August 8, 2011

Via Electronic Submission: https://comments.cftc.gov

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


Dear Mr. Stawick:

Managed Funds Association (“MFA”)\(^1\) appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the “Commission”) on its proposed rules on “Protection of Cleared Swap Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions” (the “Proposed Rules”).\(^2\) 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 risk in the swap markets, including the segregation of collateral for cleared swaps.\(^3\) In this spirit, we are providing comments on the Proposed Rules that we believe will assist the Commission in promulgating final rules that balance the need to minimize risk with the desire to maintain liquidity in the swap markets.\(^4\)

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\(^1\) 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 $2 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.


I. Support for Complete Legal Segregation Model

MFA supports the Commission’s proposed Complete Legal Segregation Model and believes this type of collateral segregation is an important step towards achieving the goals of the Dodd-Frank Act. Of the various approaches that the Commission discusses in the Proposing Release with respect to implementing new section 724(d)(f) of the Commodity Exchange Act, the Complete Legal Segregation Model provides a proper level of protection for customers’ assets should another customer of an FCM default, and this model allows for efficient portability of customer positions and related collateral in the event of a default by an FCM or one of its customers.

As the Commission explains in the Proposing Release, the Complete Legal Segregation Model requires an FCM to keep books and records that identify each customer’s cleared swaps and the related collateral, and the FCM must maintain that collateral in an account separate from any assets of the FCM or the relevant DCO. As a result, the Complete Legal Segregation Model provides strong customer protections because:

- in the event of a customer default, the DCO cannot access the collateral belonging to non-defaulting customers to satisfy any losses associated with the defaulting customer; and

- customers may identify and access collateral and port cleared swap trades if an FCM fails or appears to be failing.

The Complete Legal Segregation Model provides superior customer collateral protection when compared to the Legal Segregation with Recourse Model and the Futures Model. Unlike the Complete Legal Segregation Model, both the Legal Segregation with Recourse Model and the Futures Model would fail to protect FCM customers against fellow customer risk (though to differing degrees) and would hamper portability. The Complete Legal Segregation Model also

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5 The other three models are: (1) Full Physical Segregation, where each customer’s collateral is held in an individual account; (2) Legal Segregation with Recourse, which is similar to the Complete Legal Segregation Model, though non-defaulting customer collateral is available at the end of the derivatives clearing organization (“DCO”) default waterfall to cure a futures commission merchant (“FCM”) default caused by a defaulting customer; and (3) the Futures Model, where all customer collateral is held in an omnibus account and can be used to cure any collateral deficiency resulting from an FCM default caused by a defaulting customer after the collateral of the defaulting customer and the capital of the FCM are exhausted.

6 Proposing Release at 33820. The Commission defines the maintenance of separate books and records for cleared swap positions and related collateral as the “Legal Segregation Model”, of which the Complete Legal Segregation Model is a subset.

7 Id.

8 Id.

9 Id. at 33821.

10 The Legal Segregation with Recourse Model provides better protection from fellow customer risk than the Futures Model because fellow customer collateral is the last source of assets in the DCO default waterfall.
is operationally easier to implement than the Full Physical Segregation Model. However, MFA believes that the Commission should permit FCM customers who would prefer Full Physical Segregation to elect such increased protection as long as it can be accomplished within the Complete Legal Segregation Model.\(^\text{11}\)

A. Eliminating Fellow-Customer Risk

The Complete Legal Segregation Model eliminates “fellow customer risk” with regard to cleared swaps (\textit{i.e.}, the risk that a DCO uses assets of an FCM’s non-defaulting customers to satisfy losses of that FCM’s defaulting customer in the event that those losses exceed the margin assets of the defaulting customer and the FCM). Choosing a segregation model that eliminates fellow customer risk is important because without such protection, swap market participants will not realize an important benefit of central clearing – the reduction of credit risk to parties when entering into swaps.

More importantly, an FCM’s customers do not have the necessary information to determine and mitigate any fellow customer risk to which they are exposed. Customers do not know (and indeed should not know) the identity of their fellow customers or the nature of the trading activity or positions of those fellow customers. Without this information, which is properly kept confidential, no customer can assess the creditworthiness of its fellow customers. Accordingly, adopting the Complete Legal Segregation Model would protect customers by eliminating the need for them to accept a risk that they cannot properly assess.

