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COMMENT LETTER

January 14, 2013

ICI Letter on CFTC's Proposal to Enhance Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations (pdf)

January 14, 2013 Ms. Sauntia S. Warfield Assistant Secretary Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Re: Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations (RIN 3038-AD88) Dear Ms. Warfield: The Investment Company Institute ("ICI")1 is submitting this letter in response to the proposed new rules and rule amendments by the Commodity Futures Trading Commission ("CFTC" or "Commission") to provide greater protections to customers and to the funds deposited by customers with futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs"). The Proposal would require enhanced customer protections, risk management programs, internal monitoring and controls, capital and liquidity standards, customer disclosure, and auditing and examination programs for FCMs.2 The Proposal also would require self-regulatory organizations ("SROs") of FCMs to adopt new requirements with respect to the oversight and examination of FCMs. Our members – registered investment companies – use derivatives as a means to pursue their 1 The Investment Company Institute 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 interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.9 trillion and serve over 90 million shareholders. 2 Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 77 FR 67866 (Nov. 14, 2012) ("Proposal"), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-26435a.pdf. The Proposal also addresses certain issues concerning derivatives clearing organizations ("DCOs") and chief compliance officers ("CCOs"). Ms. Sauntia S. Warfield January 14, 2013 Page 2 of 9 stated investment objectives, policies, and strategies for efficient portfolio management purposes.3 Accordingly, we have a strong interest in the safety and soundness of the derivatives markets, including protection of customer collateral and funds held by FCMs and DCOs. For this reason, ICI has a keen appreciation, and has advocated, for ensuring the protection of customer collateral and funds, and we applaud the

Commission’s commitment to improve customer protection.4 We also commend the Commission for its efforts to seek public input on this issue, including holding two public roundtables on customer protection issues.5 Finally, we appreciate the interpretive guidance by the CFTC staff with respect to certain provisions of Part 22 of the CFTC regulations regarding the segregation of cleared swap customer collateral.6 Particularly in light of the two recent failures of FCMs, we strongly support the CFTC’s proposal to provide greater protection for customers of FCMs and customer funds held by FCMs, to require a risk management program designed to monitor and manage the risks associated with their activities, to improve the financial reporting by FCMs, and to improve public disclosure of information by FCMs. We, however, would recommend that the CFTC strengthen the proposed requirements with respect to the public disclosure by FCMs to ensure that customers are provided with more complete information regarding the FCMs, especially when FCMs are in a difficult financial condition. Notices of when FCMs are in distress will provide customers with information upon which to monitor their FCMs on an informed basis and to protect themselves should an FCM suffer adverse financial consequences.7 Finally, we also suggest an alternative method for verifying the account balances at depositories holding customer funds. We discuss these issues in more detail below. 3 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. 4 See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated August 5, 2011; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to David A. Stawick, Secretary, Commodity Futures Trading Commission, dated January 18, 2011. 5 The CFTC held a public roundtable on February 29 and March 1, 2012 with a broad cross-section of market participants and another roundtable on August 9, 2012. The CFTC also hosted a public meeting of the Technology Advisory Committee on July 26, 2012. 6 CFTC Letter No. 12-31, Staff Interpretation Regarding Part 22 (Nov. 1, 2012). 7 We also support the CFTC’s proposal to raise the level of protection provided with respect to an FCM’s holding of funds deposited by a customer for trading on foreign futures markets, which would make the regulatory approach and customer protections consistent with the FCM’s segregation requirements for futures customers trading on a designated contract market (“DCM”) or swaps customers engaging in cleared swap transactions. Ms. Sauntia S. Warfield January 14, 2013 Page 3 of 9 Customer Funds We generally support the CFTC’s proposal to provide greater protection to customer funds. In particular, we support the following aspects of the proposal: (1) prohibitions on an FCM from commingling futures customer funds with the FCM’s proprietary funds and on an FCM from commingling funds deposited by futures customers with funds deposited by 30.7 Customers8 or cleared swap customers.9 (2) prohibition on an FCM from using one customer’s funds to margin or secure another customer’s positions and from using a customer’s funds to extend credit to any other person; (3) imposition of additional safeguards with respect to an FCM withdrawing customer funds from segregated accounts that are part of the FCM’s residual interest in such accounts.10 (4) requirement on an FCM to file its segregation calculation with the Commission and with its designated SRO (“DSRO”)11 each business day. We fully support these provisions that would provide additional protections to customer funds. These proposals would address, in part, fellow customer risk in the event of a shortfall upon a default of an FCM and safeguard against FCMs and DCOs making inappropriate withdrawals or using customer funds in an unauthorized manner. The proposal to require filing of daily segregation calculations with the CFTC, which also will be publicly available, will facilitate monitoring of compliance by FCMs of the customer fund segregation requirements. 8 The term “30.7 Customer” is proposed to be defined to mean both U.S. domiciled customers and foreign-domiciled customers trading foreign futures or foreign options. 9 The CFTC is

