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Via Electronic Mail: [secretary@cftc.gov](mailto:secretary@cftc.gov)

David A. Stawick  
Secretary  
U.S. Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, NW  
Washington, DC 20581

**COMMENT**

2009 SEP 24 PM 3 24  
OFFICE OF THE SECRETARIAT  
C.F.T.O.

**Re: Proposed Rulemaking (RIN 3038-AC82) to Create a Separate Account Class for Customer Positions in Cleared OTC Derivatives**

Dear Mr. Stawick:

Managed Funds Association (“MFA”)<sup>1</sup> appreciates the opportunity to comment on the U.S. Commodity Futures Trading Commission’s (the “Commission” or “CFTC”) proposed rulemaking issued on August 13, 2009 (RIN 3038-AC82) (the “Proposal”)<sup>2</sup> to amend Part 190 of its regulations to: (1) create a sixth and separate “account class” for cleared over-the-counter (“OTC”) derivatives, applicable in the case of a bankruptcy of a commodity broker that is a futures commission merchant (“FCM”); and (2) codify the appropriate allocation of OTC derivatives positions and collateral during bankruptcy when positions and collateral of different account classes are pooled together pursuant to a Commission order. MFA applauds the Commission’s efforts to provide necessary protection to customers of FCMs regarding the treatment of cleared OTC derivatives positions and collateral in the event of an FCM bankruptcy. MFA members are active participants in the OTC derivatives markets and are generally customers of commodity brokers that are FCMs.

MFA strongly supports both parts of the Proposal. In particular, we believe the implementation of each part of the Proposal: (1) will significantly mitigate counterparty risks as between market participants and systemic risk to U.S. financial markets by providing clear bankruptcy protection when an FCM customer clears its OTC derivatives positions; (2) is necessary to ensure broad market support of customer clearing initiatives in light of alleged uncertainty; and (3) is consistent with current policy objectives and some legislative proposals that include measures to protect customer positions and collateral in the context of central clearing. In addition, we also ask the Commission to consider additional measures that are not contemplated by the Proposal, which will further mitigate counterparty and systemic risks. We elaborate on each of these points in Section II of this letter.

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<sup>1</sup> MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, fund of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world that manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington D.C. with an office in New York, NY.

<sup>2</sup> 74 FR 40794 (August 13, 2009) (the “Proposal”).

## I. Background

The Proposal seeks to amend Part 190 of the CFTC Regulations in two important respects in the case of a bankruptcy of a commodity broker that is an FCM.<sup>3</sup> Immediately below, we describe the concept of an account class, followed by a summary of each part of the Proposal.

### 1. Account Class Designation Provides Bankruptcy Protection.

Under Section 20 of the Commodity Exchange Act (the “CEA”)<sup>4</sup>, the Commission has the power to define the amount of a customer’s claim (also referred to as “net equity” under the CEA and the Bankruptcy Code) against a commodity broker in bankruptcy and to prescribe by regulation the procedures for determining such amount. Section 761(17) of the Bankruptcy Code<sup>5</sup> also provides the Commission with the power to prescribe those procedures. In furtherance of these powers, the Commission has established: the concept of an account class; procedures outlining the types of commodity contracts that fall within a certain account class; and how FCMs and Derivatives Clearing Organizations (“DCOs”) should manage accounts.

CFTC Regulation 190.01(a) currently sets forth five separate account classes—(1) domestic futures accounts; (2) foreign futures accounts; (3) leverage accounts; (4) commodity option accounts; and (5) delivery accounts—to ensure that, in the bankruptcy of a commodity broker that is an FCM, customers who hold positions in different types of commodity contracts are afforded certain protections based on the underlying characteristics of those contracts. The concept of an account class is included in the definition of net equity under section 20 of the CEA and section 761(17) of the Bankruptcy Code. In the event of an FCM bankruptcy, a bankruptcy trustee calculates and generates the total amount that each FCM customer is entitled to recover based on the account class or classes in which all money, securities and/or other property are held on behalf of such customer (*i.e.*, an FCM customer’s net equity). If an FCM customer’s positions and collateral are not held in such an account—which is current industry practice with respect to OTC derivatives—the FCM customer would become an unsecured creditor of a bankrupt FCM.

