



Futures Industry Association

2001 Pennsylvania Ave. NW
Suite 600
Washington, DC 20006-1823

202.466.5460
202.296.3184 fax
www.futuresindustry.org

By Commission Website

August 8, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

**Re: RIN 3038-AC99: Protection of Cleared Swaps Customer Contracts and Collateral,
76 Fed.Reg. 33818 (June 9, 2011)**

Dear Mr. Stawick:

The Futures Industry Association (“FIA”)¹ welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission’s (“Commission’s”) request for comment on its proposed rules governing the protection of cleared swaps customer contracts and collateral. The proposed rules implement the provisions of section 4d(f) of the Commodity Exchange Act (“CEA”) as amended by section 724 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). Section 4d(f) requires an FCM to “treat and deal with all” collateral received from a swaps customer to margin, guarantee or secure a cleared swap “as belonging to the swaps customer.”² As the Commission has previously noted,

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

FIA’s core constituency consists of futures commission merchants (“FCMs”), and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA’s regular members, which act as the majority clearing members of the U.S. exchanges, handle more than 90 percent of the customer funds held for trading on U.S. futures exchanges.

² Section 4d(f) provides, in relevant part:

A futures commission merchant shall treat and deal with all money, securities, and property of any swaps customer received to margin, guarantee, or secure a swap cleared by or through a derivatives clearing organization (including money, securities, or property accruing to the swaps customer as the result of such a swap) as belonging to the swaps customer. § 4d(f)(2).

the provisions of section 4d(f) are “similar, but not identical” to, the provisions of section 4d(a)(2), which impose a similar segregation requirement on FCMs with respect to customer funds received to margin, guarantee or secure futures transactions traded on US designated contract markets (“DCMs”).³

The Federal Register release accompanying the proposed rules is broadly divided into two parts. The first part reviews the comments received in response to the Commission’s advance notice of proposed rulemaking (“ANPR”), in which the Commission requested comment on several alternative models to implement the underlying purposes of section 4d(f),⁴ as identified by the Commission. These purposes include: (i) mitigating fellow-customer risk,⁵ investment risk⁶ and systemic risk; (ii) inducing changes in behavior; (iii) enhancing portability;⁷ and (iv) facilitating portfolio margining.⁸ The Commission then analyzes the extent to which each alternative achieves these purposes and the relative costs associated therewith.

The second part of the Federal Register release explains why the Commission is proposing to adopt the legal segregation with commingling model, renamed “complete legal segregation.” It concludes with a section-by-section analysis of the proposed rules, as set out in new Part 22 of the Commission’s rules.⁹

And:

It shall be unlawful for any person, including any derivatives clearing organization and any depository institution, that has received any money, securities, or property for deposit in a separate account or accounts as provided in paragraph (2) to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the swaps customer of the futures commission merchant. § 4d(f)(6).

³ Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed.Reg. 75162 (December 2, 2010).

⁴ The ANPR discussed four models: (i) full physical segregation; (ii) legal segregation with commingling; (iii) moving customers to the back of the waterfall; and (iv) the baseline model. FIA submitted a comment letter in connection with this advance notice of proposed rulemaking. Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated January 18, 2011.

⁵ Fellow-customer risk is the risk that a DCO would access the collateral of non-defaulting cleared swaps customers to cure an FCM default. 76 Fed.Reg. 33818, 33821, fn. 21 (June 9, 2011).

⁶ Investment risk is the risk that each cleared swaps customer would share *pro rata* in any decline in the value of FCM or DCO investments of cleared swaps customer collateral. *Id.*, fn. 22.

⁷ Portability means the ability to reliably transfer the swaps (and related collateral) of a non-defaulting customer from an insolvent FCM to a solvent FCM, without the necessity of liquidating and re-establishing the swaps. *Id.*, at 33822, fn. 33.

⁸ Also implicit in the Commission’s analysis, the commodity broker liquidation provisions of the Bankruptcy Code must not be compromised.

⁹ The proposed rules also include conforming changes to the Commission’s Bankruptcy rules, 17 CFR Part 190.

