June 30, 2023

Submitted electronically via CFTC Comments Portal

Mr. Christopher Kirkpatrick
Secretary
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Derivatives Clearing Organization Risk Management Regulations to Account for the Treatment of Separate Accounts by Futures Commission Merchants (RIN 3038–AF21)

Dear Mr. Kirkpatrick:

The Asset Management Group of the Securities Industry and Financial Markets Association[1] ("SIFMA AMG") appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC" or "Commission") on the proposed amendments to its derivatives clearing organization ("DCO") risk management regulations to permit futures commission merchants ("FCMs") that are clearing members to treat the separate accounts of a single customer as accounts of separate entities for purposes of certain Commission regulations.[2]

SIFMA AMG appreciates the Commission's recognition of the importance to memorialize the limited no-action relief granted in CFTC Staff Letter 19-17[3] into regulation. SIFMA AMG supports efforts to provide regulatory certainty on this important issue. As the Commission considers amendments to regulation, however, our members have concerns about the prescriptive nature and potential negative unintended consequences of some of the requirements in the Proposal.

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[1] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

[2] Derivatives Clearing Organization Risk Management Regulations To Account for the Treatment of Separate Accounts by Futures Commission Merchants, 88 Fed. Reg. 22934 (Apr. 14, 2023) (the "Proposal"); *available at* https://www.govinfo.gov/content/pkg/FR-2023-04-14/pdf/2023-06248.pdf.

[3] CFTC Staff Letter No. 19-17, *Advisory and Time-Limited No-Action Relief with Respect to the Treatment of Separate Accounts by Futures Commission Merchants; available at* https://www.cftc.gov/csl/19-17/download.

Overview

First, SIFMA AMG notes that the Proposal, which would amend DCO regulations, sets forth a proposed timeframe for FCM margin calls and is not directly an issue for DCOs. To the extent that residual interest covers the issues the Proposal intends to address, this issue is more so between FCMs and their customers or asset managers and their respective reasons for missing margin deadlines. Accordingly, SIFMA AMG urges the Commission to reconsider this Proposal as relevant to Part 1 of the Commission's rules (related to FCMs) rather than applying the regulatory compliance obligations on DCOs.

Second, SIFMA AMG believes that the Proposal would be difficult to implement in practice and does not reflect the longstanding (and largely successful) practices in place in the futures market today. This is particularly evident in the approach set forth for margin calls and transfer timelines, as well as the impractical treatment of global holidays. These prescriptive requirements ignore the realities of market participants' global operations and credit risk management capabilities.

Specifically, SIFMA AMG is concerned by footnote 63 of the Proposal, which posits that a "grace period" would violate the Commission's regulation.[4] This ignores longstanding contractual relationships in derivatives markets and would lead to a counterproductive and disproportionate amount of time, energy, resources, and effort being focused on arbitrary margin call timelines.

The Proposal, if adopted, would have a broad impact across market participants, including increased operational complexity and compliance obligations around the world that would lead to higher costs for FCM customers, such as pensions and retirement plans. FCM risk management practices for separately managed accounts and curing margin deficits have not risked the stability of DCOs, nor led to an FCM default. There have not been any market events that would suggest these prescriptive rules are necessary or even beneficial. Accordingly, we believe that the Commission can accomplish its regulatory objectives without imposing bright-line rules for DCOs and FCMs with respect to margin across accounts and risk management.

As we wrote to Commission staff in 2019, "treating [separately margined] accounts as separate legal entities should not expose an FCM to any greater regulatory or financial risk. To the contrary, an FCM's internal controls and procedures, . . . should assure that the FCM is not undertaking any additional risk as to the separate account."[5] The same premise holds true today.

[4] Proposal at 22941.

[5] SIFMA AMG Letter Requesting Interpretation of CFTC Rules 1.56(b) and 39.13(g)(8)(iii) (June 2, 2019); *available at* https://www.sifma.org/wp-content/uploads/2021/01/Request-for-Interpretation-Rule-1.56b-and-Rule-39.131.pdf.

For the reasons discussed below, we believe the Proposal would overcomplicate FCMs' risk management across markets, countries and accounts.

Executive Summary

I. **Withdraw this Proposal and Repropose FCM-Specific Regulations in Part 1 of the CFTC's Rules.** Commission regulations governing an FCM's treatment of its customer having separate accounts are better promulgated in Part 1, which addresses intermediaries, than in Part 39, which addresses DCOs.

