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January 18, 2011

Mr. David A. Stawick  
Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

*Re: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies*  
*(RIN 3038-AD99)*

Dear Mr. Stawick:

The Investment Company Institute<sup>1</sup> (“ICI”) is submitting this letter in response to the Commodity Futures Trading Commission’s (the “Commission” or “CFTC”) Advanced Notice of Proposed Rulemaking (“ANPR”) on the appropriate model for protecting the margin collateral posted by customers clearing swap transactions.<sup>2</sup> Pursuant to Section 724 of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the CFTC must develop a regulatory structure for swaps that promotes safety and soundness, including protection of swaps customers’ collateral.<sup>3</sup>

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<sup>1</sup> ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interest of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.31 trillion and serve almost 90 million shareholders.

<sup>2</sup> CFTC Advanced Notice of Proposed Rulemaking: Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, RIN 3038-AD99, 75 FR 75162 (December 2, 2010) available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2010-29836a.pdf>.

<sup>3</sup> Section 724 of the Dodd-Frank Act is codified in Section 4d(f) of the Commodity Exchange Act (“CEA”), as amended.

Our members – registered investment companies – use multiple types of derivatives as a means to pursue their stated investment objectives, policies, and strategies, often by hedging their investments from a decline in value, for efficient portfolio management purposes, and for securing at low cost assets they wish to acquire.<sup>4</sup> We therefore have a strong interest in the safety and soundness of the derivatives markets, in particular as standardized swaps migrate from bilateral transactions executed in the over-the-counter (“OTC”) market to the framework of centralized clearing and trading on regulated exchanges or swap execution facilities as contemplated by the Dodd-Frank Act. We believe the “full physical segregation” model proposed by the CFTC to protect customer collateral would provide the greatest protection for customers; however, there are some unanswered questions associated with customer costs and there may be other potential issues inherent in this approach. While the industry attempts to quantify the costs associated with the “full physical segregation” model and also address any other potential issues, we believe the “moving customers to the back of the waterfall” model could also be an acceptable approach to balance customer protection with costs to customers, pending further evaluation. We recommend that the CFTC further explore both of these models.<sup>5</sup>

## **I. CFTC’s Proposed Models**

ICI commends the Commission for issuing the ANPR and requesting comment on four possible models for protecting margin collateral posted by customers clearing swap transactions. We fully agree with the Commission’s stated goals for these models, namely, maximizing customer protection and minimizing costs for customers and the industry as a whole.

Section 4d(f)(2) of the CEA provides that a futures commission merchant (“FCM”) must treat property of a customer received to margin a cleared swap transaction as belonging to such customer and, subject to certain limited exceptions, that such property may not be commingled with the funds of the FCM or used to margin the trades of any swaps customer or person other than the swaps customer who posted such property. Further, Section 4d(f)(6) makes it unlawful for any depository, including a derivatives clearing organization (“DCO”), to hold, dispose of, or use any such property as belonging to the depositing FCM or any person other than the swaps customer of such FCM. As noted in the ANPR, the language of this provision concerning the protection of cleared swaps customer margin collateral is similar, but not identical, to the statutory language in other provisions of Section 4d governing the protection of margin collateral posted by exchange-traded futures customers.

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<sup>4</sup> See [Report of the Task Force on Investment Company Use of Derivatives and Leverage](#), Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010. The terms discussed in the ANPR impact all registered investment companies, including mutual funds, closed-end funds, and ETFs. For purposes of this letter, we will refer to registered investment companies as “funds.”

<sup>5</sup> Our letter is representative of a majority of our membership, but some members may believe one of the remaining two models better balance investor protection with costs to customers.

A. Full Physical Segregation

This model would require individual segregation of each customer's collateral at each level, including at the FCM, DCO, and at each custodian. This model would mirror existing arrangements that funds have negotiated with swap dealers in which collateral for OTC swap transactions posted by funds is held in individual, segregated accounts at a third-party custodian.<sup>6</sup>

B. Legal Segregation With Commingling

This model would permit the collateral of all cleared swap customers of an FCM member of a DCO to be held on an omnibus basis and thereby permit commingling of cleared swap customer funds. The value of the collateral for each customer's positions, however, would be treated and maintained as legally separate, as if each customer's margin collateral was individually segregated at each level.

