

Washington Watch

FIA Takes a Stand on Pending CFTC Rules

By Joanne Morrison

In July, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, giving the Commodity Futures Trading Commission and other agencies a year to implement a vast range of regulations impacting the derivatives industry.

The CFTC and the Securities and Exchange Commission have begun seeking industry input as they draft the regulations. In response, the Futures Industry Association has provided the agencies with comments on several critical issues, including speculative position limits and the definitions of certain key terms in the Dodd-Frank Act.

In addition, the FIA has been actively involved in other CFTC rulemakings related to ownership and control reporting and acknowledgement letters from depositories accepting customer funds. On the OCR proposal, the FIA urged the CFTC to work with the industry to develop a workable reporting solution. On the acknowledgement letter proposal, the FIA recommended setting an effective date farther into the future, which would allow foreign entities more time to adapt to the new requirement.

FIA Recommends Interim Position Limit Rules

Under Dodd-Frank, the CFTC must finalize position limit rules for energy and metals contracts by Jan. 17 and for agriculture contracts by April 17. The rules will apply not only to conventional exchange-traded contracts, but also to contracts traded in other venues such as swap execution facilities and foreign boards of trade. As a result, the CFTC must consider how to apply position limits to a much larger and more diverse range of contracts.

The CFTC first proposed federal position limits for energy contracts in January 2010 in response to Congressional concern about “excessive speculation” in the commodity futures markets. The FIA filed a comment letter strongly opposing the proposal, noting the lack of evidence that speculation had distorted

energy prices and warning that restrictions on exchange-traded commodity futures would push trading into foreign markets or into the over-the-counter markets. (See “Continued Focus on Speculative Position Limits” in the June issue of *Futures Industry*.)

After the enactment of Dodd-Frank, the CFTC withdrew the January proposal and began working on a new proposal based on the additional authorities granted by the law, including a revised definition of a bona fide hedge and the inclusion of over-the-counter contracts in position limit calculations.

On Oct. 1, the FIA submitted a letter to the CFTC outlining its views on the new position limit rulemaking. In its letter, which was submitted while the CFTC staff were still in the process of drafting proposed rules, the FIA recommended that position limits be set on an interim rather than permanent basis and urged the agency to make the interim limits “sufficiently flexible” to avoid reducing liquidity or impairing price discovery.

The FIA also recommended that any interim position limits apply only to net positions in economic equivalent contracts and “be set at a level that will not reduce market liquidity or cause migration of the price discovery function to foreign markets.” In addition, the limits should be set only for the spot month; for all other months the CFTC should rely on accountability levels rather than hard limits, the FIA said.

When determining the size of an aggregate position across multiple markets, the FIA recommended that offsetting contracts should be netted against each other. The FIA also recommended that the CFTC continue to aggregate positions held by different entities based on common control, which is in the current standard applied to exchange-imposed position limits, rather than on common ownership as the CFTC proposed in its January rulemaking. In addition, the FIA stressed the need for CFTC guidance on the definition of a bona fide hedge position and on the process for granting exemptions for bona fide hedges and other types of

positions that perform similar risk-reducing functions. Bona fide hedge positions by statute are exempt from any position limits.

“FIA respectfully submits that by proceeding cautiously and adopting FIA’s recommendations, the Commission will accomplish its statutory mandate to prevent excessive speculation and market manipulation and protect the liquidity and price discovery function of U.S. derivatives markets,” the trade association told the CFTC.

FIA Urges Clarity in Key Dodd-Frank Terms, Such as Swap Dealer Definition

In a Sept. 20 comment letter filed with the CFTC and the Securities and Exchange Commission, the FIA outlined its views on certain key definitions in the derivatives section of the Dodd-Frank Act. The FIA argued against requiring futures commission merchants to register as swap dealers if they are acting as clearing brokers and not holding themselves out as swap dealers.

