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COMMENT

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By E-Mail (secretary@cftc.gov)

Ms. Jean A. Webb
Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Proposed Rule 41.42 – Treatment of Customer Funds; Applicability of CFTC and SEC Customer Protection, Recordkeeping, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products

Dear Ms. Webb:

National Futures Association (NFA) is a registered futures association under the Commodity Exchange Act (CEA) and a limited purpose national securities association under the Securities Exchange Act of 1934 (Exchange Act), as amended by the Commodity Futures Modernization Act of 2000 (CFMA). NFA appreciates this opportunity to comment on the Commodity Futures Trading Commission's (CFTC) proposed rules regarding protection of customer funds that were proposed jointly with the Securities and Exchange Commission (SEC).[1] NFA is filing a comment letter with the SEC that contains identical comments.

The Commissions' proposal provides customer protection against insolvency losses while giving firms that are fully registered as both futures commission merchants and broker-dealers (Full FCM/Full BDs) the flexibility to meet their business needs. NFA commends the staff of both Commissions for their excellent work in crafting this proposal.

For background purposes, this comment letter will begin with a general discussion of the differences and similarities between the methods for protecting customers from insolvency in the securities and futures industries and the outstanding track record of each. It will then address specific issues raised by the proposed rules.

[1] 66 Fed. Reg. 50786 (Oct. 4, 2001).

Insolvency Protections

The futures industry's primary protection against customer insolvency losses is the CEA requirement that futures commission merchants (FCMs) segregate customer funds from their own funds.[2] Moreover, although an FCM may commingle funds belonging to separate customers trading on U.S. futures exchanges, it may not use the funds of one customer to margin or guarantee the transactions of any other customer. As a result, FCMs must gross up customer funds by adding their own funds to segregation to cover customer debits and deficits. Furthermore, since futures markets are highly leveraged and volatile, FCMs that carry customer funds must calculate their segregation requirements daily and add additional funds, if necessary.

The segregation requirement also prohibits FCMs from commingling customer funds used for trading on U.S. futures exchanges with customer funds used for other transactions. For example, funds used for futures trading on foreign exchanges must be kept in a separate account, subject to a separate calculation (known as the secured amount) for the amount of funds that must be maintained.[3] Since these funds are sent offshore and are subject to the vagaries of foreign insolvency laws, separating them from segregated funds ensures that a loss in the secured amount does not endanger the funds of customers trading in U.S. markets.

Special provisions in the bankruptcy laws work with the segregation requirement to give customers a priority in the funds in segregation.[4] As a result, as long as funds are properly segregated, customer funds are protected against insolvency losses.[5]

The segregation requirement was developed to meet the particular needs and characteristics of the futures industry, including daily settlement, rapid swings in the value of open positions, predominantly institutional customers, and small insolvency losses. The gross up and daily calculation requirements help protect customers against

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[2] *See* Section 4d of the CEA (7 U.S.C. § 6d) and CFTC Regulations 1.20-1.30 and 1.32 (17 C.F.R. §§ 1.20-1.30, 1.32).

[3] *See* CFTC Regulation 30.7 (17 C.F.R. § 30.7).

[4] *See* Sections 761-766 of the Bankruptcy Code (11 U.S.C. §§ 761-766) and Part 190 of the CFTC's Regulations (17 C.F.R. §§ 190.01-190.10.).

[5] Historically, FCMs have been undersegregated in two situations: where an FCM has fraudulently used customer funds for its own purposes or where sudden large market movements have left one or more customers in a deficit position that draws down the funds in segregation beyond the FCM's ability to add additional funds. As discussed below, however, these losses have been infrequent and small.

the possibility that trading losses incurred by one customer will draw down the funds available to another customer. It also makes up for the lack of SIPC-like protection, which would be inefficient in the futures markets, where only 6% of the volume and 3% of the equity comes from retail customers[6] and the amount of losses actually covered could be dwarfed by the administrative expenses.[7]

On the securities side, there are two primary protections for customer funds that are designed to complement each other. One of these protections is the reserve requirement adopted under Section 15(c)(3) of the Exchange Act.[8] Like the segregation requirement, the reserve requirement is designed to ensure that broker-dealers do not use customer funds to fund their own business and trading activities. However, there are two significant differences between the reserve requirement and the segregation requirement.

The first difference is the calculation itself. While the segregation calculation requires FCMs to gross up the funds in segregation by adding customer debits and deficits, the reserve requirement formula nets the obligations to customers against the obligations from customers. This means that, given the exact same population of accounts (and assuming that at least one account contains a debit or deficit), the segregation requirement would be higher – and could be substantially higher – than the reserve requirement.