C. Moving Customers to the Back of the Waterfall

This model would be consistent with the existing omnibus customer account model used in U.S. futures trading with one exception. Specifically, the collateral of non-defaulting customers of a defaulting FCM member of a DCO could be used only after all other elements of the DCO's financial safeguards package, including the DCO's own capital and the DCO's default fund, have been applied.

D. Baseline Model

This model would extend the current, longstanding approach for U.S. futures trading to cleared swap transactions. Under this model, the DCO would have recourse to customer margin collateral held in the FCM member's cleared swaps omnibus customer account in the event of a failure by the FCM member to meet a margin call with respect to the FCM's cleared swaps omnibus customer account of that DCO.

## II. ICI's Recommendations

As discussed in greater detail below, of the possible models proposed by the Commission, ICI believes that full physical segregation and moving customers to the back of the waterfall are the two models for protecting margin collateral posted by customers clearing swap transactions that warrant further consideration by the Commission at this time. In determining which model best protects customers' collateral, it is critical that the Commission weigh the protective measures provided by a particular model against customer costs associated with that model.

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<sup>6</sup> Some of our members believe that, as an alternative to segregated accounts at a third-party custodian, margin collateral could be segregated in separate accounts at the relevant DCO after being passed through by the FCM. Others believe that the FCM would have to enter into a tri-party arrangement and provide the assets to be posted at the DCO.

A. Full Physical Segregation

The full physical segregation of each customer's cleared swaps account and all property collateralizing that account would provide the maximum protection for customers and would be consistent with the current practice of funds posting collateral for OTC swap transactions in individual, segregated accounts at a third-party custodian.<sup>7</sup> We are mindful, however, that mandating this model might impose significant costs and operational and other burdens on market participants, including customers and the derivatives industry as a whole. During the Commission's October 22, 2010 Staff Roundtable on Individual Customer Collateral Protection (the "Roundtable")<sup>8</sup>, the Chicago Mercantile Exchange Inc. ("CME") and the IntercontinentalExchange, Inc. estimated that if full segregation was implemented, initial margin levels for cleared swap transactions would increase by more than 50 percent, which would undoubtedly have ripple effects, such as an increase in DCO default fund contribution levels applicable to FCM members. While we cannot be sure as to what the costs would be, it is likely that initial margin levels would increase under such a revamped model.

In addition, we anticipate that FCMs may impose new fees on swap transactions because they will not have access to the assets in a customer's segregated account. We believe, however, that some costs may already be present in the current OTC market due to the use of tri-party custodial arrangements. Given that we have not been presented with any empirical data relating to the costs likely to be associated with full physical segregation, ICI would encourage the CFTC and its staff to undertake a comprehensive study of the costs and other issues, with input from all industry participants, including DCOs, FCMs, and customers prior to promulgating any rules on treatment of customer collateral for cleared swaps.

B. Moving Customers to the Back of the Waterfall

Based upon our historical experience with the baseline model for U.S. futures trading, ICI believes that moving customers to the back of the waterfall could, pending further examination, be an acceptable alternative to full physical segregation for cleared swaps customers. In this regard, our members are familiar and generally comfortable with the existing baseline model for U.S. futures trading and would favor enhancements to this model as an interim step. We believe that adjusting the existing baseline model for U.S. futures trading by moving customers to the back of the waterfall would

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<sup>7</sup> Although we cannot fully evaluate the implications in the abstract, we believe the full physical segregation model would be consistent with the fund custody rules. Rule 17f-6 under the Investment Company Act of 1940 permits funds to maintain assets (*i.e.*, margin collateral) with unaffiliated, registered FCMs. The FCMs must comply with the segregation requirements of Section 4d of the CEA. Full segregation of assets would not conflict with these provisions. In fact, custody of assets under this model would be somewhat similar to the custody of fund assets prior to the adoption of Rule 17f-6, when funds generally were required to maintain these assets in special accounts with a custodian bank. As noted above, custody of assets under this model also would be similar to current fund practice for OTC swap transactions.

