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August 28, 2003

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

Re: Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers—
68 *Fed.Reg.* 40835 (July 9, 2003)

Dear Ms Webb:

The Futures Industry Association ("FIA") welcomes this opportunity to comment on the Commodity Futures Trading Commission's ("Commission's") proposed amendments to the Commission's minimum financial and related reporting requirements, 68 *Fed.Reg.* 40835 (July 9, 2003).[1] Among other changes, the proposed amendments would remove the provision set forth in Commission rule 1.17(a) that requires FCMs to maintain adjusted net capital at least equal to four percent (4%) of customer segregated funds on deposit. In its place, the Commission proposes to adopt the so-called risk-based capital requirements set forth in section 1(a)(vi) of the National Futures Association's ("NFA's") Financial Requirements ("risk-based capital requirements").[2]

As the Commission is aware, FIA has long supported risk-based capital requirements in lieu of the current rules, by which an FCM's minimum financial requirements are based on the amount of customer funds on deposit rather than the risk that the FCM has assumed in carrying positions for its customers. Therefore, we welcomed the

[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 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.

[2] Section 1(a)(vi) of NFA's Financial Requirements provides that each FCM must maintain adjusted net capital in the minimum amount of *(a)* eight percent (8%) of the total risk margin requirement for all futures and options positions carried by the futures commission merchant in customer accounts, plus *(b)* four percent (4%) of the total risk margin requirement for all futures and options positions carried by the futures commission merchant in non-customer accounts. The Chicago Mercantile Exchange, Chicago Board of Trade and the Board of Trade Clearing Corporation first adopted risk-based capital requirements through an interpretative statement effective January 1, 1998.

Commission's decision to publish this proposal for comment. As explained below, we support the proposed amendment to rule 1.17(a) with one significant modification. However, we strongly oppose the proposed amendments to Commission rule 1.17(c)(5)(viii) and (ix), which would reduce the time within which an FCM must take a charge for undermargined accounts. In addition, we oppose the application of an early warning notice requirement to the risk-based capital requirements, as set forth in Commission rule 1.12(b) and endorse the recommendation of the Joint Audit Committee that the early warning notice requirement be eliminated entirely.

Risk-Based Capital Requirements. Commission rule 1.17(a) currently provides that each FCM must maintain adjusted net capital in an amount at least equal to the greatest of *(a)* $250,000; *(b)* four percent (4%) of customer segregated funds on deposit; *(c)* the amount of adjusted net capital required by any registered futures association of which it is a member; or *(d)* if the FCM is also registered with the Securities and Exchange Commission ("SEC") as a broker-dealer, the amount of capital required under applicable SEC regulations. Since all FCMs are required to be members of NFA and NFA adopted risk-based capital requirements identical to those the Commission is proposing in 2000, all FCMs have been subject to these risk-based capital requirements since that date.

The risk-based capital requirements in effect at the exchanges and NFA are a significant improvement over the current Commission rule. Therefore, we support the Commission's proposal to remove the current provisions of rule 1.17(a)(1)(i)(B). However, we respectfully suggest that the Commission should refrain from adding in its stead the risk-based capital requirements set forth in the proposal. The Commission should simply reserve this paragraph. Our reasons for making this recommendation follow.

As noted above, the Chicago Mercantile Exchange, Chicago Board of Trade and the Board of Trade Clearing Corporation first adopted risk-based capital requirements effective January 1998. Although advances in risk management have been significant in the nearly six years since then, these requirements have not been subjected to rigorous analysis in light of these advances.[3] FIA believes now is an appropriate time to consider whether the current risk-based capital requirements could be enhanced. For example, we note that, although proposed amendment does not penalize FCMs that hold excess customer funds, neither does it reward those FCMs that require or otherwise hold excess collateral.