The Commission has requested comment as to whether it should require each FCM to disclose certain financial information.\(^\text{12}\) MFA supports certain additional disclosures by each FCM – specifically those relating to its overall financial condition, such as its total equity, regulatory capital and net worth. Such information, while not sufficient to allow customers to assess their exposure to fellow customer risk, would nonetheless give better insight into the financial condition of the FCM, which is important in the customer’s overall counterparty risk management policy.

However, because such collateral is available in the event of default under the Legal Segregation with Recourse Model, it does not fully eliminate fellow customer risk.\(^\text{11}\)

\(^\text{11}\) The Commission should allow market participants to elect the Full Physical Segregation Model but only to the extent that it is compatible with the Complete Legal Segregation Model. We are not advocating that the Commission adopt the “Optional Approach” set forth in the Proposing Release, because we believe that approach would be very difficult to implement. However, because both the Full Physical Segregation Model and the Complete Legal Segregation Model insulate customer assets, FCMs may be able to offer customers full physical segregation for collateral as an alternative to the Complete Legal Segregation Model.

\(^\text{12}\) Proposing Release at 33827. Suggested disclosure items include: an FCM’s total equity, regulatory capital and net worth; the dollar value of the FCM’s proprietary margin requirements as a percentage of its segregated and secured customer margin requirements; the number of FCM customers that comprise a significant percentage of its customer segregated fund; the aggregate notional value of non-hedged, principal OTC transactions into which the FCM has entered; the amount, generic source and purpose of any unsecured and uncommitted short-term funding the FCM is using; the aggregate amount of financing the FCM provides for customer transactions involving illiquid financial products; the percentage of defaulting assets that FCM had during the prior year; and a summary of the FCM’s current risk practices, controls and procedures.
MFA acknowledges that the Complete Legal Segregation Model does not eliminate the risk that each cleared swaps customer would share *pro rata* in any losses associated with investments of collateral in the omnibus account (*i.e.*, “investment risk”).\(^\text{13}\) We understand that Proposed Rule 22.5(e) (for cleared swaps) will limit the investment of collateral delivered to support cleared derivatives to high quality, liquid investments. Although that limitation will mitigate the risk of shared investment loss, we encourage the Commission to continue to study and monitor this aspect of shared risk to determine if additional regulation may be appropriate.

**B. Preserving Portability**

The Complete Legal Segregation Model also will enhance the portability of customers’ positions to a greater extent than the Legal Segregation with Recourse Model or the Futures Model.

Position portability is of great importance in swap markets. Portability of cleared swap positions will allow FCM customers the ability to move cleared swaps without incurring incremental transaction costs or encountering the various operational, accounting, tax and legal issues that would arise if the customer had to terminate and recreate those positions with another FCM. By contrast, if a DCO is to have recourse to non-defaulting customers’ funds, as is the case under the Legal Segregation with Recourse Model and the Futures Model, it is unlikely to release the collateral of such non-defaulting customers until it has completed the process of liquidating the portfolio of the defaulting FCM and its customers. This retention effectively would freeze non-defaulting customers’ accounts, rather than allowing customers to move them to another FCM, as they could under the Complete Legal Segregation Model.

In addition, portability benefits the U.S. financial system. Portability minimizes the period between the default of an FCM and the reestablishment by customers of their cleared swap positions with another FCM, allowing customers to limit their exposure to market fluctuations. The prompt transfer of customer positions also facilitates the orderly resolution of a failing FCM and minimizes any disruption or dislocation in the swap markets. In addition, the ability to quickly transfer customer positions likely will limit the contagion or “knock-on” effects that can occur when an interconnected FCM becomes insolvent.\(^\text{14}\) We believe this is consistent with a central theme of the Dodd-Frank Act – to strengthen the U.S. swap markets.\(^\text{15}\)

**C. No Moral Hazard Issue**

MFA agrees with the Commission’s conclusion that sound protections for collateral

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\(^{13}\) *Id.* at 33821.