The second difference is in the frequency with which FCMs and broker-dealers must make the calculation and maintain the funds at that level. Most broker-dealers are required to make the reserve calculation and adjust the funds in reserve on a weekly basis (although some may do so monthly), as opposed to the daily segregation requirement for FCMs.

By itself, the reserve requirement does not provide as strong a protection as the segregation requirement. When the reserve requirement is combined with Securities Investor Protection Corporation (SIPC) coverage, however, the protections in the two industries become equivalent.

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[6] NFA, Survey of the Customer Base in the U.S. Futures Industry (Dec. 31, 1996). Although approximately half of futures accounts are held by retail customers, most of the equity is in institutional accounts that are far larger in size than the SIPC coverage limits.

[7] The average annual loss of $426,000 since 1975 is less than 10% of SIPC's annual expenses, which averaged $5,746,551 over the last five years (not including expenses attributable to individual customer protection proceedings). *See* SIPC, 2000 Annual Report, pg. 32 (Appendix III).

[8] 15 U.S.C. § 78o(c)(3). *See also* SEC Rule 15c3-3 (17 C.F.R. § 240.15c3-3).

SIPC is a nonprofit membership corporation that provides coverage for insolvency losses by securities customers of its members, which consist of most broker-dealers.[9] SIPC has two primary functions. First, if customer funds appear to be at risk, SIPC institutes a proceeding to liquidate the broker-dealer. This includes getting a federal district court to appoint a trustee or, under certain circumstances, SIPC may pay customer claims directly. In either event, SIPC is involved at all stages of the proceeding.[10]

SIPC's second function is to provide coverage against customer insolvency losses. SIPC provides coverage up to $500,000 per customer, except that claims for cash are only covered up to $100,000. The reserve requirement ensures that most customer claims be can paid from the broker-dealer's assets, with SIPC paying the shortfall up to its coverage limits.[11]

Like protections in the futures industry, the protections in the securities industry were developed to meet that industry's particular needs. Most securities do not create the rapid swings in value that occur in the more leveraged futures markets, allowing securities firms the luxury of netting the amount in reserve and doing the computations weekly. Furthermore, because of the larger losses (in absolute terms)[12] and the fact that more of the equity is in retail accounts than in the futures industry,[13] SIPC coverage provides a valuable adjunct to the reserve requirement.

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[9] *See* the Securities Investor Protection Act of 1970 (15 U.S.C. § 78aaa, et seq.).

[10] Sections 741-752 of the Bankruptcy Code (11 U.S.C. §§ 741-752) govern bankruptcy proceedings involving stockbrokers. However, Section 742 (11 U.S.C. § 742) essentially provides that SIPC proceedings take the place of proceedings under the Bankruptcy Code.

[11] Both FCMs and broker-dealers must also meet capital requirements designed to ensure that they will have adequate assets to cover their liabilities in normal circumstances. These capital requirements also provide protection against insolvency losses. In fact, since NFA raised the capital requirement for FCMs in 1990, there have been no insolvency losses in funds required to be segregated.

[12] SIPC has paid an average of $8,567,000 a year from its fund, with unpaid claims averaging approximately $1,227,000 a year, which would have created annual insolvency losses of almost $10,000,000 without SIPC protection. *See* SIPC, 2000 Annual Report, pgs. 6 and 17 (Appendix I). This compares with approximately $413,000 in annual losses in the futures industry since 1974.

[13] Approximately 40% of the amounts outstanding in corporate equities were held by the household sector as of the end of the second quarter of 2001. *See* Table L.213, lines 5 and 6, of the Federal Reserve's Z.1 report dated September 18, 2001.

The customer protections in the futures and securities industries work very well. As the following discussion shows, both industries have excellent track records for protecting customer funds from insolvency losses.

Since 1975, when the CFTC began operations, insolvency losses for funds required to be segregated have amounted to $11,085,000, for an average of $426,000 per year.[14] Seventy-three percent of these losses occurred between 1978 and 1980, when the CFTC made a concerted effort to close down firms that engaged in various fraudulent activities, including using customer funds for their own purposes.