In proposing the complete legal segregation model, the Commission explains that, in its view, this model “protects cleared swaps customer collateral in the manner mandated by the Dodd-Frank Act,”¹⁰ and strikes the “best balance” between the underlying purposes of the segregation requirements and the operational and risk costs associated therewith.¹¹ The Commission nonetheless requests comment on alternatives to the complete legal segregation model.¹²

¹⁰ We do not read the Commission’s statement to imply that the Dodd-Frank Act “mandates” the Commission to adopt the complete legal segregation model. Rather, we understand the Commission’s position to be that the complete legal segregation model is in accordance with the Dodd-Frank Act and section 4d(f) of the CEA. As the Federal Register release makes clear, each of the alternatives discussed would comply with the provisions of section 4d(f).

We agree that the complete legal segregation model is permitted under section 4d(f). However, we believe that the Commission’s reliance on the apparent differences between section 4d(a) and 4d(b), on one hand, and section 4d(f), on the other, to support its position is misplaced. We submit that any apparent differences between these provisions are stylistic, not substantive. The Commission notes that section 4d(f)(6), *inter alia*, prohibits a DCO “that has received any money, securities, or property for deposit in a *separate* account or accounts as provided in paragraph (2) to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the swaps *customer* [singular] of the futures commission merchant.” [Emphasis supplied.] The Commission concludes that “the reference to ‘separate’ and ‘customer’ in section 4d(f)(6) . . . accords with the individual collateral protection currently available in the swaps market and contrasts with the omnibus approach traditionally used in futures markets.” 76 Fed.Reg. 33818, 33819-33820 June 9, 2011).

However, section 4d(b), also prohibits a DCO and any depository “that has received any money, securities, or property for deposit in a *separate* account as provided in paragraph (2) to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the *customers* [plural] of the futures commission merchant.”

Both section 4d(b) and section 4d(f), therefore refer to a *separate* account. The singular “customer” in section 4d(f)(6) must be viewed as a typographical error. Section 4d(f)(6) applies equally to “any depository” that has received cleared swaps customer funds. If the use of the singular “customer” were to be interpreted to require, rather than permit, the adoption of a model other than the “omnibus approach traditionally used in futures markets,” the only permissible model would appear to be “full physical segregation.”

Further, section 4d(f)(3)(B) provides: “COMMISSION ACTION.—Notwithstanding paragraph (2), in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, any money, securities, or property of the swaps *customers* [plural] of a futures commission merchant described in paragraph (2) may be commingled and deposited in customer accounts with any other money, securities, or property received by the futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to the swaps *customer* [singular] of the futures commission merchant.” The use of the singular “customer” in this subsection is clearly a typographical error, since the sentence does not otherwise make sense. The parallel provision in section 4d(a)(2) refers to “*customers*” each place it appears.

¹¹ 76 Fed.Reg. 33818, 33819-33820 (June 9, 2011).

¹² Although renamed, the models, with one exception, are those first identified in the ANPR: (i) physical segregation (previously, full physical segregation), which would require separate accounts for each swaps customer at each FCM, bank and DCO at which the customer collateral is held; (ii) legal segregation with recourse, which we understand is similar to complete legal segregation, with the exception that a DCO would be permitted to include the customer omnibus account at the DCO as the last asset of the waterfall (previously, moving customers to the back of the waterfall); (iii) the current futures model (previously, the baseline approach);

FIA has carefully reviewed both the several alternatives set out on the Federal Register release and the proposed rules.¹³ We have concluded that both the complete legal segregation model and the futures model meet the underlying purposes of section 4d(f) identified above. As explained below, however, we do not believe that (i) physical segregation, (ii) legal segregation with recourse, or (iii) the optional model are practical solutions for the protection of cleared swaps collateral.

