

COMMODITY FUTURES
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March 16, 1998

Ms. Jean A. Webb
Secretary of the Commission
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

COMMENT

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COMMODITY FUTURES
TRADING COMMISSION
RECEIVED FOR
PUBLIC RECORD

Re: **Proposed Rulemaking Concerning Immediate Notification of Undersegregated or Undersecured Condition**

Dear Ms. Webb:

The Board of Trade of the City of Chicago, the Chicago Mercantile Exchange, the Kansas City Board of Trade, the Minneapolis Grain Exchange, the New York Cotton Exchange and the New York Mercantile Exchange (collectively "the Exchanges") welcome the opportunity to respond to the Commodity Futures Trading Commission's ("CFTC") proposed rules for early warning amendments as delineated in 63 *Federal Register* 2188 (January 14, 1998). The importance of an effective financial surveillance system to assist in the early detection of concerns, both financial and operational, is well recognized in the futures industry. As proposed, new Rule 1.12(h) would require a futures commission merchant ("FCM") to notify the Commission and its designated self-regulatory organization ("DSRO") immediately after it knows or should know that funds segregated for customers trading on U.S. markets or set aside for customers trading on non-U.S. markets are less than the amount required to be segregated or set aside by the Commodity Exchange Act or Commission rules.

The Exchanges generally support the CFTC's efforts to enhance continually the financial surveillance procedures in our industry, including FCM reporting requirements. With regard to the current proposal, the Exchanges' review has identified one major concern and one aspect of the CFTC's proposal that should be refined in order to improve the efficiency and effectiveness of the reporting process.

The Exchanges' primary concern about the proposed rule is the anticipatory feature of segregation and secured amount deficiency notifications. The proposed rule would require immediate notification by an FCM after it knows or should know that a deficiency exists. In the *Federal Register* release, the CFTC further advises firms to report possible undersegregation and undersecured conditions in certain situations. Many FCMs have interpreted this wording to require intra-day segregation and secured computations. However, from discussions with CFTC staff, we understand this is not the case. Instead, the CFTC is seeking notice in the unusual circumstance when an FCM believes it will be undersegregated or undersecured prior to the completion of formal computations.

While the Exchanges recognize the benefits of establishing early warning requirements to alert the CFTC and self-regulatory organizations (SROs) to potential problems in order that appropriate action may be taken, we believe the "immediate" notification requirement as detailed in the *Federal Register* should be clarified. During major market moves, the first priority of firms will be monitoring accounts, collecting required deposits, and making treasury

investment and allocation decisions to ensure settlement variations will be met as well as excess funds maintained. The Exchanges believe that, during such a market move and as preliminary computations are completed, firms should provide notification of known segregation, secured amount, and capital deficiencies. While the Exchanges encourage the earliest possible notification, most deficiencies will not be known until a computation is completed during the next business day and subsequently reviewed by management. While the proposal acknowledges that the timing of notifications would depend on the circumstances, we strongly recommend that the Commission modify its proposal to provide that only deficiencies that have been confirmed by an FCM would require notification.

We also believe that required segregation and secured amount deficiency notifications should only be made to a firm's DSRO, which, in turn, would inform the CFTC and other SROs. While DSROs would be responsible for working with the firm and implementing any corrective action necessary, they would also fully inform and work with the CFTC and other SROs in addressing the situation. In this way, all regulatory questions, concerns, and requests would be funneled through one regulator, thus eliminating duplicate efforts.

As a practical matter, SROs are in constant communication with the firms for which they have primary surveillance responsibility. Over time, they develop intimate and detailed knowledge of a firm's financial and operational procedures, such as margin and equity calls, as well as its account base. These established relationships enhance the exchange of timely and critical information when dealing in a crisis situation. In informing the CFTC of a notification received from a particular firm, the DSRO would be in a position to supplement such notification by sharing with the CFTC other information obtained through ongoing surveillance responsibilities, and thus, better assist the CFTC in assessing a particular situation.

In addition to the enhancements discussed above, the Exchanges recommend that existing notification requirements in Regulation 1.12 be reviewed for effectiveness.¹ The purpose of these notifications is to provide information on firms experiencing financial or operational difficulties. However, the Exchanges' experience in monitoring the thresholds required in Regulations 1.12(f)(3), (4) and (5) has demonstrated that these thresholds, when triggered, are ineffective. We believe that sufficient systems are in place which render these notifications unnecessary, and therefore, request that the CFTC review these provisions for possible deletion.

Furthermore, the Exchanges believe that, consistent with the reasons presented above concerning notification of an undersegregated or undersecured condition, all other notifications required by Regulation 1.12 should be made only to the DSRO, with the DSRO then immediately informing the CFTC.


The Exchanges appreciate the CFTC's efforts in improving the regulatory environment for today's FCMs. We believe our recommendations will further enhance the proposed regulatory notifications.

¹ In particular, Reg. 1.12(f)(3) requires notification when an FCM is carrying an account which is undermargined by an amount which exceeds an FCM's adjusted net capital. Reg. 1.12 (f)(4) requires notification when an FCM is carrying an account subject to a margin call which exceeds an FCM's excess adjusted net capital and which remains unanswered by the close of the following business day. Finally, Reg. 1.12(f)(5) requires notification when an FCM's excess adjusted net capital is less than 6% of certain noncustomer risk margin requirements.

Ms. Jean A. Webb
March 16, 1998
Page 3

Respectfully submitted,

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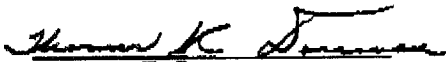
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