Depending on the account class, an FCM or DCO will have to comply with differing levels of segregation requirements with respect to a customer’s positions and any related collateral. CFTC Regulations 1.20 through 1.30 provide the strongest protections to positions (and any related collateral) that are held in a domestic futures account. An FCM or DCO must segregate customer

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<sup>3</sup> *Id.* at 40796.

<sup>4</sup> 7 U.S.C. 24.

<sup>5</sup> 11 U.S.C. 761(17). Section 761(17) of the Bankruptcy Code specifically defines “net equity” as, “*subject to such rules and regulations as the Commission promulgates under the [CEA]*, with respect to the aggregate of all of a customer’s accounts that such customer has in the same capacity - (A) the balance remaining in such customer’s accounts immediately after - (i) all commodity contracts of such customer have been transferred, liquidated, or become identified for delivery; and (ii) all obligations of such customer in such capacity to the debtor have been offset; plus (B) the value, as of the date of return under section 766 of [the Bankruptcy Code], of any specifically identifiable customer property actually returned to such customer before the date specified in subparagraph (A) of this paragraph; plus (C) the value, as of the date of transfer, of - (i) *any commodity contract* to which such customer is entitled that is transferred to another person under section 766 of [the Bankruptcy Code]; and (ii) any cash, security, or other property of such customer transferred to such other person under section 766 of this title to margin or secure such *transferred commodity contract.*” (Emphasis added.)

positions and collateral into separate accounts under these regulations, unless the Commission issues an order pursuant to Section 4d of the CEA, permitting the FCM or DCO to commingle those accounts.<sup>6</sup>

2. First Part of the Proposal: Proposed Amendments to Include “Cleared OTC Derivatives” as a Separate Account Class.

The first part of the Proposal seeks to make three amendments to Part 190 of the CFTC Regulations in the case where positions and collateral in different account classes are not commingled. The first amendment would create a sixth and separate account class for “cleared OTC derivatives” positions and collateral under CFTC Regulation 190.01(a).

The second amendment would define “cleared OTC derivatives” in CFTC Regulation 190.01 by incorporating the term “cleared-only contracts” from the Commission’s “Interpretative Statement Regarding Funds Related to Cleared-Only Contracts Determined to Be Included in a Customer’s Net Equity,” dated September 28, 2008 (the “Statement on Cleared OTC Derivatives”).<sup>7</sup> By incorporating this term, the Commission is seeking to limit the term cleared OTC derivatives to only those positions and collateral that “are required to have been (i) segregated in accordance with a rule, regulation, or order issued by the Commission, or (ii) held in a separate account for ‘cleared-only contracts’ in accordance with the rules or bylaws of a DCO.”<sup>8</sup>

The third amendment to Part 190 of the CFTC Regulations would make certain conforming changes. In particular, this amendment would: (a) incorporate the new cleared OTC derivatives account class into the procedures for calculating a customer’s net equity in the bankruptcy of an FCM under CFTC Regulation 190.07(b)(2)(viii); and (b) add the new account class to certain bankruptcy claim forms.

Prior to the release of the Proposal, some market professionals questioned whether, in the absence of a Commission order or rule, OTC derivatives positions and collateral would fall within the domestic futures account class or any of the other account classes (*i.e.*, would constitute a “commodity contract”), thereby providing those positions and collateral with certain protections in the bankruptcy of an FCM.<sup>9</sup> The Commission states that the first part of the Proposal would make it clear that those positions and collateral (held separate from other positions) are afforded bankruptcy protection.

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<sup>6</sup> 7 U.S.C. 6d.

<sup>7</sup> See 73 FR 65514, 65515 (November 4, 2008).

<sup>8</sup> See 74 FR at 40796.

<sup>9</sup> See pages 34-5 of the “Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customers CDS Positions and Related Margin” dated June 30, 2009 (the “Customer Access Report”), which provides there is uncertainty as to the proposition that cleared OTC derivatives contracts constitute “commodity contracts”, thereby receiving account class protections under the CEA and the Bankruptcy Code. The Customer Access Report is publicly available at: <http://www.newyorkfed.org/newsevents/news/markets/2009/an090713.html>.