Complete legal segregation. As the Commission explains, complete legal segregation permits an FCM to maintain its cleared swaps customer positions and collateral in an omnibus account, on its own books, at the relevant depository and at the relevant DCO. However, the FCM carrying the customer's account must advise the clearing FCM (if different) of the identity of each customer within the omnibus account, the portfolio of positions held by each customer and the margin required to support such positions. The clearing FCM must provide the same information to the DCO that clears the positions.¹⁴ In the event of the default of an FCM, which default is caused by a default of one or more customers, the defaulting FCM must notify the clearing FCM (if different), and the clearing FCM must notify the DCO (if the clearing member has defaulted), of the identity of the customer(s) that caused the default.

One of the critical purposes of the proposed rules is to facilitate the porting of non-defaulting customer positions to a solvent FCM.¹⁵ Porting may be particularly important with regard to cleared swaps, since the markets are not expected to be as liquid as the futures markets. Nonetheless, the proposed rules provide flexibility to a clearing FCM and DCO in the event of an FCM default and do not require a clearing FCM or DCO to effect the transfer of the positions of non-defaulting customers to another FCM. If the clearing FCM or DCO elects to liquidate the positions of non-defaulting customers, however, the proceeds from the positions of non-defaulting customers may not be used to offset any sums owing by the defaulting customer(s) to the FCM or the clearing FCM to the DCO.¹⁶

and (iv) an optional approach, which would permit a DCO to offer different levels of protection to cleared swaps customers.

¹³ We have a number of questions and comments on the proposed rules, which we discuss below.

¹⁴ The relevant depository does not receive information with respect to the customers whose collateral is held in the omnibus account.

¹⁵ The commodity broker liquidation provisions of the Bankruptcy Code and the Commissions rules are designed to facilitate the porting of non-defaulting customer funds and positions. Section 764(b) of the Bankruptcy Code recognizes that the Commission, by rule or order, may approve a transfer of customer positions within seven days of the date of an order for relief, which transfers, upon approval, may not be avoided. The Commission, by rule, recognizes that, no later than three business days after the date of an order for relief, the trustee, a self-regulatory organization or a commodity broker may notify the Commission of its intent to transfer customer positions to a solvent FCM. Commission Rule 190.02(a)(2).

¹⁶ Under the complete legal segregation model, therefore, the customer omnibus account cannot be a part of the DCO's waterfall.

The futures model. Although the Commission reached a different conclusion, we believe the futures model may facilitate portability in the event of a default and portfolio margining. We appreciate the Commission's conclusion that, because the complete legal segregation model should provide a DCO with more complete information with respect to the positions of non-defaulting customers, a DCO should be better able to transfer such positions to a solvent FCM. However, as the Commission also acknowledges, this information will necessarily be incomplete.¹⁷ A DCO may hesitate to authorize any transfers in these circumstances, until it had an opportunity to verify the status of each customer within the omnibus account. Under the futures model, and depending on the size of any shortfall, the DCO may be able to approve the transfer of the entire omnibus account more promptly, since it will have no obligation to confirm the status of each customer within the omnibus account.¹⁸

With respect to portfolio margining, we do not challenge the Commission's statement that it may be more willing to issue an order approving a portfolio margin regime where fellow-customer risk is reduced. However, portfolio margining may also be easier to implement when all positions receive the same protections under the Bankruptcy Code and the Commission's regulations. Because futures and cleared swaps are separate account classes under the Commission's bankruptcy rules, questions may arise if futures contracts held in a portfolio margin account receive different treatment from futures held in the futures segregated account. Conversely, cleared swaps customers may hesitate to agree to have their cleared swaps positions held in a futures account.

The futures model also reduces the moral hazard that some FCMs have identified as a shortcoming in the complete legal segregation model. Since customers have some level of fellow-customer risk under the futures model, they have an incentive to exercise care in the selection of clearing firms. Finally, from an operational and systems perspective, the futures model will certainly be the easiest for FCMs and DCOs to implement.

