

Received CFTC
Records Section

9/15/09

09-9
3



Kathleen M. Cronin
Managing Director, General Counsel
Legal and Market Regulatory

September 14, 2009

VIA ELECTRONIC MAIL

David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581
secretary@cftc.gov

COMMENT

2009 SEP 15 PM 3:59
OFFICE OF THE SECRETARIAT
C.F.T.C.

Re: RIN 3038-AC82 - Account Class - 74 FR 40794 (August 13, 2009)

Dear Mr. Stawick:

CME Group Inc. ("CME Group") appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("Commission") proposed amendments to its Part 190 Bankruptcy Regulations to create a separate "account class" applicable to the bankruptcy of a futures commission merchant ("FCM") for positions in over-the-counter ("OTC") derivatives and their accompanying margins.

CME Group is the holding company for Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX"), and is the world's largest and most diverse derivatives marketplace. CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products. CME Clearing, a division of CME, is one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for OTC derivatives transactions through CME ClearPort. The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions.

I. Background

The Commission is proposing to amend its Part 190 Bankruptcy Regulations to create a separate account class that would include positions in cleared OTC derivatives and the money, securities, and/or other property that margin such positions. It is our understanding, however, that this account class would not include cleared OTC derivatives that are subject to a 4d order permitting them to be included in the account class for U.S. futures contracts.¹ As noted by the Commission, a bankruptcy trustee considers each account class separately in calculating a bankrupt FCM's liability to a customer and the customer's

¹ A 4d order is issued by the Commission under Section 4d of the Commodity Exchange Act, as amended ("CEA"), and permits cleared OTC derivatives positions and their margins to be commingled with futures and options positions and their margins in a 4d account.

pro rata share of the assets available to pay that liability.

Under current Regulation 190.01(a), "account class" is defined to include "futures accounts", "foreign futures accounts", "leverage accounts", "commodity option accounts" and "delivery accounts", although exchange-traded commodity options are treated as being part of the futures account class. For the past several years, registered derivatives clearing organizations ("DCOs"), and FCMs that have cleared OTC positions through DCOs, have held such positions and their margins either in Regulation 30.7 accounts or in futures accounts pursuant to a 4d order.² On September 26, 2008, the Commission issued an Interpretative Statement ("Statement on Cleared OTC Derivatives") in which it stated that any cleared OTC derivatives that were held in 4d accounts pursuant to a 4d order would be treated as part of the "futures account" class for bankruptcy purposes. The CFTC has not issued a similar interpretation regarding, and current regulations do not address, whether cleared OTC derivatives that are held in a 30.7 account would be treated as part of the "foreign futures" account class.³

Therefore, the Commission has stated that its proposal is designed to address "... the need to enhance certainty regarding the treatment of cleared OTC derivatives in the bankruptcy of a commodity broker that is an FCM." 74 FR at 40796. The Commission proposes to do so by creating a cleared OTC derivatives account class to address how a bankruptcy trustee should treat claims arising out of such derivatives in the absence of a 4d order. In addition, the Commission is proposing to codify its Statement on Cleared OTC Derivatives (and its earlier October 21, 2004 Interpretative Statement ("Statement on Commingling Foreign Futures Positions")) by incorporating a general provision in Regulation 190.01(a) that states that if positions in contracts of one account class (and their margins) are commingled with futures positions (and their margins), pursuant to a Commission order, they will be treated as being held in the futures account class.

We appreciate the Commission's efforts to provide certainty with respect to the bankruptcy treatment of cleared OTC derivatives. In particular, we support the Commission's proposal to codify generally its Statement on Cleared OTC Derivatives and Statement on Commingling Foreign Futures Positions. We discuss below our several concerns with the Commission's proposal regarding the definition of a cleared OTC derivatives account class and the bankruptcy treatment of cleared OTC derivatives that are not subject to a 4d order, as well as our recommendation that the Commission adopt standards for permitting cleared OTC derivatives to be included in 4d accounts.

II. Any cleared OTC derivatives account class should apply to the bankruptcy of a clearing organization as well as the bankruptcy of an FCM

The Commission's Part 190 Regulations are generally applicable to the bankruptcy of a "commodity

² See CME Rule 8F03.

³ Regulation 30.7 accounts explicitly include money, securities, and property at least sufficient to cover obligations to foreign futures and options customers, i.e., U.S. customers trading on foreign markets. Regulation 30.7 also permits FCMs to deposit money, securities and property held on behalf of foreign customers trading on foreign markets. Although not addressed in Regulation 30.7 itself, the Commission's 1-FR Instructions indicate that 30.7 accounts may also include "other "non-regulated" transactions". It is the latter category which forms the basis of the current use of 30.7 accounts for cleared OTC derivatives.

broker." A "commodity broker" is defined in both Section 101(6) of the Bankruptcy Code, 11 U.S.C. §101(6), and Regulation 190.01(f), to include, among other things, DCOs, as well as FCMs. The proposed cleared OTC derivatives account class would apply only to the bankruptcy of an FCM and not to the bankruptcy of a DCO. There is no such exclusion with respect to any of the other account classes defined in Regulation 190.01(a).

