the DFP's portfolio." Moreover, the DFP "may have numerous other financial relationships with the DFP Guarantor" that are not subject to the exchanges rules or the DFP framework. Consequently, it is likely that the DFP Guarantor would elect to accept responsibility to liquidate a defaulting DFP's account.

That said, however, we are concerned that the proposed rules provide little guidance to DFP Guarantors (or DFPs) on the means by which a DFP Guarantor is expected to manage a DFP's default. For example, where would the DFP positions be carried until the liquidation process is completed, how would the parties taking the opposite side of the closeout orders be identified, and how would those trades be booked and processed.

Moreover, the limited structure established under the proposed rules inhibits proper risk-management of the DFP's portfolio by the DFP Guarantor. The draft Reimbursement Agreement between a DFP and the DFP Guarantor specifically provides that the second lien that the DFP may grant the DFP Guarantor may not secure any obligation of the DFP arising from any "commodity contract," as defined in the Bankruptcy Code, other than the commodity contracts that the DFP clears as a DFP.[10] The requirements of this provision, which we understand are critical to the conclusions in the memorandum of law provided by Sidley Austin LLP, denies the DFP Guarantor the ability to apply any balance remaining after liquidation of the DFP's contracts to offset any deficit remaining after liquidating the DFP's non-DFP commodity contracts. This appears to be the case even if the DFP Guarantor, in

[10] Draft Reimbursement Agreement, Section 3.

accordance with proposed CME Rule 900.C.2.d, requires the DFP to post additional collateral with the CME.[11]

Separately, we believe it is important that the CME update the netting opinion it has previously furnished to address the applicability of the opinion to the DFP program.

DFP Guarantor Guaranty Fund Contributions

The proposed rules state that the Guaranty Fund contributions of a DFP Guarantor will be sized to account for the activity of the guaranteed DFPs. The CME has provided additional information to the Commission but has requested confidential treatment with respect to such information. This information is essential in a clearing member's consideration of whether to become a DFP Guarantor and, therefore, we believe the CME should make this information available to clearing members without delay.

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Thank you for your consideration of these comments. We appreciate the CME's efforts in creating a framework for allowing qualified buy-side participants to maintain clearing accounts directly with the CME, and we look forward to working with the CME and the Commission in establishing appropriate terms and conditions of a DFP program. If you have any questions regarding the matters discussed herein or need any additional information, please contact Allison Lurton, FIA's General Counsel and Senior Vice President, at alurton@fia.org or 202.466.5460.

Sincerely,

Walt L. Lukken
President and Chief Executive Officer

cc: Honorable J. Christopher Giancarlo, Chairman
Honorable Brian Quintez, Commissioner
Honorable Rostin Benham, Commissioner

[11] *See*, footnote 6, *supra*.