proposing a similar provision for funds of 30.7 Customers. See also Rule 22.3(c)(2) (commingling prohibitions for cleared swaps). The Proposal also would prohibit a DCO from commingling futures customer funds with the DCO's proprietary funds or with any proprietary account of any of its clearing members and would prohibit the DCO from commingling funds held for futures customers with funds deposited by clearing members on behalf of their cleared swaps customers. 10 In addition to the proposed authorization and documentation requirements, the proposal would prohibit an FCM from withdrawing any of its residual interest on any given business day unless the FCM has completed the daily calculation of funds in segregation as of the close of the previous business day and the calculation showed that the FCM maintained sufficient excess segregated funds in the customer accounts. The proposed amendments make clear that no withdrawals may be made of residual interest to the extent of the sum of margin deficits. 11 A DSRO is the SRO that is appointed to be primarily responsible for conducting ongoing financial surveillance of an FCM under a joint agreement submitted to and approved by the CFTC. Ms. Sauntia S. Warfield January 14, 2013 Page 4 of 9 Depositories of Customer Funds The CFTC also proposes amendments to the written acknowledgment letters that an FCM or DCO is required to obtain from a depository holding customer funds. The CFTC proposes to require the depository to grant at all times read-only electronic access to the accounts to the Commission and, in the case of an FCM, to the FCM's DSRO. In addition to the read-only access to the accounts for the benefit of an FCM's customers, the acknowledgment letter would require depositories to agree that the accounts may be examined at any reasonable time by an appropriate officer, agent or employee of the CFTC. The CFTC is proposing an additional acknowledgment letter template form for money market funds when they are permissible investments for customer funds under rule 1.25. We support the CFTC's efforts to better monitor the account balances of FCM customers although we have some concerns with respect to the method by which the information is proposed to be provided. We believe that money market funds providing read-only access to the Commission would raise significant operational and privacy concerns for the funds, as well as practical concerns for the Commission. We believe the information the Commission seeks may be provided promptly and efficiently through alternative means that do not raise these issues, as described below. As an initial matter, we request confirmation that the "examination or audit" of the accounts (as authorized by the acknowledgment letters) would be limited to verification of account balances held for the benefit of an FCM's customers and that further inspection of a money market fund itself (if necessary) should be referred to its primary regulator – the U.S. Securities and Exchange Commission ("SEC"). We do not believe that it would be appropriate for the CFTC to examine or inspect a money market fund, which is not otherwise a CFTC regulated entity. In addition, we are concerned that providing the CFTC or a DRSO with direct electronic access to FCM accounts at a money market fund would require substantial and costly functionality modifications for money market funds although FCM accounts would likely be a small portion of these funds' investor base.12 Money market funds have thousands to millions of investors, and FCM accounts for the benefit of customers will likely constitute a small percentage of those shareholders. The CFTC's proposal to provide read-only access would impose significant costs on these money market funds, 12 Electronic access is typically designed for a limited set of accounts, based on common data found on all accounts all accounts (for example, Social Security number). To provide read-only access to CFTC or DSRO staff, new data would need to be defined, captured and stored, and systems reengineered. In addition, custom search capabilities would need to be developed to narrow access to only the relevant FCM accounts to an inquiry, which we believe would be a very limited number of shareholders in money market funds. Finally, the read-only and limited data needs for CFTC or DSRO staff will require custom investor account views to be constructed. The development of this type of