Under Dodd-Frank, a “swap dealer” is defined as a market participant that “actively holds itself out as a dealer in swaps,” “makes a market in swaps,” “regularly enters into swaps with counterparties as an ordinary course of business for its own account,” or “engages in any activity causing the person to be commonly known in the trade as a dealer or market-maker in swaps.” FIA stated that while FCMs will perform services related to the execution of swaps, they will not, solely by virtue of these services, engage in any of the activities enumerated in the swap dealer definition.

“As is the case with respect to futures transactions, an FCM, in its role as a clearing broker, is limited to acting as an agent on behalf of its customers,” FIA wrote. The FIA added that FCMs might from time to time act as brokers in matching two customers or counterparties seeking to execute a swap, which will then be submitted for clearing. “In such instances, the FCM has no role in the transaction other than matching the parties,” FIA stated.

The FIA also argued that swap dealers should not be required to register as FCMs if they are acting only in a dealer capacity and are not providing clearing services or other services characteristic of an FCM. "This additional registration will provide no additional benefits or protections to the counterparties, the market or the CFTC and will force swap dealers to comply with a regulatory scheme not appropriate for their businesses," the FIA stated. The association also asked the regulators to clarify the associated person requirement for swap dealers and major swap participants and the legal distinctions between forwards, futures and swaps.

FIA Calls on the CFTC to Coordinate with Industry on Workable OCR Solution

The FIA submitted a letter to the CFTC on Oct. 7 urging the agency to work with the industry in developing a workable ownership and control reporting system. The FIA also has formed a working group of industry representatives to design a reporting system that would meet the CFTC's goals in a practical and cost-effective manner.

The FIA's actions came in response to an OCR proposal that the CFTC released in July. The proposed rule requires "reporting entities" such as exchanges to collect ownership and control data from root data sources such as FCMs and correlate the data to the trade register on a daily basis. The CFTC included 28 different data items in the proposed rulemaking to help identify a customer. The agency is proposing to collect this information to enhance, among other things, its trade practice and market surveillance capabilities.

"The FIA is committed to working with the industry to come up with a solution that supports the Commission's plan to improve transparency and provide the tools for enhanced market surveillance," FIA President John Damgard said in a statement. "We look forward to working with the Commission and staff in developing an OCR database and reporting system that will achieve this goal."

The FIA's working group, which is comprised of senior officials and operations experts from 16 firms, has been actively involved in designing an industry-wide reporting solution. Members of the group participated in a CFTC public meeting on the OCR proposal in September and described the operational challenges involved in developing the new reporting.

In its comment letter, the FIA set out a number of practical objections to the CFTC's proposed OCR rule. The FIA said the proposed rule would require FCMs to collect and report a substantial amount of information that either is not collected in the manner the CFTC may anticipate or is not collected at all. The FIA further cautioned that the proposed rule would require a redesign of procedures, extending well beyond the proposed implementation timeline, and that implementing and maintaining the required data would be costly. For example, requiring that FCMs report the identity and position of each customer in an omnibus account would represent a major shift in business conduct, particularly for foreign investors accessing U.S. markets. The rules could potentially limit or eliminate such foreign access.

FIA cautioned against requiring FCMs to know and report the identity and position of customers in omnibus accounts. "From a regulatory perspective, omnibus accounts facilitate the conduct of business by a clearing member FCM, in particular, in connection with customers located outside of the U.S.," FIA stated. These accounts allow FCMs to carry the accounts of foreign customers without having to be registered in the home jurisdiction of each customer.

"Because the omnibus account is treated as a single customer, a clearing member FCM's rights and responsibilities under the Act and Commission rules are solely with respect to the omnibus account. The clearing member FCM has no obligation to pierce through the omnibus account to know the identity of each of the customers that comprise the omnibus account. In the absence of particular knowledge (or potentially unlawful conduct), therefore, the FCM has no rights or responsibilities with respect to the customers that comprise the omnibus account," FIA wrote.

