MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Advanced Notice of Proposed Rulemaking on Protection of Cleared Swap Customers Before and After Commodity Broker Bankruptcies

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") on its December 2, 2010 Advanced Notice of Proposed Rulemaking on *Protection of Cleared Swap Customers Before and After Commodity Broker Bankruptcies* (the "ANOPR").[2] MFA strongly supports the goals of the over-the counter ("OTC") derivatives regulation set forth in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") to enhance transparency and reduce systemic risk. In addition, we generally support measures aimed at increasing protections for customer assets posted as collateral for cleared swaps. In this comment letter, MFA offers our views as customers on the different models set forth in the ANOPR to assist the Commission with developing rules related to the protection of customer assets for cleared swaps that are in the best interests of customers and the overall functioning of the marketplace.

I. Introductory Comments of MFA

Enacted as part of Section 724 of the Dodd-Frank Act, new Section 4d(f) of the Commodity Exchange Act (the "CEA") provides that "property of a swaps customer [received to margin a swap] . . . shall not be commingled with the funds of the futures commission merchant or be used to margin, secure, or guarantee any trades or contracts of any swaps customer or

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.7 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] 75 Fed. Reg. 75162 (Dec. 2, 2010).

person other than the person for whom the same are held." New Section 4d(f)(6) of the CEA makes it unlawful for a depository institution or derivatives clearing organization ("DCO"), that has received swaps customer property "to hold, dispose of, or use any such . . . property as belonging to . . . any person other than the swaps customer of the futures commission merchant."

In response to the requirements of Section 4d(f), in the ANOPR, the Commission seeks input on the following models for the protection of customer collateral posted for cleared swaps: (1) Full Physical Segregation ("Model 1"); (2) Legal Segregation with Commingling ("Model 2"); (3) Moving Customers to the Back of the Waterfall ("Model 3"); and (4) Baseline Model ("Model 4"), which is the current approach to custody of collateral for futures.[3]

The Commission states in the ANOPR that it is seeking to achieve two basic goals: "[p]rotection of customers and their collateral, and minimization of costs imposed on customers and on the industry as a whole."[4] For any model to accomplish these goals, it must offer strong protections for customer collateral in the event of a futures commission merchant ("FCM") default and it must allow for efficient position and collateral portability in the event of an FCM default. To determine which model best accomplishes these goals, MFA respectfully suggests that the Commission consider both the degree of protection each model provides for an individual customer's assets and the ease with which a customer is able to transfer its positions and any corresponding collateral in the event of an FCM default. Further, we strongly urge the Commission to conduct a comparative cost study of each segregation option as we recommend in Section IV below, before adopting any particular model. We believe current cost estimates associated with the use of Model 1 (full physical segregation) may be overstated. Thus, if the conclusion reached from the cost study is that adopting Model 1 would not impose inordinate costs on customers, we strongly recommend adoption of this model. In our view, this model would best protect customer assets and allow for the portability of customer accounts and related assets.

II. Model 1 - Full Physical Segregation, Offers the Best Protections for Customers and the Market

A. Protection of Customer Assets

By requiring "each customer's cleared swaps account, and all property collateralizing that account, [be] kept separately for and on behalf of that cleared swaps customer, at the FCM, at the DCO, and at each depository", Model 1 provides complete protection for a customer's assets posted to collateralize a cleared swap.[5] Because under Model 1 a DCO is unable to use assets of non-defaulting customers of an FCM in the event that a default by another customer leads to the default of such FCM (a "Double Default"), each customer's collateral is completely insulated from the credit risk of other customers of their FCM. Protecting customers from Double Default

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3 ANOPR at 75164.

4 *Id.* at 75163.

5 *Id.* at 75164.

risk would reinforce the continued confidence in, and ongoing use of, DCOs and thereby fulfills a key policy goal of the Dodd-Frank Act.[6]

In addition to providing full protection to customers' assets, Model 1 offers additional benefits to the market as a whole.

First, it establishes protections for customer collateral posted for cleared swaps that are equal to those available to customers with regard to assets posted as collateral for uncleared swaps.[7] Thus, if the Commission elects to require the use of any model other than Model 1 for cleared swaps, it effectively will codify an advantage for customers in executing uncleared swaps over cleared swaps.

Second, Model 1 is the best method by which market participants can manage "fellow-customer risk" (*i.e.*, the risk of a non-defaulting customer's collateral being available to cure a Double Default). As a general matter, an FCM customer cannot meaningfully evaluate "fellow-customer risk" because the FCM does not disclose the identities, creditworthiness or positions of one customer to another. For that reason, the use of omnibus customer accounts under the current futures model (equivalent to Model 4, and in certain respects, Model 3) for cleared swaps thus exposes customers to "fellow-customer risk" in a Double Default, even though customers are not able to evaluate such risk.

