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CHICAGO MERCANTILE EXCHANGE INC.

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2003 SEP 10 PM 4:02

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Director
Audit Department
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September 5, 2003

COMMENT

RECORDS SECTION
2003 SEP 10 PM 4:30

RECEIVED
C.F.T.C.

Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington DC 20581
Attention: Secretariat

Re: Proposed Rules for Risk-Based Capital
69 Federal Register 40835

Dear Sir or Madam:

The Joint Audit Committee ("JAC") welcomes the opportunity to comment on the Commodity Futures Trading Commission's (the "Commission") proposed amendments to its minimum and early warning capital requirements as delineated in the Federal Register dated July 9, 2003.

The JAC commends the Commission on its proposal to adopt a risk-based capital model. A risk-based capital requirement is more comprehensive in its coverage of a future commission merchant's ("FCM") exposures (e.g. accounts with letters of credit, deficits and noncustomer positions) than the current "funds held" requirement. A capital requirement derived from the risks inherent in the futures and options positions carried by an FCM makes theoretical sense and, we believe, is in the best interest of the industry for its continued growth and stability in an ever-increasing global marketplace. The JAC continues to strongly support a risk-based capital requirement correlated to an FCM's risks calculated as a percentage of the margin required for all customer and noncustomer futures and options positions carried.

However, the JAC does not believe an early warning capital level and notification requirement based on a percentage of risk-based capital is necessary. When the exchanges and National Futures Association adopted risk-based capital, an early warning requirement was not implemented. The risk-based capital requirement was deemed sufficient in conjunction with existing notification regulations, required monthly financial reporting and surveillance programs in place.

Financial surveillance triggers exist in Regulation 1.12 to alert the Commission and designated self-regulatory organizations ("DSRO") of a firm's declining financial position and potential difficulties. Such reporting triggers include notifications of (1)

minimum capital deficiencies; (2) noncurrent books and records; (3) material inadequacies; (4) accounts undermargined by more than an FCM's adjusted net capital; (5) margin calls greater than an FCM's excess adjusted net capital which are not met within one day of issuance; (6) substantial reductions in capital; and (7) deficiencies of segregated or secured funds. In fact, Regulation 1.12(g) which requires notification of 20%/30% reductions in net capital/excess net capital is, in effect, an early warning of an FCM's decreasing capital position. However, the Commission could modify this regulation to also require notification if an FCM's excess net capital decreases by more than 30% due to an increase in its risk-based capital requirement.

To further alleviate the need for an early warning level, the proposed regulation enhances existing financial surveillance by requiring monthly financial reporting for all FCMs. In addition, FCMs are subject to risk-based examinations by their DSRO every 9 to 18 months and, as warranted, are monitored on a more frequent (e.g. daily) basis. Self-regulatory organizations ("SROs") employ a strong financial surveillance program over FCMs ensuring all capital, segregation and secured requirements are monitored and in compliance with industry regulations.

Today, the early warning requirement has become, in effect, the "minimum" capital requirement for FCMs. While regulations allow an FCM to operate under early warning requirements, a deficiency in early warning levels (which is public information) is interpreted negatively by customers and counterparties adversely affecting an FCM's business relationships and triggers additional regulatory scrutiny.

If the early warning level is a level of true concern, it should be a level required to be maintained and have consequences for violation. If it is an alert, we believe the regulations and surveillance programs in place, collectively, are sufficient to alert the Commission and SROs to an FCM experiencing financial and/or operational difficulties.

Nonetheless, if the Commission believes an early warning notification level is necessary, the JAC believes an early warning level of 150% of the risk-based capital requirement is too onerous. The JAC suggests that 110% of the risk-based capital requirement more closely parallels the current early warning level of FCMs whose capital is driven by CFTC requirements. Refer to the attached analysis which was calculated with the same data used by the Commission in its analysis of the impact of a risk-based capital requirement.

In the aggregate, the proposed risk-based capital requirement significantly increases minimum capital levels. An early warning level at 110% of the risk-based capital requirement would maintain the current capital levels while redistributing it to more closely correspond to the underlying risks.

The JAC also supports the proposed rule modifications for monthly filing of financial reports, extensions of time to file financial reports, changes in fiscal year-end and the

harmonization with SEC rules of notifications for material inadequacies and noncurrent books and records.

Finally, if a risk-based capital requirement is adopted, the JAC requests Regulation 1.12(f)(5) which requires notification if an FCM's excess adjusted net capital is less than 6% of its noncustomer maintenance margin requirement be rescinded. As the risk-based capital requirement includes an assessment for an FCM's exposure to noncustomer positions, this regulation would be redundant.

If the Commission does not adopt an early warning requirement or adopts a requirement at a level less than the proposed 150%, the levels proposed for equity withdrawal[1] and subordinated loans should be modified accordingly.

The JAC also requests that if a risk-based capital requirement is adopted, sufficient time be allowed before the effective date for SROs to modify their electronic financial reporting systems.

The JAC strongly urges the Commission to adopt a risk-based capital requirement without an early warning level and encourages the Commission to continue to be responsive to capital changes necessitated by the ever-increasing and changing global marketplace.

If you have any questions, please contact me.

Sincerely,

Anne E. Glass
Chairman, Joint Audit Committee

cc: Mr. Thomas J. Smith, Director, Commodity Futures Trading Commission
Joint Audit Committee Representatives

[1] The proposed language of Regulation 1.17(e)(1)(ii) states a 175% level for the equity withdrawal restriction which appears to be a typographical error as it does not correspond with the Commission's intent as discussed in the proposed rule.

Analysis of Early Warning Requirement at 150% and 110% Of Risk-Based Capital Requirement

	Aggregate Early Warning Based on Segregated Amount (111 Firms) or SEC Requirement (2 Firms)	Aggregate Early Warning Based on 150% of Risk-Based Capital Requirement	Difference at 150% Increase/(Decrease)	Aggregate Early Warning Based on 110% of Risk-Based Capital Requirement	Difference at 110% Increase/(Decrease)
FCM/Broker-Dealers Impacted by a Risk-Based Capital Early Warning Level (19 Firms)	$661,395,000	$1,020,383,000	$358,988,000	$748,281,000	$ 86,886,000
FCM only (94 Firms)	$888,868,000	$1,107,222,000	$218,354,000	$811,963,000	($ 76,905,000)
Total	$1,550,263,000	$2,127,605,000	$577,342,000	$1,560,244,000	$9,981,000