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COMMENT

March 16, 1998

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

Re: Early Warning Amendments, 63 Fed.Reg. 22188 (January 14, 1998)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit the following comments in response to the Commodity Futures Trading Commission's ("Commission's") notice of proposed rulemaking with respect to Commission rule 1.12, the Commission's early warning requirements. FIA, a not-for-profit corporation, is a principal spokesman for the futures industry. Its members include approximately seventy of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

The Commission has stated that the proposed amendments to the early warning rules are designed to assure that the Commission receives more timely notice whenever an FCM's capital may be impaired for one reason or another. In this connection, the Commission has proposed a number of amendments to rule 1.12. Specifically, the Commission has proposed to amend rule 1.12(a) to require an FCM to notify the Commission immediately when the FCM knows or should know that the FCM is undercapitalized. Similarly, the provisions of rule 1.12(f)(1) and (2) would be amended to require immediate notice whenever (1) a clearing organization determines that any position it carries for a clearing member must be liquidated or transferred immediately, or (2) an FCM determines that any position it carries for another FCM must be liquidated or transferred immediately. Currently, an FCM or clearing organization has 24 hours to furnish such notice to the Commission. FIA does not oppose the proposed amendments to the provisions of rule 1.12 (f)(1) and (2).

Proposed Rule 1.12(h)

In addition, the Commission has proposed to add a new early warning requirement. New rule 1.12(h) would require an FCM to notify the Commission (and the FCM's DSRO) immediately, whenever the FCM:

> knows or should know that the total amount of funds on deposit in segregated accounts on behalf of customers, or the total amount set aside on behalf of customers trading on non-United States markets, is less than the total amount of such funds required by the Act and the Commission's rules to be on deposit in segregated or secured amount accounts on behalf of such customers.

The proposed requirement that an FCM file notice with the Commission whenever the FCM "should know" that it is undersegregated or undersecured has caused considerable concern and confusion among FIA's members. As the Commission is aware, FCMs currently are obligated to compute daily the amount of funds held in segregation and the amount of funds required to be so held. In accordance with the provisions of rule 1.32, this computation must be completed by noon the following business day. The proposed rule, however, appears to conflict with the provisions of rule 1.32 and implies that FCMs would have the obligation to compute their segregation requirements on a continuing basis. At the very least, it implies that FCMs would have the duty to complete the required computations at some undefined earlier point in time.

The *Federal Register* release accompanying proposed rule 1.12(h) unfortunately fails to provide FCMs any additional guidance. To the contrary, the imprecise language in the release implies that the Commission would expect an FCM to file notice even before the firm has a reasonable basis to believe—or, "should know"—that it is undersegregated or undersecured. For example, at one point the Commission explains that the purpose of the rule is to assure that the Commission is notified "as soon as an FCM knows that it *may have* a problem meeting segregation requirements." [Emphasis added.] Elsewhere, the Commission states:

> In the event of a major market move, the Commission would expect an FCM to consider the impact of that move on the values of the positions that it is carrying and how this impact would affect the accrued payable to its clearing organizations and the deficits in customer accounts. If the FCM has reason to believe that this impact could be material and negative in relation to previously computed excess segregation, it would be *advisable* to report a possible undersegregated condition to the Commission. [Emphasis added.] 63 *Fed.Reg.* at 2109.

As a consequence, FCMs have expressed concern that, even if senior management has a reason to believe that the computation made by its staff is inaccurate, the proposed amendment would prohibit management from taking the time to confirm that the FCM, in fact, is undersegregated or undersecured before filing notice with the Commission. More ominously, certain FCMs fear that an FCM could be subject to an administrative proceeding for failure to notify the Commission that the firm may be undersegregated or undersecured, while others are concerned that the Commission, upon receiving notice that a firm may be undersegregated or undersecured, will take steps to transfer open positions carried at that firm to another FCM, without taking the time necessary to determine whether such an extreme measure is justified.

FIA understands that, in subsequent discussions with industry participants, Commission staff has emphasized that FCMs should not be concerned about a rash of enforcement cases being brought against firms that may be undersegregated or undersecured. In this regard, the staff emphasized that the Commission's primary concern is to assure market protection and not to bring enforcement actions. Nonetheless, taking into consideration the context in which the proposed rule was published for comment, the concerns of FIA member firms are not unfounded.

Commission staff has sought to allay FCMs' other concerns as well. In particular, staff has emphasized that, generally, the Commission would not expect to receive notice that a firm is undersegregated or undersecured until noon the following business day, when the segregation and secured amount calculation is required to be completed in accordance with Commission rule 1.32. Consistent with the provisions of rule 1.32, the Commission would expect to receive such notice prior to noon the following business day only when, as a result of a major market move, each of the following has occurred: (1) a customer becomes significantly undermargined; (2) the customer makes clear to the FCM that the customer is unable or unwilling to meet the margin call; and (3) the FCM is aware that it will be unable to transfer enough capital from its own accounts to the customer segregated account in a timely manner to meet the customer margin call.[1]

FIA welcomes the staff's assurances in this regard. Nonetheless, if the Commission determines to promulgate a final rule, it is essential that the Commission correct the confusion that has arisen from the *Federal Register* release accompanying the proposed rule. Given the broad language of the proposed rule, any final rule must be revised to incorporate the three conditions referenced above. In the alternative, the Commission must assure that the *Federal Register* release accompanying the final rule, which serves as its legislative history, provides clear guidance to FCMs that may be subject to its provisions. In this regard, unless the Commission is prepared either to amend the rule or provide such guidance in a form that substantially endorses the views expressed by Commission staff in its meeting with industry participants, FIA cannot support the proposed rule.

In these latter circumstances, we request that the Commission republish the rule for additional comment before proceeding to consideration of a final rule. The *Federal Register* release accompanying the republished rule should explain what additional regulatory obligations, if any, would be imposed on FCMs under proposed rule 1.12(h).

Separately, FIA requests the Commission to amend rule 1.12 generally to provide that all early warning notices should be filed only with the FCM's DSRO. The DSRO, in turn, would be responsible for notifying the Commission. In support of this request, FIA notes that, as a practical

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[1] Moreover, in the event that senior management questions the calculations of the FCM's staff, Commission staff has indicated that senior management would have the time to confirm the calculation before being required to file a notice.

matter, an FCM's DSRO generally has primary responsibility for working with an FCM that is experiencing financial stress. It would be more efficient if an FCM were required to file only one notice and would allow the FCM to focus its attention on resolving its problems.

FIA appreciates the opportunity to submit these comments with respect to the proposed amendments to Commission rule 1.12. FIA shares the Commission's concerns in assuring the financial integrity of the markets, and we look forward to working with the Commission in clarifying the proposed rule. If you have any questions regarding this letter, please contact me, at (202) 466-5460.

Very truly yours,

John M. Damgard

John M. Damgard
President