



MANAGED FUNDS  
ASSOCIATION



May 7, 2013

**Via Electronic Mail**

Gary Barnett  
Director of Division of Swap Dealer and Intermediary Oversight  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

Ananda Radhakrishnan  
Director of Division of Clearing and Risk  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

**Re: Request for Repeal of Segregation Interpretation 10-1 for Futures and Options Transactions**

Dear Mr. Barnett and Mr. Radhakrishnan:

Managed Funds Association (“MFA”)<sup>1</sup> and the Alternative Investment Management Association<sup>2</sup> (“AIMA”, and together with MFA, “we”) respectfully request that the Division of Clearing and Risk and the Division of Swap Dealer and Intermediary Oversight (together, the “Divisions”) of the Commodity Futures Trading Commission (“Commission”) repeal the Division of Clearing and Intermediary Oversight’s (“DCIO”) Amendment of Interpretation

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<sup>1</sup> Managed Funds Association represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

<sup>2</sup> AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.

(“**Segregation Interpretation 10–1**”)<sup>3</sup> to the Financial and Segregation Interpretation No. 10 on the Treatment of Funds Deposited in Safekeeping Accounts (“**Segregation Interpretation 10**”)<sup>4</sup> for futures and options transactions (“**Futures**”).

#### A. Background

As the Divisions know, Section 4d(a)(2) of the Commodity Exchange Act (“**CEA**”) requires a futures commission merchant (“**FCM**”) to maintain all customer collateral separate from the FCM’s own funds, but permits an FCM to commingle assets of one customer with the assets of another. In 1984, the Commission’s Division of Trading and Markets (“**DTM**”) issued Segregation Interpretation 10 to provide DTM’s view on the treatment under Section 4d(a)(2) of funds deposited in third-party custodial accounts. Pursuant to Segregation Interpretation 10, DTM permitted the use of third-party custodial accounts so long as the accounts complied with certain enumerated standards.<sup>5</sup> However, in 2005, DCIO issued Segregation Interpretation 10-1, in part, in response to concerns that FCMs did not have “immediate and unfettered access” to customer collateral.<sup>6</sup> In Segregation Interpretation 10-1, DCIO stated that, with limited exception,<sup>7</sup> third-party custodial accounts were no longer permitted or appropriate, and that FCMs would not be “in compliance with the requirements of Section 4d(a)(2) if they deposit, hold or maintain margin funds for customer accounts in third-party custodial accounts”.<sup>8</sup>

Recently, in adopting the final segregation of collateral rules for cleared swaps, the Commission clarified that Segregation Interpretation 10–1 does not apply to those swaps.<sup>9</sup> In addition, in the Final Cleared Swap Rule Release, the Commission noted a commenter’s request that the Commission repeal Segregation Interpretation 10-1 for Futures, but the Commission declined to address the commenter’s request because “it [was] beyond the scope of this rulemaking”.<sup>10</sup> However, the Commission also stated that “while the Commission does not

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<sup>3</sup> 70 Fed. Reg. 24768 (May 11, 2005), available at: <http://www.gpo.gov/fdsys/pkg/FR-2005-05-11/pdf/05-9386.pdf>.

<sup>4</sup> Comm. Fut. L. Rep. (CCH) 7120 (May 23, 1984) available at: [http://www.cftc.gov/tm/finsegiinterp\\_10.htm](http://www.cftc.gov/tm/finsegiinterp_10.htm).

<sup>5</sup> See *id.*, permitting third party custodial accounts if the accounts meet DTR’s outlined standards with respect to: (1) account name, (2) liquidation of open positions, (3) withdrawal power, and (4) account location.

<sup>6</sup> See Segregation Interpretation 10-1 at 24768. See also *id.*, where DCIO bases its decision, in part, on changes to Rule 17f–6 of the Investment Company Act of 1940, as amended, which permitted registered investment companies to deposit customer margin directly with FCMs and futures clearinghouses.

<sup>7</sup> See *id.*, where DSIO asserted that FCMs could continue to use third party custodial arrangements where existing law precludes FCMs from holding assets of registered investment companies.

<sup>8</sup> *Id.*

<sup>9</sup> See Commission final rule on “Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions”, 77 Fed. Reg. 6336 (February 7, 2012), at 6343, available at: <http://www.gpo.gov/fdsys/pkg/FR-2012-02-07/pdf/2012-1033.pdf> (the “**Final Cleared Swap Rule Release**”).