B. Portability of Customer Accounts

In the event of an FCM default, Model 1's requirement for full physical segregation of customer collateral permits the quick and efficient transfer of each non-defaulting customer's position and corresponding collateral. The ability to quickly transfer customer positions not only limits such customers' exposure to market fluctuations by minimizing the period between the default of an FCM and the reestablishment of the customer's position, but also minimizes any disruption or dislocation in swap markets.[8] In short, by enhancing portability of customer positions and collateral in the event of an FCM default, Model 1 minimizes the risk that a customer will realize a loss upon such default and, if positions are not transferred, lowers the magnitude of any loss that a customer may realize.

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6 *Committee Report to S. 3217*, S. Rep. No. 111-176, at 32 (2010).

7 Under new Section 4s(l) of the Commodity Exchange Act, customers will have the right to have its swap dealer or major swap participant counterparty fully segregate their collateral for an uncleared swap with an independent third-party custodian, a far more secure option than omnibus customer accounts.

8 In the cleared swaps markets, it is further possible that liquidity could be lower in a default event, than liquidity in cleared futures markets, particularly until swap execution facilities covering a wide range of swaps are fully established. As a consequence, it could take longer for a DCO to crystallize the losses in a Double Default. In a Double Default scenario, a DCO will likely prevent solvent customers' accounts from being ported until such losses are crystallized and any mutualization is drawn upon. In a scenario where liquidity is lower than, for example, the futures context, the delay on portability would be correspondingly longer, causing delay and uncertainty for solvent customers and potentially leading to a further reduction of liquidity in the overall market. As noted, elimination of mutualization would eliminate the need for this delay in porting.

C. Model 2 as an Alternative

While we believe Model 1 provides the most complete protection of an individual customer's collateral and allows the most effective transfer of customer positions, MFA acknowledges that Model 2 might yield similar results at a lower cost due to lesser administrative burdens. Specifically, by allowing physical comingling of customer collateral while providing for legal segregation, Model 2 likely provides a high degree of protection to customer collateral without incurring some of the administrative costs associated with full physical segregation. In addition, like Model 1, Model 2 prohibits a DCO from using customer funds to cover shortfalls arising from a Double Default.

However, unlike Model 1, Model 2 mutualizes certain other risks among an FCM's customers, such as the risk of a shortfall in value of collateral. Under Model 2, in the event of a Double Default, all non-defaulting customer collateral held in an FCM's omnibus customer account is subject to a pro-rata loss in value, if the collateral remaining after a DCO draws down the defaulting party's collateral is valued at less than what appears on the custodian's books and records.

In addition, under Model 2, the transfer of customer positions is more difficult than under Model 1 because Model 2's lack of full physical segregation would require a custodian to go through the process of identifying the collateral belonging to each customer. In such case, customers would be subject to the risk that the records of the FCM or custodian are inaccurate, increasing the probability that positions are not transferred properly or cannot be transferred. Even if a custodian's and FCM's records are in order, the identification process might be time consuming. Finally, for Model 2 to work properly, both the FCM's and the custodian's records must reflect transactions in or near real time. Any period of time between a customer executing a trade and the FCM or custodian reflecting that trade in its records creates additional operational risk that is not present under Model 1.

Because Model 2 introduces risks not present under Model 1, we strongly prefer Model 1 in the absence of a significant cost differential between the two models. However, if the Commission is able to verify that the cost savings to customers and the market from the lesser administrative burden of Model 2 are material and the risks noted above can be effectively mitigated, then we view Model 2 as an acceptable alternative.

In the event that the Commission adopts Model 2, MFA respectfully recommends that the Commission take steps to avoid potential delays in the transfer of customer positions and related margin that might be caused by the interests of third parties. The Commission should explicitly prohibit (i) any omnibus customer account from including assets of any non-customer of the relevant FCM and (ii) customer positions or assets from being encumbered in any way (whether by setoff, lien or otherwise) in favor of any third party (including the FCM's custodian).[9] These measures would preclude unrelated third parties, such as a defaulted FCM's custodian, liquidity

[9] The Commission should permit the encumbrance of customer assets in accordance with a DCO's default waterfall. Under Model 2, such a lien would allow the DCO to reach a defaulting customer's assets, but not the assets of other customers.

provider or trading counterparty, from claiming an interest in the FCM's omnibus customer account and potentially delay the transfer of customer positions until such third party resolves its claim against the defaulted FCM.