One of NFA's first actions after it began operations on October 1, 1982 was to take a Member Responsibility Action to suspend an FCM that had used most of its customer funds for its own purposes.[15] Since then, there have been no insolvency losses due to fraud by an FCM, its principals, or its employees. The few insolvency losses did occur were all due to customer defaults based on large trading losses. In fact, there have been no insolvency losses in funds required to be segregated since 1989 – over a decade ago.[16]

Insolvency protections in the securities industry have an equally impressive history. Since SIPC began operations at the end of 1970, it has paid customers $257 million from its Fund which, when added to the funds recovered from broker-dealers' estates, resulted in total payments to customers of approximately $3.8 billion. More importantly, SIPC estimates that 99.9% of eligible investors have been made whole, with total insolvency losses of approximately $36.8 million for claims in excess of SIPC coverage.[17]

In summary, the futures and securities industries use different methods to protect customer funds from insolvency losses. Although the methods differ, the goals and the results are the same, and the two methods provide equivalent protection against customer insolvency losses. Therefore, the Commissions have taken the correct approach in trying to draft rules that do not favor one method over the other.

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[14] Information for 1985 and earlier is taken from NFA, Customer Account Protection Study (Nov. 20, 1986). Subsequent information is taken from various sources.

[15] In re Traders International Inc., NFA Case No. 82-MRA-002 (Dec. 29, 1982). The CFTC also took an injunctive action against the firm. Customers ended up losing $300,000.

[16] The 1998 bankruptcy of Griffin Trading Company left a shortfall of $4.7 million in funds held in London for foreign futures and options accounts, and some of these funds may not be recoverable. However, the company was fully segregated for customer transactions on U.S. exchanges, and the separation of those funds from the funds for foreign transactions ensured that no segregated funds were lost.

[17] SIPC, 2000 Annual Report, pgs. 6 and 17 (Appendix I).

Specific Comments

NFA fully supports the Commissions' overall approach. That approach is generally designed to be protection-scheme neutral and to give Full FCM/Full BDs maximum flexibility while ensuring that customer funds remain protected against insolvency losses.

Customer protection should be – and clearly is – the Commissions' primary objective in drafting these rules. As long as that objective is met, the Commissions' secondary objective should be to provide Full FCM/Full BDs with flexibility to meet their business needs. The Commissions' approach appears to meet both those objectives. Since the two protection schemes provide customers with comparable protections, applying either protection scheme to customer accounts meets the first objective, and allowing the Full FCM/Full BD to choose how it will determine which scheme applies meets the second objective.

The Commissions' proposal provides Full FCM/Full BDs with maximum flexibility to tailor their operations and procedures to their own situation and needs. For example, one firm may decide to take advantage of the operational efficiencies involved in using only one system, while another firm may prefer the customer-relations value of offering customers a choice. Similarly, customers who are given a choice may make different elections based on their different needs. A customers who already does a significant amount of futures trading may choose to place its security futures transactions in its existing futures account, while a customer who trades stock options may choose to place its security futures transactions in its securities account. Or a particular retail customer may prefer to have the guarantee provided by SIPC coverage, while an institutional customer whose account exceeds the SIPC limits may feel more comfortable with the protections provided by segregation.

Whether or not customers have a choice, they should have a basic understanding of the protections that apply (or do not apply) to their account. The joint release mentions that industry representatives are developing a disclosure document for security futures products. NFA is an active member of this group and one of the principal drafters of the document. The uniform disclosure statement contains a section comparing the customer account protections in the two industries, and we will work to modify it in whatever manner is required to satisfy those disclosure requirements that are not firm-specific. Furthermore, NFA and NASD rules will work together to require firms to provide all security futures customers with a copy of this document before their accounts are approved to trade those products. Therefore, we believe that firms should not be required to provide separate disclosure regarding the nature of the protections in the two industries or the fact that only one protection scheme will apply.

A uniform disclosure statement cannot, of course, provide firm-specific information regarding which protection scheme will apply to a customer's account or inform a customer if it has an election (and what will happen if the customer does not make an election). Obviously, this information will have to be provided in a separate document, and, since the information is firm-specific, the rules should not mandate exact language. Furthermore, we agree that customers should be fully informed when a firm chooses to change the protection scheme. We also believe that customers who are given a choice should make that election in writing.

On the other hand, NFA does not agree that customers should be required to acknowledge receiving any of the required disclosures, including firm specific information. There are a number of acknowledgement requirements in the futures industry, with the most significant ones relating to the receipt of the risk disclosure statement required by CFTC Regulation 1.55 and the disclosure document for a commodity pool or trading program required by CFTC Regulations 4.21 and 4.31. NFA has had considerable experience with these requirements, both when auditing firms and when prosecuting cases. Although a few audits do show instances where some acknowledgements are missing, these instances tend to be recordkeeping lapses rather than actual failures to provide the risk disclosure statement or disclosure document. Additionally, we have prosecuted a number of cases against Members for misleading customers by making statements that are inconsistent with the information in those documents, but we cannot think of one instance where either the existence or absence of a written acknowledgement made any difference to our case. In fact, our experience is that even the less reputable firms have an incentive to provide the relevant documents – with or without an acknowledgement requirement – since the fact that the disclosures were given can often be used as a defense against liability. Furthermore, requiring customers to sign an acknowledgement does not ensure that customers have read and understood the relevant document; as the old adage says, you can lead a horse to water but you cannot make it drink.