We had considered requesting the Commission to defer all action on the proposed amendment to rule 1.17(a) until such analysis is complete. However, we concluded that such drastic action would be unnecessary. By simply removing the provisions of paragraph (a)(1)(i)(B), the Commission will have achieved the intent of the proposed amendments. The requirement that FCMs maintain adjusted net capital at least equal to four percent (4%) of customer segregated funds on deposit will be eliminated, and the

[3] We also note that, because the risk-based capital requirements were originally adopted as interpretative statements by the Chicago Mercantile Exchange, Chicago Board of Trade and the Board of Trade Clearing Corporation, the industry did not actively participate in their initial development or have an opportunity to comment on them before they were implemented.

risk-based capital requirements currently set forth in section 1(a)(vi) of NFA's Financial Requirements will apply to all FCMs.

The industry, in coordination with the several self-regulatory organizations, could then undertake an analysis of the risk-based capital requirements. (The Commission, of course, would be welcome to participate in this analysis to the extent it wished.) If it were concluded that the current requirements should be revised, any such revisions, of necessity, would have to be adopted as an amendment to NFA's financial requirements. These revisions, in turn, would be subject to the Commission's review and approval. FIA's recommended course of action, therefore, would allow the Commission to move forward, while affording the industry greater flexibility in proposing changes to the risk-based capital requirements.[4]

Capital Charges for Undermargined Accounts. Commission rule 1.17(c)(5)(viii) requires an FCM to take a capital charge for any customer account that is undermargined, if the customer has not met a margin call by the third business day following the issuance of the call. Rule 1.17(c)(5)(ix) similarly requires a capital charge for non-customer accounts if a non-customer fails to meet a margin call by the second business day following the issuance of the call. The Commission has proposed to amend each of these provisions to require FCMs to take a capital charge if the margin call is not met within one business day following the issuance of a margin call.

FIA opposes any change to the current rule. Notwithstanding any advancements in electronic communications that have been made since the Commission last revised these provisions of rule 1.17 in 1980, as a practical matter, margin frequently cannot be received within one business day following a margin call. A number of US futures contracts are denominated in a foreign currency and it can take two business days to settle a wire transfer for many of these currencies. Moreover, retail clients, in general, continue meet margin calls by means of a check rather than wire transfer. For those FCMs with a retail client base, therefore, it is simply impractical to expect that margin payments will be received in less than three business days.[5]

FIA understands that FCMs with an institutional client base, on the other hand, generally may receive margin within one business day following the issuance of a margin call through wire transfer or otherwise. Yet, there are circumstances beyond the control of the FCM and the customer in which margin calls will not be met within this time frame. For example, an international client may receive a margin call after banks where the client is located or where the client maintains its account have closed. (Tokyo, it should be recalled, is 14 hours ahead of New York.) There may also be different holiday schedules overseas that would make it impossible for the client to transfer funds. Finally, through

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[4] This recommendation is also consistent with the Commission's desire to place greater responsibility for direct regulation of the industry in the several futures self-regulatory organizations.

[5] In the *Federal Register* release, the Commission seems to imply that all customers could be required to transfer funds by means of wire transfer or other electronic means. We respectfully disagree. Since banks often charge substantial wire transfer fees, the cost of requiring retail customers to send funds by wire would significantly exceed any potential regulatory benefit that might result from reducing the time within which an FCM must take a charge for undermargined accounts.

error, funds may be misdirected. Although these errors are resolved promptly, they may not be resolved within the business day following the issuance of the margin call.

Separately, FIA understands that the reconciliation process for trades executed on behalf of institutional trading managers can extend into the business day following the trade date. This delay may result from a number of factors, including late give-ins. These trading managers set early morning cut-off times for receipt of margin calls. Because these entities actively manage their cash assets, excess cash must be invested early in the day in order to enhance the available yield. Although trading managers generally receive timely preliminary margin calls the size of the margin call may not be confirmed until after the established cut-off time. This could result in a delay in meeting the call beyond the one business day the Commission contemplates. Yet, the FCM carrying the client's account has no reason to believe the call will not be met.