III. Comparison of Models 3 and 4

We believe that neither Model 3 nor Model 4 provides the best protection for, and best ease of portability of, customer collateral posted on cleared swaps.[10] However, if the Commission does not adopt the fuller protection offered by either Model 1 or Model 2, MFA respectfully requests that the Commission adopt Model 3 rather than Model 4 because Model 3 will provide better protection for customer collateral. Specifically, Model 3 is preferable to Model 4 because by moving an FCM's omnibus customer account to the back of the default waterfall, Model 3 limits exposure to "fellow-customer risk" in the event of a Double Default. Moving the margin in an FCM's omnibus customer account to the back of the default waterfall does not reduce the amount of aggregate reserves available to the DCO in the event an FCM defaults.

Under both Models 3 and 4, the DCO has the same amount of assets available to it in the case of a Double Default. The difference is the order in which the DCO is permitted to draw down assets under its default waterfall, which changes the profile of possible losses to classes of market participants, but does not alter the total amount of their assets at risk in the event of default. We believe that moving an FCM's customer account to the back of the default waterfall reflects a more rational distribution of risk than Model 4, because as discussed herein, it is not practical for customers to hedge "fellow-customer risk" and all the other entities whose assets are subject to the DCO default waterfall can more easily mitigate this exposure.

However, the Commission should note that use of Model 3 may result in DCOs and FCMs seeking to assess swap customers more margin than DCOs and FCMs would require under Model 4. Under Model 4, the omnibus customer account precedes recourse to the DCO's capital and the guaranty fund. In contrast, under Model 3, a DCO would have recourse to the omnibus customer account under its default waterfall, behind recourse to the DCO's capital and the guaranty fund. Thus, DCOs and FCMs might theorize that, in a Double Default scenario, because the omnibus customer account falls at the end of the default waterfall, there is an increase in the probability that the DCO will need to use its own capital or the guaranty fund to cover any resulting losses. To lower this probability under Model 3, DCOs and FCMs might increase their assessments of margin on every customer. Before DCOs or FCMs assess additional margin, we would ask that any such increase be supported by objective, risk-based analysis and that such analysis be made transparent to participants who must bear the increased margin requirement. Consistent with our request for an objective study in Section IV below, we are not certain that such analysis will support the need for such increased margin, and especially will not support inordinate increases.

[10] Both Models 3 and 4 subject customer collateral to "fellow-customer risk" and use omnibus customer accounts. Therefore, both models limit the portability of individual customers' positions.

As MFA recommends in Section II.C. above, if the Commission adopts Model 3 or Model 4, it should explicitly prohibit: (i) any omnibus customer account from including assets of any non-customer of the relevant FCM; and (ii) customer positions or assets from being encumbered in any way (whether by setoff, lien or otherwise) in favor of any third party (including the FCM's custodian).

IV. Cost Study

We request that the Commission, prior to adopting any regulations for the protection of customer assets related to cleared swaps, conduct or sponsor an independent cost analysis of the different segregation models. We recognize that the models proposed by the Commission, other than Model 4, might result in: (i) higher costs, in the case of Models 1 or 2;[11] or (ii) a redistribution of risk among different classes of market participants, in the case of Model 3. However, as discussed above, we believe that such a cost analysis might show that the benefits offered by each of these models, when compared to Model 4, outweigh the costs imposed. The Commission should complete this study before promulgating any rules regarding the protection of customer assets for cleared swaps, and the Commission should provide market participants sufficient time to evaluate the results of the study and respond.

Although other market participants have suggested that the costs to the market imposed by both Models 1 and 2 exceed any benefits realized from improved customer protections and portability,[12] we believe that the estimated increase in administrative costs could be overstated. We are not aware of any empirical evidence offered that definitively establishes that costs of full physical segregation are prohibitive. To the contrary, for uncleared swaps, it has been the experience of our members that in negotiating fully segregated, individual account arrangements, the increased administrative burdens and related costs for its counterparty were both manageable and reasonable.

In addition, the argument that Models 1 and 2 would necessitate increased initial margin is based on the assumption that to compensate for the loss of customer funds in the default waterfall a DCO would need to increase its confidence interval on initial margin requirements, resulting in an increase in such margin requirements.[13] This argument and the corresponding estimate are potentially flawed on two levels:

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[11] We note that while Models 1 and 2 would likely increase costs to the market, market participants would know those costs before they would incur them, and therefore, the costs would not be the function of an unknown risk.

