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September 14, 2009

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: Separate Account Class for Cleared Only Derivatives
74 Fed.Reg. 40794 (August 13, 2009)

COMMENT

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's) proposal to amend its bankruptcy rules, 17 CFR Part 190 ("Bankruptcy Rules"). The proposed amendments would achieve two purposes.

Futures Account Class. First, the amendments would codify the Commission's September 2008 *Interpretative Statement Regarding Funds Relating to Cleared-Only Contracts Determined to be Included in a Customer's Net Equity* ("Interpretative Statement").[2] In that Interpretative Statement, the Commission concluded that where, pursuant to Commission order, cleared-only contracts,[3] and property margining such contracts, are properly included in an account segregated in accordance with section 4d of the Commodity Exchange Act ("Act"), a claim arising out of a cleared-only contract, or property margining such a contract, would be includable in the futures account class.[4]

In support of this determination, the Commission cited its October 2004 order, in which it held that contracts traded on non-domestic boards of trade, and the assets margining such

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1 FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among FIA's 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 73 Fed.Reg. 65514 (November 4, 2008).

3 A cleared-only contract is a derivatives contract that is cleared by a registered derivatives clearing organization ("DCO") but not executed on or subject to the rules of a designated contract market ("DCM").

4 The Bankruptcy Rules currently list five account classes that must be recognized as separate account classes by a trustee: (i) futures (*i.e.*, contracts executed on a DCM) accounts; (ii) foreign futures accounts; (iii) commodity options accounts; (iv) leverage accounts; and (v) delivery accounts. 17 CFR §190.01(a).

contracts, that are included in accounts segregated in accordance with section 4d of the Act, should be included in the futures account class.[5] As the Commission noted then:

> [I]t would be inconsistent with the Commission's intentions to deny customers who had contributed property that was, in accordance with Commission Orders, deposited into accounts segregated pursuant to Commission Regulation 1.20, any participation in those accounts based on those contributions. . . . [C]ustomers whose assets are deposited in such an account should benefit from that pool of assets.[6]

To codify the Interpretative Statement, therefore, the Commission has proposed to revise Rule 190.01(a) to add the following *proviso*:

> *Provided, further*, that, if positions in commodity contracts of one account class (and the money, securities, and/or other property margining, guaranteeing, or securing such positions), are, pursuant to a Commission order, commingled with positions in commodity contracts of the futures account class (and the money, securities, and/or other property margining, guaranteeing, or securing such positions), then the former positions (and the relevant money, securities, and/or other property) shall be treated, for purposes of this part, as being held in an account of the futures account class.

Cleared OTC Derivatives Account Class. Second, the Commission proposes to amend Commission Rule 190.01(a) to add a sixth and separate account class for a limited group of cleared over-the-counter ("OTC") derivatives. As defined in proposed Rule 190.01(oo), "cleared OTC derivatives", including the money, securities and other property held to margin such positions, that would be included in this account class would be limited to those cleared OTC derivatives and related assets that are:

- carried by an FCM;
- cleared by a DCO;
- with respect to which the Commission has not issued an order requiring such positions and assets to be held in a section 4d account; *but*

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5 69 Fed.Reg. 69510 (November 30, 2004).

6 69 Fed.Reg. 69510, 69511 (November 30, 2004).

- with respect to which such positions and assets are nonetheless "required to be segregated in accordance with a rule, regulation or order issued by the Commission,[7] 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 [DCO]."

Discussion. FIA supports the proposed amendment to Commission Rule 190.01(a) that would confirm that a claim arising out of a cleared-only contract, or property margining such a contract, would be includable in the futures account class when such cleared-only contracts, and property margining such contracts, are properly included in an account segregated in accordance with section 4d of the Act. It is appropriate that the Commission's guidance to trustees in connection with the bankruptcy of a commodity broker be found in the Commission's Bankruptcy Rules rather than one or more interpretative statements issued from time-to-time.

In addition, we support in concept the Commission's proposal to create a separate account class for "cleared OTC derivatives." We agree that customers that participate in cleared OTC derivatives should have the benefits of a separate account and customer priority under the Commission's bankruptcy rules, to the extent that may be provided by law. Further, as is evident from our support of portfolio margining, FIA does not oppose commingling futures segregated positions and funds with related OTC derivatives positions and funds in appropriate circumstances. However, we also believe that certain OTC derivatives positions and funds, even if cleared by a DCO, should not be held in a section 4d account. Therefore, a separate "cleared OTC derivatives" account class, which will provide "cleared OTC derivatives" customers protections comparable to those afforded exchange-traded futures customers, makes eminent sense.

In order to assure that "cleared OTC derivatives" customers receive the benefits intended by the proposed rule, we recommend that, concurrent with the creation of the proposed separate account class for "cleared OTC derivatives", the Commission adopt (after notice in the Federal Register and a reasonable opportunity for comment) objective standards by which the Commission will determine which cleared OTC derivatives will be eligible or required to be held in a section 4d segregated account and which cleared OTC derivatives will be required to be held in separate, *i.e.*, non-section 4d, accounts. We are concerned that failure to adopt such objective standards will result in legal uncertainty in the event of an FCM bankruptcy, which may threaten the integrity of the section 4d customer segregated account.