\(^{14}\) Portability helps to contain financial contagion by quickly defusing the number of customers, cleared swaps and collateral maintained with a failing FCM. *First,* customers who port quickly do not incur losses should their swaps be “out-of-the-money” at the time the customer ports its cleared swap positions. *Second,* once a customer has ported swaps and related collateral to a new FCM, it is no longer exposed to further risks associated with the failing FCM, including operational issues such as the ability to receive the proceeds of a terminated swap in an expedient manner. *Finally,* porting allows the estate of a failed FCM to quickly liquidate, thus, lowering the related costs.

\(^{15}\) S. Rep. No. 111-176 at 32.
delivered to support trading of cleared swaps will have a positive impact on how customers trade cleared swaps. Customers will be insulated from their fellow customer risk and able to port their positions in times of stress. This level of protection does not mean, however, that moral hazard – that customers will do less diligence on the financial strength of an FCM – will increase. Customers select FCMs based on multiple criteria, most notably the quality of services the FCM provides. In addition, if the Commission mandates the disclosure by FCMs of certain financial information, customers will be in a better position than they are today to evaluate the financial strength of their FCM. This will be important because even under the Complete Legal Segregation Model, customers will need to perform diligence on their FCM, because a solvent FCM will alleviate any fellow customer risk. Accordingly, MFA does not believe that the elimination of fellow customer risk will increase moral hazard.

II. Permitting Liens on Collateral for Netting Purposes

The Commission, when issuing final rules with respect to the treatment of customer collateral in cleared swap accounts, should not limit the ability of parties to net margin across many different exposures and assets, including cleared and uncleared swap positions. As MFA has advocated in other comments it has submitted to the Commission, netting is beneficial to market participants and the overall swap markets because, among other things, it abates counterparty credit risk and can lower costs by permitting more efficient margin management.

MFA is concerned that Proposed Rule 22.2(d)(2), without clarification, might make netting of cleared and uncleared swaps extremely difficult. That Proposed Rule states:

“(2) A futures commission merchant may not impose or permit the imposition of a lien on Cleared Swap Customer Collateral. . . .” (emphasis added)

A plain reading of Proposed Rule 22.2(d)(2), particularly the emphasized language, indicates that an FCM has a duty to ensure that no liens are placed on Cleared Swap Customer Collateral, which would include liens granted or requested by the FCM’s customer.

In the Proposing Release, the Commission’s limited explanation as to why Proposed Rule 22.2(d)(2) is necessary is that it would prevent creditors of a failing FCM from interfering with its orderly resolution. We agree that the language of 22.2(d)(2) facilitates this purpose.

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16 Proposing Release at 33827.
17 These criteria include, for example, an assessment of an FCM’s strength in trade execution and collateral management.
18 See the discussion in Section I.A. of this letter at pages 3-4 infra.
20 Proposing Release at 33852.
21 Id.
However, the language does not limit the scope to shielding customer assets from creditors of the FCM. Thus, we are concerned that Proposed Rule 22.2(d)(2), without modification or clarification by the Commission, also will completely bar customers from granting liens on their collateral, even though such liens would be subordinate to DCO’s interests in the FCM customer’s collateral.  

A customer’s ability to grant a lien on its cleared swaps and related collateral is important for cross-product, and many multilateral, netting agreements. In such netting arrangements, an FCM or its affiliates may agree to an offset of margin for uncleared swaps or other trading relationships to the extent they have recourse to any cleared swap positions and related collateral. Customers should be able to place liens on both their cleared swaps and any related collateral, which both the Bankruptcy Code and Part 190 of the Commission’s rules identify as belonging to the customer. The FCM or its affiliates, without a lien on such cleared swap positions and collateral, would have limited recourse (if any) to such assets should a customer default. Thus, the FCM or its affiliates are unlikely to allow such margin offsets in the absence of a lien.

The inability of customers to net across products will increase their trading costs, as they will be required to fund separate margin obligations without the benefit of any offsetting cleared swap positions or related collateral. Netting also is an effective method for FCMs and the affiliates to mitigate counterparty credit risk associated with a customer across several trading relationships.

To address these concerns, we recommend that the Commission implement one of the remedies discussed below.

First, the Commission could modify the language of the Proposed Rule to limit its application to prohibiting an FCM’s creditors from obtaining a lien on the Cleared Swap Customer Collateral. For example, the Commission might restyle Proposed Rule 22.2(d)(2), in relevant part, to read:

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22 However, we note that the Commission’s stated purpose would be more clearly achieved if the Proposed Rule was written as the “futures commission merchant may not grant . . . a lien.” The verb “impose” suggests that the FCM is taking the lien for its benefit, not creating the lien for the benefit of the FCM’s creditors.