Nonetheless, we recognize that many customers have expressed concern over the extent to which they may be subject to fellow-customer risk under the futures model. Because they cannot know the identity of these customers, they believe they are unable to conduct the necessary due diligence to assess this risk.¹⁹ Moreover, we recognize that the operational and systems efficiencies of the futures model may not extend to institutional customers that have

¹⁷ Because the DCO would allocate collateral between defaulting and non-defaulting cleared swaps customers based on information the FCM provided the day prior to default, such allocation would not reflect movement in the cleared swaps portfolio of such customers on the day of default. 76 Fed.Reg. 33818, 33826, fn. 72 (June 9, 2011).

¹⁸ Moreover, if the Commission adopts its proposed margin requirements for cleared swaps, fellow-customer risk arising under the futures model should be further reduced. Proposed Rule 39.13(g). Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed.Reg. 3698, 3720-3721 (January 20, 2011)

¹⁹ Such customers, of course, conduct thorough due diligence with respect to the creditworthiness and risk management practices of the FCMs through which they clear.

not previously traded futures. For example, at the Commission's June roundtable on the proposed rules, representatives of several investment managers noted that, whichever model is adopted, they will have to undertake significant systems and documentation modifications that could take one to two years to implement.²⁰

Physical segregation. These investment managers also strongly supported both the physical segregation model and the optional model, as the preferred models to protect cleared swap customers more fully against fellow-customer risk. Although we appreciate their concerns, we do not believe that either model provides a practical solution. In this regard, we agree with the Commission that the physical segregation model carries significantly greater operational costs, while providing only marginally better protection than the complete legal segregation model. Moreover, we are concerned that this model may impose significant operational responsibilities on a trustee in bankruptcy before the trustee may authorize any transfers of non-defaulting customer positions.

Optional Model. We acknowledge that the optional model has the potential advantage of allowing customers with significant assets to pay for a greater level of protection and clearing organizations to compete for business based in part on the level of protection they are prepared to offer. However, this model would be operationally burdensome to implement and would appear to make portfolio margining difficult.

More important, this model would compromise the scheme envisioned in the commodity broker liquidation provisions of the Bankruptcy Code and, therefore, may not provide the expected level of protection. As the Commission notes, section 766(h) of the Bankruptcy Code provides that, in the event of a shortfall in the funds available for distribution to customers in a particular account class, such funds are to be distributed to customers *pro rata*. Therefore, any model that would treat cleared swaps customers of a defaulting FCM differently would be contrary to section 766(h).²¹ Finally, we question whether, as a matter of public policy, it would be appropriate for the Commission to adopt a regulatory scheme that provides protection to customers based on their ability and willingness to pay.

Legal segregation with recourse. Although legal segregation with recourse addresses, to a limited extent, the moral hazard concerns expressed by some FCMs, it, too, does not provide a practical model for the protection of cleared swaps customer funds. Because the omnibus account may be included at the end of a DCO's waterfall, the ability to port the positions of non-defaulting swaps customers to a solvent FCM is severely impaired. Moreover, customers

²⁰ Transcript, Commission Staff Roundtable to Discuss Protection of Cleared Swaps Customer Collateral, comment by William C. Thum, Vanguard Group Inc., p. 10; comment by Christine Ayotte-Brennan, Fidelity Investments, p. 12.

²¹ Id., at 33829.

are exposed to fellow-customer risk. In contrast, fellow-customer risk is “largely mitigated” with complete legal segregation.²²

Comments on the Complete Legal Segregation Model

As noted earlier, we have a number of questions and comments regarding proposed Part 22. In particular, the Commission’s intent with respect to several provisions are unclear and may cause considerable uncertainty if left unresolved.

Cleared Swaps Customer Collateral. The Commission has proposed to define cleared swaps customer collateral to mean, in part, “all money, securities, or other property received by a futures commission merchant or by a derivatives clearing organization from, for, or on behalf of a Cleared Swaps Customer, which money, securities, or other property . . . [is] intended to or does margin, guarantee, or secure a Cleared Swap.”²³ We read this provision to mean, and ask the Commission to confirm, that any sums required by an FCM to margin a cleared swap, even if that sum is in excess of the amount required by the relevant DCO, would fall within the definition of cleared swaps customer collateral. We further ask the Commission to clarify the extent to which collateral voluntarily deposited by a cleared swaps customer in a cleared swaps customer account would be deemed to be cleared swaps customer collateral.

