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June 14, 2012

Honorable Debbie Stabenow, Chairwoman  
Senate Committee of Agriculture, Nutrition, and Forestry  
328A Russell Senate Office Building  
Washington DC 20510-6000

**Re: Response to Bankruptcy of MF Global Inc.**

Dear Chairwoman Stabenow:

The Futures Industry Association (“FIA”)<sup>1</sup> is pleased to submit this letter in response to your request for our evaluation of the current regulatory framework for the exchanged-traded derivatives markets established in the Commodity Exchange Act (“Act”) and our recommendations on changes that would create stronger, safer markets and provide customers with greater protections. The bankruptcy of MF Global Inc. has been a personal tragedy for its thousands of customers who have suffered financially. It has also imposed a significant reputational cost on the exchange-traded markets generally, seriously damaging the confidence in the markets that is essential to their success. It is critical that the industry, working in coordination with Congress, the Commission and the several self-regulatory organizations (“SROs”), do everything it can to restore this confidence.

As discussed in greater detail below, FIA has identified and recommended to the Commodity Futures Trading Commission (“Commission”) and the several SROs, in particular, the National Futures Association (“NFA”) and the Chicago Mercantile Exchange (“CME”), which serve as the designated self-regulatory organizations (“DSROs”) for all FCMs, a number of amendments to the existing regulatory framework that will strengthen the protections afforded customers and customer funds and help restore confidence in the

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<sup>1</sup> FIA is the leading trade organization for the futures, options and OTC cleared derivatives markets. It is the only association representative of all organizations that have an interest in the listed derivatives markets. Its membership includes the world’s largest derivatives clearing firms as well as leading derivatives exchanges from more than 20 countries. As the principal members of the derivatives clearing organizations, our member firms play a critical role in the reduction of systemic risk in the financial markets. They provide the majority of the funds that support these clearinghouses and commit a substantial amount of their own capital to guarantee customer transactions.

FIA’s core constituency consists of futures commission merchants (“FCMs”), and the primary focus of the association is the global use of exchanges, trading systems and clearinghouses for derivatives transactions. FIA’s regular members, which act as the majority clearing members of the U.S. exchanges, handle more than 90 percent of the customer funds held for trading on U.S. futures exchanges.

markets. These recommendations have been well-received, and we are having productive discussions with the Commission and the SROs regarding their implementation.

At this time, we have not identified any changes to the Act or the Bankruptcy Code that we believe are necessary to enhance protection of customers and customer funds. However, we continue to consider this issue, including evaluating proposals made by other market participants. We will advise you promptly in the event we determine that legislative changes would be appropriate.

We also note the recent publication of the Report of the Trustee's Investigation and Recommendations, which discloses greater details on the MF Global insolvency with recommended changes to prevent this sort of incident from reoccurring. FIA is pleased to report that several of its Initial Recommendations for Customer Funds Protection described below were adopted in the recommendations of the Trustee. We continue to study the remaining recommendations of the Trustee and will keep the Committee apprized whether any of these additional recommendations may deserve further consideration.

#### **FIA's Initial Recommendations for Customer Funds Protection**

In January, FIA formed a special committee, the Futures Markets Financial Integrity Task Force, to develop and recommend specific measures that could be implemented in the near term through both industry best practice and regulatory change to address the issues arising from the bankruptcy of MF Global. With the assistance of FIA's Financial Management Committee, whose members include representatives of FIA member firms, derivatives clearing organizations and depository institutions, the Task Force released its Initial Recommendations for the Protection of Customer Funds on February 28, 2012 ("Initial Recommendations"), a copy of which is enclosed for your convenience. The Task Force concluded that, with the possible exception of the rules governing the offer and sale for foreign futures and foreign options, the current regulatory framework is fundamentally sound.<sup>2</sup> The Initial Recommendations, therefore, are intended to enhance, not replace, the existing protections.<sup>3</sup>

The Initial Recommendations generally fell into three categories: (i) enhanced disclosure regarding customer funds protections; (ii) enhanced reporting with regard to customer funds; and (iii) enhanced internal controls.

**Enhanced disclosure regarding customer funds protections.** The Task Force recognized that one of the more important services an FCM can provide its customers is to assure that these customers appreciate the limitations as well as the benefits of the customer funds protections set out in the Commodity Exchange Act and the Commission's rules. To address

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<sup>2</sup> Our recommendations with respect to the foreign futures and foreign options rules are below.