II. **Redefine "Ordinary Course of Business" to Exclude Defined Events.** SIFMA AMG encourages the Commission to better define "ordinary course of business" and consider developing an approach that presumes operation in the "ordinary course of business," with clearly delineated events (such as default or bankruptcy) to be the limited instances that would not be considered "ordinary course of business."

III. **Eliminate Prescriptive Timing Requirement for Margin Calls.** The prescriptiveness of the Proposal does not reflect an adequate appreciation of the differences in operational workflows and risk management processes in place across the market and how they may differ depending on the markets, products, clients, custodians, and fund structures involved.

IV. **Preserve the Flexibility of a Limited Discretionary Grace Period.** The grace period is not inconsistent with ensuring the timely correction of shortfalls or timely identification of a customer's inability to meet a margin.

V. **Do Not Limit Compliance Carve-outs to "Unusual Administrative Errors or Operational Constraints."** This type of regulation will be challenging to implement and difficult to administer and is inconsistent with the Commission's longstanding principles-based approach to regulation.

VI. **Abandon Effort to Regulate Approach for Addressing Operational Complexities.** To be effective, Commission rules should focus on behaviors that evidence an intent to evade or game the system, rather than calendar-driven technical deficits that can be resolved in the ordinary course of business through prudent risk management, as they have been handled for years.

VII. **Codify Staff Letter 20-28's Interpretation of CFTC Rule 1.56.** That letter makes clear that "no specific or express language" must be contained in customer agreements to meet Rule 1.56.

Discussion

I. Withdraw this Proposal and Repropose FCM-Specific Regulations in Part 1 of the CFTC's Rules.

SIFMA AMG believes the Proposal is better suited as an amendment or addition to Part 1, and not Part 39, of the CFTC's rules. In particular, the Commission may consider incorporating the Proposal's conditions, with modifications, in CFTC Rules 1.11 and 1.56. Adopting rules for FCMs related to the treatment of FCM customer accounts would directly establish the obligation for the FCM, and not the FCM's DCO, to treat separate customer accounts within the CFTC's regulatory framework. Furthermore, it would clarify that the obligation is the FCM's, and not the DCO's obligation to evaluate and determine if the FCM's behavior was appropriate.

II. Redefine "Ordinary Course of Business" to Exclude Defined Events (Proposed 39.13(j)(1))

The Proposal would limit a clearing member to only permit disbursements on a separate account basis during the "ordinary course of business," as defined in the Proposal. The Proposal defines "ordinary course of business" as "the standard day-to-day operation of the clearing member's business relationship with its customer."[6] The Proposal then lists events (A) through (I) as those which "are inconsistent with the ordinary course of business and would require the clearing member to cease permitting disbursements on a separate account basis with respect to all accounts of the relevant customer receiving separate account treatment."[7]

From an operational complexity perspective, the organization of the "ordinary course of business" framework poses regulatory compliance challenges. The definition does not provide significant clarity on what "standard day-to-day operation" might mean. Rather, FCMs and DCOs must continuously monitor for a series of events. Some of these events do not seem to rise to the level of significance to suggest they are not "ordinary course of business," such as the failure of a customer to make a maintenance margin payment. Other events require discretion and subjective analysis, such as a good faith determination that a customer is in financial distress or there is a "significant and bona fide risk that the customer will be unable promptly to perform its financial obligations to the clearing member."[8]

Relatedly, this framework fails to recognize that FCMs must, under Commission regulations, manage risk effectively. This is in addition to the obvious commercial incentives that require FCMs to effectively manage risk in order to conduct their business.

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[6] Proposal at 22939.
[7] *Id*.
[8] *Id*.

Pursuant to CFTC Rule 1.11, an FCM must "establish, maintain, and enforce a system of risk management policies and procedures designed to monitor and manage the risks associated with the activities of the [FCM]."[9] The FCM Risk Management Program ("RMP") obligations are intentionally fluid ("the risks associated with the activities of the [FCM]") – and are designed to allow FCMs to customize the RMP to the specific activities of the FCM and its customers.

That regulatory philosophy is at odds with the Proposal's "ordinary course of business" framework, which requires an FCM to maintain heightened alert for a series of potential events, some of which are undefined or subject to retroactive second-guessing.

SIFMA AMG encourages the Commission to better define "ordinary course of business" and consider developing an approach that presumes operation in the "ordinary course of business," with clearly delineated events (such as event of default or bankruptcy) to be the limited instances that would not be considered "ordinary course of business."