<sup>10</sup> *Id.* at 6343.

believe it would be appropriate to address this request at this time . . . the Commission may address this concern in the future.”<sup>11</sup>

## **B. FCM Immediate and Unfettered Access to Futures Customer Collateral**

We believe that, in light of the MF Global, Inc. (“**MF Global**”) and Peregrine Financial Group, Inc. (“**Peregrine**”) failures, it is the appropriate time for the Divisions to consider the commenter’s request, and we respectfully request that the Divisions repeal Segregation Interpretation 10-1 for Futures. Our members are customers to FCMs and are fiduciaries to their investors. Thus, we were very troubled by the MF Global and Peregrine insolvencies, which resulted in Futures customers experiencing a delay in the return of their segregated Futures assets or incurring material losses of their Futures funds.<sup>12</sup> Therefore, we believe that repealing Segregation Interpretation 10-1 to permit third-party custodial accounts for Futures is an important step towards safeguarding investors’ assets.

We understand that the Divisions are concerned about maintaining FCM and market stability. Therefore, “any impediments or restrictions on the FCM’s ability to obtain immediate and unfettered access to customer funds are not permitted”<sup>13</sup> because any potential delay in a customer margin payment could significantly disrupt the market, particularly in times of market stress. We also appreciate that DCIO issued Segregation Interpretation 10-1, in part, to address “evidence of significant risks that may impair immediate and unfettered access by FCMs”.<sup>14</sup>

However, in Segregation Interpretation 10-1, DCIO’s concern about restrictions to FCMs’ access to customer collateral resulted from:

- (1) a comment letter indicating that Futures customers, rather than FCMs, have the client relationship with the custodian banks, which limits FCMs ready access to the third-party custodial account;<sup>15</sup> and
- (2) reports by Commission audit staff and the Joint Audit Committee<sup>16</sup> of instances where the custodian released significant amounts of customer assets from the third-party custodial account without the FCM’s knowledge or permission.<sup>17</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> See Complaint, Commodity Futures Trading Commission v. Peregrine Financial Group, Inc., and Russell R. Wasendorf, Sr., No. 12-cv-5383 (N.D. Ill. July 10, 2012), available at: <http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfpfgcomplaint071012.pdf>. See also Report of the Trustee’s Investigation and Recommendations, In re MF Global Inc., No. 11-2790 (MG) SIPA (Bankr. S.D.N.Y. Jun. 4, 2012), available at: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/mfglobalinvestreport060412.pdf>.

<sup>13</sup> Segregation Interpretation 10-1 at 24769.

<sup>14</sup> *Id.* at 24768.

<sup>15</sup> See *id.* at 24769, citing a comment letter from the Futures Industry Association dated April 4, 2005.

As described below, we strongly believe that the structure of typical third-party custodial account arrangements and the standard provisions in the related account agreements address these concerns and justify the Divisions' repeal of Segregation Interpretation 10-1 for Futures. In addition, we remind the Divisions that, following repeal of Segregation Interpretation 10-1 for Futures, the tri-party custodial accounts would remain subject to the standards enumerated in Segregation Interpretation 10.

## 1. Typical Third-Party Custodial Account Arrangements

Some of our members have established third-party custodial accounts in the over-the-counter ("OTC") derivatives market for collateral they have posted on uncleared swap positions. Typically, the related agreement is a tri-party agreement among the customer, its dealer counterparty and a third-party custodian bank.<sup>18</sup> Therefore, both the customer and its dealer counterparty have a relationship, and are in contractual privity, with the third-party custodian (*i.e.*, it is not only the customer that has a relationship with the custodian). Although the third-party custodial account holds the customer collateral, as discussed further below, the dealer counterparty has a secured interest in the posted customer collateral and has exclusive control over the account and related customer collateral, except when the FCM is in default. Limiting the FCM's exclusive control over the third-party custodial account upon its default is necessary because providing the FCM with exclusive control is what allows potential misuse and misappropriation of customer collateral.

## 2. UCC Control of Collateral by Dealer Secured Party

For third-party custodial accounts, a custody bank or other institutional custodian assumes responsibilities for safeguarding, investing, transferring and releasing customer posted collateral under the three-way contract among the custodian, the customer and the dealer counterparty.<sup>19</sup> The control agreement is in favor of the dealer and the collateral safeguarding covenants provided by the custodian to the dealer in that agreement allow the dealer to control the customer's collateral. The dealer becomes a secured party by obtaining and perfecting its valid security interest in the posted collateral by having "control" over the collateral assets under

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<sup>16</sup> See The Joint Audit Committee website, available at: <http://www.wjammer.com/jac/>, which describes the Joint Audit Committee as a representative committee of U.S. futures exchanges and regulatory organizations, including the ACC, BTEC, CBOT, CME, COMEX, CSC, ELX Futures, KCBOT, MESL, MGE, NQLX, NYCE, NYFE, NYMEX, One Chicago, PBOT and the NFA.