<sup>3</sup> Several of the Initial Recommendations are similar to the recommendations in the Report of the MF Global Inc. Trustee's Investigation and Recommendations issued on June 4, 2012 ("Trustee's Report").

those elements of the protections that are of immediate concern to customers, the FIA Law and Compliance Executive Committee prepared a memorandum setting out responses to frequently asked questions that FIA member firms have received from their customers. The Task Force determined that this document, which may be accessed on the FIA website, is an appropriate first step in providing customers critical information regarding customer funds protection.<sup>4</sup>

**Enhanced reporting with regard to customer funds.** Commission rules currently require each FCM (i) to compute as of the end of each business day the amount of funds held, and required to be held, in segregation, and (ii) to maintain detailed records of the investment of customer funds held in accordance with Commission Rule 1.25. NFA has required those FCMs for which it is the DSRO to file a copy of each daily segregation calculation and a monthly report identifying the sectors in which the FCM invests customer funds, the amount of customer funds invested in each sector and the weighted average maturity of the assets held in each sector. However, this information has not been reported to the other DSROs or the Commission on a routine basis.

In order to provide the Commission and all SROs with more up-to-date information on customer segregated funds, the Task Force recommended that the NFA reporting requirements be extended to all FCMs. Specifically, each FCM should be required to file with its DSRO its daily segregation calculation. Further, each FCM should be required to file twice monthly reports, as of each month-end and as of the 15<sup>th</sup> of each month (or the next business day), identifying: (i) the sectors in which the FCM invests customer funds; (ii) the amount of customer funds invested in each sector; and (iii) the weighted average maturity of the assets held in each sector. FIA understands that the CME and NFA, to the extent necessary, have adopted rules to implement these recommendations and expects that they will be approved by the Commission in the near future.

**Enhanced internal controls.** The Task Force recognized that no rules can adequately protect customer funds unless the firms responsible for complying with those rules maintain strong internal controls.<sup>5</sup> The Task Force, therefore, recommended that all FCMs document and implement policies and procedures regarding their internal controls. These recommendations reflect the best practices of those firms represented on the Financial Management Committee.

Specifically, the Task Force recommended that:

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<sup>4</sup> A copy of the Frequently Asked Questions available on the FIA website is also enclosed for your convenience. We view this document as a “living document” and will revise the document as other questions are identified or as required by amendments to the Act or the Commission’s rules. In this regard, the Commission staff has asked us to prepare a question and answer that would expand on the risks associated with trading on foreign boards of trade. We expect to add this question and answer shortly.

<sup>5</sup> As the Trustee’s Report confirms, the lack of strong internal controls played a significant role in MF Global’s bankruptcy.

- The Commission propose a rule requiring each FCM to certify annually that there are (and have been since the last report) no material weaknesses in its internal controls regarding the computation of adjusted net capital and compliance with the provisions of the Act and the Commission's rules regarding the protection of customer funds.
- The SROs require FCMs to document their policies and procedures that require an appropriate separation of duties among individuals responsible for compliance with the Act and the Commission's rules relating to the protection of customer funds, subject to appropriate oversight and review.
- NFA consider whether it should develop an examination for chief financial officers of FCMs and other personnel responsible for compliance with the provisions of the Act and the Commission's rules relating to the calculation of the FCM's adjusted net capital and the protection of customer funds.
- The SROs require each FCM to document its policies and procedures for valuing all securities held in the customer segregated account, including permitted investments under Commission Rule 1.25, to assure that such securities are accurately valued and, in particular, are readily marketable and highly liquid.<sup>6</sup>
- The SROs require each FCM to document policies and procedures for selecting the depositories, including affiliates, with which the FCM deposits and maintains customer funds.
- The SROs require each FCM to document its policies and procedures with respect to the FCM's determination of the appropriate targeted residual interest it maintains in the customer segregated account.<sup>7</sup> Such policies and procedures should be designed to reasonably assure that any withdrawals from the customer segregated account to the FCM's own account comprise the FCM's residual interest and will not result in a violation of the Act and the Commission's rules, or the FCM's targeted residual interest.<sup>8</sup> The FCM's chief financial officer or the chief financial officer's delegate must approve in writing any withdrawal from the customer segregated account in

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<sup>6</sup> FIA also recommended that the Commission amend Rule 1.25 to confirm that an FCM investing customer funds in accordance with the rule bears the risk of loss arising from any such investment and must use its own funds to restore the value of the customer segregated account. FIA believes that the responsibility of an FCM for losses incurred in connection with investments under Commission Rule 1.25 is clear and is implicit in the Act and the Commission's rules. Nonetheless, because this question has been raised by certain customers, the Commission's rules should make this obligation explicit in order to remove any ambiguity.

<sup>7</sup> All such FCM funds are held for the exclusive benefit of the FCM's customers while held in a customer segregated account.