23 We note that the words “may not impose or permit the imposition of” likely prohibit all liens on the Cleared Swap Customer Collateral regardless of whether the FCM or a third-party would be the lien beneficiary.

24 These other trading relationships may include, without limitation, repurchase agreements, security lending arrangements and security forward transactions.

25 Bankruptcy Code Sections 760-767; Commission Rule 190.08(a).

26 Any lien granted by a customer with respect to its cleared swaps and related collateral should not impair the ability of the DCO or the FCM to take recourse to such collateral if such client should default.
“(2) A futures commission merchant may not grant a lien to one or more of its creditors on Cleared Swap Customer Collateral or allow one or more of its creditors to impose or maintain a lien on Cleared Swap Customer Collateral. . . ”

Second, if the Commission does not choose to modify Proposed Rule 22.2(d)(2), it should clarify in the final rule release or other interpretive guidance that nothing in Proposed Rule 22.2(d) limits the ability of a customer to grant liens on entitlements to cleared swap positions and related collateral as contemplated in Article 9 of the Uniform Commercial Code. This clarification would be consistent with the current Commission staff position that state law governs situations where a customer assigns an FCM’s obligations to it to a third party. If the FCM becomes insolvent, one customer’s lien on its cleared swaps and related collateral would not interfere with: (i) the ability of fellow customers to port their positions and related collateral; or (ii) the resolution of the FCM. We believe any such guidance issued by the Commission should require that an FCM customer, when granting a lien on the Cleared Swap Customer Collateral, may not impair the DCO’s first priority right to such collateral. Either of these solutions would permit an FCM customer to grant liens with respect to its cleared swaps and related collateral sufficient to enter into beneficial netting agreements.

III. Costs

Although MFA has not analyzed the costs of the different segregation models, we do not believe that the cost of implementing the Complete Legal Segregation Model would be substantially more than the other possible segregation models. It has been our members’ experience that in negotiating fully segregated, individual account arrangements for uncleared swaps, the increased administrative burdens and related costs for them and their counterparties were both manageable and reasonable. We completely agree with the Commission’s questioning of the assumptions underlying some commenters’ assertions that the “risk costs” associated with Complete Legal Segregation Model would be significant. We encourage the Commission to require FCMs to justify any increases in costs and/or margin requirements against verifiable risks.

27 An FCM may not be fully empowered, absent the consent of one or more of its creditors, to waive or eliminate any liens on the Cleared Swap Customer Collateral that arose by operation by law in favor of its creditors. That said, we are not sure what such lien might be.

28 Pursuant to § 9-102(49) of the Uniform Commercial Code (“UCC”), a “commodity contract” and a “commodity account” are two types of “investment property”. Under UCC § 9-102(15), a commodity contract is a contract that either has been designated as a commodity contract under federal commodities law or is traded as such on a foreign market, board of trade, or exchange. Under UCC §§ 9-102(16) and (17), a “commodity contract” is held for the “commodity customer” by a “commodity intermediary”, who is a merchant of commodity contracts. Under UCC § 9-102(14), a commodity account is the book-entry account maintained by the commodity intermediary that contains a commodity customer’s commodity contract(s).


30 Should an FCM become insolvent, some question exists as to whether a customer’s lien on cleared swap account might impair that customer’s efficient transfer of its cleared swap positions and related collateral. Buy-side firms understand this risk and often accept it for the immediate benefits afforded by netting cleared and uncleared positions.

31 Proposing Release at 33826.
associated with the Complete Legal Segregation Model, taking into account historical probability of a default by an FCM customer that resulted in the failure of its FCM.

In general, our members contend that the associated “risk costs” are merely incremental, particularly the probability of an FCM failing due to insufficiently secured positions of one of its customers. Thus, we believe that the benefits of the Complete Legal Segregation Model, principally the ability to identify and access collateral and port cleared swap trades upon the default of an FCM, outweigh any expected cost.

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MFA appreciates the opportunity to comment on the Proposed Rules. We would be pleased to meet with the Commission members or staff to discuss our comments and the different segregation models for cleared swaps. If the Commission members or staff have any questions, 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