By Electronic Submission

January 17, 2024

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations (RIN 3038-AF24)

Dear Mr. Kirkpatrick:

Better Markets[1] appreciates the opportunity to comment on the proposed rule[2] ("Proposed Rule") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission"), which would amend regulations governing the types of investments that futures commission merchants (''FCMs'') and derivatives clearing organizations ("DCOs") may make with funds held for the benefit of customers trading futures, foreign futures, and cleared swap transactions.

A fundamental objective of the Commission's financial responsibility framework is to protect the funds of customers participating in CFTC-regulated derivative transactions. Essential to this framework is the requirement for FCMs and DCOs to distinctly separate customer funds from their own assets. The segregation of customer funds is not just a procedural necessity but a fundamental principle of trust and integrity in financial dealings. The Commodity Exchange Act ("Act") and Commission regulations enforce this by mandating that customer funds be kept in specially designated accounts at banks, trust companies, or other FCMs or DCOs. This practice establishes a clear division between the assets of customers and those of FCMs or DCOs, reinforcing the framework's focus on safeguarding client investments in the derivatives market.

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Investment of Customer Funds by Futures Commission Merchants and Derivatives Clearing Organizations; 88 Fed. Reg. 81236 (November 21, 2023).

Segregation of funds serves a dual purpose. First, it guarantees that customer funds are exclusively utilized for the intended purpose – supporting their trading and transactional activities. Secondly, and equally important, it provides a safety mechanism for the swift and orderly return of these funds to customers in the unfortunate event of an FCM's or DCO's insolvency. The importance of these objectives becomes particularly evident when we consider the failures of MF Global and Peregrine Financial Group, two high-profile cases that underscored the vulnerabilities in the financial system and the dire consequences of inadequate customer fund protection.

In 2011, MF Global, a major global financial derivatives broker, declared bankruptcy following risky investments in European sovereign debt and the misuse of customer funds. The firm had improperly transferred approximately $1.6 billion from customer accounts to cover its liquidity shortfalls, directly violating the principle of customer fund segregation.[3] This incident not only led to significant financial losses for MF Global's clients but also shook the confidence in the regulatory framework designed to protect them. Similarly, in 2012, Peregrine Financial Group, a futures commission merchant, collapsed due to fraud that went undetected for nearly two decades.[4] The firm's CEO admitted to embezzling customer funds, falsely reporting the company's financial health, and fabricating bank statements.[5] This highlighted severe lapses in regulatory oversight and the auditing process, leaving customers with massive losses.

In response to these failures, the CFTC has since strengthened its rules and oversight mechanisms.[6] Enhancements include stricter auditing and reporting requirements for FCMs, enhanced customer fund protection standards, and more rigorous risk management protocols. The Commission has also increased transparency in the operations of FCMs, requiring them to provide daily and detailed reports of customer fund segregation.[7] These reforms aim to fortify the financial system against such failures in the future, ensuring that the mismanagement and misuse of customer funds, as seen in the cases of MF Global and Peregrine, are prevented. The strengthened rules not only safeguard customer assets but also provide trust and integrity in the financial markets, which is vital for their efficient and stable operation.

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3 James B. Stewart, *Trustee Sees Customers Trampled at MF Global*, The New York Times (June 8, 2012), *available at* https://www.nytimes.com/2012/06/09/business/trustee-suggests-mf-global-misused-customers-money.html

4 Scott Cohn, *PFG Founder Admits: I Forged Bank Statements for 20 Years*, CNBC (July 13, 2012), available at https://www.cnbc.com/2012/07/13/pfg-founder-admits-i-forged-bank-statements-for-20-years.html

5 Laura Goldsmith, *The Collapse of MF Global and Peregrine Financial Group: The Response from the Futures Industry, Regulators, and Customers*, Review of Banking and Financial Law (Volume 32: Fall 2012 – Spring 2013), *available at* https://www.bu.edu/rbfl/files/2013/09/The-Collapse-of-MF-Global-and-Peregrine-Financial-Group.pdf

6 Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations, 78 Fed. Reg. 68506 (November 14, 2013).

