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September 8, 2003

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

Submitted via e-mail

COMMENT

RE: Minimum Financial and Related Reporting Requirements for Futures Commission Merchants ("FCMs") and Introducing Brokers ("IBs")

Dear Ms. Webb:

This letter is in response to the Commission's request for comment on the above-referenced rule proposal. I am a certified public accountant and hold an MBA (concentration in finance). I spent about 19 years at the Commodity Futures Trading Commission ("CFTC" or "Commission"), where I directed the Commission's financial compliance program over FCMs. Effective March 31, 2002, I retired from the Commission and, since then, I have been a consultant in domestic and international financial regulatory matters.

For the sake of conceptual simplicity and discussion, even though haircuts and non-current assets are not, technically, part of an FCM's capital requirements, I refer to them herein as part of a firm's capital requirements. That is, I use the term "capital requirements" generically to mean that if a haircut is increased or an asset previously considered a "good" asset is changed to a "non-current" asset, the FCM "capital requirements" would be deemed to be "increased" in my terminology used herein.

I believe that the Commission's proposed risk-based approach to the capital requirements will, on occasion, cause sudden increases in the capital

requirements of some firms. This effect would be unfortunate, as the times when this may occur would be when the capital requirements are most important, i.e., during times of financial crisis. That is, the proposed requirements by virtue of how they are calculated, as explained below, could result in spikes in the requirements for individual firms. This could be problematic for many firms in the FCM community, as during volatile markets it is often difficult or impossible to obtain more capital. Provided a firm is not insolvent, I believe there is little point in forcing a firm to report an under-capitalized condition, because of a temporary market condition.

When a volatile market has occurred, customers on the losing side of futures and options contracts have losses posted to their accounts, which can dramatically increase the amounts of under-margin accounts and deficits. At the same time, exchange-set margin requirements are usually increased for the volatile contracts, sometimes by large percentage amounts. Such increased margin requirements affect the margin status of the accounts of customers on both sides of the market. The increase in SPAN margin requirements, at the same time as when losses have been posted to the customers' accounts (resulting in increased under-margin and deficit amounts), is a "double-whammy" impact on FCM capital requirements. Under the proposed rule change, the increases in these three factors would result in an almost immediate increase (with approximately only a one-day delay) in capital requirements. I believe sudden increases in the Commission's capital requirements should be avoided, as this type of increase serves no useful purpose. The true test, to which firms should be subjected during a volatile market before they might be shut down, is discussed below. The Commission's capital requirements for FCMs should be a requirement which should be met on a routine basis during normal markets – before a volatile market is encountered. Attempting to require an FCM to bring in more capital in the face of a volatile market is tantamount to a homeowner attempting to purchase fire insurance on a home, after his home has caught fire.

Instead of the current proposal which focuses on a daily "snapshot" approach for the numbers which enter into the capital requirements calculation, I would propose the Commission use a month's daily average for each of the three factors mentioned above. By using daily averages for the prior month, there would be no spike in FCM capital requirements, unless the increases occurred very early in the month. And, even in such a case, there would be more time to bring in more capital than under the

current proposal. For example, if the increases occurred on the 15th of a month the increase in the requirements would be approximately one-half that of the proposed rule. Also, in such an example, the FCM would know of the changes two weeks in advance of the end of the month and, therefore, could plan to bring in additional capital and/or collect margin from customers. (No change should be made to the treatment of debit/deficit amounts in the segregation calculation, however.)

I would agree that the present amounts of capital held by the industry's FCMs are generally adequate. The record of FCM financial stability under the Commission's existing rules stands as testament to this fact. Therefore, if the Commission were to adopt the suggestions I have set forth above, I believe it would be well to evaluate the correctness of the 8 percent and 4 percent factors, by which the SPAN margin requirements are multiplied. Because of the effects of adding deficits and under-margin amounts to the factors which would determine a firm's capital requirements, it may be necessary to adjust the 8 percent and 4 percent factors downwards, to reach the same target amounts of capital envisaged in the currently proposed rule change.

For the Commission, the main purpose of the capital rule is to provide a "bright line", where an FCM should be shut down, because it can no longer meet its obligations to its customers. The proposals I have made (as well as the Commission's own proposal for under-margin accounts) pre-suppose that under-margin and deficit amounts will be collected in the normal course of business by the FCM. In contradiction to this concept, the failure of many FCMs in the past has been associated with one or a few customers with large risk positions, where the customers have failed to meet their margin and deficit obligations to the carrying FCM – and, these impending failures were evident prior to the expiration of the parameters for "good" capital treatment contained in the Commission's rules. Therefore, special provision should be made in the capital rule regarding under-margin and deficit amounts, which the FCM has reason to believe may not be collected. That is, I would suggest that the capital rule require an immediate special charge of 100 percent for any account or accounts where there is an issue regarding a customer's ability or willingness to pay. This would be important so that an undercapitalized FCM could be quickly ordered shut down by the Commission and its customers' accounts transferred to other FCMs.

Any change to the capital rule should be thoroughly tested before final adoption of the rule. Therefore, if the Commission wished to pursue what I have suggested in this letter or any other proposal, thorough testing should be undertaken. With such a careful approach (as the Commission has already executed respecting the present proposal), I am sure the Commission's record of assuring financial stability for the FCM community will be maintained.

Finally, given the many provisions of CFTC rule 1.12 which are aimed at providing a timely warning to the Commission of a financial problem at an FCM, it is not clear that the provision requiring notice of a "violation" of the early warning capital level is, any longer, relevant. The issue with the early warning notification requirement is that, since such a notice to the Commission is a public event, it is in effect the "true" capital requirement. This is because any firm under the early warning level is publicly scorned for being in a "risky" position and nobody will want to deal with such a firm. So, I would recommend that there is little point in having, in effect, two capital requirements – a lower capital requirement and a higher "actual" capital requirement, which any firm which seeks to avoid public scorn must maintain. What with monthly financial reporting to the CFTC and the other 1.12 reporting provisions, I would propose that the CFTC drop the 150% early warning level and just have one "real" capital requirement.

I appreciate the opportunity to share my views with the Commission.

Very truly yours,

Paul H. Bjarnason, Jr.