III. Eliminate Prescriptive Timing Requirement for Margin Calls (Proposed 39.13(j)(4))

Operational Complexities from Prescriptive Regulation

Proposed 39.13(j)(4) would require each separate account be on one business day margin call. The Proposal then specifies that "if the margin call is issued by 11:00 a.m. Eastern Time (ET) on a United States business day, it must be met by the applicable customer no later than the close of the Fedwire Funds Service on the same United States business day."[10]

Proposed 39.13(j)(4) also provides that a clearing member may not contractually agree to delay issuing a margin call until after 11:00 a.m. ET on any given U.S. business day or to otherwise engage in practices that are intended to circumvent this requirement by causing such delay. Footnote 63 to the Proposal declares that a contract containing "a grace or cure period that would operate to make margin due and payable later than the deadlines described herein . . . would be inconsistent with the conditions under which such clearing FCM may engage in separate account treatment."[11]

SIFMA AMG believes that the Proposal is overly prescriptive and does not consider that there are legitimate reasons for why firms may have different margin call deadlines. Requiring margin calls by 11:00 a.m. ET on a U.S. business day is inconsistent with the spirit of Commission Staff Letter 19-17, which appropriately provided firms with more flexibility from an operational perspective.

Finally, SIFMA AMG believes the Proposal does not adequately appreciate the differences in operational workflows and risk management processes in place across the market

[9] 17 C.F.R. § 1.11(c).
[10] Proposal at 22941.
[11] *Id*.

and how they may differ depending on the markets, products, clients, custodians, and fund structures involved. SIFMA AMG would be pleased to provide more detail to Commission staff to better inform any potential adoption of the Proposal.

Timing for Margin Call

FCMs that choose to make all daily margin calls at a specific time should be accommodated under the Proposal. As long as there is same-day margining, what the FCM and its customers agree to as the margin deadline should not be at issue. There are a number of accounts that have margin calls earlier for legitimate reasons, such as handling internal processes overnight and working across jurisdictions to ensure margin calls are met by the morning. If transfer timing is too late in the morning, there is a risk that extra margin calls could be made on an ad hoc basis. Instances such as this are an unintended consequence of being overly prescriptive in rulemaking.

Further, the Proposal fails to appreciate the operational complexity SIFMA AMG members face with respect to receiving and responding to multiple margin calls from multiple FCMs with the additional potential liability of violating (or the DCO violating) Proposed Rule 39.13(j)(4). The Proposal will result in each FCM setting its own margin call deadlines, all before Fedwire closing at 6:00 p.m. ET. FCM customers will need to be on heightened alert for receiving and processing margin calls, from different FCMs, with different custodians. Similar stress will be placed on FCMs with respect to issuing margin calls and accounting for the timely collection of these margin payments.

Further, this prescriptive approach runs contrary to industry guidelines. The Joint Audit Committee Margins Handbook (the "Margins Handbook")[12] advises that a "reasonable time" may be "deemed acceptable for the collection of required margin calls." Specifically, the Margins Handbook advises that "a reasonable time is defined to be less than five business days for customers and less than four business days for noncustomers and omnibus accounts."[13]

SIFMA AMG believes that the FCM and its customers should agree that the settlement cycle and the associated margin calls for the prior day must occur in the morning and agree to a same day transfer. But the transfer should not be as prescriptive as 11:00 a.m. ET, or any other specific time of day. We recommend that the Commission promote an approach that would have the DCO and FCM determine that a failure to meet a margin call results in a determination that the event is no longer in the "ordinary course of business" and resolve appropriately, rather than a DCO/FCM risk management failure.

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[12] National Futures Association Joint Audit Committee, Margins Handbook, 26 (June 1999); *available at* https://www.nfa.futures.org/members/member-resources/files/margins-handbook.pdf.
[13] *Id*. at 6.

IV. Preserve the Flexibility of a Limited Discretionary Grace Period (Footnote 63).

The Proposal notes the purpose of the one business day margin call is to ensure shortfalls are "timely" corrected and a customer's inability to meet a margin call is "timely" identified.[14] As the issues arise from what the Commission has defined as "timely," SIFMA AMG encourages the Commission to consider whether the goals intended by the Proposal are being met or compromised by having an arbitrary definition of timely in this sense.

The grace period is not inconsistent with ensuring the timely correction of shortfalls or timely identification of a customer's inability to meet a margin. Rather, the grace period supports these notions. A contractual grace period provision is not only a separately managed account issue and can manifest in other scenarios depending on a fund's structure.