Cleared swaps customer collateral also includes “accruals, *i.e.*, all money, securities, or other property that a futures commission merchant or derivatives clearing organization receives, directly or indirectly, which is incident to or results from a Cleared Swap that a futures commission merchant intermediates for a Cleared Swaps Customer.”²⁴ The scope of this provision is unclear.

In the Federal Register release accompanying the proposed rule, the Commission acknowledges that it is based on Commission Rule 1.21. However, the Commission then goes on to state that inclusion of investment proceeds among accruals

is appropriate since proposed regulation 22.3 permits a DCO to invest “Cleared Swaps Customer Collateral” that it receives from an FCM in accordance with regulation 1.25 . . . [and] any increase in value resulting from the investment would properly belong to the Cleared Swaps Customer, and would constitute another form of “Cleared Swaps Customer Collateral.”²⁵

²² 76 Fed.Reg. 33818, 33826 (June 9, 2011).

²³ *Id.*, at 33850.

²⁴ *Id.*

²⁵ *Id.*, at 33831-33832. Since the definition applies to accruals received by an FCM or a DCO, it is unclear why the explanation discusses only investments made by a DCO.

We are not aware that Commission Rule 1.21 has ever been interpreted to include within “accruals” the proceeds from the investment of customer funds in accordance with Rule 1.25. To the contrary, “accruals” have been limited to those gains that are “incident to, or result from” a futures transaction. The proposed rules recognize the right of FCMs and DCOs to invest cleared swaps customer collateral in accordance with Rule 1.25²⁶ and incorporate by reference Rule 1.29.²⁷ Commission Rule 1.29, in turn, specifically recognizes the right of an FCM or DCO to “receiv[e] and retain[] *as its own* any increment or interest resulting therefrom.” Taken together, these provisions directly contradict the Commission’s statement that “any increase in value resulting from the investment [of cleared swaps customer collateral] would properly belong to the Cleared Swaps Customer.”²⁸ [Emphasis supplied.]

As the Commission is aware, the courts that have examined the provisions of Commission Rule 1.29, affirming the right of an FCM to retain interest earned on the investment of customer funds, have consistently held, after a careful examination of the provisions of section 4d and the legislative history of the Commodity Exchange Act, that “Congress intended that futures commission merchants be entitled to any and all interest on their investment of customer margin funds.”²⁹ We ask the Commission to confirm that its proposed definition of “cleared swaps customer collateral” is not intended to change in any way the right of an FCM to retain interest earned from the investment of customer funds and encourage the Commission to revise the proposed definition in order to remove any uncertainty in this regard.³⁰

Requirements as to Amount. Related to the above discussion, proposed Rule 22.2(f) sets forth the formula for calculating the value of cleared swaps customer collateral. Among other factors, an FCM is required to include in the calculation “any accruals or losses on permitted investments of such collateral under § 22.3(e) of this part that, pursuant to the [FCM’s] customer agreement with that customer, are creditable or chargeable to such customer.” This provision appears to state that a customer may agree with its FCM to assume all or a portion of losses incurred in connection with the investment of customer collateral in accordance with the provisions of Commission Rule 1.25.

²⁶ Proposed Rules 22.2(e)(1), with respect to FCMs, and 22.3(e), with respect to DCOs.

²⁷ Proposed Rule 22.10.

²⁸ We understand that an FCM may agree to pay a customer interest on funds deposited by the customer.

²⁹ *Marchese v. Shearson Hayden Stone, Inc.* 644 F.Supp. 1381(C.D. Cal. 1986), *aff’d*, 822 F.2d 876 (9th Cir. 1987). See, also *Craig v. Refco*, 624 F.Supp. 944 (N.D. Ill. 1983), *aff’d*, 816 F.2d 347 (7th Cir. 1987); *Bibbo v. Dean Witter Reynolds, Inc.*, 151 F.3d 559 (6th Cir. 1998). As the *Craig* court also confirmed, “the FCM, not the customer, bears the risk of any decline in the value of investments purchased with customer funds.”