We further submit that neither the increase in the number of products offered on futures markets since 1980 nor the higher volatility associated with certain of these products supports a reduction in the period within which an FCM must take a charge for undermargined accounts.[6] The risk-based capital requirements to which all FCMs are subject already take into account any increase in the potential threat to the financial integrity of an FCM arising from these factors. Under the risk-based capital requirements, a significant market move has a more immediate impact on an FCM's minimum capital requirement than a calculation based on four percent of segregated funds. Increasing a firm's capital further by requiring an FCM to take a capital charge if the margin call is not met within one business day following the issuance of the call is simply unnecessary.

Finally, we note that, pursuant to the provisions of Commission rule 1.17(c)(2)(i), the entire value of a customer or non-customer account is excluded from an FCM's current assets to the extent that the account liquidates to a deficit or contains a debit ledger balance. We believe this distinction between accounts that are undermargined yet have a positive balance and those accounts that do not have a positive balance is appropriate and should be continued.

Early Warning Requirements. Commission rule 1.12(b) currently requires an FCM whose adjusted net capital falls below the early warning level, *i.e.*, 150 percent of its minimum capital requirement, to file a notice with the Commission and its DSRO within five business days and, thereafter, file financial reports monthly rather than quarterly. The Commission is proposing to eliminate the monthly filing requirement in rule 1.12(b), since this provision will become unnecessary if, as discussed below, rule 1.10 is amended to require that all FCMs file monthly financial reports with the Commission and with their DSRO.[7] However, the Commission is proposing to retain the notice requirement. Further, the Commission is proposing to require that notice be provided within 24 hours rather than five business days.

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[6] 68 *Fed.Reg.* 40835, 40840.

[7] As discussed below, FIA supports the adoption of the proposed amendment to Commission rule 1.10(b).

In the *Federal Register* release accompanying the proposed rules, the Commission notes that the Joint Audit Committee has suggested that the Commission eliminate the early warning notice requirement entirely, since FCMs will be filing financial reports monthly in any event. 68 *Fed.Reg.* at 40842. FIA supports the Joint Audit Committee's suggestion. We note that institutional clients, in particular, generally insist that their FCMs maintain capital above any applicable early warning requirement. Consequently, application of an early warning notice requirement to the risk-based capital rule would effectively establish the early warning level as the minimum capital requirement. For many FCMs, 150 percent of the risk-based capital requirements would be substantially higher than six percent of segregated funds.

As noted above, under the risk-based capital requirements, any significant market move will have a more immediate effect on an FCM's minimum capital requirement than a calculation based on four percent of segregated funds. The risk-based capital requirements will also reflect any substantial change in the nature of an FCM's business. Consequently, as a matter of necessity as well as prudent business practice, FCMs will maintain excess capital in order to avoid falling below the minimum capital requirements. Imposition of an early warning notice requirement is simply unnecessary.

This is particularly true in light of the fact that other means are in place to identify and monitor FCMs that may experience financial stress. For example, NFA requires each FCM for which it is the designated self-regulatory organization to report daily its segregation requirements, the amount of funds actually held in segregation and the FCM's SPAN margin calculation. With this information, NFA identifies those FCMs that are approaching the minimum capital requirement. Similarly, the exchanges receive pay and collect information daily. This information, along with other reports available to them, provides the exchanges with sufficient data with which to identify and monitor FCMs' capital on a daily basis, if appropriate.

Finally, we note that, in accordance with the provisions of Commission rule 1.12(g), an FCM must provide written notice to the Commission within two business days, if any event or series of events cause a reduction in net capital of 20 percent or more from the amount last reported to the Commission in a financial report. Even without the proposed amendment to rule 1.10, which would require all FCMs to file financial reports to the Commission monthly, the Commission receives monthly financial reports from virtually all FCMs now. Consequently, the Commission currently has in place rules to assure that it receives timely information that will allow it "to react promptly to potential financial crises at an FCM that has experienced a decrease in capital." 68 *Fed.Reg.* at 40842.

