

April 9, 2001

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: Proposed Rule 1.68, 66 Fed.Reg. 14506 (March 13, 2001)

Dear Ms. Webb:

The Futures Industry Association (“FIA”) is pleased to submit the following comments on the Commodity Futures Trading Commission’s (“Commission’s”) proposed rule 1.68 and related amendments (collectively, the “proposed rules”). FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately sixty of the largest futures commission merchants (“FCMs”) in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

The proposed rules would implement that provisions of section 5a(f) of the Commodity Exchange Act (“Act”), which provide that a registered derivatives transaction execution facility (“DTF”) may adopt rules authorizing FCMs to offer its customers that are eligible contract participants the right to “opt out of segregation.” That is, eligible contract participants would have right to elect to have their funds carried in an account that would not be subject to the segregation requirements of section 4d(2) of the Act and the regulations thereunder, *i.e.*, Commission rules 1.20-1.30. The Commission is required to adopt rules implementing the provisions of section 5a(f) within 180 days of the effective date of the Commodity Futures Modernization Act of 2000.

Proposed rule 1.68 and related amendments are designed to: (1) assure the financial integrity of an FCM that offers its customers the right to opt out of segregation; (2) provide certain disclosures and other protections to eligible contract participants that elect to opt out of segregation; and (3) assure that protections afforded the funds of customers that either are not eligible to opt out of segregation or elect not to opt out are not diminished. In this connection, the proposed rules would: (a) require an FCM, for purposes of computing the FCM’s capital requirements, to take into account funds of customers that have opted out of segregation;¹ (b) require an FCM to enter into a signed written agreement with customers that elect to opt out

¹ Proposed amendments to Commission rules 1.12(b)(2) and 1.17.

of segregation which, among other things, would advise such customers of the consequences of opting out in the event of the FCM's bankruptcy; (c) provide that the claims of customers that have opted out of segregation would not be taken into account in determining the net equity of customers under the Commission's bankruptcy rules; and (d) prohibit an FCM from establishing third party custodial accounts for customers that have opted out of segregation. The intended purpose of the latter three provisions would be to assure that, in the event of the default of an FCM carrying accounts of customers that have opted out of segregation, such customers would not receive a priority equal to or greater than the priority accorded customers whose funds are segregated under the commodity broker liquidation provisions of the Bankruptcy Code and Part 190 of the Commission's rules.²

FIA agrees with the purposes underlying the proposed rules. Specifically, an FCM should be required to take into account funds of customers that have opted out of segregation for purposes of computing the FCM's capital requirements. Further, an eligible contract participant that elects to opt out of segregation should enter into a written agreement with the FCM in which customer acknowledges that the customer understands certain consequences of making such an election.³ Finally, a customer that elects to opt out of segregation should not be permitted to structure its relationship with an FCM for the purpose of assuring that, in the event of the FCM's bankruptcy, the customer receives a priority that is equal to or greater than the priority accorded customers whose funds are segregated. Nonetheless, FIA believes that the revisions to the proposed rules recommended in this letter are necessary to achieve the Commission's objectives.

Three provisions of the proposed rules seek to assure that customers that opt out of segregation take after customers whose funds are segregated in the event of the carrying FCM's bankruptcy. First, proposed rule 1.68(a)(4)(iii)(C) would require a customer to acknowledge in writing that, in the event of the FCM's bankruptcy, the customer may be treated as a general creditor of the FCM. Second, under the proposed amendment to Commission rule 190.07(b), the calculation of a customer's allowed net equity would exclude any claim based on contracts traded on a registered DTF that has authorized opting out of segregation. Finally, proposed rule 1.68(e) would prohibit a customer that opts out of segregation from establishing "a third party custodial account for those funds, as described in the Commission's Division of Trading and Markets Financial and Segregation Interpretation No. 10." Nor may the customer obtain a security interest in such funds.

² In the *Federal Register* release accompanying the proposed rules, the Commission states that an FCM would be permitted to provide customers that elect to opt out of segregation with a single account statement listing both segregated account positions and opt out account positions. FIA endorses the Commission's interpretation of its existing rules in this regard.

³ FIA notes that, in requiring a written agreement between an FCM and its customer, the Commission has not prescribed either the form of the proposed agreement nor the manner in which it must be signed. For example, in the *Federal Register* release accompanying the proposed rules, the Commission stated that an electronic signature that complied with the provisions of Commission rule 1.4 would be acceptable. FIA agrees with the Commission's decision in this regard. Both the form of any such agreement and the manner in which it is executed should be left to the FCM and its customer.

Customers that Opt Out of Segregation are not General Creditors

FIA suggests that it is unnecessary for the Commission's purposes and inconsistent with current law to require a customer that elects to opt out of segregation to agree that the customer will be treated as a general creditor in the event of the bankruptcy of the FCM. The Commission's proposal would effectively deny these customers their status as "customers" under the Bankruptcy Code ("Code") and result in such customers being treated less favorably than the proprietary accounts carried by the FCM.