<sup>8</sup> The Task Force believes that the Commission or DSRO should have authority to require an FCM to increase the amount of FCM funds held in segregation or to prevent an FCM from withdrawing its residual interest only in carefully circumscribed circumstances and in accordance with carefully articulated objective standards.

violation of the policies and procedures, as well as any material change in the policies and procedures regarding the maintenance of the FCM's residual interest in the customer segregated account.<sup>9</sup>

### **Foreign Futures and Foreign Options Secured Amount**

The Commission's foreign futures and options rules currently provide an FCM with greater flexibility in the manner in which it treats customers that trade on foreign boards of trade and the funds deposited by such customers to margin transactions on foreign boards of trade. For example: (i) foreign futures and foreign options customers are defined to include only those customers located in the US; (ii) only funds received from foreign futures and foreign options customers are required to be taken into account in calculating the foreign futures and foreign options secured amount in accordance with Rule 30.7; (iii) Rule 30.7 provides for an alternative calculation of the foreign futures and foreign options secured amount that does not assure protection of customer funds as fully as the net liquidating equity calculation that is used to determine the amount required to be segregated in connection with trading on US futures markets; and (iv) there is no limit on the amount of foreign futures and foreign options customer funds that may be held in permitted depositories outside of the US (although capital charges may apply).

Providing such flexibility was reasonable in 1987, when the foreign futures and foreign options rules (Part 30) were adopted. US participation in foreign markets was small and generally limited to commercial users. However, the international derivatives markets have changed significantly in the past twenty-five years. Although FIA understands that FCMs have generally adopted policies and procedures designed to provide protections to all customers trading on foreign boards of trade that are comparable to the protections afforded customers trading on US futures markets, the Task Force has recommended that the Commission publish for comment proposed amendments to the Part 30 rules that would:

- revise the definition of a foreign futures and foreign options customer to include all customers, wherever located;
- require all FCMs to calculate the foreign futures and foreign options secured amount using the net liquidating equity calculation;<sup>10</sup>

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<sup>9</sup> The Trustee's Report made a similar recommendation. FIA understands that both NFA and the CME have adopted rules to require the FCMs for which they are the DSRO to document their policies and procedures for determining the appropriate targeted residual amount. Further, the CEO, CFO or, in the case of NFA, a financial principal, would be required to approve in writing any withdrawal of a portion of the FCM's residual amount, not for the benefit of customers, in excess of 25 percent of the residual amount reflected in the FCM's most recent daily segregation calculation. Such written approval would be required before the withdrawal is made, followed by immediate notice to the FCM's DSRO. FIA fully supports these rules.

<sup>10</sup> The Trustee's Report made a similar recommendation.

- hold funds deposited with the FCM for the purpose of trading foreign futures and foreign options in the US, except as reasonably expected to meet margin obligations on foreign boards of trade;<sup>11</sup> and
- provide that, except as the Commission otherwise provides by order, only funds deposited or otherwise required to be held for the purpose of trading foreign futures and foreign options should be held in the foreign futures and foreign options secured amount.

The Task Force further recommended that the Commission withdraw that portion of the Commission's September 30, 2003 order that authorizes firms that are subject to regulation by the FSA and have qualified for an exemption from registration as an FCM in accordance with Commission Rule 30.10 to offer their customers that meet the definition of an eligible contract participant to opt out of the applicable UK segregations requirements.

### **Conclusion**

We would welcome the opportunity to meet with you, Senator Roberts and your respective staffs at your convenience to discuss FIA's recommendations in greater detail.

FIA shares your commitment, and that of the Commission, the several SROs and all other industry participants, to understand fully the reasons underlying the bankruptcy of MF Global Inc., the extent to which any shortcomings in the regulatory framework may have facilitated the conduct that led to its bankruptcy, and the appropriate regulatory response to such shortcomings. We look forward to working with you in this endeavor.

Sincerely,



Walter L. Lukken  
President

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<sup>11</sup> The appropriate excess is not amenable to a prescriptive rule, but will depend, for example, on the volatility from time-to-time of the products traded, the type of collateral (cash or securities) deposited with the foreign broker, the time-zone in which the market is located, and the jurisdiction of the markets traded. To the extent that a numerical standard is deemed necessary, the Task Force suggested that it should be no less than 50 percent of the amount that an FCM is required to deposit with a foreign broker to maintain customer foreign futures and foreign options positions. This number is consistent with the provisions of Commission Rule 1.17(c)(5)(xiii)(C), which requires an FCM to take a five percent capital charge to the extent unsecured receivables with a foreign broker is greater than 150 percent of the current amount required to maintain futures and option positions in accounts with the foreign broker.