<sup>17</sup> See Segregation Interpretation 10-1 at 24769.

<sup>18</sup> See Memorandum, "Independent Amount Segregation: Summary of ISDA's Sample Tri-Party IA Provisions", published in 2011 by the International Swaps and Derivatives Association, Inc. ("ISDA"), available at <https://www.managedfunds.org/wp-content/uploads/2013/02/ISDA-SampleTri-Party-IA-Provisions-Memorandum.pdf>, which contains standard contractual provisions to facilitate negotiation of third-party custodial account agreements.

<sup>19</sup> See *id.*

Article 8<sup>20</sup> and Article 9<sup>21</sup> of the Uniform Commercial Code (“UCC”). UCC Articles 8 and 9 have been widely adopted in the U.S. Subject to the UCC and the respective rights of the parties under the third-party custodial account agreement, the dealer (as the secured party) typically establishes the requisite degree of control under the UCC by virtue of its contractual ability to direct the custodian to follow its instructions (except when it is the defaulting party under the relevant agreements).

The dealer may also gain exclusive control over the collateral posted by the customer (in the event of the custodian’s default or other specified condition) by issuing an “entitlement order” to the custodian. In particular, if the dealer issues a “Notice of Exclusive Control” to the custodian in such circumstances, it will eliminate any right of a defaulting customer to attempt to instruct the custodian to move its collateral.<sup>22</sup> The contractual terms would then require the custodian to cede possession of the collateral to the dealer, ensuring the dealer’s timely access to the collateral. Such access facilitates the dealer’s timely liquidation of the customer’s non-cash collateral to cover its exposures.<sup>23</sup> In the event of the customer’s bankruptcy, the dealer’s contractual rights to liquidate, terminate or accelerate a derivatives contract would be unimpaired, as such contractual rights are not subject to the automatic stay.<sup>24</sup>

### **C. Equal Protection of Cleared Swaps, Futures and Options Customers**

Although Segregation Interpretation 10-1 reflects DCIO’s prior views and concerns about third-party custodial accounts, recently, as mentioned in Section A above, in adopting the final segregation of collateral rules for cleared swaps, the Commission demonstrated a willingness to reconsider Segregation Interpretation 10-1 and the extent to which third-party custodial accounts comply with Section 4d of the CEA.<sup>25</sup> In addition, the Commission has proposed rules that will allow customers to utilize third-party custodial accounts with regard to their uncleared swap collateral.<sup>26</sup> As mentioned, some of our members have established third-party custodial account

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<sup>20</sup> Article 8 relates to “perfection by control over a certificated security, an uncertificated security, or a security entitlement is provided in §8-106).

<sup>21</sup> Article 9 relates to “perfection by control over deposit accounts is provided in §§9-104, 9-314 and 9-327”.

<sup>22</sup> See “Independent Amounts”, Release 2.0, dated March 1, 2010, a white paper produced jointly by ISDA, MFA and the Securities Industry and Financial Markets Association at 10, available at: <https://www.managedfunds.org/wp-content/uploads/2013/02/Independent-Amount-WhitePaper-Final.pdf>, which describes arrangements for holding initial margin in third party custodial accounts and control provisions for the secured party to achieve a perfected security interest in the collateral.

<sup>23</sup> See *id.* at 40, endnote 38.

<sup>24</sup> 11 U.S.C. sections 555 (securities contract) and 560 (swap agreement).

<sup>25</sup> See Final Cleared Swap Rule Release at 6343, where the Commission clarified that subject to the conditions described therein, FCMs may deposit their cleared swaps customers’ collateral in a third-party custodial account without the FCM being deemed in violation of Section 4d(f) of the CEA.

<sup>26</sup> See Commission notice of proposed rulemaking on “Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy”, 75 Fed. Reg. 75432, (December 3, 2010),

arrangements in the OTC derivatives market for protection of their uncleared swaps collateral, and we believe the protections provided by third-party custodial accounts<sup>27</sup> should be available to all customers, including Futures customers.

Moreover, we believe that there is no difference between cleared swaps and uncleared swaps on the one hand and Futures on the other that supports retaining Segregation Interpretation 10-1 and limiting the use of third-party custodial accounts for Futures. In fact, it was the Futures customers of MF Global and Peregrine that were harmed by MF Global and Peregrine's misuse and misappropriation of customer assets and subsequent insolvencies.<sup>28</sup> These events suggest a clear need to enhance protections of Futures customers' collateral, and we feel strongly that Futures customers should have protections that mitigate "fellow customer" risk<sup>29</sup> as well as FCM operational and investment risk for their collateral equal to those that the Commission permits a cleared swaps customer to receive.