The proposed acknowledgement requirement appears to be swimming against the tide in both industries. As we understand it, requiring written acknowledgements is not a standard regulatory practice in the securities industry. And the trend at the CFTC has been to ease its acknowledgement requirements – reducing the number of signatures and eliminating many of the acknowledgements for sophisticated customers. While firms may choose to receive acknowledgements for liability purposes, we believe that should be a business decision rather than a regulatory one.

NFA recommends that the CFTC make an additional amendment to CFTC Regulation 1.55 to exempt FCMs and IBs from providing the regular futures risk disclosure statement to customers only trade security futures and carry those positions in securities accounts. NFA and NASD rules, when taken together, will require all FCMs and IBs to provide security futures customers with a uniform disclosure statement for security futures products. That disclosure statement will contain all of the disclosures currently required by 1.55 as they apply to security futures products. Therefore, providing the regular 1.55 disclosure to customers who trade these products in securities accounts will be duplicative and unnecessary.

NFA believes that firms should be allowed to change the type of account in which customer security futures positions are held, with some restrictions. Allowing firms to change the account type provides firms with maximum flexibility for responding to customer needs or new developments in operational technology without losing the operational efficiencies of using only one type of account.

On the other hand, customers should be given adequate notice so they can move their accounts or positions to another firm if they do not want to change account types. Furthermore, firms should not be allowed to change the account type on a regular basis or for potentially fraudulent purposes (e.g., because the firm is in danger of being undersegregated due to the security futures positions in its segregated accounts).

NFA supports the proposal to match the recordkeeping requirements to the account type. This approach ensures that Full FCM/Full BDs are not subject to duplicative recordkeeping requirements.[18] We believe that both monthly and confirmation statements should also follow the account. While CFTC Regulation 1.33(b) does not spell out the information that must be provided for futures transactions, FCM's invariably provide, and customers expect, the following information in the confirmation statement: the date of the transaction, commodity and delivery month, exchange the contract was executed on, transaction price, buy or sell, and quantity. Although commissions and fees may not be included on the confirmation for an initiating trade that remains open overnight, they are always included on the purchase and sale (P&S) statement that customers receive when the position is closed out and on the monthly statement.[19]

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[18] The SEC's recent amendments to Exchange Act Rules 17a-3 and 17a-4 were designed, at least in part, to enhance state regulators' ability to enforce state securities laws. Furthermore, the remaining provisions of those rules are similar to current CFTC and NFA requirements. Since all futures – including security futures – are preempted from state regulation, applying the SEC's amended rules to futures accounts would create additional burdens without any corresponding benefit.

[19] CFTC Regulation 1.35(b) (17 C.F.R. § 1.35(b)) requires FCMs to maintain all of this information.

SEC Rule 10b-10 requires several additional pieces of information that are not generally included on futures confirmations and would require programming changes to the automated systems that generate futures confirmations. Although three of those requirements could be met by adding legends to the confirmation form, NFA does not see any reason to require the programming changes that would be necessary. Rule 10b-10(a)(1) requires the confirmation to include the time of the transaction or a notice that the time of the transaction will be furnished upon written request and Rule 10b-10(a)(2)(i)(A) requires the confirmation to include the name of the person on the opposite side of the transaction or to state that the information will be furnished upon written request. CFTC Regulation 1.35(a-1) requires exchange member FCMs to record the time the order reaches the floor (or the trade-matching system) and, in practice, FCMs also record the time the fill is reported back from the floor. Similarly, CFTC Regulation 1.35(c) requires exchange member FCMs to record the opposite floor broker or trader and the opposite clearing member. Customers already have a right to obtain this information and do not hesitate to ask for it if they think they need it. Rule 10b-10(a)(9) requires the confirmation to state that the broker-dealer is not a member of SIPC if that is the case. The spirit of this requirement is met by the Commission's proposal that firms disclose the protections that apply to the type of account being used. Therefore, requiring the confirmation to include these three legends does not provide any additional protection to a security futures customer who carries its trades in a futures account.