[12] *See e.g.*, the transcript of the Commission's *Staff Roundtable on Individual Customer Collateral Protection* at 66, where one roundtable panelist estimated that the full physical segregation proposed by Model 1 would result in $75-100 million in additional administrative costs. In addition, a panelist representing a DCO argued that, if the Commissioner were to adopt a model like Model 1 or Model 2 and the effective mutualization of "fellow-customer risk" is not available through the use of an omnibus account, then there is an increased risk that a DCO would use its own capital or its default fund to cover losses associated with the default of a clearing member. The panelist contended that such risk increase would require DCOs to increase initial margin requirements by 63%. Available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission6_102210-transcrip.pdf.

[13] *See Id.*

First, the argument assumes that DCOs will pass on the additional risk and cost associated with removing an FCM's omnibus customer account from the DCO default waterfall directly to customers in the form of increased margin requirements. In fact, there are other options available to DCOs to address the risk resulting from the change to the default waterfall, and these options are potentially less costly for customers. For example, DCOs could maintain their current confidence interval and increase guarantee fund requirements to compensate for the loss of access to customer funds. [14]

Second, it does not appear that the estimated increase in initial margin takes into account the low probability of a Double Default. Under the current futures segregation regime, DCOs can only use non-defaulting customer collateral to cover a default by a member FCM if one or more of an FCM's customers caused such FCM's default. Such assets are not available for other types of defaults by the FCM. We believe that such a Double Default scenario is unlikely because we are aware of only two instances where FCMs have defaulted due to a customer default.[15] Given that non-defaulting customer collateral is only available to cover a clearing member default in such limited circumstances, we question why a DCO would need to substantially increase its initial margin requirements to compensate for the loss of access to non-defaulting customer collateral.

Given the discrepancies in cost estimates by market participants, MFA strongly encourages the Commission to conduct an impartial study of the incremental costs associated with a segregation model that contemplates full physical segregation, such as Model 1. In conducting such study, the Commission should consider any potential incremental administrative costs and additional margin costs as well as the benefits provided to customers and markets by full physical segregation. In addition, the Commission should not rely only on cost estimates from stakeholders because, although such information might be useful to the Commission, those estimates could contain some bias or be based on unfounded assumptions.

Moreover, we believe that the Commission should have dealers and clearinghouses establish why the use of fully segregated accounts would be administratively burdensome. Many dealers already provide their customers with full account segregation for uncleared swaps using tri-party custodial arrangements. The cost of adopting a full segregation model should not by itself result in the Commission effectively denying customers the benefits of fully segregated accounts, especially since those benefits exist in the uncleared OTC swap markets. If the Commission's study concludes that the costs of customers assets being outside of the default waterfall is significant, in the alternative, the Commission should consider a method of allocating such cost equitably among market participants while still adopting a full segregation model.[16]

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[14] Another potentially inexpensive alternative would be for DCOs to have more nuanced margining with respect to participating FCMs. For example, DCOs could permit FCMs with a portfolio of customers that represent a minimal amount of concentrated counterparty risk to benefit from lower margin requirements.

[15] Volume Investors Futures Inc. (1985) and Klein and Co. Futures Inc. (2000).

[16] If the study concludes that the cost of adopting a full segregation model is minimal relative to the benefits provided to the market, then we would encourage the Commission to consider reforming the segregation model for futures markets to eliminate fellow customer risk as well.

We recommend that the Commission complete this study before promulgating any new rules regarding the protection of FCM customer assets with respect to cleared swaps. In addition, the Commission should provide market participants the opportunity to review and comment on such study. The study along with market input would provide the Commission with the information necessary to implement effective new regulation in this area.

Finally, the Commission seeks input in the ANOPR on whether the Commission should allow FCM customers to choose among the different models for account segregation. We believe the study recommended above should analyze the feasibility of offering customers the option to elect full segregation for their collateral in the event that the Commission adopts a model other than Model 1.

V. Other Questions

A. Moral Hazard Question

In the ANOPR, the Commission raises the possibility that the removal of an FCM's customer omnibus account from a DCO's default waterfall would create moral hazard because it would result in customers not conducting adequate due diligence on their FCM. MFA believes the moral hazard risk associated with the elimination of "fellow-customer risk" is overstated because, as discussed previously, customers do not have the information necessary to conduct due diligence on an FCM's other customers. Without this information, customers cannot determine the entire credit risk associated with a particular FCM under any of the proposed models.[17]

In addition, customers select FCMs based on multiple criteria, most notably the quality of services the FCM provides. In particular, an FCM's overall credit quality as well as its strength in trade execution, collateral management and operational risk are essential to the customer relationship and unchanged by the presence or absence of customer funds in the DCO's default waterfall. If the Commission adopts Model 1, then customers would have the same incentives to choose well-capitalized, creditworthy and experienced FCMs. In addition, FCMs would still be subject to membership requirements of DCOs, which consider the credit standards of its members as well as requirements imposed by the Commission, including regulatory capital requirements.