As the Commission is aware, the commodity broker liquidation provisions of the Code define the term "customer." Pursuant to the provisions of section 761(9) of the Code a "customer" of an

entity for or with whom such futures commission merchant deals and that hold a claim against such futures commission merchant on account of a commodity contract made, received, acquired or held by or through such futures commission merchant in the ordinary course of such futures commission merchant's business as a futures commission merchant from or for the commodity futures account of such entity.

Further, although Congress has authorized the Commission under section 20 of the Act to promulgate rules and regulations defining the scope of customer property and for other limited purposes, Congress has not authorized the Commission to revise the definition of the term "customer." Customers that elect to opt out of segregation, therefore, are nonetheless "customers" under the Code and, therefore, are entitled to the priority over general creditors the Code establishes.⁴

This does not mean, however, that customers that elect to opt out of segregation are entitled to a priority that is equal to the priority provided customers whose funds are held in segregation. The Commission faced this same issue when it initially promulgated the bankruptcy rules. Under the Code, associated persons, principals and other affiliated persons of a bankrupt FCM are nonetheless "customers" of the FCM under the Code. Believing that such customers should not be entitled to the same priority as customers that are subject to the segregation requirements, the Commission resolved the matter by establishing two separate categories of customers: (1) "public *i.e.*, customers whose funds are segregated under section 4d(2) of the Act; and (2) "non-public customers," *i.e.*, customers whose accounts (other than the accounts of the debtor FCM itself) that fall within the definition of a proprietary account as defined in Commission rule 1.3(y).

⁴ 11 USC §766(h).

In lieu of the Commission's proposal, therefore, we recommend that the Commission make no change in existing rule 190.07(b). Instead, the Commission should amend rule 190.01(bb) to define that customers that elect to opt out of segregation are non-public customers for purposes of Part 190 of the Commission's rules. We believe this approach is appropriate, since a customer that elects to opt out of segregation effectively will have elected to be treated as a proprietary account of the FCM. Moreover, it is entirely consistent with the provisions of the Code governing commodity broker liquidations.⁷ Finally, decision to treat customers that elect to opt out of segregation as non-public customers would be less susceptible to challenge in the event of an FCM's bankruptcy and, therefore, the ability of a trustee in bankruptcy to effect the transfer of non-defaulting public customers should be facilitated. Suggested language to implement this and other revisions suggested in this comment letter are set forth in Appendix A to this letter.

⁵ In this regard, it should be noted that Congress amended the Code in 1982 to provide express statutory authority for the Commission's proposal. Specifically, section 766(h) of the Code provides in relevant part:

Notwithstanding any other provision of this subsection, a customer net equity claim based on a proprietary account, as defined by Commission rule, regulation, or order, may not be paid either in whole or in part, directly or indirectly, out of customer property unless all other customer net equity claims have been paid in full.

⁶ We further note that efforts to draw comparisons between the Commission's proposal and the treatment of clients that elect to opt out of segregation under the rules of the United Kingdom's Financial Services Authority ("FSA") are not appropriate. Under FSA rules, the pool of funds with respect to which clients have a priority claim is limited to the funds actually held in the client money funds account, the parallel to the US segregated funds account. Thereafter, all clients, whether they have elected to opt out of segregation or not, are treated as general creditors under FSA rules.

⁷ In this connection, we note that the Code would not appear to authorize the Commission to distinguish further among customers. That is, although the Code authorizes the Commission to distinguish between public customers and customers whose accounts the Commission defines as proprietary accounts, the Commission does not have the authority to accord a higher priority to certain public customers to the detriment of other public customers.

The Prohibition on Certain Contractual Relationships

Proposed rule 1.68(e) prohibits a customer that elects to opt out of segregation from entering into certain contractual relationships with its FCM. Specifically, rule 1.68(e) would provide:

A customer who elects not to have its funds separately accounted for and segregated, in accordance with this section, may not establish a third-party custodial account for those funds, as described in the Commission's Division of Trading and Markets Financial and Segregation Interpretation No. 10, 1 Comm. Fut. L. Rep. (CCH) para. 7120 (May 23, 1984), and may not obtain a security interest in such funds.

The clear intent of the proposed rule is to prohibit a customer that has elected to opt out of segregation from attempting to secure a priority that is equal to or greater than the priority accorded customers whose funds are segregated in the event of the FCM's bankruptcy. As indicated earlier, we endorse the Commission's objective. However, as the Commission is aware, Financial and Segregation Interpretation No. 10 governs accounts that are intended to meet the segregation requirements under section 4d(2) of the Act. Prohibiting a customer that has elected to opt out of segregation from entering into such an agreement would have no meaning and most certainly would not achieve the Commission's goal.

