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COMMENT

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April 16, 2001

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OFFICE OF THE SECRETARIAT
RECEIVED
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Ms. Jean A. Webb, Secretary
Commodity Futures Trading Commission,
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Commission Rule 1.68

Dear Ms. Webb:

We are writing on behalf of The Options Clearing Corporation ("OCC") to comment on the Commission's proposed Rule 1.68. Proposed Rule 1.68 would permit certain customers to agree with their futures commission merchant ("FCM") that the FCM need not treat the funds and assets of such customers as subject to the provisions of the Commodity Exchange Act (the "Act" or "CEA") relating to the segregation of customer funds. This agreement would apply only to assets of the customer held by the FCM for the purpose of trading on or through registered derivatives transaction execution facilities ("DTFs"). Although we support the "opt-out" concept, OCC believes it should apply more broadly than provided for in proposed Rule 1.68 in that it should be available for qualified customers trading on contract markets as well as on DTFs. We also question certain other provisions of proposed Rule 1.68 relating to the status of customer claims against an insolvent FCM where the customer has opted out of segregation.

The Commission is proposing Rule 1.68 pursuant to the provisions of Section 5a(f), recently added to the Act by the Commodity Futures Modernization Act of 2000 (the "CFMA"). Section 5a(f) permits DTFs, subject to rules of the Commission, to authorize FCMs to offer customers that qualify as "eligible contract participants" the right to waive the segregation requirements of Section 4d of the Act and the Commission's rules thereunder with respect to funds carried by the FCM for purposes of margining, guaranteeing or securing the customers' trades on or through a registered DTF. Proposed Rule 1.68, proposed to implement Section 5a(f), specifies the conditions under which the FCM can offer, and certain customers can elect to exercise, this right to "opt out" of segregation.

We recognize that Rule 1.68, as proposed, is limited to transactions effected on a DTF because Section 5a(f) applies only to DTFs. Trading on DTFs, a new category of futures market created under the CFMA, is intended to be limited to a class of participants that are more sophisticated and less in need of regulatory protection than other members of the general public that are permitted to trade on a fully regulated contract market. In order to trade on a DTF, a customer must either be an "eligible contract participant" or trade through a well-capitalized FCM.[1] As a result of these and other limitations on the trading activity that may be conducted on a DTF, the Act applies a lesser degree of regulatory oversight to DTFs than is applicable to a contract market. The opt-out provision of Section 5a(f) is simply one provision among others in which the CFMA effectively directs the Commission to ease the regulatory burden for DTFs. We do not believe, however, that in giving this direction the legislature intended to prohibit the Commission from using other authority under the Act to grant similar relief to similarly situated participants in other markets where appropriate.

In order to bring greater consistency, rationality and efficiency to the statutory scheme, OCC believes that the opt-out provisions of Rule 1.68 should not be limited to customers trading on DTFs, but should also be applied to customers trading on contract markets. As the Commission makes clear in the proposing release, "[t]he main consideration relevant to the proposed new rule is the . . ."protection of market participants and the public."[2] In proposing Rule 1.68, the Commission has determined that customer protection is not compromised when eligible contract participants choose to opt out of segregation under the procedures set forth in proposed Rule 1.68. However, if customer protection is the primary goal, there is no reason to distinguish between customers trading on a DTF and the same, or other customers meeting the same criteria, when they trade on contract markets rather than DTFs. Whether the protection of the segregation rules is mandatory should depend on the experience and financial means of the customer or the applicability of alternative protections and not on the identity of the futures market on which the customer's trades are executed.

OCC believes that, as proposed, Rule 1.68 will be of limited or no utility. To our knowledge, no DTFs yet exist. If and when one or more markets are operating as DTFs, it is likely that many customers trading in those markets will trade in other markets as well. If so, the FCM would still have to maintain a segregated account for a customer even if such customer opts out of segregation with respect to those transactions effected on DTFs. The value to the customer of opting out of segregation is presumably that such customers will receive, through individual negotiation or the forces of competition, at least a portion of the anticipated financial advantages to the FCM resulting from elimination of the need to observe the requirements and restrictions of the segregation rules. However, the cost of carrying two sets of accounts for the same customer could reduce or eliminate any such financial advantages. Consequently, until there is uniformity between the opt-out rules for funds carried for trading on DTFs and funds carried for those same customers trading on contract markets, the rule may be of little value.