The larger problem is the transaction-specific information in Rule 10b-10(a)(2), which requires the confirmation to state whether the broker-dealer is acting as principal or agent. With limited exceptions, the Commodity Exchange Act and CFTC Regulations require all futures transactions – including security futures transactions – to be agency transactions.[20] The exceptions are transactions under exchange block trading rules, exchanges for physicals, and principal-to-principal transactions between eligible contract participants. The first two exceptions require the customer's consent, and Rule 10b-10 would not even apply to the third exception since no customers are involved.

Applying SEC Rule 10b-10 to security futures transactions held in futures accounts would create an operational and programming burden that does not provide corresponding benefits. Therefore, NFA encourages the SEC to adopt a rule that exempts security futures transactions carried in futures accounts from Rule 10b-10.

NFA supports the SEC's proposal to exempt notice broker-dealers from Exchange Act Rules 17a-3 and 17a-4. As noted in footnote 17 of this letter, applying

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[20] *See* Section 4b(a)(iv) of the Commodity Exchange Act (7 U.S.C. 6b(a)(iv)) and CFTC Regulations 1.38 and 155.2(a)-(b) (17 C.F.R. §§ 1.38 and 155.2(a)-(b)).

these rules to notice broker-dealers would create additional burdens without providing a corresponding benefit. We also support exempting notice broker-dealers from the SEC's requirements to file FOCUS reports, maintain records within the U.S., and send telegraphic notifications to the SEC, which are duplicative of similar CFTC requirements, and from performing quarterly securities counts to verify positions, which is unnecessary given the fact that notice broker-dealers may not engage in any other securities business requiring registration.[21]

Obviously, security futures margin and positions should receive protection under only one insolvency scheme. Therefore, NFA supports the CFTC's proposed amendments to its Part 190 rules to exclude margin and positions in securities accounts from the definitions of "specifically identifiable property" and "customer property." In light of In re Griffin Trading Company,[22] we also urge the CFTC to seek corresponding amendments to the Bankruptcy Code.

NFA recommends two technical changes to proposed CFTC Regulation 41.42. First, we assume from the discussion in the release and from the SEC's corresponding changes to SEC Regulation 15c3-3(o)(1) that the CFTC meant the written policy requirements of CFTC Regulation 41.42(a)(2) to apply only to Full FCMs/Full IBs. Therefore, we believe that section should refer to futures commission merchants "registered pursuant to Section 4f(a)(1) of the CEA." Second, we suggest that section (d) specifically identify the CFTC's recordkeeping rules in order to eliminate any possible confusion as to what is or is not a recordkeeping rule.

Finally, in keeping with the general principle that differing CFTC and SEC regulatory requirements should follow the account, NFA believes that the CFTC should exempt security futures transactions in securities accounts from CFTC Regulation 166.5 and Section 14 of the CEA.[23] NASD and the securities exchanges already provide effective forums for resolving these disputes. Furthermore, those sections of CFTC Regulation 166.5 that prohibit the use of predispute arbitration agreements as a condition of doing business are inconsistent with the longstanding and accepted

[21] We assume that notice FCMs and IBs are similarly exempt from the CFTC's requirements to file Form 1-FR-FCM or 1-FR-IB and to send telegraphic notifications to the CFTC since the CFTC has included these requirements in its financial rules rather than its recordkeeping rules. The CFTC may want to consider explicitly exempting notice FCMs and IBs from these requirements.

[22] 245 B.R. 291 (Bankr. N.D. Ill. 2000).

[23] 17 C.F.R. § 166.5 and 7 U.S.C. 17.

practice in the securities industry.[24] If the CFTC does not exempt securities accounts from that regulation, full broker-dealers will be placed in the untenable position of having to decide whether to apply the CFTC requirements to all transactions in the account – including traditional securities transactions – or to use a "two-tiered" agreement that treats the transactions in the account differently depending on whether they are security futures or traditional securities.[25]

If you have any questions concerning this letter, please contact me (312-781-1413, tsexton@nfa.futures.org) or Kathryn Camp (312-781-1393, kcamp@nfa.futures.org).

Respectfully submitted,

Thomas W. Sexton
Vice President and General Counsel

cc: Elizabeth L.R. Fox, Esq. (Office of the General Counsel)
Lawrence B. Patent, Esq. (Division of Trading and Markets)

(kpc/CommentLetters/SPF Customer Funds-CFTC)

[24] NASD Regulation 3110(f) requires NASD members to highlight the predispute arbitration clause and to include disclosures designed to ensure that customers are aware of the consequences of signing the agreement.

[25] Similarly, while NFA arbitration will be available for any security futures dispute against an NFA Member regardless of the type of account, we do not believe that the CFTC should mandate that the Member give the customer the option of arbitrating at NFA if the transactions are in a securities account, especially since most transactions in that account may involve traditional securities.