³⁰ Of course, an FCM can, and frequently does, negotiate with its customer to pay the customer a portion of such interest. As the Court of Appeals in *Craig* observed: “The regulation permits brokers to retain the interest; it does not require them so to do. . . . The parties could have agreed that any such interest would go to Craig. People with sufficient financial savvy to invest in such speculative things as commodities futures should be able to understand such contractual provisions and, if they do not like them, negotiate something different.”

FIA does not believe that a customer may agree to share in losses incurred in connection with investments under Rule 1.25. A customer should never be responsible for losses arising from such investments.³¹ A customer should share in this “investment risk” only in the event that an FCM has defaulted.³²

Treatment of Variation Margin FIA understands that variation margin with respect to cleared swaps may properly be viewed either as collateral for credit exposure or as a settlement payment.³³ However, some market participants are concerned that, if variation margin is viewed as collateral and not as a settlement payment, proposed Commission Rule 22.3(b) may prohibit a DCO from passing such margin to the receiving party. A DCO may be required, instead, to hold such margin until the swap is closed out. We believe this result is not intended or required under the proposed rules and, therefore, we ask the Commission to confirm that a DCO will not be prohibited from passing variation margin to the receiving party, if such variation margin is characterized as collateral and not as a settlement payment by the parties to the swap.

Limitations on Use. Proposed Rule 22.2(d)(1) provides, in part, that cleared swaps customer collateral may not be used “to margin, guarantee, or secure trades or contracts of the entity constituting a cleared swaps customer other than in cleared swaps, except to the extent permitted by a Commission rule, regulation or order, or by a derivatives clearing organization rule.” Proposed Rule 22.2(d)(2) further provides that an FCM “may not impose or permit the imposition of a lien on Cleared Swaps Customer Collateral.” These provisions of the proposed rule appear to prohibit an FCM from asserting a security interest in the cleared swaps customer account or permitting such security interests in connection with cross-margin arrangements or margin financing arrangements with related or third-parties

As the Commission may be aware, currently in determining the collateral that a customer may be required to deposit with an FCM or an affiliate with respect to certain transactions (including uncleared swaps), an FCM or its affiliate will consider the risks posed by the customer’s entire portfolio of positions, thereby effectively cross-margining such positions. To

³¹ See, *Craig v. Refco*, fn. 29, supra. In *Marchese*, the District Court noted that Commission Rule 1.28 requires an FCM that invests customer funds in accordance with Rule 1.25 to “include such obligations in segregated account records and reports at values which at no time exceed current market value.” The Court then found: “Since the FCM must maintain funds in an amount equal to the amount deposited by the customer and the profits realized on the customer’s futures transactions, the FCM must add its own funds to the account if the value of the obligations decreases. See Opinion of the Associate Solicitor, Department of Agriculture (March 17, 1949). The FCM, therefore, bears the risk of a decline in the value of the investments.” Fn. 15.

³² Upon the default of an FCM, neither the FCM nor the trustee has the authority under the Bankruptcy Code to transfer assets from the FCM’s estate to make up for any shortfall arising from the investment of customer funds in Rule 1.25 permitted investments.

³³ We have been advised that, because cleared swaps are not subject to section 1256 of the Internal Revenue Code, the characterization of such payments as settlement payments may have tax consequences that may impair the ability of certain financial end-users, in particular, to enter into cleared swaps transactions.

benefit from these lower margin requirements, the customer will grant the FCM or affiliate a security interest in the customer's account, subject at all times to the FCM's obligation to comply with the segregation requirements of section 4d(a)(2). Separately, an affiliate or an unrelated third party may agree to finance a customer's margin obligations and, among other collateral, will receive a security interest in the customer's account, which interest is subordinate to the FCM's own security interest and applicable law.