The proposed reporting would also be costly to implement. An FIA survey of 12 firms showed that the median cost to build and maintain an OCR database would be an estimated \$18.8 million per firm.

"The OCR rule would force an unwarranted structural change in the conduct of business among U.S. futures markets participants, especially among clearing member and non-clearing member FCMs, foreign brokers and their respective customers," the FIA cautioned in its letter.

The FIA also pointed out that the proposed rule would impose a substantial increase in regulatory and financial obligations, which would likely cause a number of FCMs to withdraw from registration. The FIA further warned that a "significant number" of foreign customers would effectively be denied access to U.S. markets.

FIA Seeks Longer Effective Date for Acknowledgment Letter

In August the CFTC asked for public comment on a new set of proposed amendments to its regulations relating to the acknowledgment letters that futures commission merchants and derivatives clearing organizations are required to obtain from depositories that hold customer segregated and/or secured amount funds. These letters are intended to ensure that the depositories are fully aware of the rules that require customer funds to be segregated from the funds of their brokers. Among other things, these rules require that in case of a broker default, depositories must immediately release customer funds upon proper notice and instruction from the FCM or DCO or from the CFTC.

The CFTC proposed the amendments to clarify the obligations that depositories incur when accepting customer funds. The proposed amendments incorporated a number of changes suggested by the FIA and other industry representatives in response to an earlier version of the proposal that was issued in February 2009, such as the ability to use standard templates and an electronic filing system.

In comments submitted to the agency on Sept. 8, the FIA praised the agency for accepting these suggestions, but raised a concern

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about the time period allowed for implementation. Once finalized, the amended regulations would require FCMs and DCO to obtain updated acknowledgment letters in compliance with the new requirements within 90 days. The FIA warned that the 90-day period would not be long enough for the industry to negotiate and put in place the updated letters and urged the agency to extend the implementation deadline.

“The need for additional time is especially critical with respect to the numerous non-U.S. depositories located across multiple foreign jurisdictions,” the FIA cautioned. “Such depositories often lack familiarity with the Commission’s regulations and will be unaware of this rulemaking proceeding, and as a result will need to be educated regarding the new requirements.” The FIA therefore suggested extending the deadline to 180 days at the least.

The FIA also recommended several other technical changes to the proposed amendments, and asked the CFTC to confirm that the proposed acknowledgment letters may also be used for funds deposited in the recently created account class for cleared over-the-counter derivatives.

The CFTC first proposed the use of standardized acknowledgment letters in February 2009. These proposals are intended to clarify the obligations depository banks incur when they accept customer funds and will ultimately require the use of a standard template acknowledgment letter.

In March 2009, FIA commented on an initial CFTC proposal. At that time, FIA recommended that the CFTC support an industry-wide effort to develop a standardized acknowledgment letter and also consider electronic filing. In response to the CFTC’s earlier proposals, an FIA-assembled committee of FCMs and depository banks drafted sample templates, which were sent to the CFTC as the proposed basis for any acknowledgment letters.

In its latest comments, FIA highlighted the importance of clarifying and narrowing who at the CFTC would be authorized to request the release of funds from a customer account. “It also would be helpful for the Commission to confirm our understanding that this authority would be expected to be used sparingly,” FIA stated.

The FIA letter also asked the CFTC to address a concern raised by depositories regard-

ing claims on funds loaned to FCMs. This arises when depositories advance funds for the benefit of customer accounts on an intra-day basis with the understanding that the FCM will deposit funds into the customer accounts sufficient to repay the advance later in the day.

“FIA believes that depositories will be reluctant to provide intra-day advances to FCMs for the benefit of customer accounts without having adequate assurances of recourse against these accounts in respect of the amounts loaned,” the FIA warned, adding that might be a particular problem for FCMs without banking affiliates. “FIA therefore believes that the Commission should revisit this issue, including the proposed language in the standard template acknowledgment letter.”

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