Therefore, we respectfully request that the Divisions repeal Segregation Interpretation 10-1 for Futures and allow the use third-party custodial accounts to: (1) ensure that Futures customers will have protections for the collateral they post equal to those available to other derivatives customers, and (2) enhance customer protections and increase customer confidence while not impairing FCMs' unfettered access to their customers collateral.

#### **D. Importance of Third-Party Custodial Arrangements**

Repealing Segregation Interpretation 10-1 for Futures is necessary because third-party custodial accounts are important mechanisms for: (1) mitigating "fellow customer risk" and FCM operational and investment risk, and (2) facilitating the prompt transfer of customers' positions and collateral in the event of an FCM's default.<sup>30</sup>

##### **1. Mitigating Fellow Customer and Other FCM Risks for Futures customers**

Third-party custodial accounts would provide increased protection for Futures customers from a number of risks, including "fellow customer risk". "Fellow customer risk" is the risk that a derivatives clearing organization ("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. As a general matter, a customer cannot

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available at: <http://www.gpo.gov/fdsys/pkg/FR-2010-12-03/pdf/2010-29831.pdf>, which provide for individual segregation with a third-party custodian for customer collateral posted on uncleared swaps.

<sup>27</sup> See Section C below for a brief discussion of the benefits of tri-party custodial accounts.

<sup>28</sup> See *supra* note 12.

<sup>29</sup> See Section D.1 below for a description of "fellow customer risk".

<sup>30</sup> In such circumstance, an FCM's default may be due either to the default of another customer or to the FCM's independent default.

meaningfully evaluate “fellow-customer risk” because the FCM does not disclose the identities, creditworthiness or positions of one customer to another. Therefore, under the current commingled account model for Futures,<sup>31</sup> a non-defaulting Futures customer would be exposed to the default risk of its FCMs’ other customers and share in any losses attributable to those customers’ defaults, even though the non-defaulting Futures customer is unable to evaluate or mitigate such risk.

Third-party custodial accounts provide help to mitigate “fellow customer risk” because they would allow Futures customers to maintain their collateral in an account at a custodian separate from the collateral of FCMs or other FCM customers. Therefore, in the event that an FCM defaults independently or a customer default leads to the FCM’s default, a DCO would be limited in its ability to use assets of the FCM’s non-defaulting Futures customer to satisfy any defaulting customer shortfalls.

In addition, third-party custodial accounts would help insulate Futures customers from FCM operational risks (*e.g.*, fraud, misuse or misplacement of Futures customer collateral) and investment risks (*e.g.*, losses of Futures customer collateral due to losses in permitted FCM investments). As discussed in Section B above, in tri-party arrangements, the customer typically has contractual privity with its dealer counterparty and the custodian. As a result, the customer has greater transparency into its custodial account. In addition, since only the customer’s (and no other customers’) collateral is in the account, it allows the customer to ensure that its collateral is accurately accounted for and present at all times. This transparency is critical to improving customer confidence, and would prevent FCMs from misusing or misappropriating funds of Futures customers in the future.

## **2. Increasing Portability of Futures Customer Accounts**

Third-party custodial accounts would also permit the quick and efficient transfer of a non-defaulting Futures customer’s positions and collateral in the event of its FCMs’ default. Because the Futures customer would have a separate account holding only its positions and collateral, in the event of its FCM’s default, there would be no delay in identifying the positions and collateral belonging to the customer. In a commingled customer account, the identification process hinders the speed with which a customer may transfer its positions and collateral.

A Futures customer’s ability to transfer its positions promptly would not only limit its exposure to market fluctuations by minimizing the period between the default of an FCM and the reestablishment of the customer’s positions, but would also minimize any disruption or dislocation in the Futures markets. In short, by enhancing portability of Futures customer positions and collateral in the event of an FCM default, third-party custodial accounts would reduce the risk that a customer will realize a loss upon such default, and lowers the magnitude of any loss that a Futures customer may realize, if it is unable to transfer its positions.

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<sup>31</sup> See sections 4d(a) and (b) of the CEA and Commission regulations §1.20 to §1.30 for a description of the commingled account model currently permitted for Futures.

Mr. Radhakrishnan  
May 7, 2013  
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We thank the Divisions for your consideration of our request for repeal of Segregation Interpretation 10-1 for Futures. We would welcome the opportunity to discuss our request in greater detail. Please do not hesitate to contact Stuart J. Kaswell or Carlotta King of MFA at (202) 730-2600 and Jiří Król, Adam Jacobs or Wesley Lund of AIMA at +44 (0) 20 7822 8380 with any questions the Divisions or their staffs might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

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

/s/ Jiří Król

Jiří Król  
Director of Government and  
Regulatory Affairs  
Alternative Investment Management  
Association

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