If the Commission nonetheless adopts an early warning requirement, FIA would oppose any reduction in the time by which notice must be provided. Although firms compute their capital daily, that computation generally is not complete until late afternoon. Further, the computation intra-month is an estimate only. If that estimate indicates that the firm is below the early warning requirement, the firm would have to undertake an effort to confirm all of the numbers. FCMs conduct business internationally, and it would be impossible to confirm these numbers within the 24 hours the Commission proposes. Early warning notices are publicly available. Consequently, it would be inappropriate to require an FCM to file such notice based on estimates alone.

Monthly Filing of Financial Reports. Commission rule 1.10 requires an FCM to file an unaudited Form 1-FR-FCM report on a quarterly basis with the Commission and with its designated self-regulatory organization. In lieu of a Form 1-FR-FCM, an FCM that is registered as a broker-dealer may elect to file a copy of its FOCUS Report. FCM financial reports must be filed with the Commission and with an FCM's DSRO within 17 business days of the end of the fiscal quarter.

The Commission is proposing to amend rule 1.10 to require each FCM to file an unaudited Form 1-FR-FCM or FOCUS Report with the Commission and with the FCM's DSRO as of the end of each month, including the FCM's fiscal year end. The FCM would be required to file the financial reports within 17 business days of the end of each month. As the Commission points out in the *Federal Register* release, NFA and the CME currently require the FCMs for which they are the DSRO to file financial reports monthly. The CBT requires all clearing member FCMs to file monthly as well. Therefore, the proposed amendment should not impose additional requirements on the majority of FCMs. FIA supports the proposed amendment to Commission rule 1.10

Miscellaneous Requirements. The Commission is also proposing other amendments, each of which appear to reduce administrative burdens on FCMs. FIA supports adoption of these proposed amendments.

1. **Oath or Affirmation.** The Commission is proposing to amend Commission rule 1.10(d)(4) to provide that the oath or affirmation that must accompany financial reports may be made by either *(a)* a representative duly authorized to bind the FCM, or, *(b)* if the FCM is registered with the SEC as a broker-dealer, a representative authorized to file the FOCUS Report for the broker-dealer under applicable SEC rules.

2. **Extensions of Time to File Reports.** The Commission is proposing to amend rule 1.10(f) and 1.16(f) to provide that the DSRO of an FCM may approve an application for an extension of time to file an unaudited or audited financial report, *provided* that the FCM files with the Commission a copy of its DSRO's written approval or denial of the request to extend the time for filing the Form 1-FR. A registrant would file a copy of its application, and a copy of any notices it receives from the DSRO to approve or deny its application, with the regional office of the Commission where the FCM is required to file its unaudited or audited financial statements.

3. **Change in Fiscal Year.** The Commission is proposing to amend rule 1.10(e) to provide that a DSRO may approve an FCM's application for a change in fiscal year, *provided* that the FCM files with the Commission a copy of its application, and also files a copy of the DSRO's written approval or denial of a change in fiscal year end. The Commission also is proposing that any dual registrant that has filed a notice or application with its DEA to request a change to its fiscal year or "as of" date would not need to file a separate application with its DSRO, but the dual registrant would need to file with its DSRO and the Commission a copy of the notice or application filed by the registrant with its DEA. Further, upon approval or denial of the request to change the dual registrant's fiscal year or "as of" date, the registrant would be required to file a copy of such approval or denial with the Commission and its DSRO.

Conclusion

FIA appreciates the opportunity to submit these comments on the proposed amendments to the Commission minimum financial and related reporting requirements. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, at (202) 466-5460. FIA and its members would be pleased to meet with the Commission and the staff to explain in greater detail the reasons underlying the positions we have expressed regarding these proposed amendments.

Sincerely,

John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Barbara Pedersen Holum
Honorable Walter L. Lukken
Honorable Sharon Brown-Hruska

Jane K. Thorpe, Director
Thomas J. Smith, Deputy Director
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