7 *Id.*

However, the CFTC is contemplating the relaxation of some of these stringent requirements, particularly those put in place after the collapse of MF Global in this Proposed Rule.[8] The Commission is proposing to allow FCMs and DCOs to invest in sovereign debt of Canada, France, Japan, Germany, and the UK. This move, strongly advocated by the industry during the Trump administration, suggests a shift in regulatory approach.[9] It is important to remember that MF Global's disastrous bets on European sovereign debt were a key factor in its downfall.[10] Given this history, allowing investments in sovereign debt, even from countries known for their stable economies, presents a move that warrants caution, as it might compromise the protection of customer funds in favor of expanding the financial industry's quest for wider investment options.[11] Thus, it is essential for the CFTC to maintain a strong focus on safeguarding customer funds and to thoughtfully consider the implications of this change. Therefore, Better Markets contends that the CFTC's lack of a compelling, public interest-focused rationale for altering the prudent 2011 rulemaking is reason enough not to adopt the Proposed Rule's section on foreign sovereign debt.

I. The Commission should not adopt the portion of the Proposed Rule relating to foreign sovereign debt as permissible investments and continue evaluating exemption requests on a case-by-case basis.

Commission Regulation 1.25(a)(1) allows FCMs and DCOs to invest only in U.S. sovereign debt.[12] Before the collapse of MF Global in 2011, this regulation had permitted FCMs and DCOs to use customer funds for investments in the sovereign debt of any country.[13] However, such investments were limited to amounts corresponding to the balances owed to customers and had to be in the currency of that foreign sovereign debt.[14] In response to the MF Global crisis and the economic difficulties faced by several foreign countries at the time, the Commission decided in 2011 to remove all foreign sovereign debt from the list of Permitted Investments. This move aimed to simplify the regulation and enhance the protection of customer funds.[15] Despite this change, the

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8 Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78776 (Dec. 19, 2011).

9 Lydia Beyoud, *Wall Street Brokerages Near Win in Bid to Ease Post-MF Global Rule on Collateral, Bloomberg* (November 1, 2023), *available* at https://www.bloomberg.com/news/articles/2023-11-01/wall-street-brokerages-near-win-in-bid-to-ease-mf-global-rule-on-collateral?sref=mQvUqJZj.

10 Zoe Chance, *MF Global A U.S. Casualty Of EU's Debt Crisis*, NPR (November 1, 2011), *available at* https://www.npr.org/2011/11/01/141895727/mf-global-a-u-s-casualty-of-eus-debt-crisis

11 *See* Petition for Order under Section 4(c) of the Commodity Exchange Act, dated May 24, 2023, *available at* https://www.cftc.gov/media/9531/FIA_CMEPetition_Regulation125_052423/download

12 17 CFR 1.25(a)(1).

13 CFTC Regulation 1.25(a)(1) (2005).

14 *Id.*

15 Proposed Rule at 81243.

Commission acknowledged in the 2011 final rule that the safety and stability of sovereign debt can vary significantly from one country to another.[16] It recognized that investing in certain foreign sovereign debts might still align with Regulation 1.25's goals of preserving the principal amount of the investments and maintaining their liquidity. Furthermore, the Commission expressed its willingness to consider specific requests for exemptions under Section 4(c).[17] These exemptions would allow FCMs and DCOs to invest customer funds in foreign sovereign debt, subject to certain conditions and approvals.

A. The CFTC does not provide an adequate public benefit-orientated justification for overturning its 2011 rulemaking.

However, the Commission is now proposing to amend CFTC Regulation 1.25, essentially returning it to the framework that existed before the MF Global implosion with investments in the sovereign debt of five of the seven G7 countries.[18] While the rationale for this amendment is to provide FCMs and DCOs with a broader range of investment options, potentially increasing profitability and market presence,[19] which will, in turn, lead to reduced charges for customers, Better Markets believes this approach relies on assumptions that do not always hold true in practice. There is substantial historical evidence suggesting that benefits accruing at the higher end of the economic spectrum often do not 'trickle down' effectively to lower levels.[20] In the context of FCMs, higher profits do not inherently guarantee reduced customer charges. The dynamics of profit allocation within businesses, market competition, and economic realities often complicate the direct correlation between increased profits and reduced costs for customers.