If, as proposed by the Commission, an FCM were to utilize a separate account for customers' cleared OTC derivatives in the absence of a 4d order, the DCO must also maintain a similar account for holding such positions and their accompanying margins. If the cleared OTC derivatives account class will not apply in the unlikely event of a DCO bankruptcy, then it is unclear what account class would apply to the funds in the DCO's separate account for those OTC derivatives that it clears on behalf of its clearing FCMs' customers.

By contrast, the Commission also proposes to amend its regulations to state that if positions in one account class are commingled with positions in the futures account class, pursuant to a Commission order, they will be treated as being held in the futures account class. This proposed amendment would apply to all commodity brokers, including DCOs, thus clearly defining the applicable class with respect to margins for cleared OTC derivatives held by a bankrupt DCO in a 4d segregated account.

The commodity broker bankruptcy provisions in Subchapter IV of Chapter 7 of the Bankruptcy Code do not require that a new cleared OTC derivatives account class must apply only to FCMs and not to DCOs. The Commodity Futures Modernization Act of 2000 ("CFMA") extended the application of the commodity broker bankruptcy provisions to cleared OTC derivatives by expanding the term "contract market" to include any "registered entity" for the purpose of the Bankruptcy Code. 11 U.S.C. §761(7). At the same time, the CFMA defined a "registered entity" to include DCOs, 7 U.S.C. §1a(29), and incorporated this definition into the Bankruptcy Code by reference. 11 U.S.C. §761(8).

The definition of a "contract market" is relevant to the Bankruptcy Code's definition of a "commodity contract". Section 761(4) defines a "commodity contract" separately for FCMs and for clearing organizations as follows:

(4) "commodity contract" means—

(A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

* * * *

(D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;

The Commission's exclusion of DCOs with respect to the proposed cleared OTC derivatives account

class appears to rest upon an assumption that cleared OTC derivatives do not meet the definition of "commodity contract" in Section 761(4)(D). However, cleared OTC derivatives clearly meet the definition of "commodity contract" both with respect to a futures commission merchant and with respect to a clearing organization. Cleared OTC derivatives are contracts for the purchase or sale of a commodity for future delivery subject to the rules of a DCO, a "contract market". This requirement appears in the definition of "commodity contract" for FCMs and for clearing organizations. There is a second element of the definition of a "commodity contract" with respect to a clearing organization, which is that the contract is cleared by the clearing organization. The definition of a commodity contract with respect to a clearing organization does not require that there be a contract market that is a different entity than the clearing organization. A cleared OTC derivatives contract may be both subject to the rules of a DCO and be cleared by that DCO, i.e., "cleared by such clearing organization" should be read to modify the word "contract" rather than "contract market or board of trade". For example, CME currently clears certain ethanol and agricultural OTC swaps. The clearing and settlement of these swaps are subject to Chapter 8-F of the CME Rulebook, which governs Over-the-Counter Derivative Clearing. In these instances, the ethanol and agricultural swaps are subject to the rules of the CME DCO (a "contract market" as defined in the Bankruptcy Code) and are cleared by the CME DCO, thus meeting the definition of a "commodity contract" with respect to a clearing organization under Section 761(4)(D). Therefore, there is no statutory basis for excluding DCOs with respect to a cleared OTC derivatives account class.

Failing to recognize a cleared OTC derivatives account class with respect to DCOs, even when those DCOs maintain cleared OTC derivatives accounts for the deposit of customer margins, will create greater uncertainty regarding the treatment of cleared OTC derivatives in the unlikely event of the bankruptcy of a DCO. In addition, if the Commission were to define cleared OTC derivatives as a separate account class for FCMs but not for DCOs, it could create uncertainty with respect to the application of CME Rule 818 (Close-Out Netting). Rule 818.C. provides, in relevant part, that in the event of the bankruptcy of CME:

[a]t such time as a Clearing Member's positions are closed, the obligations of the Clearing House to a Clearing Member in respect of all of its proprietary positions, accounts, collateral and deposits to the security deposit fund shall be netted, in accordance with the Bankruptcy Code, the Commodity Exchange Act and the regulations adopted thereunder in each case, against the obligations of that Clearing Member in respect of both its proprietary and its customers' positions, accounts, collateral and its then matured obligations to the security deposit fund to the Clearing House and to the Exchange. All obligations of the Clearing House to a Clearing Member in respect of its customer positions, accounts, and collateral shall be separately netted against the positions, accounts and collateral of its customers in accordance with the requirements of the Bankruptcy Code, the Commodity Exchange Act and the Regulations adopted thereunder in each case.