The Commission has authority under the Act to adopt a more useful and consistent rule. Although the Commission's authority under Section 5a(f) is limited to transactions on DTFs, the Commission could rely on its broad exemptive authority under Section

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[1] CEA § 5a(b)(3).

[2] Opting Out of Segregation, (March 8, 2001), 66 Fed. Reg. 14507, 14510 (March 13, 2001).

4(c) of the Act to create a parallel opt-out provision for customers trading on contract markets. Section 4(c)(1) grants the Commission authority to exempt any "agreement, contract, or transaction" from any provision of the Act, including the segregation requirements of Section 4d, so long as "the Commission determines that the exemption would be consistent with the public interest" and the agreement, contract or transaction is entered between "appropriate persons." The definition of "appropriate person" includes, among others, banks, insurance companies, investment companies, commodity pools, and business entities and employee benefit plans with a net worth or net assets exceeding a specified amount.[3] In addition, appropriate persons include "[s]uch other persons that the Commission determines to be appropriate in light of their financial or other qualifications, or the applicability of appropriate regulatory protections."[4] Thus, the Commission may determine that, for purposes of the opt-out rules, an "appropriate person" includes an "eligible contract participant" regardless of the market on which the customer trades. The Commission could then permit contract markets as well as DTFs to adopt opt-out rules applicable to eligible contract participants. OCC believes that this action would greatly enhance the utility of Rule 1.68, contribute to the overall consistency and rationality of the Commission's regulations, and promote the public interest.

As a separate matter, OCC questions the appropriateness of treating customers who opt out of segregation as general unsecured creditors of the FCM. Paragraph (e) of proposed Rule 1.68 conditions the opt-out election on the customer's relinquishing "the usual customer priority in bankruptcy."[5] The policy reason for this restriction is not clear to us. OCC believes that an opt-out customer should be permitted to maintain an arrangement with an FCM having the effect of improving the customer's position in relation to the FCM's other creditors so long as the customer has no claim against the customer segregated funds account. In the event that there is a shortfall in the customer segregated funds account, it may be appropriate for customer claims against that account to have a higher priority against the general assets of the insolvent FCM than an opt-out customer's claim would have. However, it is not apparent to us as a matter of policy why an opt-out customer should not be permitted to have, either by Commission rule or through special custody accounts or other individually negotiated arrangements between the customer and the FCM, a status superior to that of general unsecured creditors of the FCM. We also believe that an opt-out customer should be able to arrange for its own assets to be held separately and not subjected to the claims of other customers.[6]

Finally, we believe that the Commission should in no event take the position that customers who opt out of the customer segregated funds account should be precluded, as a result of such opt-out, from taking advantage of the protection and priority given to customers under other potentially applicable regulatory schemes. For example, to the extent that positions or assets of a customer trading in financial futures (including, potentially, index futures as well as

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[3] CEA §§ 4(c)(3)(A)-(J)

[4] *Id.* at § 4(c)(3)(K)

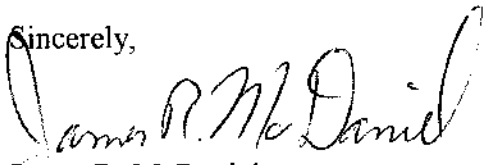
[5] 66 Fed. Reg. at 14508.

[6] We are aware of the position taken by the Division of Trading and Markets in Financial and Segregation Interpretation No. 10—Treatment of Funds Deposited in Safekeeping Accounts (May 23, 1984), Com. Fut. L. Rep. (CCH) ¶ 7120. In that interpretation, the Commission expressed the view that all customers in the segregated funds pool must be treated equally in a liquidation. However, where a customer opts out of the protections of segregation altogether, it is unclear why the customer should be required to subject its own assets to the claims of other customers.

security futures) might be included in a securities account subject to Rule 15c3-3 under the Securities Exchange Act of 1934 and the Securities Investor Protection Act of 1970, the Commission should not preclude the customer from taking advantage of such protections.

We recognize the tight deadline under which the Commission is operating with respect to Section 5a(f). To the extent that our comments cannot be addressed in the current rule-making, we hope the Commission and staff will take them into consideration as these issues may be addressed in future rule-making.

Sincerely,



James R. McDaniel

cc: Lawrence B. Patent
Michael A. Piracci