functionality and access for such limited purposes would be costly to implement. Ms. Sauntia S. Warfield January 14, 2013 Page 5 of 9 which would be borne by all investors and not just by FCMs.13 We do not believe it would be reasonable to require money market funds to incur such costs for a limited group of investors, particularly where we believe an alternative method (as described below) could provide the CFTC and the DSRO with the same information in a timely manner.14 Moreover, providing the CFTC and a DSRO with direct electronic access would raise concerns regarding protection of data and security of access. The CFTC and DSROs that have access to the systems of money market funds would have to implement security controls to ensure that a third-party cannot obtain or compromise the account information through the systems of the CFTC or the DSRO.15 Given these significant concerns involved in providing the CFTC and the DSRO with direct read-only access to FCM accounts, we recommend, as an alternative, that money market funds through an FCM acknowledgment letter agree to provide the CFTC and the DSRO with FCM account data promptly upon request. Specifically, money market funds would agree to provide, in electronic form, account information of an FCM within 48 hours upon request by the CFTC or the DSRO.16 We urge the CFTC to specify in the rule and/or acknowledgment letter (1) the standardized format in which the information should be provided and (2) the universe of information requested – the identifying information about the account and account balances for specified periods of time. We believe the identifying account information and account balances would allow the CFTC staff "to review an FCM's segregated account balances reported by depositories and to compare those balances to the 13 Each fund (even within a fund complex) potentially employs separate systems, each requiring a separate web address, user ID, and password for each user to obtain electronic access to investor accounts. Therefore, each CFTC or DSRO staff user would likely need to maintain an overwhelming number of these combinations for various money market funds. In addition, each record keeping system has basic operating assumptions underlying its functioning, including which transactions may appear, how balances are calculated, and when data is refreshed. The CFTC and DSRO staff would need to obtain individualized training on each system to accurately interpret what is being reviewed, a process which may be inefficient and burdensome. 14 Proposed rule 1.26 (b) would require each FCM that invests futures customer funds in money market funds to account separately for such funds and segregate such funds as belonging to the futures customers. The funds also must be deposited under an account name that clearly shows that they belong to futures customers and are segregated as required by the CEA. Because money market funds would have no way to determine directly the source of monies in the FCM account, they would have to rely reasonably on the representations of the FCMs that the account belongs only to FCM customers. 15 It has been reported that the CFTC suffered a data breach in May 2012 in which a third-party was able to enter illegally into an employee's account, which had access to personnel information. See CFTC Data Breach Risks Employees' Social Security Numbers, Bloomberg (June 25, 2012). 16 Delivery options could vary but typically would incorporate some form of data encryption and/or utilization of secure communication channels. Ms. Sauntia S. Warfield January 14, 2013 Page 6 of 9 FCM's reported account balances"17 and permit the CFTC to achieve its regulatory purpose in obtaining the information. Finally, we seek confirmation that the CFTC is proposing to require only those money market funds in which FCMs directly invest customer funds to agree to provide the FCM account information. Many investor accounts in mutual funds are held in intermediated positions. Intermediaries typically process customer transactions through omnibus18 or through intermediary- controlled accounts through the National Securities Clearing Corporation. Because the money market fund's transfer agent does not know the individual identity or specific transaction activities of each underlying investor, it would be impossible for the fund transfer agent to know whether any of the underlying investors within the omnibus