Such arrangements are commonplace and substantially benefit customers by allowing more efficient use of capital, while assuring that the integrity of the segregated account is maintained.³⁴ We urge the Commission to confirm that Rule 22.2(d) will permit FCMs and their affiliates to enter into such arrangements with their cleared swaps customers.

Currency-by-currency segregation. Proposed Rule 22.2(g) requires each FCM to compute the daily segregation requirement on a currency-by-currency basis. Specifically the rule provides:

Each futures commission merchant must compute as of the close of each business day, on a currency-by-currency basis: (i) The aggregate market value of the Cleared Swaps Customer Collateral in . . . all Cleared Swaps Customer Accounts held at Permitted Depositories (the "Collateral Value"); (ii) The sum referenced in paragraph (f)(4) of this section (the "Collateral Requirement"); and (iii) The amount of the residual financial interest that the futures commission merchant holds in such Cleared Swaps Customer Collateral, which shall equal the difference between the Collateral Value and the Collateral Requirement.

We understand that proposed Rule 22.2(g) mirrors the provisions of Commission Rule 1.32(a), which require an FCM to perform a similar calculation with respect to customer funds required to be held in a segregated account under section 4d(a)(2).³⁵ Nonetheless, the effect of this latter rule has been limited, since few futures contracts listed for trading on US DCMs are denominated in a foreign currency. In contrast, a significant number of cleared swaps are expected to be denominated in foreign currencies, and we are concerned that the financial consequences for FCMs and their customers may be substantial.

This is because the proposed rules require an FCM, in calculating a customer's cleared swaps collateral requirement, to exclude from the calculation any debit balances that a cleared swaps customer has in its account.³⁶ With currency-by-currency segregation, an FCM will not be

³⁴ These arrangements are also consistent with the Commission's intent to facilitate portfolio margining.

³⁵ An FCM has no comparable requirement with respect to funds held in the foreign futures and foreign options secured account required to be maintained under Commission Rule 30.7, which permits the calculation to be based on the net balances owing to customers across currencies.

³⁶ Proposed Rule 22.2(f).

permitted to offset the debit balance in one currency against a positive balance in another currency. As a result, an FCM may be required to segregate amounts in excess of the amount actually payable to the customer, and the customer and its FCM alike will be subject to unnecessary funding expenses.

For example, assume a cleared swaps customer has a net cleared swaps collateral requirement of \$125,000 comprised of (i) a positive USD balance of \$100,000, (ii) a positive Euro balance in an amount equal to \$75,000, and (iii) a negative GBP balance in an amount equal to \$50,000. With currency-by-currency segregation, the customer's segregation requirement would be \$175,000, which is \$50,000 more than its net margin requirement.

Location of Securities Depositories. Proposed Rule 22.9 incorporates by reference the provisions of Commission Rule 1.49. This latter rule provides that, except as a customer may otherwise authorize, customer funds must be held (i) in the United States, (ii) in a money center country,³⁷ or (iii) in the country of origin of the currency.³⁸ Rule 1.49 further provides that customer funds, if held outside of the US, must be held in at a "bank or trust company that has in excess of \$1 billion of regulatory capital."³⁹

Because "customer funds" are defined to include securities as well as money,⁴⁰ we understand that Rule 1.49 would apply to securities deposited to margin, guarantee or secure cleared swaps. As the Commission is aware, Euroclear serves as the Central Securities Depository for Euro denominated securities. However, since Euroclear is not a bank or trust company, it is not clear that Euroclear is an acceptable depository for purposes of Rule 1.49. In this regard, therefore, we ask the Commission in adopting final rules to confirm that securities that are cleared swaps customer collateral may be held at Euroclear.

Time to meet margin calls; loans. In discussing the provisions of proposed Rule 22.12, Information to be Maintained Regarding Cleared Swaps Collateral, the Commission states that, to the extent an FCM meets a margin call on behalf of a cleared swaps customer or otherwise cover the negative account balance of a cleared swaps customer, such payment will be deemed a loan. Separately, proposed Rule 22.10 incorporates by reference the provisions of Commission Rule 1.30, which requires that any loan made by an FCM to a customer must be adequately secured. These provisions, taken together, appear to require a swaps customer to pre-fund its anticipated margin obligations.