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[7] The term "segregated" is used in the generic sense. In the Federal Register release accompanying the proposed amendments, the Commission explains:

> "By creating such an account class, the Commission is effectively specifying the manner in which the trustee in the bankruptcy of a commodity broker that is an FCM must treat, in the absence of an applicable Section 4d Order, claims arising out of cleared OTC derivatives when determining net equity and allowed net equity." 74 Fed.Reg. 40794, 40797 (August 13, 2009).

In adopting these standards, the Commission should also provide guidance regarding the treatment of funds deposited to margin "cleared OTC derivatives." In this regard, we ask the Commission to confirm that an FCM's obligations with respect to such funds will be comparable to its obligations with respect to the foreign futures and options secured amount under Commission Rule 30.7. That is, the FCM: (i) will be required to hold such funds in a account separate from the customer segregated account under section 4d(a)(2) of the Act (and, we assume, the foreign futures and foreign options secured amount); (ii) will be entitled to invest such funds in accordance with the guidelines established for the foreign futures and foreign options secured amount; (iii) will be required to obtain acknowledgment letters from depositories holding such funds, similar to those required under Commission Rules 1.20 and 30.7; and (iv) will be required to maintain books and records with respect to such funds.

To date, the Commission's section 4d orders have relied on factors that would appear to be found whenever a DCO would clear an OTC derivatives contract. For example, in issuing its order authorizing ICE Clear US and FCMs clearing through ICE Clear to commingle in a section 4d account funds supporting positions in cleared-only OTC swaps on coffee, sugar and cocoa and other agricultural products,[8] and, again, in authorizing the Chicago Mercantile Exchange ("CME") and FCMs clearing through the CME to commingle in a section 4d account funds supporting positions in cleared-only OTC swaps on corn, wheat and soybeans,[9] the Commission identified the following factors:

- all eligible products are submitted for clearing by a clearing member of the relevant DCO;
- each cleared-only contract is marked to market on a daily basis;
- the DCO applies its margining system and calculates performance bond rates for each cleared-only contract in accordance with its normal and customary practices;
- the DCO applies appropriate risk management procedures with respect to transactions and open interest in the cleared-only contracts;
- the DCO conducts financial surveillance and oversight of clearing members clearing cleared-only contracts sufficient to assure the DCO that the clearing member has appropriate operational capabilities necessary to manage defaults in such contracts; and
- the DCO makes available open interest and settlement price information for cleared-only contracts in the same manner as exchange-traded contracts.[10]

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8 Commission Order dated December 12, 2008.

9 Commission Order dated March 18, 2009, 74 Fed.Reg. 12316 (March 24, 2009).

10 Because the products underlying each of the cleared-only agricultural swaps also underlie exchange contracts traded on each DCO's related DCM, each Commission order was also subject to the conditions that: (i) the related DCM establishes a coordinated market surveillance program that encompasses the cleared-only contracts and corresponding futures contracts listed on the DCM; (ii) the related DCM adopts speculative

The CME suggests similar conditions in its petition requesting an order authorizing the CME and FCMs clearing through the CME to commingle in a section 4d segregated customer funds account assets deposited to margin, guarantee or secure credit default swap ("CDS") contracts cleared by the CME.[11]

As the Commission itself has noted, these factors are essentially identical to the factors that a DCO would apply in clearing exchange-traded contracts. In the November 4, 2008 Interpretative Statement, the Commission found that "over-the-counter contracts that are cleared-only contracts are contracts for the purchase or sale of a commodity for future delivery within the meaning of this section [761] of the Bankruptcy Code. When cleared, they are subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures that are substantially similar, and often identical, to those applicable to exchange-traded products at the same clearinghouse."[12]

In light of these similarities, it is incumbent on the Commission to enunciate clear, objective standards, pursuant to which affected parties will be able to determine whether particular cleared-only derivatives contracts and related margin will be permitted to be commingled in a section 4d customer segregated account and thereby be included in the futures account class under the Commission's Bankruptcy Rules. The failure to adopt such standards may cause those whose cleared-only derivatives contracts are included instead in the proposed "cleared OTC derivatives" account class to argue in Bankruptcy Court that they should have access to the same pool of assets, *i.e.*, the futures account. At the very least, such a claim threatens to delay the potential transfer of positions from a defaulting FCM to a solvent FCM. More troubling, it could dilute significantly the pool of assets available to meet the claims of exchange-traded futures customers.[13]

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position limits for each cleared-only contracts that are the same as the limits for the corresponding contract listed by the DCM; (iii) the cleared-only contracts are not be treated as fungible with any contract listed for trading on the related DCM; (iv) each FCM acting pursuant to the order keeps the types of records that are described in section 4g of the Act and Commission rules thereunder, including Rule 1.35; and (v) the relevant DCM applies large trader reporting requirements to cleared-only contracts.

11 Letter from Lisa A. Dunsky, Director and Associate General Counsel, CME, to David A. Stawick, Secretary to the Commission, dated June 15, 2009.

12 73 Fed.Reg. 65514, 65515 (November 4, 2008).