B. Interpretative Statement No. 85-3

In the ANOPR, the Commission solicits input on its Office of General Counsel's Interpretative Statement, No. 85-3, *Regarding the Use of Segregated Funds by Clearing Organizations upon Default by Member Firms* (Aug. 12, 1985) and asks how Interpretative Statement No. 85-3 should inform the Commission's rulemaking on segregation of collateral for cleared swaps. In Interpretative Statement No. 85-3, the Commission's Office of General Counsel ("OGC"), finds that Section 4d(2) of the CEA "does not preclude the clearing

[17] Model 1, however, removes considerations of "fellow-customer" risk entirely from a customer's assessment.

organization from applying all margin deposits of a defaulting firm to discharge such firm's obligations on behalf of the customer account for which they were deposited with the clearing organizations."[18]

MFA believes that Interpretative Statement No. 85-3 does not contain a persuasive interpretation of the CEA because the OGC does not cite any affirmative authority to support a DCO having such blind recourse, but rather it takes a non-affirmative position that such action is "not preclude[d]" or "not inconsistent" with Section 4d(b) of the CEA.[19]

The central question at issue in Interpretative Statement No. 85-3 is whether under Section 4d(b) of the CEA, a DCO can have recourse to assets in a customer account without regard to allocation of such assets to individual accounts of the defaulting member's customers. A more straightforward reading of Section 4d(b) of the CEA yields a conclusion that conflicts with the position reached by the OGC. CEA Section 4d(b) states that a clearing organization is not "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 of such futures commission merchant." The principal holding of the Interpretative Statement is inconsistent with the plain meaning of such words because when an FCM defaults, the capital of its stakeholders is at risk and followed by the guaranty of the DCO. This use of customer assets would constitute involuntary support to an FCM. Curing an FCM's default should be the exclusive role of the FCM's stakeholders and the DCO. A more straightforward interpretation of Section 4d(b) of the CEA would suggest that a DCO *cannot* have blind, general recourse to customer assets.

In addition, we note that Interpretive Statement No. 85-3 does not preclude or otherwise detract from the Commission adopting Model 1 or Model 2 because it does not mandate that customer collateral must be included in a DCO's default waterfall, rather it merely provides that inclusion be permitted. Thus, Interpretive Statement No. 85-3 should not limit the Commission's consideration of any model identified in the ANOPR.

Therefore, we suggest that the Commission consider Interpretative Statement 85-3 in light of its historical context and view it as an interpretation that reached a pragmatic outcome appropriate for the time. In 1985, technology was less advanced and requiring a clearing organization to recognize assets at the individual counterparty level may have been

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[18] ANOPR at 75166.

[19] *See Id.* at 75166-75167. In reaching its conclusion, the OGC primarily relies of the following observations: First, Section 4d(2) allows commingling for administrative convenience. Second, customers of clearing organizations are the member firms (not the ultimate counterparties). Third, legislative history suggests Congress intended that customer funds should not be used to offset liabilities of an FCM. Fourth, the Bankruptcy Code: (i) affords treatment of customers' funds collectively as separate from the assets of an FCM, and (ii) does not require clearing organizations to acknowledge individual accounts of the FCM's customers. Fifth, no regulation of the Commission compels DCOs to acknowledge individual accounts of the FCM's customers. Sixth, the Commission asserts that, "margin deposits at the clearing level thus facilitate the clearing organization's performance of its guaranty obligation." None of these observations, individually or collectively, logically support the OGC's conclusion that recourse can be taken to an omnibus customer account without attribution of the assets in such account to the individual customers of the clearing member.

administratively cost prohibitive. MFA believes that such technological complexities are easily surmountable today, and thus, the need to protect customers' assets far outweighs any pragmatic, technological problem. Consequently, the Commission should interpret Section 4d(b) as codifying that assets posted by a customer should support only the obligations of such customer, and DCOs should treat such assets accordingly.

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MFA appreciates the opportunity to comment on the ANOPR. We would be pleased to meet with the Commission's members or staff to discuss our comments and the different segregation models for cleared swaps. If the Commission's members or staff have questions about this letter, please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President, Managing Director & General Counsel

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