³⁷ Money center countries include Canada, France, Italy, Germany, Japan and the United Kingdom. Commission Rule 1.49(a)(1). Further, "[f]or the Euro, the country of origin includes any country that is a member of the European Union and has recognized the Euro as its official currency." Denomination of Customer Funds and Location of Depositories, 68 Fed.Reg. 5545, 5547 (February 4, 2003).

³⁸ Commission Rule 1.49(c).

³⁹ Commission Rule 1.49(d). Customer funds may also be held at an FCM or a DCO.

⁴⁰ Commission Rule 1.3(gg).

This requirement is a significant change from the treatment of such advances in connection with exchange-traded futures contracts, which are not viewed as loans. In accordance with the provisions of Commission Rule 1.17(c)(5)(viii), an FCM is required to take a capital charge only if such advance has been outstanding more than three business days.⁴¹ We urge the Commission to clarify that, if the FCM collects initial and variation margin within the specified grace period pursuant to Commission and Securities and Exchange Commission rules, an advance will not be deemed a loan to the customer, prohibited unless secured by readily marketable collateral.

Information to be Provided. Proposed Rule 22.12 further requires each FCM to provide certain information with respect to each customer in an omnibus account to a clearing FCM (if different) or a DCO daily. The proposed rule does not require the information to be provided by any specific time. We recommend that the Commission revise Rule 22.12 to set a time by which the required information must be provided.

Reliance on defaulting FCM. Proposed Rule 22.14(a) requires a defaulting FCM to advise a clearing FCM (if different) or the relevant DCO of the identity of the customer(s) whose default has caused the default of the FCM. This means that the clearing FCM or DCO must rely on the defaulting FCM to provide the necessary information. Since the clearing FCM or DCO will not be able to verify the information provided by the defaulting FCM, we request that the rules make clear that the FCM or DCO is not liable if it reasonably relies on the information provided by the defaulting FCM (or if the defaulting FCM fails to provide such information).

FCM Disclosures. Proposed Rule 22.16 requires an FCM to provide detailed disclosure to customers regarding the applicable rules of each DCO relating to the use of cleared swaps customer collateral, transfer, neutralization of the risks, or liquidation of cleared swaps in the event of default by the FCM relating to the cleared swaps account, as well as the changes in such governing provisions. The Commission states that the purpose of this rule is to make cleared swaps customers aware of the limits of the complete segregation model.⁴² We submit that requirement of developing such disclosures should not be left to each FCM. Rather, these disclosures should be the subject of a uniform disclosure document prepared by the industry, subject to Commission approval.

Omnibus accounts. We ask the Commission to confirm that, in the event of an FCM default, the proposed rules continue to provide flexibility to a clearing FCM and DCO to liquidate all of the positions of an omnibus account that the FCM is carrying on behalf of a defaulting non-clearing FCM or foreign broker. However, if the clearing FCM or DCO elects to liquidate the positions of non-defaulting customers, the proceeds from the positions of non-defaulting

⁴¹ We understand, however, that most FCMs generally require margin calls to be met within one business day following the date on which the call is made.

⁴² 76 Fed.Reg. 33818, 33840 (June 9, 2011).

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customers may not used to offset any sums owing by the defaulting customer(s) to the FCM or the clearing FCM to the DCO.

Conclusion

FIA appreciates the opportunity to submit these comments on the proposed rules relating to the protection of cleared swaps customer collateral. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel at (202) 466-5460.

Sincerely,

A handwritten signature in black ink, appearing to read "John M. Damgard". The signature is fluid and cursive, with the first name "John" being more prominent.

John M. Damgard
President

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

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
Robert Wasserman, Associate Director
Jon DeBord, Attorney-Advisor

Office of the General Counsel
Martin White, Assistant General Counsel

Office of the Chief Economist
David Reiffen, Senior Economist
Todd Prono, Financial Economist