13 We realize that developing these objective standards will not be a simple task and will involve the consideration of a number of potentially competing factors. We encourage the Commission to work with representatives of DCOs, DCMs, FIA and other interested parties in crafting standards that would then be published in the Federal Register for comment. For purposes of discussion only and subject to further consideration, FIA has identified the following factors that we believe would support a finding that cleared-only OTC contracts and related margin should be held in a section 4d account: (i) the OTC contract is integrally related with an exchange-traded contract; (ii) the OTC contract is sufficiently liquid to permit offset in the event of a clearing member default; (iii) in the absence of offset, the risk of carrying the positions may be easily hedged; and (iv) the cleared-only OTC contracts provide opportunities for cross-margining with exchange-traded contracts.

As a consequence of the recent financial crisis, it is likely that DCOs will be asked, or required, to provide clearing services for an increasing number of OTC derivatives.[14] The Commission, in particular, has proposed legislation that, if enacted, would assure this result.[15] In these circumstances, we submit it is essential that the Commission take a more holistic approach to the rules relating to the liquidation of commodity brokers. We suggest that neither the Subchapter IV of Chapter 7 of the Bankruptcy Code nor the Commission's Bankruptcy Rules were written with the understanding or expectation that registered DCOs would clear OTC derivatives.

In this regard, we note that on June 30, 2009, an *ad hoc* group of major buy-side and sell-side OTC derivatives participants submitted a *Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin* ("Report") to the Supervisors of the Major OTC Derivatives Dealers (as identified in the Report). The Report, which is available on the website of the Federal Reserve Bank of New York,[16] was prepared primarily by Cleary, Gottlieb Steen & Hamilton LLP, counsel to the group ("Cleary"). In Part II.C.2. of the Report (pp. 34-38), Cleary describes the provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code and the Commission's bankruptcy rules, as well as the Commission November 2008 Interpretative Statement.

Cleary concludes that there are reasonable arguments that cleared OTC derivatives may be viewed as "commodity contracts" for purposes of Subchapter IV and Part 190. However, "*the risk of a contrary conclusion is not insignificant.*" [Emphasis supplied.] Cleary adds that "in light of residual uncertainty as to this issue, we believe there is a significant possibility (in a worst-case scenario) that the proposition that cleared [OTC derivatives] contracts constitute "commodity contracts" within the meaning of the Bankruptcy Code may be challenged. . . . In addition, we also believe that any challenge to the proposition that [OTC derivatives] constitute commodity contracts would likely result in significant delay for customers seeking the return of margin through the insolvent FCM."

The Commission may have reached the same conclusion. In its August 17, 2009 recommendations to Congress, the Commission has proposed amendments to the Bankruptcy Code that amend the definition of a "contract market" to remove the reference to "registered entity," which is currently the Commission's basis for finding that cleared-only derivatives contracts are "commodity contracts" under the Bankruptcy Code. Instead, the Commission recommends that the definition of a "commodity contract" be amended to include a "swap that is submitted to a derivatives clearing organization for clearing" by a "swap clearer" (as

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[14] *E.g.*, The Department of the Treasury's "Over-the-Counter Derivatives Markets Act of 2009"; "Principles for OTC Derivatives Legislation", Chairman Barney Frank and Chairman Collin Peterson.

[15] Letter from Gary Gensler, Commission Chairman, to the Chairmen and Ranking Members of the relevant Congressional Committees, dated August 17, 2009, and attached legislative recommendations.

[16] http://www.ny.frb.org/markets/Full_Report.pdf

defined). The broad definition of a "swap" in the Bankruptcy Code would encompass all cleared OTC derivatives contracts.

We welcome the Commission's desire to rationalize the applicable provisions of the Bankruptcy Code and encourage the Commission pursue the adoption of appropriate amendments to the Bankruptcy Code to remove any legal uncertainty surrounding cleared-only OTC derivatives. However, we do not yet understand how these proposed amendments would fit with the existing regulatory regime. For example, the proposed amendments imply that those cleared OTC swaps that currently are subject to a section 4d order could lose that perceived benefit. Further, a "swap clearer" is defined to include a swap dealer, FCM, foreign FCM, leverage transaction merchant, or commodity options dealer that, "directly or indirectly, submits a swap to a derivatives clearing organization for clearing." The proposed amendments imply that an entity other than an FCM could be admitted as a member of a DCO for the purpose of clearing OTC derivatives on behalf of customers. The import of such a result for FCMs and DCOs alike would need to be carefully examined.

We look forward to working with the Commission to better understand its recommendations and, perhaps, suggest further improvements. With the state of the law surrounding cleared OTC derivatives in such flux, especially in the event of a default of an FCM carrying such cleared OTC derivatives, we respectfully suggest it may be appropriate that the Commission defer action on the proposed amendments to the Bankruptcy Rules creating a "cleared OTC derivatives" account class, until Congress has an opportunity to decide how to respond to the various recommendations presented.

Conclusion.

We appreciate the opportunity to submit these comments. If the Commission has any questions concerning the matters discussed in this letter, please contact Tammy Botsford, FIA's Vice President and Assistant General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner

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