We believe the Commission can achieve its purpose in a much more straightforward way by prohibiting certain contractual provisions generally. Specifically, the Commission should revise proposed rule 1.68(a) to require a customer that elects to opt out of segregation to agree that it will not enter into any agreement with the FCM, including taking a security interest in any assets deposited with the FCM that are not subject to segregation, the terms and conditions of which, directly or indirectly, purport to give the customer a priority in bankruptcy that is equal or superior to the priority afforded customers whose funds are segregated under the Code and the Commission's rules. With this revision, proposed rule 1.68(e) would be unnecessary.⁸

Other Comments

The *Federal Register* release accompanying the proposed rules makes clear that a customer is an "opt-out customer" as defined in proposed rule 1.3(uu) only to the extent that the customer has elected to opt out of segregation. For all other purposes, the customer's funds are subject to the segregation requirements and the customer is entitled to receive the benefits resulting therefrom. FIA is concerned, however, that the rule could be read more broadly. We suggest clarifying language in Appendix A. This language also confirms that a customer election would apply to all contracts traded on a particular derivatives transaction execution facility.

In addition, we are suggesting revisions to proposed rule 1.68(c) for the purpose of permitting an FCM to establish a reasonable notice period before a customer's decision to rescind its election to

⁸ As noted, we suggest proposed language to effect this change in Appendix A to this letter.

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opt out of segregation becomes effective. An FCM must be afforded sufficient time to make the appropriate changes in its books and records.

We are further recommending that the Commission revise rule 1.68(c) to provide that, upon the effective date of the abrogation of an election to opt out of segregation, the FCM carrying the account must transfer to a customer segregated account all trades and positions held in the opt out account and all and all money, securities or property held in such account to margin, guarantee or secure such trades or positions. We assume that the Commission proposed to authorize an FCM to continue to hold such trades and positions in a non-segregated account for the administrative convenience of the FCM. Although we appreciate the Commission's intent, we have concluded that offsetting positions between a customer's segregated account and a non-segregated account would be operationally difficult at best, especially at the clearing organization. Therefore, we are recommending that, upon abrogation of an election to opt out of segregation, all positions of the customer should be held in a single account, provided that the customer's positions are fully margined and the customer is not in default with respect to its positions in the non-segregated account.

Conclusion

FIA appreciates the opportunity to submit these comments on proposed rule 1.68 and related amendments. If you have any questions regarding this letter, please contact me or Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard

cc: Honorable James E. Newsome
Honorable Barbara Pedersen Holum
Honorable David D. Spears
Honorable Thomas J. Erickson

APPENDIX A

This Appendix A sets forth specific revisions to proposed rule 1.68 and related amendments described in FIA's attached comment letter on the proposed rules. (Additions are in *italics*, deletions are in [brackets]). With respect to those rules for which FIA is not recommending any changes, we note:

- FIA supports the proposed amendments to Commission rules 1.3(gg), 1.12, 1.17 and 1.37, as published in the *Federal Register*.
- FIA opposes the proposed amendment to Commission rule 190.07(b) in its entirety. As discussed in the attached letter, we believe the proposed amendment and the regulatory approach that underlies it is wrong both as a matter of law and as a matter of public policy.

FIA's suggested revisions follow:

1. Proposed Commission rule 1.3(uu) is proposed to be further amended as follows:

(uu) Opt-out customer. This term means a customer that is an eligible contract participant, as defined in section 1a(12) of the Act, *and that, in accordance with Sec. 1.68, has elected[, in accordance with Sec. 1.68,] not to have funds that are being carried for purposes of trading on or through the facilities of a registered derivatives transaction execution facility, separately accounted for and segregated by the futures commission merchant pursuant to the provisions of section 4d(2) of the Act and Sec. 1.20-1.30 of this chapter. A customer shall be an opt-out customer solely with respect to those agreements, contracts and transactions, and the money, securities and property received by a futures commission merchant to margin, guarantee or secure such agreements, contracts and transactions, executed on or through a registered derivatives transaction execution facility that has adopted rules permitting a customer to elect to be an opt-out customer and with respect to which the customer has made such an election. For all other purposes under the Act and these regulations, an opt-out customer shall be a customer, as defined in Sec 1.3(k).*

2. Proposed Commission rule 1.68 is proposed to be further amended as follows:

Sec. 1.68 Customer election not to have funds, carried by a futures commission merchant for trading on a registered derivatives transaction execution facility, separately accounted for and segregated.

