



NATIONAL FUTURES ASSOCIATION

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COMMENT

April 11, 2001

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OFFICE OF THE SECRETARY

VIA E-MAIL AND REGULAR MAIL

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

Re: Opting Out of Segregation

Dear Ms. Webb:

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RECORDS SECTION

In the March 13, 2001 *Federal Register*, the Commodity Futures Trading Commission published a proposed new rule and related amendments to its existing regulations regarding segregation of customer funds. The proposal is designed to implement the provisions in the Commodity Futures Modernization Act of 2000 which provide that a registered derivatives transaction execution facility (DTF) may adopt rules authorizing FCMs to offer eligible market participants the ability to opt out of the segregation requirements set forth in the CEA and the Commission's regulations. NFA welcomes the opportunity to comment on this proposal.

The primary purpose of the Commission's proposal is to govern the bankruptcy treatment of a customer that opts-out of segregation in order to ensure that, in the event of an FCM insolvency, claims of opt-out customers do not threaten the priority given to customers whose funds are in fully segregated. The proposal is also designed to ensure that customers choosing to opt-out of segregation are given full disclosure regarding the consequences associated with not having customer funds carried in segregation. Although NFA supports the purposes behind the Commission's proposed framework, we request that the Commission consider the following issues before adopting the final rules.

Bankruptcy Issues

The Commission's proposal contains a number of provisions designed to protect the priority status of customer funds held in segregation. Among other things, the proposal amends the definition of "net equity" in Rule 190.07(b) to make clear that the net equity of an opt-out customer shall not include funds that he has chosen not to have held in segregation. In addition, the Commission's proposal prohibits a customer that chooses to opt-out from establishing a third party custodial account or from taking a security interest in funds held by the FCM in order to gain priority over other creditors of



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the FCM. Finally, the customer and FCM must execute a written agreement where the customer acknowledges that, in the event of the FCM's bankruptcy, the customer may be treated as a general creditor of the FCM. NFA is in full support of the Commission's intention to protect the priority of customer funds in segregation, however, we believe that the current proposal could be revised to provide this protection and also give opt-out customers a higher priority than general creditors.

NFA joins with the Futures Industry Association (FIA) in its concerns that opt-out customers should not be treated as general creditors of the FCM. Rather, NFA supports FIA's recommendation that the Commission amend Rule 190.01(bb) to define customers that opt-out of segregation as non-public customers for purposes of Part 190 of the Commission's rules. NFA believes FIA's approach accomplishes the Commission's objective of protecting the priority of segregated customers without the unintended consequence of opt-out customers having lesser priority than the proprietary accounts of the FCM.

NFA also agrees with FIA's concerns regarding the prohibition against third party custodial accounts. NFA encourages the Commission to consider FIA's alternative recommendation that the Commission revise proposed Rule 1.68(a) to require a customer that elects to opt out of segregation to agree that it will not enter into any agreement with the FCM that would purport to give the customer a priority in bankruptcy that is not authorized by Commission rules.

Although NFA agrees that a customer that chooses to opt-out of segregation should have the ability to revoke this decision at a later date, NFA believes that the Commission's rules should provide additional requirements regarding positions and property held in the opt out account after the rescission of the opt out instruction. Specifically, the Commission should require that all positions and property held in the opt-out account be transferred to a segregated account in the event a customer decides to rescind its decision to opt-out of segregation. NFA believes that offsetting positions between the non-segregated account and the segregated account could raise additional issues in the event of an FCM bankruptcy – issues that would be avoided by requiring that all positions and property be transferred to the segregated account.¹

Although it is not of immediate concern, NFA also recommends that the Commission consider whether any additional bankruptcy issues may arise for fungible single stock futures products with linked and coordinated clearing allowing for these products to be initiated and offset on different markets. Again, under this scenario, an

¹ Obviously, before the FCM transfers these positions, it needs to ensure that the customer is properly margined with respect to those positions in the non-segregated account.



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opt-out customer could have an order filled on a DTF that allows opting out and offset on a DTF that does not. NFA believes that this could raise serious questions regarding, among other things, any profits associated with this type of trade.

In addition, NFA recommends that the Commission consider whether it needs additional rules governing the treatment of customer funds in bankruptcy in the event of the insolvency of an exchange or clearing organization. Clearly, the regulatory framework has changed considerably since the Commission first adopted Part 190. NFA believes that given the fact that exchanges are no longer all mutual companies, coupled with the varying degrees of regulation of these entities, the Commission should review Part 190 to determine whether additional regulation is needed with respect to an exchange's or clearing organization's insolvency.

Finally, with respect to bankruptcy issues, NFA has concerns, in light of the decision in In re Griffin Trading Company, 245 B. R. 291 (N.D. Ill. 2000), that the current bankruptcy laws make it unclear whether the Commission's proposed priority scheme would hold up if challenged by a customer that opts out of segregation. Although NFA understands that the Commission must adopt rules implementing the opt-out provisions of the CFMA by June 21, 2001, NFA encourages the Commission to take a closer look at this issue and work proactively – both before and after adopting final rules – to have the bankruptcy laws revised as necessary to ensure that customers with funds in segregation have superior priority to those that opt out of the segregation requirements.

Disclosure Issues

NFA fully supports the Commission's requirement that customers electing to opt out of segregation enter into a written agreement with the FCM where the customer acknowledges the consequences associated with the decision to opt out. Although NFA believes that this written agreement will provide adequate disclosure in most cases, NFA recommends that the Commission consider additional disclosure requirements related to commodity pool funds that qualify as eligible contract participants.

Specifically, under the proposal, a commodity pool that qualifies as an ECP may choose to opt out of segregation. As a result, for certain pools, retail investors may be investing in a vehicle that does not have its funds segregated under the Act. Although NFA supports the overall framework that looks to the pool's assets in determining its ECP status, NFA also believes that retail participants should be given full disclosure regarding the consequences of investing in a pool that may opt out of segregation. Therefore, NFA recommends that the Commission require any pool that



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qualifies as an ECP and intends to opt out of segregation to provide full disclosure to its retail participants regarding the consequences of doing so.

NFA appreciates the opportunity to comment on this proposal. We encourage the Commission to consider the above comments, along with the comments of other industry participants, before adopting its final rules.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Daniel J. Roth', written over a faint, larger version of the same signature.

Daniel J. Roth
Executive Vice President
and General Counsel

/nam(LTRS:Opting Segregation.caw)