account would be an FCM account. For accounts held through intermediaries, the intermediaries would have to provide the FCM account information. Proposed rule 1.26(b) seems to contemplate the manner in which money market fund shares are held by requiring an FCM to obtain the acknowledgment letter from the money market fund if the customer funds are invested directly with the money market fund. If the funds are held with a depository acting as custodian for fund shares, the acknowledgment letter may come from the depository (rather than the money market fund).19 We believe it would be helpful for the CFTC to confirm our understanding that the intermediary should agree to provide the FCM account information in situations where fund shares are held through an intermediary. Risk Management Program for FCMs The CFTC proposes to require each FCM that carries customer accounts (for transacting in futures, options on futures, and swaps) to establish a risk management program designed to monitor and manage the risks associated with its activities as an FCM. The risk management policies and procedures of an FCM must include, among other things, the establishment and maintenance of an adequate targeted amount of excess funds in customer accounts reasonably designed to ensure that the 17 See Proposal, supra note 2, at 67886. 18 An omnibus account includes the shares of multiple investors—sometimes numbering in the thousands—that are customers of the intermediary. Omnibus accounts are held on the books of a fund in the name of the financial intermediary, acting on behalf of its customers. This includes omnibus account structures and intermediary-controlled individual accounts in which the fund has no relationship or contact with the customer, as well as other institutional customers for which the fund lacks direct knowledge of the beneficial owners of the shares. 19 See proposed rule 1.25(c)(3) (the FCM or DCO shall obtain the acknowledgment letter required by rule 1.26 from an "entity that has substantial control over the fund shares purchased with customer funds and has the knowledge and authority to facilitate redemption and payment or transfer of the customer funds. Such entity may include the fund sponsor or depository acting as custodian for fund shares"). We note that, because mutual funds do not typically have employees, the fund sponsor or an affiliate would sign these letters on behalf of the fund. Ms. Sauntia S. Warfield January 14, 2013 Page 7 of 9 FCM is at all times in compliance with the segregation requirements for customer funds under the CEA and CFTC regulations.20 We fully support these proposals, which would require FCMs to evaluate and monitor for risks of their businesses. We believe these provisions would reinforce the risk mitigating practices of FCMs and enhance the protection of customer funds that must be segregated. We also support a requirement to maintain an adequate targeted amount of excess funds in customer accounts, which would assist FCMs to maintain compliance with the segregation requirements. The CFTC's proposed requirement for FCMs to maintain an adequate target amount of excess funds in customer accounts and to comply with segregation requirements would help ensure that one customer's funds would not be used to satisfy another customer's obligations and would properly re-allocate costs from customers with excess margin to undermargined customers. Disclosure to Regulators Existing CFTC regulations require FCMs to provide the Commission and the FCM's DSRO with prompt notice of potential adverse conditions at the FCM that may indicate or lead to a threat to the financial condition of the firm or the protection of customer funds held by the FCM.21 The CFTC proposes amendments to include several additional reportable events and to submit reportable events to the Commission and DSROs through an electronic filing system. These amendments would require reporting if the FCM: (1) cannot compute or document its actual capital at the time it knows that it is undercapitalized; (2) fails to hold sufficient funds in segregated accounts for cleared swaps customers to meet its obligations; (3) discovers or is informed that it has invested funds held for customers in investments that are not permitted investments or holds permitted investments in a manner that is not in compliance with rule 1.25; (4) does not hold an amount of funds in segregated accounts