(a) A futures commission merchant shall not separately account for and segregate *in accordance with the provisions of section 4d(2) of the Act and Sec. 1.20-1.30 of this chapter* [as belonging to commodity or options customers,] funds received from a customer if:

- (1) The customer is an eligible contract participant as defined in section 1a(12) of the Act;

(2) The customer's funds are being carried by the futures commission merchant for the purpose of trading on or through the facilities of a derivatives transaction execution facility registered under section 5a(c) of the Act;

(3) The registered derivatives transaction execution facility has authorized, in accordance with Sec. 37.7 of this chapter, futures commission merchants to offer eligible contract participants the right to elect not to have funds that are being carried for purposes of trading on or through the facilities of the registered derivatives transaction execution facility, separately accounted for and segregated by the futures commission merchant; and

(4) The futures commission merchant and the customer have entered into a written agreement, signed by the customer, in which the customer [acknowledges that]:

(i) *Represents and warrants that the* [The] customer is an eligible contract participant as defined in section 1a(12) of the Act;

(ii) [The customer elects] *Elects* not to have its funds separately accounted for and segregated *in accordance with the provisions of section 4d(2) of the Act and Sec. 1.20-1.30 of this chapter* with respect to agreements, contracts or transactions traded on or subject to the rules of [any] *the* registered derivatives transaction execution facility that has authorized such treatment in accordance with Sec. 37.7 of this chapter;

(iii) [The customer] *Acknowledges that it* has been informed, *and agrees* that, by making this election:

(A) The customer's funds, related to agreements, contracts or transactions on any registered derivatives transaction execution facility that authorizes the opting out of segregation will not be segregated from the funds of the futures commission merchant *in accordance with the provisions of section 4d(2) of the Act and Sec. 1.20-1.30 of this chapter*;

(B) [Such funds may be used by the] *The* futures commission merchant *may withdraw and otherwise use such funds* in the course of the futures commission merchant's business *without the prior consent of the customer or any other third-party*; [and]

(C) In the event the futures commission merchant files, or has a petition filed against it, for bankruptcy, the customer, as to those funds that the customer has elected not to have separately accounted for and segregated by the futures commission merchant *in accordance with the provisions of section 4d(2) of the Act and Sec. 1.20-1.30 of this chapter*, [in accordance with this section,] will not be entitled to the priority for public customer claims provided for under the Bankruptcy Code and Part 190 of this chapter[, and may be treated as a general creditor of the futures commission merchant]; and

(D) *The customer may not enter into any agreement or other understanding with the futures commission merchant relating to the manner in*

which the customer's assets will be held at the futures commission merchant, including an agreement by which the customer takes a security interest in the assets deposited with the futures commission merchant, unless the terms and conditions of such agreement specifically provide that such agreement does not and is not intended to, directly or indirectly, give the customer a priority in bankruptcy that is equal or superior to the priority afforded public customers under the Bankruptcy Code and Part 190 of this chapter; and

(iv) *Acknowledges that the* [The] agreement shall remain in effect unless and until the customer revokes the agreement in accordance with paragraph (c) of this section.

(b) In no event may money, securities or property representing those funds that customers have elected not to have separately accounted for and segregated by the futures commission merchant, in accordance with this section, be held or commingled and deposited with customer funds in the same account or accounts required to be separately accounted for and segregated pursuant to section 4d(2) of the Act and [rules thereunder] *Sec. 1.20-1.30 of this chapter.*

(c) A customer that has entered into an agreement in accordance with paragraph (a)(4) of this section may abrogate that agreement by so informing the futures commission merchant in writing *within such reasonable time prior to the effective date of abrogation as the futures commission merchant may require.* The customer's statement, indicating its intent to abrogate the agreement, must be signed by a person with the authority to bind the customer [and will be effective with respect to any agreements, contracts or transactions entered into by the customer on or subject to the rules of a derivatives transaction execution facility after the customer's written statement is received by the futures commission merchant]. *Upon the effective date of such abrogation, provided that the customer's positions in both the non-segregated account are fully-margined and the customer is not in default with respect to any of its obligations to the futures commission merchant, the futures commission merchant shall transfer to a customer segregated account (i) all trades or positions of the customer with respect to which the customer had elected to opt out of segregation, (ii) and all money, securities or property held in such account to margin, guarantee or secure such trades or position.*

(d) Each futures commission merchant shall maintain any agreements entered into with customers pursuant to paragraph (a) of this section and any cancellations of such agreements, made pursuant to paragraph (c) of this section, in accordance with Sec. 1.31.

[(e) A customer who elects not to have its funds separately accounted for and segregated, in accordance with this section, may not establish a third-party custodial account for those funds, as described in the Commission's Division of Trading and Markets Financial and Segregation Interpretation No. 10, 1 Comm. Fut. L. Rep. (CCH) para. 7120 (May 23, 1984), and may not obtain a security interest in such funds.]

3. Commission rule 190.1(bb) is proposed to be amended as follows:

Non-public customer means any person enumerated in Sec. 1.3(y), *Sec. 1.3(uu)* or in Sec. 31.4(e) of this chapter, who is defined as a customer under paragraph (k) of this section.