3. Second Part of the Proposal: Proposed Amendment to Codify Appropriate Allocation of Collateral to Certain Account Classes When Positions Are Commingled.

The second part of the Proposal intends to codify the appropriate allocation of positions and related collateral during the bankruptcy of an FCM when those positions and collateral are commingled or otherwise pooled together pursuant to a Commission order under Section 4d of the CEA.<sup>10</sup> A Section 4d order permits an FCM or DCO to commingle positions and collateral of one account class with positions and collateral of the domestic futures account class.<sup>11</sup> If the Commission issues a Section 4d order, CFTC Regulation 190.01(a) provides that those commingled positions are treated as being held in the domestic futures account class. As a result, FCMs or DCOs who commingle commodity options positions with domestic futures positions in one account are required to implement the most stringent protections under CFTC Regulation section 1.20 through 1.30 for all customer positions and related collateral.

In the Proposal, the Commission also notes that some have questioned the certainty regarding whether cleared OTC derivatives positions that are commingled with domestic futures positions would be afforded the same bankruptcy protections of the latter. The Proposal cites to two of its previous interpretations in support of this treatment. The Commission issued its first interpretation on October 21, 2004 regarding the commingling of positions in the foreign futures accounts class with positions in the domestic futures account class (“Statement on Commingling Foreign Futures Positions”).<sup>12</sup> In the Statement on Commingling Foreign Futures Positions, the Commission stated that “collateral supporting foreign futures placed in [an account with] domestic [futures] segregation pursuant to a Commission Order should be treated as in a futures account, not a foreign futures account, for purposes of Part 190.”<sup>13</sup> The Commission subsequently issued the Statement on Cleared OTC Derivatives, which extended the conclusion reached in the Statement on Commingling Foreign Futures Positions to cover cleared OTC derivatives that are commingled with positions relating to commodity contracts of the domestic futures account class. Notwithstanding the release of the Statement on Cleared OTC Derivatives, some argue that ambiguity continues to exist as to the legal effect of these interpretations on cleared OTC derivative positions.

Through the release of the Proposal, the Commission now seeks to “codify explicitly, in Regulation 190.01(a), a generalized version of the Statement on Commingling Foreign Futures Positions and the Statement on Cleared OTC Derivatives.”<sup>14</sup> The Commission intends for the second part of the Proposal to remove doubts as to whether cleared OTC derivatives positions can be afforded the highest bankruptcy protections (*i.e.*, the protections under CFTC Regulation 1.20 through 1.30) when those positions are commingled with domestic futures account positions pursuant to a Section 4d order.

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<sup>10</sup> See 74 FR at 40797.

<sup>11</sup> 7 U.S.C. 6d.

<sup>12</sup> See 69 FR 69510 (November 30, 2004).

<sup>13</sup> *Id.* at 69511. The Commission also noted in the Statement on Commingling Foreign Futures Positions that it would accord similar treatment to other positions that were commingled with domestic futures accounts.

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

## II. Discussion

As mentioned above, MFA strongly supports both parts of the Proposal. Specifically, we believe the implementation of each part of the Proposal: (1) will significantly mitigate counterparty risks as between market participants and systemic risk to U.S. financial markets; (2) is necessary to ensure broad market support of customer clearing initiatives; and (3) is consistent with current policy objectives and some legislative proposals. Lastly, in Sub-section 4 below, we raise an important issue, which is not addressed in the Proposal, but that we believe the Commission should consider with respect to non-cleared OTC derivatives.

### 1. The Proposal Would Significantly Mitigate Counterparty Risk and Systemic Risk.

We believe that both parts of the Proposal would significantly mitigate counterparty risk and systemic risk in the context of the OTC derivatives market. As noted above, some market professionals have questioned whether cleared OTC derivatives positions and collateral would be considered a commodity contract that falls within any of the five account classes under the CEA and Bankruptcy Code in the absence of a Commission order or rule. The first part of the proposal would enact such a rule pursuant to the Commission's authority under the CEA and Bankruptcy Code. As a result, cleared OTC derivatives (which are required to be segregated) would be included within the definition of net equity and FCM customers would thereby receive the minimum protections afforded to commodity contracts in other account classes.