<sup>8</sup> A transcript of the Roundtable is available at:

[http://www.cftc.gov/lawregulation/DoddFrank/OTC\\_6\\_SegBankruptcy.html](http://www.cftc.gov/lawregulation/DoddFrank/OTC_6_SegBankruptcy.html)

provide customers additional protection without dramatically altering current practices or customer costs in the exchange-traded futures industry.<sup>9</sup>

Under this model, a DCO applies a series of financial safeguards, in the form of customer and DCO assets, when addressing an FCM member default, often referred to as the “waterfall,” and these financial safeguards typically include, in order, the following: (i) the property of the defaulting FCM member of the DCO; (ii) the margin collateral posted on behalf of that defaulting FCM member’s non-defaulting customers; (iii) a portion of the capital of the DCO; and (iv) the default fund contributions of other non-defaulting FCM members. By moving the margin collateral posted on behalf of that defaulting FCM member’s non-defaulting customers to the back of the waterfall, each non-defaulting customer would have increased protection from losses incurred as a result of the positions of other customers than in the current futures model and would be exposed to “fellow customer risk” in fewer circumstances.<sup>10</sup> We recognize that there would be some residual risk associated with moving customers to the back of the waterfall in lieu of full physical segregation, and these risks should be evaluated and addressed to ensure maximum protection of customer funds.

In addition, very different regulatory regimes for protecting margin collateral posted by customers for cleared swaps and futures contracts may result in divergent pricing for instruments that are otherwise economically similar and may result in customers favoring one instrument at the expense of the other, which we do not believe is the CFTC’s intention, as well as introduce other complexities. By way of example, ICI’s members often benefit from portfolio margining platforms, which calculate a customer’s margin collateral based on the customer’s entire portfolio (*i.e.*, across products and markets). Portfolio margining platforms generally reduce costs and improve market efficiencies for all participants. In the event that there are substantially different models for protecting margin collateral posted by customers as between cleared swap transactions and futures contracts, the use of portfolio margining may be reduced. In contrast, moving customers to the back of the waterfall should require only relatively minimal changes to the baseline model for U.S. futures trading and should not be disruptive of existing practices in view of its limited nature. Indeed, should the industry become

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<sup>9</sup> We believe that the “moving customers to the back of the waterfall” model would be consistent with the fund custody rules. As previously discussed, Rule 17f-6 under the Investment Company Act of 1940 permits funds to maintain assets with FCMs subject to certain conditions. *See supra* note 7. The Securities and Exchange Commission (“SEC”) staff has provided temporary no-action relief to the CME, a DCO, to the effect that certain cleared OTC derivatives may be treated as futures under Rule 17f-6 and therefore fund assets may be maintained at the CME or with its FCM members, subject to similar conditions as imposed on FCMs in Rule 17f-6. *See* No-Action Letter: Investment Company Act of 1940 – Section 17(f) and Rule 17f-6; Chicago Mercantile Exchange (July 16, 2010), Reference No. 20103121347, File No. 132-3, available at <http://www.sec.gov/divisions/investment/noaction/2010/cme071610-17f.htm>. Given this relief, we believe that the SEC staff would be equally supportive of a model that further insulates fund customer assets from incident of loss by moving them to the back of the waterfall.

<sup>10</sup> In connection with moving customers to the back of the waterfall, we wish to clarify our understanding that any assessment powers of the clearing house for additional funds from its members would be exhausted before accessing non-defaulting customers’ funds. If the non-defaulting customers’ funds are ultimately accessed, there should be a fair and equitable allocation method.

Mr. David A. Stawick

January 18, 2011

Page 6 of 6

comfortable with this approach after further evaluation, perhaps the Commission would consider implementing a similar model for U.S. futures trading, building upon the industry's developing experience with protecting cleared swaps customer margin collateral.

C. Optionality

The Commission is requesting comment as to whether individual customer protection should be made available on an optional rather than a mandatory basis. Due to the host of legal, regulatory, operational, and other issues which would be presented, ICI does not believe that it would be appropriate to implement individual customer collateral protection on an optional basis. If the Commission does determine to further consider individual customer collateral protection on an optional rather than a mandatory basis in connection with this rulemaking proceeding, however, ICI believes that the cost imposed by a customer obtaining such individual protection should be charged to that customer.

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Based upon our desire to minimize costs and disruption, ICI believes that moving customers to the back of the waterfall is the most appropriate and cost effective model for protecting margin collateral posted by customers clearing swap transactions at this time. That being said, and given the importance of this issue, we recommend that the Commission and its staff undertake a comprehensive study of the costs and other potential issues of this model, the full physical segregation model, as well as the other two models, with input from all industry participants.

If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815, Heather Traeger at (202) 326-5920, or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan  
General Counsel

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott D. O' Malia, Commissioner  
Ananda Radhakrishnan, Director, Division of Clearing and Intermediary Oversight  
Robert B. Wasserman, Associate Director, Division of Clearing and Intermediary Oversight