for futures customers or for cleared swaps customers or does not hold sufficient funds in separate accounts for 30.7 Customers sufficient to meet the firm's targeted residual interest in one or more of these accounts or if its residual interest is less than the sum of outstanding margin deficits for such accounts; and (5) experiences a material adverse impact to its creditworthiness or its ability to fund its obligations (or of its parent or a material affiliate). In addition, an FCM would be required to provide notice in the event 20 Under the Proposal, senior management of the FCM must perform appropriate due diligence in setting the amount of the excess funds in customer accounts and must consider the nature of the FCM's business including the type and general creditworthiness of its customer base, the types of markets and products traded by the firm's customers, the proprietary trading activities of the FCM, the volatility and liquidity of the markets and products traded by the customers and the FCM, and the FCM's own liquidity and capital needs, historical trends in customer fund balances, and customer debits and margin deficits. 21 Currently, FCMs are required to provide notice to the CFTC and to their DSROs for certain specified reportable events including: (1) failing to maintain the minimum level of required regulatory capital; (2) failing to maintain current books and records; (3) failing to comply with the requirement to properly segregate funds; and (4) experiencing a significant reduction in capital from the previous month-end. Ms. Sauntia S. Warfield January 14, 2013 Page 8 of 9 of a material adverse impact to the financial condition of the firm or a material change in the firm's operations.22 We believe that these reportable events, including most of the proposed additional triggering events, also should trigger a requirement to disclose the information to customers for a couple of reasons.23 First, this type of information is critical for customers to monitor their FCMs to determine whether they should continue to do business with their FCMs. The notice would permit customers to be aware of potential issues and to evaluate on a more informed basis the risks involved with a particular FCM. The ability to monitor closely the financial condition and other potential risks of FCMs is critically important. Because customer funds currently are not individually segregated at all times, customers would only receive their pro rata share of the FCM's estate (and a claim for the remainder of their funds) in the event of a default of an FCM and a shortfall of funds. Second, we believe that a requirement to disclose would provide a level playing field for all customers with respect to information about the FCMs. A requirement to disclose to all customers would prevent only a few customers from being privy to information while other (potentially smaller) customers may not have access to certain critical information about the FCM. Finally, we recommend that the information be posted on the FCM's website in a location that would be easily accessible to customers to provide all customers with equal access to important information. Public Disclosures by FCMs The CFTC proposes to enhance the disclosures provided to customers and potential customers, including certain firm specific information regarding the FCM's financial condition and operations to allow customers and potential customers to assess the risks of engaging the firm and the risk of entrusting their funds to the FCM. We support these provisions that would provide important information to customers of the FCM with respect to their businesses and their financial condition. This information would allow customers to evaluate the FCMs with which they would like to engage and to consider the financial and other risks of a particular FCM. The CFTC proposes to require disclosure of this information on the FCM's website available to the public. FCMs may, however, use an alternative electronic means to make information available to its customers provided that the electronic version is presented in a format that is readily communicated to its customers. FCMs also would be required to provide a paper copy upon request. 22 The CFTC also is proposing to require a FCM to file a copy of a notice, examination report, or any other correspondence from the SEC or an SRO. The CFTC should specifically identify the types of "notice" or "correspondence" that would trigger the filing obligation to avoid the CFTC

being inundated with routine information sent from the SEC or SRO to the FCM. 23 We would not expect SEC or SRO examination reports and other non-public correspondence from regulators to be disclosed to customers. Ms. Sauntia S. Warfield January 14, 2013 Page 9 of 9 As discussed above, information provided to customers should be posted on an easily accessible place on the FCM's website. * * * We appreciate the opportunity to submit our comments on the Commission's proposal to enhance protection afforded customers and customer funds held by FCMs. We generally believe the Commission's proposal will strengthen the protection of customers of FCMs by strengthening the oversight as well as the regulation of FCMs. We request that the Commission modify certain aspects of the requirements to reflect how money market funds can most efficiently provide information about FCM accounts and to provide customers with more complete information about their FCMs. If you have any questions on our comment letter, please feel free to contact me at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876. Sincerely, /s/ Karrie McMillan General Counsel cc: The Honorable Gary Gensler The Honorable Jill E. Sommers The Honorable Bart Chilton The Honorable Scott D. O' Malia The Honorable Mark Wetjen Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight Robert Wasserman, Chief Counsel, Division of Clearing and Risk

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