Nevertheless, the current financial landscape, characterized by high interest rates, has generated substantial additional revenues for FCMs, reportedly amounting to hundreds of millions of dollars.[21] This economic shift has led to expectations of an expansion in the number of FCMs entering the market.[22] Given these changing market conditions and the potential for growth in the FCM sector, the CFTC's rationale for deviating from its 2011 rulemaking, which was more

[16] *See* Investment of Customer Funds and Funds Held in an Account for Foreign Futures and Foreign Options Transactions, 76 Fed. Reg. 78776 (Dec. 19, 2011).

[17] *Id.*

[18] Canada, France, Germany, Japan, and the United Kingdom.

[19] Proposed Rulemaking at 81267.

[20] Aimee Picchi, *50 years of tax cuts for the rich failed to trickle down, economics study says*, CBS News Money Watch (December 17, 2020), *available at* https://www.cbsnews.com/news/tax-cuts-rich-50-years-no-trickle-down/

[21] Anna Lyudvig, Futures Commission Merchants Target Expansion, Traders Magazine (June 26, 2023), available at https://www.tradersmagazine.com/departments/clearing/fcms-target-expansion/.

[22] *Id.*

restrictive, seems less justified. The anticipated increase in FCM presence due to favorable market conditions challenges the need for a regulatory change aimed at further increasing profitability.

Better Markets strongly believes that it is imperative that the CFTC provides a strong, ***public benefit-orientated*** justification for overturning its 2011 rulemaking that extends beyond mere profit enhancement for FCMs and DCOs. This rationale should convincingly demonstrate how such a change would concretely benefit the broader market ecosystem and the end customers, without compromising the foundational principle of customer fund protection.[23] In 2011, the CFTC, after thoroughly evaluating risks similar to those we see today, decided to prohibit investments in sovereign debt. This decision underscores the need for the CFTC to conduct an equally rigorous evaluation of potential impacts before considering any reversal of this established regulatory policy.[24]

B. Sovereign debts from foreign entities can exhibit variable degrees of liquidity.

The collapse of MF Global, primarily attributed to risky bets on European sovereign debt, serves as a stark reminder of the perils associated with speculative use of customer funds. Introducing sovereign debt as an expanded investment option could inadvertently lead to similar risk scenarios. While the G7 countries are currently considered economically stable and low-risk, it is crucial to recognize that we cannot predict future economic and political shifts with certainty. Relying on the assumption that G7 sovereign debt will consistently remain a low-risk investment overlooks the dynamic nature of global economic conditions. Factors such as shifting economic policies, global events, and geopolitical dynamics can unexpectedly alter the risk landscape.[25] A pertinent example is the 2008 financial crisis, which profoundly reshaped global perceptions of risk and market stability.

Furthermore, sovereign debts from foreign entities can exhibit variable degrees of liquidity depending on market conditions, geopolitical stability, and economic policies of the issuing

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[23] However, in her 2017 research report, Hester Peirce suggested that increased regulations were contributing to the dwindling number of FCMs in the marketplace. This perspective implies that the regulatory environment has played a significant role in shaping the landscape of FCMs. Given this context, the CFTC's rationale for revisiting and potentially overturning the 2011 rule is an attempt to relax regulations in a bid to enhance the profitability or viability of FCMs. It is important for the CFTC to reflect on the lessons learned from the relaxation of regulations in the past, notably the 2008 financial crash and the more recent 2022 bank crisis. These historical examples underscore the potential risks and consequences of easing regulatory controls in complex financial markets.

Please see Hester Pierce, Dwindling numbers in the financial industry, Brookings (May 15, 2017), *available at* https://www.brookings.edu/articles/dwindling-numbers-in-the-financial-industry/.

[24] Statement of Commissioner Christy Goldsmith Romero: The CFTC's Sacrosanct Responsibility to Safeguard Customer Funds to Protect Customers and Avoid Systemic Risk, *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement110323.

[25] S&P Global, Top geopolitical risks of 2023, available at https://www.spglobal.com/en/enterprise/geopolitical-risk/.

countries. In times of financial stress or market volatility, these instruments may not be readily convertible to cash without significant loss of value. This reduced liquidity could hinder the ability of DCOs and FCMs to promptly meet withdrawal requests or margin calls, potentially compromising their operational efficiency and financial stability.