The second part of the Proposal would provide even greater protections to those FCM customers. Specifically, FCM customers' cleared OTC derivatives positions and collateral would benefit from the strongest protections under CFTC Regulations 1.20 through 1.30 following the Commission's issuance of a Section 4d order. Thus, a customer's cleared OTC derivatives would be treated like domestic futures positions once both positions are commingled pursuant to such an order.

By issuing both parts of the Proposal pursuant to its authority under the CEA and Bankruptcy Code, the Commission would mitigate counterparty and systemic risks that were seen during the most recent financial crisis. In a letter to the Commission, the Federal Reserve Bank of New York and the U.S. Securities and Exchange Commission dated December 23, 2008, MFA explained how these risks arise in the context of OTC derivatives trading between the major OTC derivatives dealers (the "Major Dealers") and their non-dealer counterparties, which include MFA's members.<sup>15</sup>

As is described more fully in MFA's letter, when entering into an OTC derivatives contract with non-dealers, the Major Dealers require their counterparties to post upfront collateral (also known as "initial margin") to cushion against default risk. The Major Dealers do not typically segregate initial margin posted by their counterparties from other unsecured assets. When a Major Dealer becomes insolvent, initial margin posted by a counterparty is treated in bankruptcy as a general unsecured claim of that counterparty. As a result, counterparties to the Major Dealers stand to incur significant losses, regardless of the current value of their OTC derivatives contracts. When the creditworthiness of a Major Dealer appears to be diminishing, certain counterparties will seek to protect the assets of their investors and minimize their losses by purchasing credit default swap ("CDS") protection, shorting

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<sup>15</sup> See Letter from Richard H. Baker (President and C.E.O., Managed Funds Association) dated December 23, 2008 to Timothy F. Geithner (President) the Federal Reserve Bank of New York; The Honorable Christopher Cox (Chairman) U.S. Securities and Exchange Commission; and The Honorable Walter Lukken (Acting Chairman) U.S. Commodity Futures Trading Commission. A copy of this letter is attached.

equity, and, if the Major Dealer is their prime broker, transferring assets held at that Major Dealer to another prime broker. Each of these factors may contribute to market instability and uncertainty at the point when the markets are most volatile.

Additionally, if a Major Dealer files for bankruptcy, its counterparties must cover their losses arising from the loss of initial margin held at the Major Dealer. These counterparties may be forced to sell unrelated assets, which may further contribute to market instability.

A good example of this uncertainty and its effects on the global economy was seen in the bankruptcy of Lehman Brothers Holdings, Inc. ("LBHI"). LBHI traded OTC derivatives through one of its affiliates. LBHI's failure triggered the unwinding of a significant percentage of the CDS and other OTC derivatives positions held by LBHI's derivatives affiliate. The majority of the affiliate's customer assets were not segregated. Once LBHI was placed into bankruptcy, its customers became general unsecured creditors, freezing up several billions of dollars of its customers' investment capital. Since LBHI and the Major Dealers were highly interconnected to each other through their exposures to one another, LBHI's failure resulted in market concerns about the viability of other Major Dealers. These concerns ultimately caused significant volatility in global capital markets when many market participants simultaneously began selling assets to cover their losses.

Ultimately, we support both parts of the Proposal because we believe they would help reduce counterparty risks associated with cleared OTC derivatives positions and all related collateral (not for just initial margin, and regardless of whether those positions and collateral are segregated or commingled) in the event of the bankruptcy of an FCM. In addition, by providing protections to customers in the event of an FCM failure, the Proposal would help promote broader market stability by allowing capital to continue to flow freely regardless of such a failure.

