INVESTMENT COMPANY INSTITUTE

INVESTMENT ADVISER ASSOCIATION

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June 4, 2013

Mr. Ananda Radhakrishnan
Director
Division of Clearing and Risk
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: *Implementation of LSOC Protections for Excess Customer Margin by Derivatives Clearing Organizations and Futures Commission Merchants*

Dear Mr. Radhakrishnan:

The Investment Company Institute ("ICI"),[1] the Investment Adviser Association,[2] and the Asset Management Group ("AMG")[3] of the Securities Industry and Financial Markets Association are writing to express our concern with respect to the incomplete implementation of the protections provided to customer excess margin[4] held by futures commission merchants ("FCMs") and derivatives clearing organizations ("DCOs") under the "legal segregation with operational commingling" or "LSOC" model adopted by the Commodity Futures Trading Commission ("CFTC" or "Commission"). To ensure that customers benefit from the full margin protections offered by the

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[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 $15.2 trillion and serve over 90 million shareholders.

[2] The Investment Adviser Association is a not-for-profit association that represents the interests of investment adviser firms registered with the Securities and Exchange Commission. Founded in 1937, the IAA's membership consists of more than 550 advisers that collectively manage in excess of $10 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

[3] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

[4] Excess margin is any collateral above the "amount required by the [DCO]." Rule 22.13(c) under the Commodity Exchange Act ("CEA").

LSOC model, we request that the Division of Clearing and Risk ("Division") delay the deadline for mandatory clearing by Category 2 entities until September 9 (the deadline for Category 3 entities) to allow DCOs and FCMs the necessary time to implement the technological systems to provide these critical protections.

Our members have been working diligently to be ready for the June 10 clearing mandate by completing the necessary documentation, installing the "plumbing" with middleware providers, and testing trades in the system to resolve any gaps. This request does not reflect a lack of will or commitment regarding clearing but, rather, one of inadequate time for the DCO and FCM industry to implement the necessary technological infrastructure to provide this critical protection to their customers.

Two-Phase Implementation of LSOC Protections

In meetings last summer with the Commissioners and with CFTC staff, it was acknowledged that, although the LSOC model fully protected initial and excess margin from "fellow customer risk," it was necessary to implement the protections allowing customers to instruct FCMs to move excess margin to DCOs in two phases. The first phase, characterized as "LSOC without excess," commenced in November, 2012 (the compliance date for LSOC). The second phase, characterized as "LSOC plus excess," was to be operational by May 2013 (*i.e.,* before the June 10 mandatory clearing deadline for Category 2 entities). Moreover, at industry meetings, the DCOs and FCMs confirmed their commitment to this timeline with the CME even initially instructing its members that beginning May 27, members must operate in a "client-specific excess mode."[5] It now appears, however, that only the CME has launched a model providing for the "LSOC plus excess" functionality, and we understand that no FCMs have yet adhered.[6] Some FCMs have told our members that they are waiting until each DCO has implemented its model so that they can adhere to all of the DCO models at once and on a consistent basis.

Need for Full LSOC Protection for Excess Margin

Our concerns with the incomplete protection of excess margin are particularly acute because the Rule 22.2(d)(1) prohibition on FCMs using one customer's margin to secure another customer's positions will have the practical effect of requiring customers to either always have excess margin

[5] *See* CME Group Advisory Notice 12-360 (Aug. 22, 2012), *available at* http://www.cmegroup.com/tools-information/lookups/advisories/clearing/files/Chadv12-360.pdf.

[6] For example, CME issued an updated advisory note earlier this year stating that "[t]here is no requirement that firms begin operating in LSOC with excess mode on [April 22, 2013], and we anticipate a transition process occurring over a period of several months, as firms test and go live with LSOC phase 2. CME has not established a date by which firms must convert…." *See* CME Group Advisory Notice 13-064 (Feb. 7, 2013), *available at* http://www.cmegroup.com/tools-information/lookups/advisories/clearing/files/Chadv13-064.pdf.

available to pre-fund new positions (which may be the less costly option) or borrow such margin from their FCMs. Use of the pre-funding option will likely result in significant amounts of customer excess margin being maintained in the system. Many of our members have been planning to instruct their FCMs to hold such excess at the DCO so that it can be treated as "allocated excess," removed from potential FCM fraud, and available for porting. Absent implementation of LSOC plus excess, excess margin remaining in the possession of the FCMs may be subject to heightened fraud risk, and such excess margin in the possession of DCOs must be treated as "unallocated excess," required, in the event of the FCM's insolvency, to be returned to the FCM's trustee for distribution and unavailable for porting.