* * * *

In other words the Clearing House's proprietary obligations to a Clearing Member would be netted against the Clearing Member's proprietary and customer obligations to the Clearing House, while the Clearing House's customer obligations to a Clearing Member would be netted only against the Clearing Member's customer obligations to the Clearing House. In both instances such netting shall be done "in accordance with the requirements of the Bankruptcy Code, the Commodity Exchange Act and the Regulations adopted thereunder." Under the Part 190 Regulations, customer obligations must be netted separately

for each account class. However, if the FCM has an account for cleared OTC derivatives that Commission Regulations identify as a separate account class and the Clearing House has an account for cleared OTC derivatives that Part 190 does not recognize as a separate account class, an issue is presented with respect to the appropriateness of netting these two accounts.

III. The Commission should clarify in its proposed definition of cleared OTC derivatives that such transactions must be cleared through an FCM but are not required to be submitted to the clearing system directly by an FCM

The Commission has defined "cleared OTC derivatives" in its proposed amendments to include:

... positions in commodity contracts that have not been entered into or traded on a contract market ... or on a derivatives transaction execution facility ... , but which nevertheless *are submitted by a commodity broker that is a futures commission merchant* ... for clearing by a clearing organization ... (emphasis added).

74 FR at 40799.

The Commission stated in its Federal Register release that it intended to incorporate the definition of "cleared OTC derivatives" from its September 26, 2008 Statement on Cleared OTC Derivatives into Regulation 190.01. The definition in that Statement defined "cleared OTC derivatives" as contracts that:

... although not executed or traded on a Designated Contract Market or a Derivatives Transaction Execution Facility, are subsequently *submitted for clearing through a Futures Commission Merchant* ... to a Derivatives Clearing Organization. (emphasis added).

These two definitions are substantively different in that the proposed amendment to Regulation 190.01 requires that cleared OTC positions must be submitted *by* an FCM, and the definition in the Statement on Cleared OTC Derivatives requires that the cleared OTC positions must be submitted *through* an FCM.

We request that the Commission modify its proposed amendment to Regulation 190.01 to replace "submitted by a commodity broker that is a futures commission merchant" with "submitted for clearing through a futures commission merchant" to effectuate its intent to incorporate the same definition set forth in its Statement on Cleared OTC Derivatives. This will clarify that the Commission does not intend to prohibit clearing FCMs from authorizing their customers to directly enter their transactions into the clearing system, in order to meet the definition of cleared OTC derivatives, as long as the transactions are cleared through an FCM.

IV. If each DCO is expected to define its own rules for the treatment of positions and margins in a cleared OTC derivatives account, different DCOs could impose varying and potentially inconsistent requirements

The Commission has proposed to define "cleared OTC derivatives" as positions:

... which are required to be segregated, in accordance with a rule, regulation, or order issued by the Commission, or which are required to be held in a separate account for cleared OTC derivatives only, *in accordance with the rules or bylaws of a clearing organization* ... (emphasis added)

The Commission stated in its Federal Register release that:

[t]he Commission does not intend to specify substantive requirements for the treatment of cleared OTC derivatives (and the money, securities, and/or other property margining, guaranteeing, or securing such derivatives). Rather, the Commission proposes to define "cleared OTC derivatives" in such a manner as to specify the sources from which such substantive requirements may originate.

74 FR at 40796.

Therefore, it appears that the Commission has left the task of defining such requirements to each DCO. This could pose a number of issues.

The Commission described the rationale for the concept of account class as being the fact that the Regulations apply different requirements to the treatment of positions, and therefore different protections, with respect to different types of commodity contracts. For example, the Commission noted that the segregation requirements in Regulations 1.20 through 1.30 are more stringent than the Regulation 30.7 requirements. However, the same segregation requirements apply to all contracts that are in the futures account class, and the same 30.7 requirements apply to all contracts that are in the foreign futures account class (and apply to all cleared OTC derivatives that are held in 30.7 accounts).

If each individual DCO that clears OTC derivatives can make the rules that define the requirements for the treatment of positions and margins in a cleared OTC derivatives account, with no guidelines from the Commission other than that such positions would be "required to be held in a separate account for cleared OTC derivatives only", there could be various levels of protection afforded by different DCOs. For example, one DCO could model its rule on the requirements for 4d segregated accounts which limit the instruments in which such funds may be invested to those set forth in Regulation 1.25, while another DCO could use Regulation 30.7 requirements as its guide, and choose not to specify permissible investments. DCOs may also impose differing requirements with respect to the frequency of the computations of the amounts on deposit in such accounts, or with respect to requirements for obtaining acknowledgement letters.