2. The Proposal Is Necessary to Ensure Broad Market Support of Customer Clearing Initiatives.

MFA also strongly supports both parts of the Proposal because each would provide necessary protections to FCM customers, which to date, have been discouraged from centrally clearing their OTC derivatives positions as a result of the uncertainty surrounding the protection that would be afforded to those positions. MFA members and other FCM customers are supportive of, and extremely interested in, centrally clearing their OTC derivatives positions because of the benefits central clearing would provide to them in terms of reducing counterparty exposure. To date, however, some market professionals have expressed concern regarding whether central clearing through use of an FCM would actually reduce counterparty exposure in the absence of a Commission order or rule providing bankruptcy protection to FCM customer positions and collateral. In addition, some central counterparty offerings, which operate outside of the commodity futures regulatory framework, do not provide any bankruptcy protection to customers of clearing members with respect to their positions and collateral.<sup>16</sup> Many market observers have asserted that, without certainty regarding such protection when centrally clearing under any regulatory framework, counterparty exposure would continue to present a problem for customers.<sup>17</sup>

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<sup>16</sup> See pages 1-31 of the Customer Access Report.

<sup>17</sup> See *id.*

Again, we believe that the two parts of the Proposal would provide certainty to MFA members and other FCM customers with respect to the protection afforded to their cleared OTC derivatives positions under the CEA and the Bankruptcy Code regardless of whether an FCM segregates those positions or commingles them with positions in other accounts classes. While we completely agree with the Commission that its prior interpretations were clear on this issue<sup>18</sup>, we believe that the two parts of the Proposal will make certain that a bankruptcy trustee includes such positions and collateral in its calculation of net equity, regardless of whether those positions are segregated or commingled.

We recognize that policy makers and regulators are proposing a regulatory regime under which large volumes of OTC derivatives are centrally cleared.<sup>19</sup> In addition, a number of central clearing offerings have begun to central clear inter-dealer OTC contracts, with a 2009 year-end goal to expand those offerings to customers.<sup>20</sup> In MFA's view, the Commission's issuance of the Proposal is an important and necessary first step in encouraging all market participants to centrally clear their positions, which ultimately will result in the central clearing of a significant number of OTC derivatives positions.

### 3. The Proposal Is Consistent with Current Policy Objectives and Legislative Proposals.

MFA believes that the Commission's actions are consistent, in part, with sweeping legislative reform proposals that are currently under review by Congress with respect to the OTC derivatives market. All of these proposals seek to promote stability in the OTC derivatives market through the enhancement of market transparency and strengthening of market infrastructure. Some proposals even include measures to provide protections to customer OTC derivatives positions and related collateral. For example, on August 11, the Obama Administration released a comprehensive legislative proposal to regulate the OTC derivatives market.<sup>21</sup> The Administration's proposal includes a measure requiring central counterparties to develop risk control mechanisms that protect customer positions and related collateral in the event a clearing member default.

In addition to the introduction of several legislative proposals, Congress has held several hearings on OTC derivatives regulatory reform, during which protection of customer positions and related collateral were discussed. At one such hearing before the House Financial Services Committee on July 22, Commission Chairman Gary Gensler asserted that a comprehensive regulatory framework governing OTC derivatives dealers and the OTC derivatives market should include safeguards for customer positions and collateral.<sup>22</sup> In particular, Chairman Gensler stated that "Congress should also

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<sup>18</sup> See 73 FR at 65514; see also 69 FR at 69510.

<sup>19</sup> See the Obama Administration's legislative proposal, which is available at: [www.financialstability.gov/docs/regulatoryreform/titleVII.pdf](http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf). See also House Chairmen Barney Frank and Collin Peterson's outline, which is available at: [www.house.gov/apps/list/press/financialsvcs\\_dem/otc\\_principles\\_final\\_7-30.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/otc_principles_final_7-30.pdf).

<sup>20</sup> See Letter from market participants to William Dudley, President of the Federal Reserve Bank of New York, June 2, 2009. A copy of this letter is available at: [www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html](http://www.newyorkfed.org/newsevents/news/markets/2009/ma090602.html).

<sup>21</sup> See the Obama Administration's legislative proposal.

<sup>22</sup> CFTC Chairman Gensler's written statement is available at: [www.house.gov/apps/list/hearing/financialsvcs\\_dem/gensler\\_testimony\\_before\\_house\\_financial\\_services\\_7-22-09\\_final.pdf](http://www.house.gov/apps/list/hearing/financialsvcs_dem/gensler_testimony_before_house_financial_services_7-22-09_final.pdf)