Moreover, our concerns are not eliminated by the ability of customers to request the return of excess margin at any time. Although this option may be helpful with respect to the small amounts of excess that may be naturally generated by increases in the value of margin or in decreases in the need for initial margin, there are other sources of margin that cannot be returned to customers. Under Rule 22.13(c), excess margin is defined broadly to include any collateral above "the amount required by the [DCO]." Three of the most obvious sources of excess margin for which customers cannot request the return include: (1) excess margin arising from an FCM's credit requirements; (2) excess margin arising from the extra 10% of initial margin to support "speculative" trades; and (3) excess margin transferred by a customer to pre-fund new trading. These sources of excess margin must be held by the FCM unless the DCO "provides a mechanism by which the [FCM] is able to, and maintains rules pursuant to which the [FCM] is required to, identify each Business Day, for each [customer], the amount of collateral posted in excess of the amount required by the [DCO]."[7] Because Category 2 entities were promised that this mechanism would be in place before the June 10 clearing mandate, we are now requesting that the CFTC delay the clearing deadline to allow adequate time for DCOs and FCMs to make the technological changes necessary to ensure the protection operational.

The move to mandatory clearing under the "LSOC without excess" model raises particular concerns for our members given that the manner in which they currently trade derivatives over the counter subjects their margin to neither fraud risk nor fellow-customer risk. Fraud risk is eliminated through netting arrangements, which provide that regardless of how a dealer may treat a customer's variation margin, its value is netted against the customer's payment obligations. Both variation margin and initial margin are further protected when held in third-party, segregated custodial accounts.

We also see significant benefits in the added discipline and controls to be provided under the "LSOC plus excess" model in the FCMs' daily reporting to their DCOs under Rule 22.13(c)(2) regarding the identity of their customers and the amount of each customer's excess margin. We believe that such reporting, coupled with the transfer of excess margin from the FCM to the DCO, should substantially mitigate the risks to customers and to the CFTC, particularly in light of the MF Global

[7] Rule 22.13(c)(2) under the CEA.

and Peregrine insolvencies in which insufficient records made it an almost insurmountable challenge to confirm the amount and location of customer margin.

Finally, we urge the Commission to remain fully engaged with the efforts of the DCOs, FCMs, and customers to complete the implementation of the "LSOC plus excess" model. As the other DCOs work to finalize their rules to implement LSOC plus excess in the coming weeks, it is critical that all approaches are consistent with the principles expressed in the interpretation of the Part 22 rules provided by the Division on November 1, 2012.[8] In response to Question 7.1, the Division wrote that "[w]here a DCO does elect to hold and accept [customer excess], the value …is the value, after application of any applicable haircuts, in the DCO's books and records that is assigned to the [customer excess] . . . ." Although the exact approach may differ among the DCOs, it is crucial that following receipt of an FCM daily report, such excess margin must be treated as "allocated excess" until the next FCM report is received.

In sum, we remain gravely concerned about requiring a substantial portion of the market to clear before these important protections for customer collateral are completely in place. Without the requested extension, we fear that once most of the buy-side participants are subject to the clearing mandate, there will be less incentive for FCMs and DCOs to progress diligently with implementing the models that will provide full protection to excess margin. We believe it is imperative that the full protections of LSOC be provided to *all* customer collateral, including excess margin. Therefore, we urge the CFTC to delay the mandatory clearing for Category 2 entities until September 9 so that FCMs and DCOs can have the additional time needed to build the technological infrastructure for FCMs to report on and transfer customer excess margin to the DCOs and to implement LSOC plus excess.

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We appreciate the opportunity to express our concerns regarding the implementation of LSOC and the implications of the upcoming clearing deadline for many buy-side participants. We strongly believe that the CFTC staff must continue to enhance protection afforded customers and customer funds held by FCMs and DCOs, including excess margin. If you have any questions on our letter, please feel free to contact Karrie McMillan at (202) 326-5815, Sarah Bessin at (202) 326-5835, or Jennifer Choi at (202) 326-5876 of the ICI, Karen Barr or Monique Botkin at (202) 293-4222 of the IAA, or Timothy Cameron at (212) 313-1389 or Matt Nevins at (212) 313-1176 of AMG.

Sincerely,

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[8] *See* CFTC Letter No. 12-31, *Staff Interpretation Regarding Part 22* (Nov. 1, 2012).

/s/

Karrie McMillan
General Counsel
Investment Company Institute

/s/

Karen L. Barr
General Counsel
Investment Adviser Association

/s/

Timothy W. Cameron, Esq.
Managing Director, Asset Management Group
Securities Industry and Financial Markets Association

/s/

Matthew J. Nevins, Esq.
Managing Director and Associate General Counsel, Asset Management Group
Securities Industry and Financial Markets Association

cc: The Honorable Gary Gensler
The Honorable Jill E. Sommers
The Honorable Bart Chilton
The Honorable Scott D. O' Malia
The Honorable Mark Wetjen

Robert Wasserman, Chief Counsel, Division of Clearing and Risk

Certification Pursuant to Commission Regulation 140.99(c)(3)

As required by Commission Regulation 140.99(c)(3), we hereby (i) certify that the material facts set forth in the attached letter dated June 4, 2013 are true and complete to the best of our knowledge; and (ii) undertake to advise the Commission, prior to the issuance of a response thereto, if any material representation contained therein ceases to be true and complete.

Sincerely,

/s/

Karrie McMillan
General Counsel
Investment Company Institute

/s/

Karen L. Barr
General Counsel
Investment Adviser Association

/s/

Timothy W. Cameron, Esq.
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