For example, in instances where subadvisors are hired for a specific fund and the investment firm is managing the same fund with potentially the same FCM, removing the grace period means that a single "foot fault" with respect to a single manager can cause an FCM to revert to margining on a gross basis. This disrupts the ability of some SIFMA AMG members to get excess margin back and can cause a lack of awareness of a client's overall margin requirements. This would only incentivize moving to different FCMs, meaning less transparency and less opportunity for the existing FCMs to cover themselves if a client defaults.

For these reasons, SIFMA AMG believes the Commission should reconsider its position regarding grace periods. Further, SIFMA AMG is concerned that the Commission's views regarding this issue are addressed in the preamble to the adopting release, and not the Proposal itself. Accordingly, SIFMA AMG requests that any prospective regulation regarding a grace period should be proposed in a future notice of proposed rulemaking for an appropriate opportunity for notice and comment.

V. Do Not Limit Compliance Carve-outs to "Unusual Administrative Errors or Operational Constraints."

The Proposal suggests that a failure to meet margin obligations "due to unusual administrative error or operational constraints that a customer or investment manager acting diligently and in good faith could not have reasonably foreseen" does not a constitute a failure to comply with Proposed Rule 39.13(j)(4).[15]

Respectfully, SIFMA AMG believes this type of regulation will be challenging to implement and difficult to administer. SIFMA AMG requests that the Commission remove or repropose provisions like this that include subjective and ambiguous terms.

[14] Proposal at 22941.
[15] Proposal at 22953.

For example:

- What does "unusual" mean in this context? Unusual to whom?
- What does it mean for the customer or investment manager to act "diligently and in good faith"?
- From whose perspective, and without the benefit of hindsight, is the "reasonably foreseen" standard applied?
- What factors determine whether a customer or investment manager met this standard?
- How is the DCO to administer this standard in connection with FCMs?

SIFMA AMG believes this level of regulation is inconsistent with the Commission's longstanding principles-based approach to regulation and believes this provision, and other similar provisions in the Proposal, should be removed or reproposed with this information in order for commenters to engage in a more informed dialogue.

V. Abandon Effort to Regulate Approach for Addressing Operational Complexities.

The Proposal also regulates margin payments in Japanese Yen (in compliance if received by 12:00 p.m., ET on the second U.S. business day), non-U.S. banking holidays (one additional U.S. business day extension), and stipulates that for Euro-denominated payments, "either the customer or the investment manager managing the separate account may designate one country within the Eurozone that they have the most significant contacts with for purposes of meeting margin calls, whose banking holidays shall be referred to for this purpose."[16]

The Commission's specific focus on currencies and jurisdictions is too narrowly tailored, and without data or analysis to support such an approach. The Proposal seems to look for technical margin deficit scenarios from global businesses that regularly navigate U.S. and non-U.S. bank holidays. Firms may plan for expected events (e.g., Golden Week in Japan) by pre-funding accounts. But such an approach under the framework contemplated by the Proposal would be unwieldly and unsustainable, and impose a regulatory burden without a corresponding public policy benefit.

When clients are posting cash margin in EUR, they choose a country in the Eurozone and follow their holiday schedule. The Proposal does not consider what happens in the event different managers for the same client choose different Eurozone countries. This would not only require the overhaul of agreements currently in place, but also burden FCMs with additional monitoring responsibilities. We believe there should be a greater degree of flexibility to allow for better risk management. By avoiding having to navigate the bank holidays of two different countries, the clearing member can appropriately manage its risk based on its business and its customers. The grace period further allows for flexibility and serves to address issues such as

[16] Proposal at 22953.

bank holidays. However, proposing a prescriptive framework around timing and deadlines would eliminate that flexibility.

More often than not, for funds or third party separately managed accounts, there is a base currency of the fund that is a logical choice based upon the strategy and/or domicile of the fund or the client. One must then consider the global nature of investing and how those portfolios are positioned in terms of products traded. The final layer is the custodian and where the custodian is located. These three elements conspire and complicate efforts to provide pre-funding ahead of known holidays. For example, one of our members (who is not a large asset manager) has nearly 100 custodial relationships. Typically, margin payments are made in the base currency of the fund or the client and the FCM effectuates single currency margining. The asset manager then engages in an active repatriation of foreign currency balances on a regular basis. This process has been successfully implemented and is designed to reflect and address the complexities of this member's global operations. The Commission's rules should not try to establish or require certain methods for achieving these goals.

To be effective, Commission rules should focus on behaviors that evidence an intent to evade or game the system, rather than calendar-driven technical deficits that can be resolved in the ordinary course of business through prudent risk management, as they have been handled for years.