Depending on how much the requirements for cleared OTC derivatives accounts vary among DCOs, FCMs could find themselves in the position of having to maintain multiple cleared OTC derivatives accounts with respect to different DCOs. Moreover, under the Commission proposal, all cleared OTC derivatives accounts are considered to be part of the same account class, even if the accounts relate to multiple DCOs with varying requirements for such accounts. Therefore, the available funds in the cleared OTC derivatives account class could be diluted for customers of a bankrupt FCM who hold OTC derivatives cleared by a DCO with more stringent requirements because the account class also contains the margins of customers who hold OTC derivatives cleared by a DCO with less stringent requirements.

Given that the Commission's goal is to ensure that customers clearing OTC derivatives receive bankruptcy protection, and in the interest of providing consistency in the safeguards for OTC customer positions and margins, the Commission should define the minimum requirements that must apply to cleared OTC derivatives accounts for transactions that are cleared through any DCO with respect to those areas that the Commission has already addressed for 4d accounts, including permitted

investments, recordkeeping, and acknowledgement letters. We believe that such requirements should be consistently applied to both 4d accounts and cleared OTC derivatives accounts.⁴ Doing so would also eliminate any incentive for DCOs to impose less stringent requirements and any opportunity for regulatory arbitrage, both of which could negatively impact certain customers.

V. The Commission should adopt standards for permitting cleared OTC derivatives to be included in 4d accounts

Many of the market participants that clear, or would clear, their OTC transactions through a DCO also trade futures and options on designated contract markets. These participants have indicated a strong desire to be able to realize the capital efficiency benefits of margin offsets between their related OTC and futures and options positions. Although it is clear that such margin offsets may be provided by FCMs and DCOs with respect to related positions within a 4d account, Commission staff has raised issues regarding the appropriateness of margin offsets between segregated futures positions and cleared OTC derivatives positions that are held in 30.7 accounts. Our understanding is that the Commission would apply the same analysis with respect to potential margin offsets between positions in 4d accounts and accounts that contain only cleared OTC derivatives positions.

Since the Commission has proposed to define cleared OTC derivatives to include those ". . . which are required to be segregated, in accordance with a rule, regulation, or order issued by the Commission . . .", it appears that the Commission anticipates that it will continue to review and grant 4d petitions after the adoption of any rules relating to a separate account class for cleared OTC derivatives. We expect to continue to request 4d relief for the vast majority of the new OTC products that we intend to clear, regardless of the availability of a new account class, in large part, to enable us to provide market participants with the benefit of margin offsets between their cleared OTC derivatives positions and related futures and options.

It has proved to be burdensome for DCOs to submit multiple 4d petitions and requests for amendments to 4d orders, and it is also burdensome for the Commission to review such petitions and requests from multiple DCOs. We believe it would be beneficial to DCOs and the Commission if the Commission were to adopt standards that would define the requirements that must be met for a cleared OTC derivative product to qualify for 4d treatment. Such standards would facilitate and streamline DCO requests for, and Commission approvals of, 4d orders for particular cleared OTC derivatives. Increasing the efficiency of the process for obtaining 4d relief for these products is likely, in turn, to enhance the competitiveness of U.S. DCOs and further encourage market participants to bring their OTC transactions to such DCOs for clearing.⁵

⁴ Similarly, in our July 21, 2009 comment letter with respect to RIN 3038-AC79, 74 FR 23962 (May 22, 2009) (Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions), we stated that "CME Group is not aware of any business reason or risk related reason to require different standards between Regulation 1.25 and Regulation 30.7 investments and encourages the CFTC to harmonize the two investment standards." (pg. 6).

⁵ In addition to adopting standards which would govern those cleared OTC derivatives that would qualify for inclusion in a 4d account, the Commission should consider whether a structure can be created that would allow for portfolio margining between cleared OTC derivatives accounts and 4d accounts.

VI. Conclusion

The Commission's proposal reflects its intent to replace the use of 30.7 accounts for cleared OTC derivatives with new accounts for cleared OTC derivatives only, unless subject to a 4d order. If the Commission adopts the proposed rules, we request that the Commission allow a sufficient period of time before their effective date for DCOs to adopt any necessary implementing rules, and for DCOs and FCMs to establish such accounts and transfer positions and margins.

CME Group thanks the Commission for the opportunity to comment on this matter. We would be happy to discuss any of these issues with Commission staff. If you have any comments or questions, please feel free to contact me at (312) 930-3488 or Kathleen.Cronin@cmegroup.com; or Anne Polaski, Associate Director and Regulatory Counsel, at (312) 338-2679 or Anne.Polaski@cmegroup.com.

Sincerely,



Kathleen Cronin
Managing Director, General Counsel
and Corporate Secretary
CME Group Inc.

cc: Chairman Gary Gensler
Commissioner Michael Dunn
Commissioner Bart Chilton
Commissioner Jill Sommers
Robert B. Wasserman