The increased exposure to credit and market risks, as acknowledged in the proposal, could lead to situations where losses incurred from these investments impact the DCOs' and FCMs' financial health.[26] Under Regulations 1.29(b), 22.2(e)(1), 22.3(d), and 30.7(i), DCOs and FCMs are liable for losses resulting from the investment of customer funds.[27] In the event of significant losses, these entities might face challenges in maintaining sufficient liquidity to return customer funds, especially during periods of market turmoil.

The proposed conditions for including foreign sovereign debt, such as a 45 BPS cap on the two-year credit default spread and limits on the time to maturity of investments, while intended to mitigate risks, may not sufficiently address the underlying liquidity concerns.[28] The dynamic and unpredictable nature of global financial markets means that even sovereign debts with initially favorable credit default spreads and maturity profiles can quickly become less liquid and riskier.

Moreover, using Credit Default Swap (CDS) spreads as an indicator to determine the suitability of foreign sovereign debt investments in the context of preserving principal and maintaining liquidity requires careful consideration. CDS spreads reflect the market's perception of the risk associated with a debt issuer's default. While they can provide insights into the creditworthiness of a sovereign issuer, their reliability heavily depends on the health and liquidity of the CDS market.[29] In a liquid and transparent CDS market, these spreads can be efficient in reflecting true credit risk. However, in markets that are illiquid or distorted, CDS spreads might not accurately represent the issuer's credit risk due to influences from market dynamics unrelated to creditworthiness, such as trading volumes and market sentiment.

CDS spreads are highly sensitive to global economic conditions, policy changes, and geopolitical events, leading to potential volatility that may not align with the actual changes in the sovereign's fundamental credit situation. This volatility necessitates a cautious approach to using

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[26] Proposed Rule at 81238.

[27] *Id.*

[28] Statement of Commissioner Kristin N. Johnson: Preserving Trust and Preventing the Erosion of Customer Protection Regulation, available at https://www.cftc.gov/PressRoom/SpeechesTestimony/johnstatement110323.

[29] Inaki Aldasoro and Torsten Ehlers, *The credit default swap market: what a difference a decade makes*, BIS Quarterly Review (June 2018), available at https://www.bis.org/publ/qtrpdf/r_qt1806b.htm.

CDS spreads as the sole indicator.[30] It is more prudent to use them in conjunction with other financial indicators, such as sovereign credit ratings, bond yields, and economic performance metrics, to obtain a comprehensive view of the credit risk.[31] In essence, while CDS spreads can be a part of the toolkit for assessing the suitability of foreign sovereign debt investments, their use should be balanced and contextualized within the broader economic and market landscape to ensure alignment with the objectives of safeguarding principal and ensuring liquidity.[32]

In light of the complexities and risks outlined above, the Commission should not adopt the proposed rule regarding foreign sovereign debt as permissible investments. Better Markets advocates for continuing the current practice of evaluating exemptive requests on a case-by-case basis. This approach, which has proven to be manageable over the past 12 years with only one such request, allows for a more nuanced assessment of each request.[33] It enables a detailed evaluation of each request, factoring in the specific context, including the underlying reasons, public interest considerations, and prevailing liquidity conditions. This strategy not only reduces systemic risk but also allows for agility in responding to changing market situations. A thorough review of each request, complemented by the opportunity for public input, offers a more targeted and adaptable approach compared to a fixed rule, ensuring that the regulatory framework remains flexible. Moreover, in rapidly changing markets, adjusting individual exemptive orders is likely more efficient and faster than revising a broad regulation, offering a more dynamic regulatory response.

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30 Marlene Amstad, Eli Remolona, and Jimmy Shek, *How do global investors differentiate between sovereign risks? The new normal versus the old*, Bank for International Settlements – Monetary and Economic Department (January 2016), *available at* https://www.bis.org/publ/work541.pdf.

31 *Id.*

32 *Id.*

33 Statement of Commissioner Christy Goldsmith Romero: The CFTC's Sacrosanct Responsibility to Safeguard Customer Funds to Protect Customers and Avoid Systemic Risk, *available at* https://www.cftc.gov/PressRoom/SpeechesTestimony/romerostatement110323

CONCLUSION

We hope these comments are helpful as the Commission finalizes its Proposed Rulemaking.

Sincerely,

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