We believe that the Proposal's premise that firms might use holidays to gain margin is misguided and impractical. When a global holiday approaches, firms are asked by FCMs to pre-fund anticipated, expected initial and/or variation margin (i.e., asked to overcollateralize). Pre-funding margin is more operationally risky, particularly when scaled across multiple custodians and with a global client base. This is not only a function of FCMs, but a function of our clients and our custodians. With large, separate accounts, there is always margin on hand to meet volatile market movements. A default that requires pre-funding as a precaution may be unnecessary because of a firm's ability to pay cash when needed.

There are several operational risks introduced by the concept of overcollateralizing. First, overcollateralizing places excess risk at the FCM. Second, it is impractical to attempt to estimate what other market moves will be in order to pro-actively overcollateralize and post. Third, different custodians have different cut-off times, which may not be met ahead of a holiday. Lastly, pre-funding leads to an inefficient process of having to be credited back payments as opposed to paying what is owed on a daily basis.

The Proposal fails to take into consideration the involved parties, such as the FCM, asset manager, clearinghouse, product and FX associated with a particular trade. For example, one SIFMA AMG member has an Australia-based client (where AUD is the base currency) with a U.S.-based FCM that trades ITRX Australia (USD) and voluntarily clears on ICE. Our member trades the product during Australian hours. However, ICE does not open and accept the trade for clearing until after the Australian market closes. This example illustrates how that client is

always behind on margin as a function of the client's or fund's location, client custodian, product traded and clearinghouse. Commission regulations should encourage voluntary clearing, not make it more difficult for FCMs to support.

VI. Codify Staff Letter 20-28's Interpretation of CFTC Rule 1.56

SIFMA AMG urges the CFTC to codify the interpretation of Rule 1.56 set forth in CFTC letter 20-28.[17] That letter makes clear that "no specific or express language" must be contained in customer agreements to meet Rule 1.56 and, importantly, recognizes that:

> "[T]he liability of a beneficial owner may be limited due solely to external law applicable to that beneficial owner that operates independent of contractual agreements. This would include state laws establishing separate accounts of insurance companies and cases of sovereign immunity, or similar cases. For the avoidance of doubt, an agreement between an FCM and a beneficial owner that recognizes, but does not add to, a statutory limitation of liability applicable to the beneficial owner would not violate Regulation 1.56."[18]

The Proposal allows delays based on errors and operational difficulties. However, Footnote 63 of the Proposal says there cannot be a contractual grace period that might otherwise extend the margin period. Several FCMs have negotiated grace periods into their agreements that do not relate to errors or operations. Limiting the ability to negotiate contractual grace periods seems to be an extreme measure. There is a distinction between margin call transfer timing in the ordinary course of business and the time at which the FCM will be entitled to close out.

If the FCM is comfortable with extending a grace period before being entitled to exercise its remedies, the Commission should allow that practice to continue. If the concern is market participants evading the same-day transfer rule through default grace periods, the Commission has other mechanisms to address this. Further, the Margins Handbook and other regulations are less prescriptive and provide greater flexibility. There is still the concept of same business day transfer timing, but there is not a required margin deadline. Removing the grace period is also contrary to the operational potential and risk management of the FCMs. The Commission's residual interest rule is intended to address any potential delays in grace periods. If there is no grace period, there would be no reason for residual interest. Rather than eliminating the grace period, the better approach would be for outside ordinary course to be triggered if a customer does not meet the margin call by the end of the day.

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[17] CFTC Letter No. 20-28, *Supplemental Advisory and Time-Limited No-Action Relief with Respect to the Treatment of Separate Accounts by Futures Commission Merchants* (Sept. 15, 2020); *available at* https://www.cftc.gov/csl/20-28/download

[18] *Id*. at 3.

As noted at the outset of these comments, SIFMA AMG supports the Commission's principal aim of additional certainty beyond staff letters. However, there are also concerns that the Commission should address prior to finalizing the proposed rules.

On behalf of SIFMA AMG, we appreciate the opportunity to respond to the Proposal and your consideration of our comments and recommendations. If you have any questions or require additional information, please do not hesitate to contact us by calling William Thum at (202) 962-7381

Sincerely,

William C. Thum
Managing Director and Assistant General Counsel, SIFMA AMG

cc: The Honorable Rostin Behnam, Chairman
The Honorable Kristin Johnson
The Honorable Christy Goldsmith Romero
The Honorable Summer Mersinger
The Honorable Caroline Pham